Lesson II: A Deeper Insight into Everyday FX Market Practice

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Table of Contents

Spot FX Markets
Bid/Ask Prices and
Quoting Conventions
Reciprocal Rates,
Cross Rates and
Bid/Ask Spread

Fwd FX Markets
Main Features and
Quoting Conventions
Fwd Premium and
Discount
Major Traded
Instruments

Terminology

To Put It into
Practice

Getting Started

Some useful trading jargon:

- **Bid**: rate at which a certain market player is willing to buy
- **Ask**: rate at which a certain market player is willing to sell

Watch out: Bid<Ask

The Bid/Ask Spread

Bid/Ask Spread=Ask-Bid

The bid-ask spread can be conceived as a **transaction cost**
(step back to Lesson I)

The Bid/Ask Spread in Practice I

International
Financial and
Foreign Exchange
Markets

Spot FX Markets

Bid/Ask Prices and
Quoting Conventions
Reciprocal Rates,
Cross Rates and
Bid/Ask Spread

Fwd FX Markets

Main Features and
Quoting Conventions
Fwd Premium and
Discount
Major Traded
Instruments

Terminology

To Put It into
Practice

Apart from two notable exceptions (GBP and EUR), all the other major currencies are quoted in **European terms**, that is **foreign currency per USD** (Lesson I).

$S_{\frac{F}{USD}} \Rightarrow$ think of these exchange rates as the **buying and selling prices of USD**

The Bid/Ask Spread in Practice II

For instance,

- $S_{\underset{\text{bid}\,USD}{CHF}} \Rightarrow$ rate at which a certain mkt player is willing to

  buy USD against CHF

- $S_{\underset{\text{ask}\,USD}{CHF}} \Rightarrow$ rate at which the same mkt player

  sells USD against CHF

- **Watch out**: $S_{\underset{\text{bid}\,USD}{CHF}} < S_{\underset{\text{ask}\,USD}{CHF}}$

The Bid/Ask Spread in Practice III

Conversely, EUR and GBP are quoted in **USD equivalent**

$S_{\frac{USD}{F}} \Rightarrow$ think of these exchange rates as the **buying and selling prices of EUR or GBP**

The Bid/Ask Spread in Practice IV

International Financial and Foreign Exchange Markets

Spot FX Markets
Bid/Ask Prices and Quoting Conventions
Reciprocal Rates, Cross Rates and Bid/Ask Spread

Fwd FX Markets
Main Features and Quoting Conventions
Fwd Premium and Discount
Major Traded Instruments

Terminology

To Put It into Practice

For instance,

- $S_{\underset{\text{bid}GBP}{USD}} \Rightarrow$ rate at which a certain mkt player is willing to

  buy GBP against USD

- $S_{\underset{\text{ask}GBP}{USD}} \Rightarrow$ rate at which the same mkt player

  sells GBP against USD

- **Watch out**: $S_{\underset{\text{bid}GBP}{USD}} < S_{\underset{\text{ask}GBP}{USD}}$

A Closer Focus on Everyday Mkt Practice I

International
Financial and
Foreign Exchange
Markets

Spot FX Markets

Bid/Ask Prices and
Quoting Conventions
Reciprocal Rates,
Cross Rates and
Bid/Ask Spread
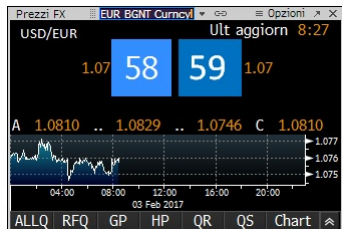
Fwd FX Markets

Main Features and
Quoting Conventions
Fwd Premium and
Discount
Major Traded
Instruments

