FX Month-End Rebalancing

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Buy EUR/USD into month-end

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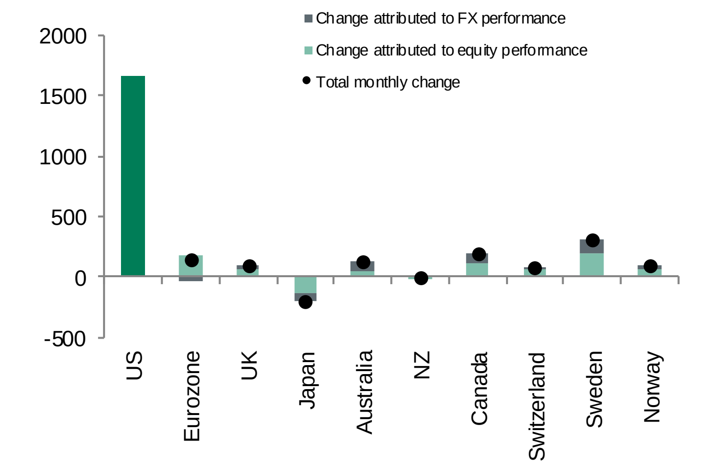
- **Global equity markets were broadly firmer in October. In FX, the USD was somewhat mixed on the month. Overall, the moves in equity markets, when adjusted for market capitalisation and FX performance this month, suggest month-end portfolio-rebalancing flows are likely to be moderate USD selling across the board with the strongest sell signal in the case of the USD vs JPY.**
- **Our corporate flow model is pointing to EUR/USD buying at the end of the month. In our combined strategy, we therefore use the signals of our corporate flow model.**

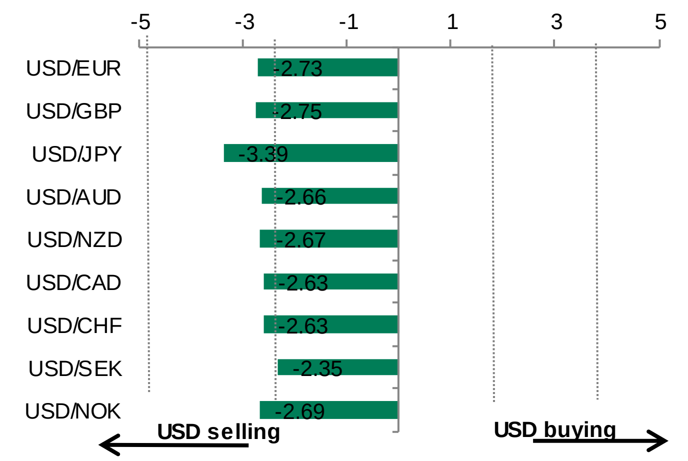
As detailed in our report [Month-end rebalancing model upgrade](), the month-end rebalancing model generates signals for the G10 USD-crosses based on the performance of US stock markets relative to the rest of G10 adjusted for changes in exchange rates and market capitalisation (Figure 1). In particular, we allocate weights to create a portfolio of the nine G10 USD-crosses. In that, we use the signals' relative strength to determine the portfolio weights (Figure 2).

Fig 1. Relative monthly equity/FX performance



Source: Crédit Agricole CIB, Bloomberg

Fig 2. Month-end rebalancing signal

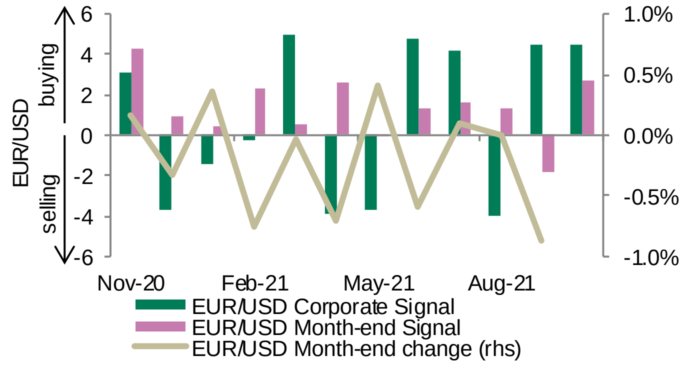


Source: Crédit Agricole CIB, Bloomberg

We derive signals from the net corporate EUR-flows by examining corporate EUR buying and selling in the days before month-end. In particular, under the trading strategy, evidence of net EUR-buying would constitute a buy signal while indications of net EUR-selling would trigger a sell signal ahead of month-end. We combine the monthly signal from our corporate EUR-flows with the signals from our month-end rebalancing model (Figure 3). To this end, when the signal from the flow data corroborates the EUR/USD signal from the month-end rebalancing model, we allocate the full portfolio weight to buying or selling EUR/USD at month-end. When the signals diverge, we revert to the original month-end rebalancing model, using the different portfolio weights to place trades on the G10 USD-crosses.

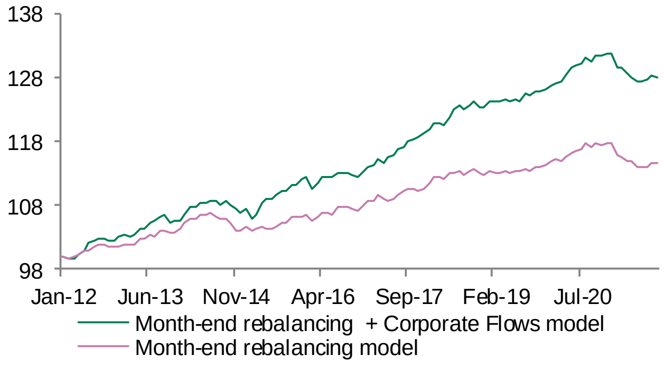
The combined trading strategy has yielded an annualised return of 3.1% since 2012, with a hit ratio of 72.3% and Sharpe ratio of 1.7. The combined strategy successfully improves the signal given by the FX month-end rebalancing model, as trading the weighted portfolio has yielded an annualised return of 1.8%, with a hit ratio of 64.4% and a Sharpe ratio of 1.1 (Figure 4).

Fig 3. Model signals vs EUR/USD month-end performance



Source: Crédit Agricole CIB, Bloomberg

Fig 4. Model performance since 2012 (2012=100)



Source: Crédit Agricole CIB, Bloomberg

The FX Month-End Rebalancing model explained

The model is based on the concept that global portfolio managers have set benchmarks for currency hedge ratios and, as the value of their assets within their portfolio changes over the course of the month, portfolio managers will need to re-hedge their currency exposure, so that their currency benchmarks are maintained. Typically, these FX rebalancing flows are seen at the end of the month and usually their impact is felt most near the 16:00 London fix on the last trading day of the month.

We look at the change in equity performance by market capitalisation for all G10 currencies, and we adjust this for monthly FX spot moves. This provides an indication of how the value of assets has changed over the course of the month and thus the extent of portfolio rebalancing flows that will likely take place at the end of the month. We generate a signal for all USD/G10 currency pairs indicating the expected direction and strength of FX month-end flows. The strength of the signal is dependent on the size of equity/FX moves over the course of the month, relative to previous history (from 2002). The signal is on a scale from +5 to -5. A signal of +5 indicates month-end flows are expected to be strongly USD/CCY positive, while -5 indicates flows are projected to be strongly USD/CCY negative.