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QCAM Special

Expanding «FX BIAS»

After a good first year, FX BIAS ran into powerful headwinds in 2022. The Russian attack on the Ukraine was not anticipated by business surveys and the interchange of dovish and hawkish central bank decisions created additional volatility. By now, nearly half of the total drawdown has been recovered. Meanwhile, we have added more business surveys and two additional currencies and flattened the currency weighting to increase the diversification and stability of FX BIAS.

Review of 2022 year-to-date

On December 10th 2020, we launched QCAM FX BIAS via a UBS certificate. The performance over the first year was promising and validated the value of business surveys in FX trading (see Chart 1 next page)[1]. This year, FX BIAS ran into powerful headwinds, which resulted in a temporary drawdown of 4% in the USD certificate. Two factors caused the unfavorable outcome.

First, business surveys did not anticipate the Russian attack on the Ukraine. The emerging global growth optimism at the start of the year spurred business surveys and FX BIAS went long most basket currencies versus the USD (see Chart 2 next page). At the time of the Russian attack on Ukraine, FX BIAS had a net short USD position of over 80%. Moreover, most business surveys had just been conducted and were not due for several weeks. To limit the downside, the QCAM Risk Committee decided to suspend the positions of EUR, JPY, GBP and SEK until new surveys became available in March. At the beginning of April, the Risk Committee decided to reactivate all positions but reduce the leverage temporarily from 1.5 to 0.3 as the signals from the business surveys adjusted with some lag, while volatility and uncertainty remained high. In the second half of April, FX BIAS had turned net long USD with only the positions in the JPY and the AUD remaining short USD thanks to more resilient business surveys and the Risk Committee decided to increase the leverage again gradually.

The second negative performance factor was the interchange of both dovish and hawkish central bank decisions. The biggest drag came from the BoJ's refusal to join other central banks in normalizing policy. As the JPY went from 115 at the end of February to 139 recently, this subtracted about 2.5% points from the performance of the FX BIAS certificate. The other disturbance was the belated policy shift by the ECB, which suddenly caused financial markets to expect much faster interest rate increases. Since FX BIAS had turned short EUR in April thanks to weaker business surveys, the rally of the EUR from 1.04 to 1.08 in May temporarily reduced the performance of the FX BIAS certificate by 1.5% points.

The way forward

At the end of July, FX BIAS was modestly long USD with a leverage factor of 1.0 and performance had recovered 1.9% from the earlier lows (see Chart 1 again). So far this year, the most negative performance contribution came from the JPY (-1.7% points) followed by the EUR and the GBP (both -0.4% points). Despite this year's setback, we believe that systematic trading strategies based on business surveys are well suited to produce solid returns at moderate volatility and low correlations with other major asset classes as FX BIAS demonstrated during the first year.

