EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt am Main, Wednesday, 18 November 2020, 14:00-16:00

SUMMARY OF THE DISCUSSION

1. Review of recent market developments and outlook

The Group discussed the outlook for major currencies and key market events for the next six months. Members reported that with the central bank support and vaccination news, markets could be in a sweet spot even if there is reluctance among market participants to take large positions before year-end. However, assuming that coronavirus (COVID-19) infection rates will flatten off, the market will look through the current nervousness and sentiment will stabilise, which will be constructive on risky assets and the normalisation of economic and market conditions into next year. The reflation theme will be a key market focus as the data next year is expected to start supporting it, with some risks concerning the US fiscal support. From an asset management perspective, members expected to see a strong performance by cyclical stocks and strong earnings growth next year, a further steepening of the US Treasury yield curve and some depreciation of the US dollar against the euro. Some members noted that the euro's substantial strengthening against the US dollar was due to the positive news about the EU recovery fund which may become a risk factor if the decisions on implementation are further delayed.

In an environment of low volatility, members agreed that low-yielding currencies such as the Japanese yen and Swiss franc would tend to underperform. On the Japanese yen, one member, while seeing it as very undervalued compared to their model estimates, still saw potential for temporary depreciation, as this is the yen's typical behaviour in a low volatility environment. Another member reckoned that the yen's moves against the US dollar have been muted largely due to the fact that Japanese local market participants are currently not very active and much less leveraged than in the past. On the British pound, one member expressed an out-of-consensus view that the announcement of an EU-UK trade deal would be negative for the pound, as once the uncertainty is resolved, it could become a good funding currency in 2021.

2. FX options market from a structural perspective

The Group received presentations on the FX options market.

The growth of the FX options market has generally underwhelmed compared to the initial hopes, mainly due to low take-up by the real money community. For example, in terms of the number of trade tickets, the top ten FX banks have daily tickets in options in the order of hundreds, compared to hundreds of thousands of tickets for FX swaps and spot. One large corporate mentioned that one hurdle for broader use was the complexity of hedge accounting rules together with the ensuing reporting obligations. One asset manager reported that they simply do not have many client mandates to trade FX options. Another challenge for wider adoption of FX options mentioned was the lack of a reliable and competitive streaming price for FX options similar to other markets.

The degree of electronification of the FX options market is increasing but still relatively low and relationship-based voice trading remains the dominant trading channel. This is largely because the complexity and lower liquidity of FX options leads clients first to seek to understand the market conditions better before trading. Moreover, unlike for spot FX, there is less need for immediate execution in FX options, as the spot market risk for OTC options is hedged at the time of the trade, making trade execution less time-critical and reducing the need for electronic execution. Still, a growing number of banks are providing electronic pricing of FX options.

Liquidity in FX option markets is still mostly concentrated in a few major currencies (euro, dollar, offshore renminbi and lately also the British pound) and mainly in tenors of up to three months, but active options trading is broadening beyond the G10 currencies. Banks and hedge funds remain the largest users of FX options and are net buyers of volatility via options, while corporates and private banks are net sellers of volatility, mainly for yield enhancement.

3. The FX Global Code and the Global Foreign Exchange Committee

Members discussed the areas of focus of the Global Foreign Exchange Committee (GFXC) in the light of the ongoing three-year review of the FX Global Code.