Terminology

To Put It into
Practice

- $S_{\frac{USD}{\mathbf{bid}\,EUR}} = 1.0758 \Rightarrow$ the price provider is willing to

    buy EUR at 1.0758 USD

- $S_{\frac{USD}{\mathbf{ask}\,EUR}} = 1.0759 \Rightarrow$ the price provider is willing to

    sell EUR at 1.0759 USD

A Closer Focus on Everyday Mkt Practice II

International
Financial and
Foreign Exchange
Markets

Spot FX Markets
Bid/Ask Prices and
Quoting Conventions
Reciprocal Rates,
Cross Rates and
Bid/Ask Spread

Fwd FX Markets
Main Features and
Quoting Conventions
Fwd Premium and
Discount
Major Traded
Instruments

Terminology

To Put It into
Practice

► $S_{\frac{JPY}{\mathbf{bid}\,USD}} = 113.05 \Rightarrow$ the price provider is willing to

buy USD at 113.05 JPY

► $S_{\frac{JPY}{\mathbf{ask}\,USD}} = 113.06 \Rightarrow$ the price provider is willing to

sell USD at 113.06 JPY

Equivalent Notations I

$$S_{\frac{USD}{\mathbf{bid}\,GBP}} = S_{\frac{\mathbf{ask}\,USD}{\mathbf{bid}\,GBP}}$$

Rate at which the price provider is willing to **buy GBP
against (selling) USD** (i.e. the buying rate for GBP and
the selling rate for USD)

Equivalent Notations II

$$S_{\frac{USD}{\mathbf{ask}\,GBP}} = S_{\mathbf{bid}\,\frac{USD}{\mathbf{ask}\,GBP}}$$

Rate at which the price provider is willing to **sell GBP against (buying) USD** (i.e. the buying rate for USD and the selling rate for GBP)

Watch Out!

Given

$$S_{\frac{USD}{\mathbf{bid}\,GBP}} \text{ and } S_{\frac{USD}{\mathbf{ask}\,GBP}},$$

what if **YOU** were to sell/buy GBP?

- $S_{\frac{USD}{\mathbf{bid}\,GBP}} \Rightarrow$ number of USD **YOU** will receive from the bank from the sale of GBP per USD

- $S_{\frac{USD}{\mathbf{ask}\,GBP}} \Rightarrow$ the price that **YOU** must pay to buy GBP from USD

Evidence on the bid-ask spread

International
Financial and
Foreign Exchange
Markets

Spot FX Markets
Bid/Ask Prices and
Quoting Conventions
Reciprocal Rates,
Cross Rates and
Bid/Ask Spread

Fwd FX Markets
Main Features and
Quoting Conventions
Fwd Premium and
Discount
Major Traded
Instruments

Terminology

To Put It into
Practice

The **bid ask spread** tends to:

- ▶ **vary** throughout the day ⇒ in particular, the spread is higher:
    - ▶ at the start/end of the trading day;
    - ▶ on Fridays (at closing), on Mondays (at opening) as well as on the last trading day of the month;
    - ▶ on market holidays (for big financial centres)

- ▶ **increase with the volatility** of the spot rate

- ▶ **decrease when more dealers** are in the market⇒ the larger the number of dealers, the thinner the spread

Reciprocal Rates and Bid/Ask Spread

When bid-ask prices are taken into account:

$$S_{\frac{i}{\text{ask}j}} = \frac{1}{S_{\frac{j}{\text{bid}i}}}$$

and

$$S_{\frac{i}{\text{bid}j}} = \frac{1}{S_{\frac{j}{\text{ask}i}}}$$

Cross Rates and Triangular Arbitrages I

Suppose you were to buy GBP from EUR and assume that:

	Bid	**Ask**
$S_{\frac{USD}{EUR}}$	1.102	1.105
$S_{\frac{USD}{GBP}}$	1.5775	1.581
$S_{\frac{GBP}{EUR}}$	0.696	0.6965

In principle, you could **either** choose a **direct** transaction
(you sell EUR to buy GBP) or an **indirect** transaction via
USD (you first sell EUR to buy USD and then you sell USD
to buy GBP)...

