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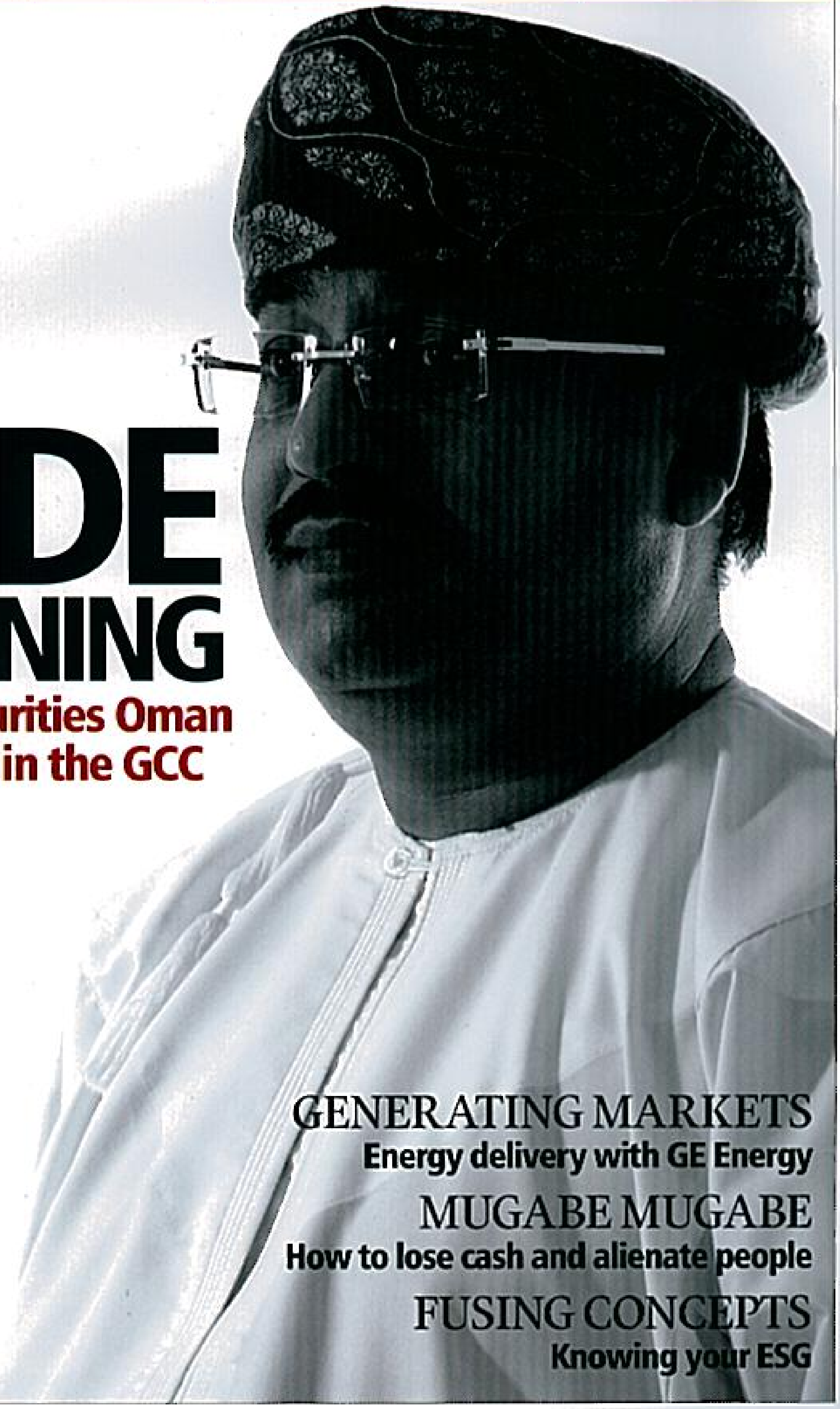

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Changing times

Regime shifts in the FX market, by David Metzger, CFA Risk Manager Dukascopy – Swiss forex marketplace

As greater, more powerful economies emerge through regime shifts, markets and platforms must likewise evolve

MODERN FINANCIAL MARKETS are governed by a numerous set of rules and influenced by the behaviour of many variables. Actions of the participants in the market lead to the creation of an endless number of cycles. Usually, prices react according to the balance of demand/supply depending on the degree of liberalisation of the underlying market, and this environment is altered by the dissemination of new information. Over time, the participants adapt the investment process and they are able to determine both the spectrum and boundaries of the universe they are dealing with.

