E-A-R©'s
Flash Note I Forex (FX) and Commodities

4 September 2017

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Scene Setting

The art of trading can be complicated by the flow of information that is often conflicting and sometimes confusing. The challenge for investors is to distinguish between information that is germane and information that is inessential. Once the information is culled, the dilemma is how to interpret and analyse it, more so in the context of taking advantage of anomalies between prices of related assets. This all takes place as one "publication" advocates for a "buy", another says "sell" and some pundit says "hold". Thus, market dislocations are bound to exist as some could be buyers of irrationality and some could be sellers of noise! Inbred in EAR's DNA is taking advantage of financial market dislocations! EAR demonstrated how to mine for opportunities in this week's equity trading note. This note serves as a blend through which some indication is provided on when the metal's shine could risk being corroded by the very mine acids and polished by some exchange rate pair.

Glittery Trades

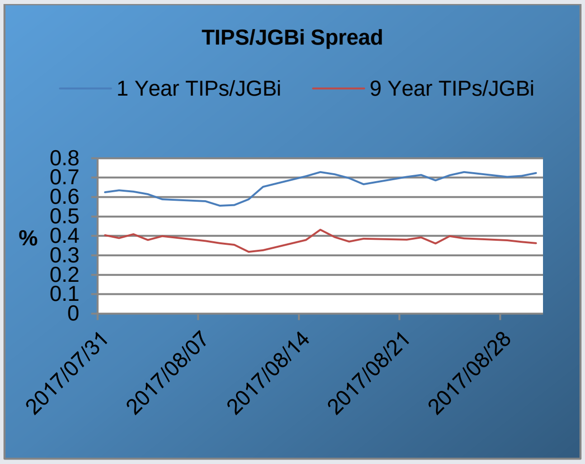
The much vaunted proposition that the price of Gold mimics the USDJPY exchange rate could inform some trading strategies. This proposition is formulated upon the view that both Gold and the Japanese Yen (JPY) play the role of safe haven assets. Whilst billed as fact, this assumption ignores the impact of carry. Moreover, is there some empirical evidence to support or refute this ingrained assumption? Table 1 clearly reflects that, over the past year, the relationship between the Japanese Yen and the yellow metal has been negative, some 88% of the time. Amongst the developed markets pronouncements by some central bank's (such as the European Central Bank and the Bank of Japan) to embark on and expand their asset/bond purchase programs served as the propellant gas for higher gold prices in 2012. Carry was visible here as investors would borrow Yens at low interest rates and buy among others, US Treasuries. This trading episode would therefore dampen sentiment toward gold. Why is this important? Investors can take of advantage of multiple asset classes all at once. In this note, EAR spurts pair trading strategy that could expose opportunities of temporary anomalies between USDJPY and Gold which both evince some fair degree of mean reversion. Therefore, EAR suggests **cointegration,** which incorporates mean reversion. In this regard, the one asset can be short sold whilst the other can be bought (long position). For example, during this trading week (Tuesday 29th August 2017), there were instances where one could have been long on gold whilst the USDJPY could have been sold during some trading sessions on the same day. This is further strengthened by the cointegration test results which indicate that the two assets are indeed cointegrated. Furthermore, the H for both assets imply that these two tend to drift to some levels. This reveals more about that which complicates the modelling process of financial markets – *the white noise that is difficult to account for!* Next up, traders may track the H and cointegration results of both Gold and the USDJPY to spot selling levels with respect Gold) and buying levels with respect to USDJPY with the following price triggers: Gold at a range of– $1,321.70 – $1,351.04 and USDJPY at a range of 108.45 – 108.60

Table 1: Correlation: Gold and USDJPY

Assets	USDJPY	GOLD
USDJPY	1.00	
GOLD	-0.88	1.00

Source: EAR and Bloomberg

Table 2: TIPS/JGBi Spread



Source: EAR and Bloomberg

The puzzle that relates to both gold and the USDJPY is further enveloped in fixed income markets. With regards Japan and the US; real interest rate expectations play some role in so far as carry trade is concerned. The US issues Treasury Inflation Protected Securities (TIPS) whilst Japan issues Japanese Inflation linked bonds (JGBis). Therefore, the spread between the two instruments tends to anchor inflation expectations and thus some level of carry. Higher real yields in the US could be welcomed by investors who are looking for safer assets amidst increasing emerging market risks. Interestingly, short term inflation expectations (1 year) are much higher in the US than mid-term inflation expectations (9 years). In Japan inflation expectations remain very low. This could boost carry as some traders and pensioners could borrow cheaper in Japan in anticipation of slightly higher rates in the US. The two currencies are very liquid; therefore the degree of carry could come with "layers" such as both countries inflation swap markets. The USDJPY carry trade has since been dealt a blow when the US Fed lowered Fed funds rate to 0 back in 2008. Hence, EAR will bring another gold producing country's currency into the picture so as to further examine the impact of carry. All the more reason for traders to bide the time and keep some dry powder!

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