Mizuho Brief: FX Risks

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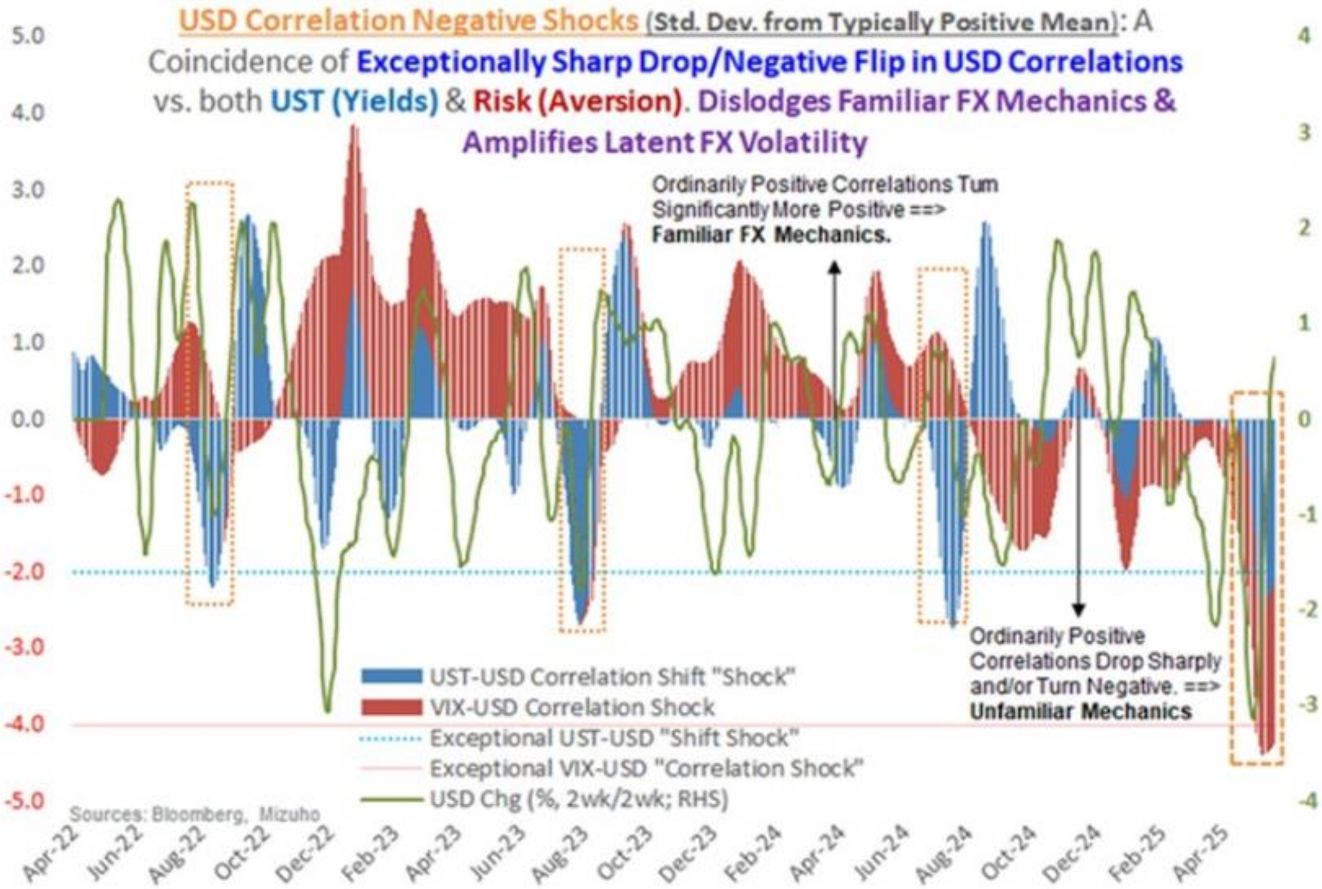
Exceptional USD Correlation Departures Mask FX Risks

"I'm afraid I can't explain myself, sir. Because I am not myself, you see?" – **Alice in Wonderland**



- **Exceptional departures from well-established USD correlation dynamics warn of elevated unpredictability** that has become ***inconspicuously embedded* in FX markets**.
- For the record, the **Greenback typically tends to**;
  - i) **rise with yields** (positive UST-USD correlation) and;
  - ii) **rise alongside** haven demand prompted by **mounting risk aversion** (that is, **on "risk off" triggers**), which coincides with positive USD-VIX correlation.
- **But not always**. Admittedly, the **"usual" USD correlations are not set in stone**.
- In fact, *ordinarily positive* **USD correlations** with UST yields and risk aversion **may fluidly** *flip negative* **even in of market cycles**
- Hence, **at first blush**, it may be **tempting to dismiss the recent run of negative UST-USD and VIX-USD correlations as not consequentially extraordinary**.
- Granted (that correlations are not static). **But** a closer look reveals that **this episode** is in fact **exceptional in the *momentum* and *degree* of correlation shifts**.

- The tell is in the **extraordinarily stretched standard deviations** in USD correlations with UST yields and risk aversion (proxied by VIX).
- Specifically, the **magnitude** and **coincidence** of excessive (> than 2 standard deviation) decline in both change in UST-USD correlation and VIX-USD correlation.
- The implications are that;
    i) USD has decoupled, and *unpredictably so,* from (UST) yield-driven moves
    ii) USD's haven allure has weakened dramatically, **arresting received wisdom about buying USD (especially vis-à-vis EM FX) into "risk off" triggers.**
- Consequently, for now, the **Greenback may be less reliably predicted by both rates** (long-end UST yields) **and risk** (aversion).
- And given the dominance of USD-driven global FX forces, the resulting unfamiliarity of FX mechanics inevitably **elevates unpredictability in FX markets**.
- This in turn *sets the stage for outbursts of latent* (currently subdued) *volatility.*
- Notably, what's **at risk is the remarkable (and unexpected) stability of AXJ through turbulent tariff headlines in the cover of a bearish USD *dissociated from haven allure and higher UST yields***.
- Hence, **risks of sharp downside volatility in AXJ cannot be dismissed prematurely**.
- Neither on complacency about resilience thus far (which is **distorted by correlation departures**), nor on account of US-China tariff relief that falls woefully short of a durable resolution.

Technical Note:

1. The **standard deviations** of; i) VIX-USD correlations and; ii) *change* in UST-USD correlations was **used to get a better, normalized gauge of how exceptional this negative swing in USD correlations have been**.
2. Change in UST-USD correlations has been used to enhance the sensitivities of what is typically a high, positive, correlation.