Spot FX Markets
Bid/Ask Prices and
Quoting Conventions
Reciprocal Rates,
Cross Rates and
Bid/Ask Spread

Fwd FX Markets
Main Features and
Quoting Conventions
Fwd Premium and
Discount
Major Traded
Instruments

Terminology

To Put It into
Practice

Indirect Transaction (via USD)

	Bid	**Ask**
$S_{\frac{USD}{EUR}}$	1.102	1.105
$S_{\frac{USD}{GBP}}$	1.5775	1.581

- ▶ Step 1:**sell EUR to buy USD**⇒ $S_{\frac{USD}{bid\,EUR}}$
- ▶ Step 2:**sell USD to buy GBP**⇒ $S_{\frac{USD}{ask\,GBP}}$

The **indirect** FX rate $S_{\frac{GBP}{bid\,EUR}}$ is thus

$$\frac{S_{\frac{USD}{bid\,EUR}}}{S_{\frac{USD}{ask\,GBP}}} = \frac{1.1020}{1.581} = 0.6970$$

International
Financial and
Foreign Exchange
Markets

Spot FX Markets
Bid/Ask Prices and
Quoting Conventions
Reciprocal Rates,
Cross Rates and
Bid/Ask Spread

Fwd FX Markets
Main Features and
Quoting Conventions
Fwd Premium and
Discount
Major Traded
Instruments

Terminology

To Put It into
Practice

Direct Transaction

	Bid	Ask
$S_{\frac{GBP}{EUR}}$	0.696	0.6965

In this case, you only have to **sell EUR to buy GBP** $\Rightarrow$
$S_{\frac{GBP}{\mathbf{bid}\,EUR}} = 0.696$

Some Profit to Cash In...

Notice that, if you choose the **indirect transaction**, you would get 0.6970 GBP. If you conversely go for the **direct transaction**, you would only get 0.696: are there profit opportunities? If so, how would you exploit them?

In More General Terms...

▶ As long as $S_{\frac{GBP}{\mathbf{bid}\,EUR}} \geq \dfrac{S_{\frac{USD}{\mathbf{bid}\,EUR}}}{S_{\frac{USD}{\mathbf{ask}\,GBP}}}$, you are better off choosing the **direct** transaction

▶ Conversely, if $S_{\frac{GBP}{\mathbf{bid}\,EUR}} \leq \dfrac{S_{\frac{USD}{\mathbf{bid}\,EUR}}}{S_{\frac{USD}{\mathbf{ask}\,GBP}}}$, the **indirect** transaction will offer you a better return

The Empirical Evidence

In practice, however, **triangular arbitrage opportunities are very unlikely to materialize**.

An **increasing number of people will try to profit** from the price differential and will consequently sell EUR $\Rightarrow$ buy USD $\Rightarrow$ sell USD $\Rightarrow$ buy GBP, thus driving EUR down and GBP up, until equilibrium is finally restored **(No free lunch principle)**

$$S_{\frac{GBP}{\mathbf{bid}EUR}} = \frac{S_{\frac{USD}{\mathbf{bid}EUR}}}{S_{\frac{USD}{\mathbf{ask}GBP}}}$$

To Rust Off - Lesson I

- **Spot exchange rate**: FX rate that is contracted today for **immediate** delivery (generally, t+1 or t+2)

- **Forward exchange rate**: rate that is contracted today for the exchange of currencies on a specific date in the **future** (1m, 3m, 6m).

FX Fwd Markets: an Overview

Exactly **like the spot** market:

- ▶ **No** central **location**
- ▶ **24h** trading
- ▶ Direct **interbank market** (decentralized, continuous, open-bid, double-auction) and indirect **broker-based** market (quasi-centralized, continuous, limit-book, single-auction market) [Step back to Lesson I]
- ▶ **Bid/Ask** quotation

Adopted Notation

Forward exchange rate: rate that is contracted today for the exchange of currencies on a specific date in the future. $F_n(\frac{i}{j})$ is the n-year forward exchange rate of currency i per unit of currency j

Quoting Conventions

Forward rates are generally quoted in terms of the corresponding **spot rate** $\pm$ a suitable number of **swap points**, depending on the forward maturity taken into consideration.