1 See QCAM Special – One year of FX BIAS,; QCAM FX Monthly; December 2021.

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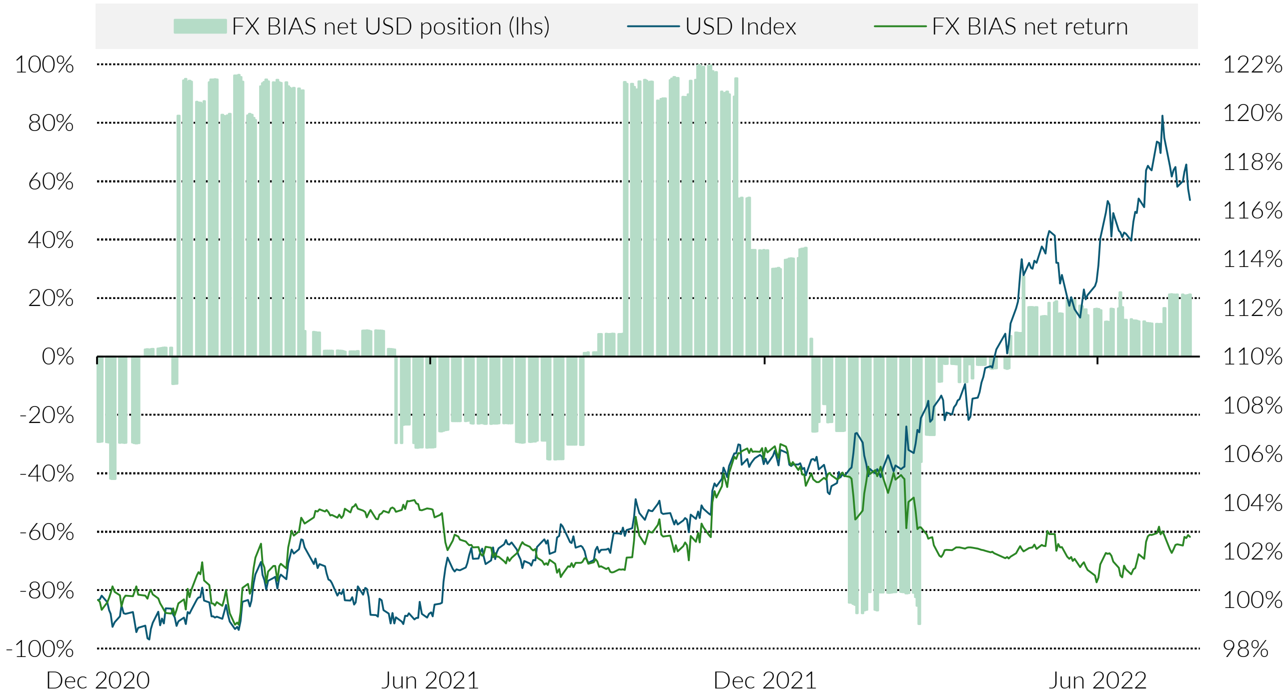
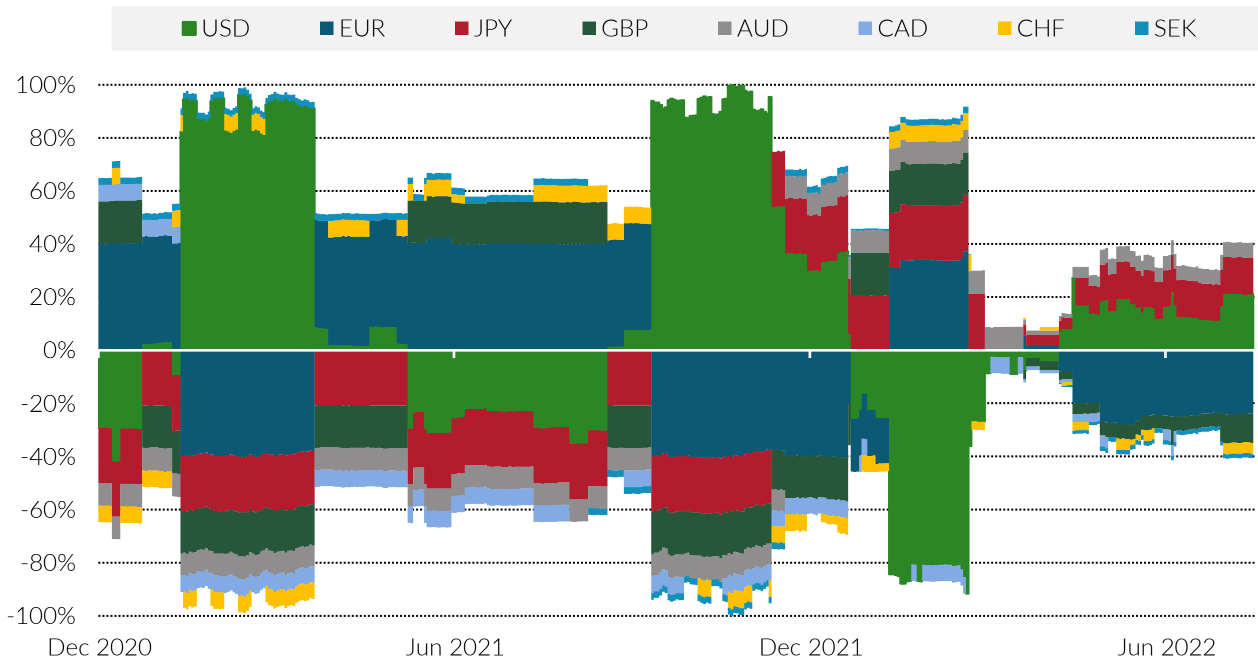
Chart 1: QCAM FX BIAS net USD position and return versus USD index since launch



