Forex Market Erupts on Central-Bank Moves

Increased volatility marks turnaround for currency market after years of relative calm

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**Whipsawed**

The euro surged against the dollar on Federal Reserve comments Wednesday, but soon resumed its slide. How many dollars one euro buys.

Source: Tullett Prebon
Central banks have lighted a fuse under the foreign-exchange market.

Volatility in currency markets has recently rushed up, as shifts in policy by major central banks spark massive bets. The turmoil marks a turnaround from recent years, when ultra-loose monetary policy around the world put markets into hibernation.

In the latest episode Wednesday, a message from the U.S. Federal Reserve that it is in no hurry to raise interest rates caused a big slump in the dollar, which has run up a huge rally so far this year. The euro surged more than 4% against the buck, its biggest jump in a single day in 15 years, according to Deutsche Bank. Early on Thursday, the European currency resumed its slide.

The sheer speed of the round trip in the euro-dollar exchange rate—the world’s most heavily traded currency pair—left traders and investors reeling.

“I haven’t seen anything like it since the financial crisis,” said Paul Lambert, head of currency at Insight Investment, which manages $480 billion of assets.

Traders said Wednesday’s move brought back memories of January’s surge in the Swiss franc, when the currency climbed more than 40% after the Swiss central bank abandoned its policy of capping the franc’s strength against the euro. For a few minutes on Wednesday, the lack of dollar buyers caused a short-term freeze in electronic trading platforms, according to a New York-based trader at a major currency-dealing bank. “There was a lot of shouting on the desk, a lot of nervousness,” the trader said.

Deutsche Bank’s currency volatility index hit its highest level since 2011 early this year. Short-term investors are behind the choppy moves, piling in and out of markets en masse as they turn, said Bilal Hafeez, a macro strategist at Deutsche Bank. “It seems like everyone is chasing their tail,” he added.

To some investors, the increased activity marks a return to normality. “What was abnormal was the very, very low levels of volatility we saw last year with the calming influence of quantitative easing on asset prices,” said Tom Clarke, a portfolio manager at William Blair, which oversees more than $74 billion. Aside from January’s exceptional Swiss franc move, volatility in 2015 hasn’t been “abnormal,” he said.

The currency shifts have come as the Fed breaks ranks with other major central banks and moves toward a rate increase. That has stoked huge bets that the dollar will continue its rise, particularly against the euro, which has fallen sharply as the European Central Bank this month kicked off a massive bond-buying stimulus program. The size of these wagers exaggerated Wednesday’s move, as many investors were forced to throw in the towel when the dollar retreated.

“The dollar has been experiencing fastest pace of ascent in 40 years. Our long-term outlook for the euro is still lower, but risk here is for a decent pullback,” said Matthew Cobon, head of interest rates and currencies at Threadneedle Investments in London, which has a total $54.3 billion of assets. Mr. Cobon had bet on a bounce back for the euro ahead of Wednesday’s Fed meeting.
The sharp swings also raise a now-familiar complaint from investors: Regulations brought in after the financial crisis have dried up the liquidity in markets, by crimping banks’ ability to carry risky bets on their balance sheets.

On Wednesday, the Bank for International Settlements became the latest major authority to caution that a lack of liquidity could lead to major disruptions in financial markets.

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**A New Spring in Its Step**

Deutsche Bank’s currency volatility index hit its highest level since 2011 early this year, and bounced up again in the days leading up to the March 17–18 Fed meeting.

“When flow hits the market, there’s no buffer, so it translates straight into big price moves,” said Mr. Lambert at Insight Investment. During the financial crisis, big swings were sparked by fears of a collapse of the banking system. Similar moves can now result from a minor reassessment of the Fed’s rate-increase plans, according to Mr. Lambert.

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