To Hedge Just About Anything, Traders Are Shorting Mexico's Peso

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By Isabella Cota

(Bloomberg) -- The Mexican peso's virtue as the most-traded currency in emerging markets is also its biggest curse.

The peso's $135 billion in daily trading makes the market so much deeper than for other developing countries that investors use the currency as a general proxy for risk. Bought a Brazilian corporate bond? Sell pesos to hedge any losses. Stuck with a load of Treasuries? Buy pesos to blunt the pain if a risk-on environment sparks a rout. Correlations are high enough that the hedges often work, according to JPMorgan Chase & Co.

Greece's debt crisis, China's stock market crash and speculation that the U.S. Federal Reserve will soon start raising interest rates have spurred a wave of global volatility that's now hitting the peso by proxy. On the Chicago Mercantile Exchange, futures trades designed to profit from the currency's decline have climbed to a record.

"People use hedges via the peso like Kleenex -- if they think they are about to sneeze, they grab one," said Alejandro Silva, a partner at Chicago-based Silva Capital Management, which has about $180 million under management. **"It's a currency so liquid, so large that when big problems like Greece happen and a money manager needs to place a hedge for its portfolio, the easiest thing to do is buy dollars with their pesos."**

On the CME, net futures contracts betting on a decline in the peso have grown 28 percent this year to 81,424 as of July 21. A year ago, roughly the same number of trades were staked on an increase.

This means that the peso's being hurt at a time when investors already are becoming disillusioned with Mexico's prospects for an oil-fueled surge in foreign investment. The depreciation has been so swift that Morgan Stanley said in a research note published Monday that the likelihood is growing that Mexico's central bank will increase efforts to prop up the exchange rate.

At the start of 2015, the peso was forecast by analysts to strengthen 9.3 percent this year versus the dollar, the most in the world. Instead, it has tumbled 9.5 percent to a record low of 16.2992 per dollar.

In 2013, none other than Bill Gross, then overseeing the world's biggest bond fund at Pacific Investment Management Co., called the peso a "great currency." In a June 17 interview with CNBC, Gross said the peso "is 15 to 20 percent undervalued." At that point, it was trading at 15.2550 per dollar.

The French bank Societe Generale SA wrote in a July 1 report that the peso could weaken to 17.

Investors like the peso as a hedge partly because it trades 24 hours, five days a week. That's true of only two other emerging-market currencies - the South African rand and Turkish lira, both of which have far lower daily trading volumes.

Based on the most-recent data from the Bank of International Settlements, the peso's daily trading volume of $135 billion a day is $15 billion higher than for China's yuan, the next-most traded among developing countries.

A textbook example of the phenomenon came on May 1, when most of Latin America was celebrating Labor Day. In Brazil, the Senate leader proposed a stimulus plan to counter President Dilma Rousseff's austerity program, which her team had hatched to help stave off a credit-rating cut to junk grade.

There wasn't much news in Mexico, but the peso fell 1.2 percent. That was largely because of the goings on in Brazil, but that country's currency wasn't trading, according to Christian Lawrence, a trader at Rabobank in New York.

"The Mexican peso was hammered despite nothing standout in Mexico, but there were headlines relating to stress in Brazil," Lawrence wrote in an e-mail.

Investors are using the peso as a hedge against falling oil prices as well as increased volatility in the U.S. stock market, according to Siobhan Morden, head of Latin America fixed income for Jefferies Group LLC.

James Lord, a global emerging-market macro strategist at Morgan Stanley, says the peso is cheaper to borrow than the rand and the lira. That makes it attractive for investors who want to make "short" bets -- where the currency is borrowed and then sold in the hopes that it can be bought back later at a lower price.

So many investors are shorting the peso that the cost of the hedge has increased. For a three-month forward contract, it currently works out to an annualized rate of about 3.07 percent, a 13-month high.

Even at that level, it's still a bargain, according to Lord.

"It's good that the Mexican economy has low inflation and low interest rates," Lord said by phone from New York. "An unfortunate side effect is it makes the currency cheaper to short."