Source: QCAM; The returns refer to the USD based FX BIAS certificate and are net of costs and fees.

Chart 2: QCAM FX BIAS individual currency positions since launch of certificate



Source: QCAM

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However, two lessons are clear. First, business surveys are not immune to exogenous shocks and may take some time to adjust. Second, while business surveys capture business cycle dynamics and their impact on exchange rates, other factors such as a diverging monetary policy stance can be temporarily stronger.

There is no simple fix to these challenges. Besides prudent risk management, however, we believe that more diversification across business surveys and currencies and less concentration risk can significantly mitigate downside risks.

More surveys and currencies

Initially, FX BIAS was based on 8 currencies (USD, EUR, JPY, GBP, AUD, CAD, CHF and SEK) with one business survey for each currency. Last year, we already added 6 more surveys. Now we are expanding FX BIAS by two more currencies (NZD and NOK) and 8 more surveys. We differentiate between surveys that focus entirely on domestic business conditions in each currency's economy and complementary surveys that are relevant to the currency but not country specific (see Table next page). For AUD, CAD, NOK and NZD, we have added a specific survey that captures price dynamics in the oil and commodity sector. For AUD and NZD, we have also added a China survey, as both countries depend significantly on China's business cycle. Finally, we have added a Euro-area survey for CHF, NOK and SEK as these currencies have strong links to the EUR. In total, we now have 19 domestic surveys plus 3 complementary surveys. Importantly, all currencies now rest on at least 2 surveys. This means currency positions are no longer binary (100% long or short) but can take positions in-between including neutral.

Flattening the weighting distribution

When we launched FX BIAS we used the BIS FX trading statistics to calculate the currency weights. The rational was that more liquid currencies are more likely to respond to business cycle dynamics and less to idiosyncratic factors. As a result, the EUR got the largest weight with 40%. We were comfortable with this concentration at the time since we had the longest and best life track record with business surveys in EURUSD. With more life experience, currencies and surveys we believe it is time to flatten the weighting distribution. The simplest and cleanest method, in our view, is a 50/50 split between BIS trading weights and equal weights. The last column in the table on the next page shows the new weights. The EUR retains the largest weight, but comes down to just below 25%. JPY and GBP also decline in weight, while all other currencies gain weight.

Better return and risk profile

Chart 3 on the next page shows the back-tested performance of the new expanded FX BIAS versus the old FX BIAS. The performance of the two is fairly similar in 2017 and 2018 and starts to diverge in 2019. Overall, the new FX BIAS outperforms the old by more than 2% points p.a. with more than 1% point less volatility, reaching a Sharpe ratio of almost 2. Notable is the much better performance so far in 2022. The new FX BIAS fell in response to the Russian attack on the Ukraine by 1% point, but stabilized and recovered quickly (without risk management intervention) and is up 2.5% YTD, outperforming the old FX Bias by 4% points. The performance of the JPY position is still negative this year, but this matters less given the lower weight and is fully offset by the positive performances of all other currency positions, especially from some of the smaller once, like the NOK, the NZD and the SEK. We have implemented the new FX BIAS this week and expect to increase the leverage back to 1.5 after a short transition period. Shocks can still create setbacks, but we believe the new FX BIAS is better equipped to handle them and to deliver attractive returns at modest volatility and low correlations with other assets classes over time.