Swap points will be **added to (subtracted from) the spot bid-ask** quotes whenever they are ascending (descending).

Quoting Conventions: an Example

Given the spot rates and the swap points below, how to find the corresponding fwd bid-ask quotation?

Spot Bid/Ask	Swap Points
1.3965/1.3970	27/23

Descending swap points $\Rightarrow$ to be **subtracted**
$F_{bid} = 1.3965 - .0027 = 1.3938$
and
$F_{ask} = 1.3970 - .0023 = 1.3947$

A Closer Mkt Insight

The **bid-ask spread for forward quotations** is wider as
time to maturity increases: this is mostly due to market
"**thinness**"

Fwd Premium and Discount

When it is necessary to pay more (less) for forward delivery than for spot delivery of a currency, we say that the currency is at a **forward premium (discount)**.

N-year forward premium/discount $= \dfrac{F_n \frac{i}{j} - S_{\frac{i}{j}}}{n \cdot S_{\frac{i}{j}}}$

Fwd Premium and Discount: an Exmple

Given $S_{\frac{JPY}{USD}} = 76.89$ and $F_{0.5\frac{JPY}{USD}} = 76.65$,

Fwd Premium/Discount$=\frac{76.65-76.89}{0.5 \cdot 76.89}=0.00624$

Fwd **discount** of the Dollar versus the Yen (or, equivalently, fwd **premium** of the Yen versus the Dollar)

Spot FX Markets

Bid/Ask Prices and
Quoting Conventions
Reciprocal Rates,
Cross Rates and
Bid/Ask Spread

Fwd FX Markets

Main Features and
Quoting Conventions
Fwd Premium and
Discount
Major Traded
Instruments

Terminology

To Put It into
Practice

Major Traded Instruments

International Financial and Foreign Exchange Markets

Spot FX Markets
Bid/Ask Prices and Quoting Conventions
Reciprocal Rates, Cross Rates and Bid/Ask Spread

Fwd FX Markets
Main Features and Quoting Conventions
Fwd Premium and Discount
Major Traded Instruments

Terminology

To Put It into Practice

- ▶ **Outright fwd contract**: agreement to exchange currencies at a pre-determined price on a future date

- ▶ **FX Swap**: agreement to buy and sell foreign exchange at pre-specified exchange rates, where the buying and selling are separated in time (two major components: a spot transaction plus a forward transaction in the reverse direction). A **swap-in** (**swap-out**) EUR consists of an agreement to buy (sell) EUR spot and to sell (buy) them forward

- ▶ **Currency Swap**: agreement involving two parties in the exchange of principal and interest payments on a loan in one currency for principal and interest payments in another currency.

- ▶ **Options**: derivative contracts that give the buyer the opportunity to buy (call) or to sell (put) the underlying asset at a given price sometime in the future

Some Trading Jargon

EBS Non-Premium Rates   Properties ? □ ×

| USD/EUR | 1.17 | 72 5 | 75 5 | 1.17 | JPY/USD | 119 | 80 5 | 83 5 | 119. |

| 1.17630 | 1.18475 | | 119.185 | 119.960 |
| 1.18020 | 1.18020 | 1.18965 | 1.18975 | 118.450 | 118.480 | 119.650 | 119.650 |

Source: Bloomberg, 8th January 2015

BIG FIGURE

PIPS (1 pip= $\frac{1}{100}$ of a percentage point)

The Trading Book

International
Financial and
Foreign Exchange
Markets

Spot FX Markets
Bid/Ask Prices and
Quoting Conventions
Reciprocal Rates,
Cross Rates and
Bid/Ask Spread

Fwd FX Markets
Main Features and
Quoting Conventions
Fwd Premium and
Discount
Major Traded
Instruments