Structural changes occur however, that can have far more consequences on the investment universe and underlying markets. These structural changes can be described as regime shifts as they do not only change the local market variables, but the market expectations over the long run. Regime shifts, as opposed to events, are changes in drift significant enough to modify the characteristics of the underlying financial market. For instance, the variables used for risk premium estimation purposes, which in turn, would alter the capital market expectations over the long run to a great extent. Of course, events can play the role of a triggering device of regime shift, especially if the current drift is toward disequilibrium. Otherwise, regime shifts can be induced by any other output, whether this latter is random, implemented as a new rule, arising from an event of another economic sector, or triggered by political actions.

A historical perspective

From a historical perspective, the gold standard progressive give-up through the World War I, the Bretton Woods Agreement in 1944, the Smithsonian Agreement in 1971, ERM design, between others, can all be seen as regime shifts as they deeply changed the rules governing the valuation of currencies, and because of the long-run impact they had on inflation, interest rates and other macroeconomic variables. Such shifts are provoked by a random event, or voluntary actions toward further stability or as a response to turmoil. Closer to us in the time span is the international reserve currency issue. Before the current crisis started to spread over the whole planet, a decent part of US dollar weakness was supposed to be attributed to shifts in reserve currency preferences, especially toward the euro. This could have been described as a regime shift, however, the risk aversion growth coupled with aggressive deleveraging changed the picture, demonstrating that what could be spotted as a regime shift can prove to be wrong, or exhibit cyclical characteristics, which are not shifts. The question of having the frequency of regime shifts increase as a result of financial distress, or as a result of higher incertitude over the long-run would deserve further analysis.

Regime shift impact on the investment process

Regime shifts put high pressure on exiting investment processes because a lot of structures adjust only slowly to dynamic market underlying conditions. It stresses a lot the portfolio optimisation processes because such procedures are highly sensitive on return expectations inputs and associated assumptions where regime shifts tend to call for a new assessment of market expectations and assumptions underlying the investment process. As portfolio rebalancing involves cost considerations, correctly assessing the consequences of a regime shift once it is checked, is of paramount importance.

Regime shift forecasting

Forecasting of regime drift is by nature very difficult. On the other hand, changes implied by a regime drift can take a long span before having deployed its ultimate effects on every structure concerned and superior analysis ability may be a creator of competitive edge because impacts of a regime drift on financial markets can be anticipated with a more robust degree of confidence. Participants themselves may exploit situations where they find unsustainable market environment, especially in the FX area and in emerging economies. Then we could assist to a regime shift that is created by the investors and effective market exposures. Thus, the regime shift is anticipated and such actions, often described as speculative, tend to increase the imbalances and accelerate the move to a regime shift.

Regime shift and market efficiency

At first sight, one could say that regime shifts potentially introduce some room for inefficiency but in fact, they more introduce changes in rules, both explicit and implicit that may drive the functioning of financial markets for a period. Therefore, the question about efficiency remains around the ability of the underlying markets to absorb the new picture consequences fast enough to eliminate any inefficiency that could have been created by such a process. Depending on the level of integration of the underlying market, it is very likely that any inefficiency created by regime shifts will quickly evaporate the same way as they are usually. At the opposite side of the spectrum, regime drifts in emerging markets probably represent the most tremendous investment opportunities in these markets, especially with foreign currency trading. ■

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