→ Please contact us for further information and the fact sheet

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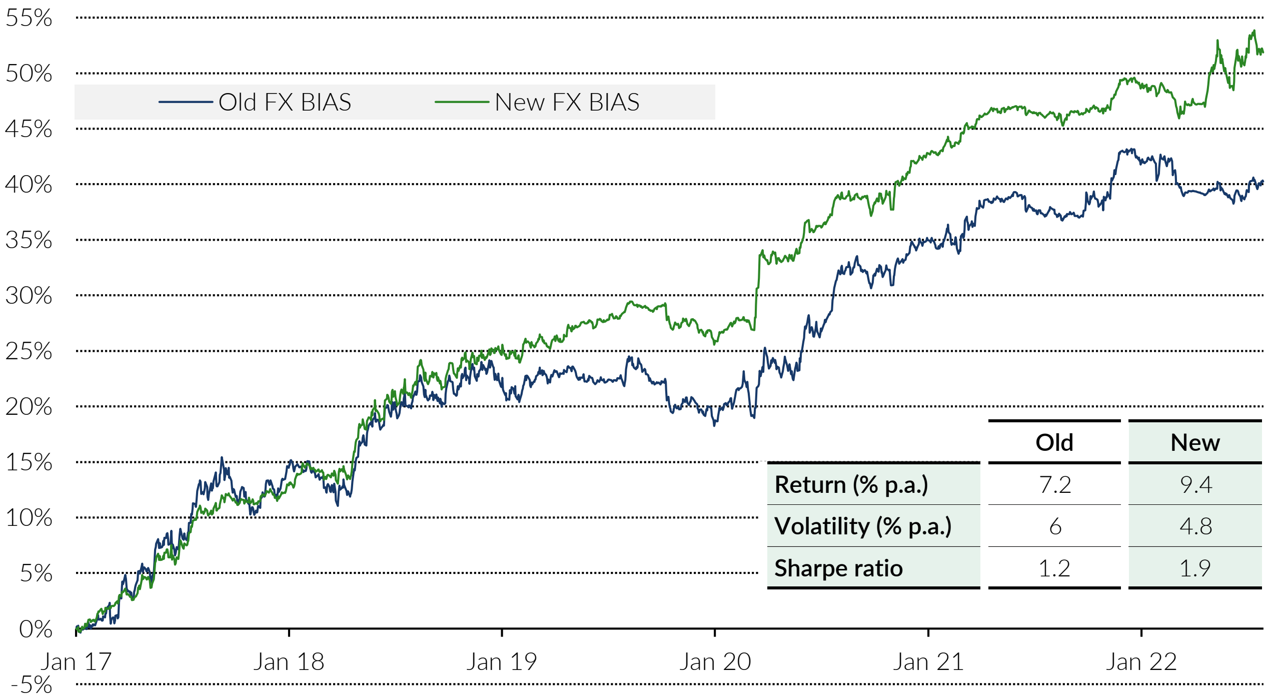
Table: QCAM FX BIAS currencies, surveys and weights

	Domestic surveys	Complementary surveys	Weights based on BIS trading volume	50% weights based on BIS trading volume & 50% equal weighted
USD	3		100.0%	100.0%
EUR	3		38.2%	24.6%
JPY	2		19.9%	15.5&
GBP	2		15.1%	13.1%
AUD	3	China, oil/commodities	8.0%	9.6%
CAD	1	Oil/commodities	6.0%	8.5%
CHF	1	Euro-area	5.9%	8.5%
NZD	2	China, oil/commodities	2.5%	6.8%
SEK	1	Euro-area	2.4%	6.8%
NOK	1	Euro-area, oil/commodities	2.1%	6.6%

Source: QCAM

Chart 3: QCAM FX BIAS gross returns – new versus old



Source: QCAM Currency Asset Management - The returns refer to the USD based FX BIAS (1.5 leverage) and do not include costs and fees. The "Old FX BIAS" is the life performance since December 10th, 2020 and the back-tested performance before then.