Terminology

To Put It into
Practice

MMID	Bid	Size	Time	MMID	Ask	Size	Time
NSDQ	617.77	1	10:54:04	baty	617.87	1	10:54:05
baty	617.60	1	10:54:04	edga	617.87	1	10:54:05
edga	617.60	1	10:54:01	NSDQ	617.88	1	10:54:04
edgx	617.51	1	10:53:52	bats	617.92	4	10:54:04
cinn	617.50	3	10:53:51	edgx	618.05	1	10:53:28
UBSS	617.50	1	10:51:39	arcx	618.36	1	10:54:04
bats	617.50	1	10:54:04	UBSS	618.40	1	10:49:20
arcx	617.43	2	10:54:02	amex	618.40	1	10:54:00
amex	616.93	1	10:53:59	WCHV	618.50	1	10:16:10
bosx	616.60	1	10:54:05	cinn	618.50	1	10:53:51
HDSN	616.59	1	10:53:52	HDSN	618.81	1	10:54:04
NITE	616.32	1	08:30:36	bosx	618.87	1	10:54:05
SBSH	615.37	1	10:53:52	NITE	620.13	1	08:30:36
cbsx	611.51	1	06:56:46	cbsx	624.02	1	06:56:46
NMRA	611.49	1	08:33:23	NMRA	624.93	1	08:33:23
BOOK	611.00	1	05:29:01	SBSH	625.00	1	10:36:17
SUSQ	603.61	1	07:24:09	SUSQ	631.05	1	07:24:09
SURG	603.00	1	07:02:27	MSCO	633.21	1	10:53:18

- **Bid Section**: **buying** proposals, **ascending** prices
- **Ask Section**: **selling** proposals, **descending** prices
- **Ranking criteria**: **Price** priority and **Time** priority
- **Mkt Depth**: Ability to **sustain large mkt orders without impacting the price** of a security $\Rightarrow$ a very large order will **not** significantly move the price of a security
- **Mkt Width**: it refers to the **cost of executing a trade** of a given size

No Free Lunch Principle

Free Lunch: situation where a good or a service is received at **NO** cost. In strict financial terms, **No Free Lunch** means that an investor will not be able to make **large and riskless** profits on a continuous, persistent basis.

To put it into practice I

2.1: Based on the table below, answer the following questions:

	Bid	**Ask**
$S_{\frac{USD}{Currency_1}}$	1.35135	1.35227
$S_{\frac{Currency_2}{USD}}$	83.365	83.3925

- ▶ How much would you lose if you converted USD 1000 into $Currency_1$ and then back into USD?
- ▶ What is the bid-ask spread for $S_{\frac{Currency_2}{USD}}$?
- ▶ What is the bid-ask spread for $S_{\frac{Currency_2}{Currency_1}}$?
- ▶ How much would you lose if you converted USD 1000 into $Currency_1$, then into $Currency_2$ and finally back into USD?

To put it into practice II

2.2: Fill in the table below and answer the following questions:

	Bid	**Ask**
$S_{\frac{CZJ}{GBP}}$	42.7512	42.7983
$S_{\frac{DKK}{GBP}}$	11.3065	11.3235
$S_{\frac{EUR}{GBP}}$	1.2439	1.2501
$S_{\frac{NOK}{GBP}}$	12.3363	12.3479
$S_{\frac{DKK}{EUR}}$		
$S_{\frac{EUR}{NOK}}$		
$S_{\frac{GBP}{CZJ}}$		

- Find the bid-ask spread for the $S_{\frac{EUR}{CZJ}}$ quote.
- How much would you lose if you converted 1500 DKK into GBP, then into EUR, further into NOK and finally back into DKK?

International Financial and Foreign Exchange Markets

Spot FX Markets
Bid/Ask Prices and Quoting Conventions
Reciprocal Rates, Cross Rates and Bid/Ask Spread

Fwd FX Markets
Main Features and Quoting Conventions
Fwd Premium and Discount
Major Traded Instruments

Terminology

To Put It into Practice