FOREX-Yen rallies as investors unwind bets, shun risk

Tue Feb 27, 2007 4:37 PM ET

(Recasts throughout, adds comments, closing prices)

By Vivianne Rodrigues

NEW YORK, Feb 27 (Reuters) - The yen surged on Tuesday, rising more than 2 percent against the dollar for its biggest jump in a year, as investors fled risky trades on fears of rising volatility in financial markets.

A tumble in global stock prices, soft U.S. economic data, and growing tensions with Iran jolted investors from complacency, sparking the sell-off in the dollar, which has benefited in past months from a steady decline in the yen.

Against the yen, the dollar fell as low as 117.50 yen <JPY=>, according to electronic platform EBS. At 4 p.m. in New York (2100 GMT) the dollar traded at 118.04 yen.

The euro <EUR=> ended the New York session at $1.3233, up 0.4 percent on the day, near a two-month high around $1.3260 hit earlier.

"The dollar is no longer the safe cash option for investors that it once was," said Axel Merk, portfolio manager at Merk Hard Currency Fund in Palo Alto, California. "The jump in volatility today is a reminder for investors that they may have gotten too complacent regarding carry trades."

A key Wall Street fear gauge had the biggest jump in its 17-year history on Tuesday. The Chicago Board Options Exchange Volatility Index <.VIX>, or VIX, which measures anticipated stock market volatility, shot up more than 70 percent before closing up 64 percent.

Demand for the yen -- which has been a key fixture in carry trades in which investors borrow in a low-yielding currency to invest in higher-yielding markets -- accelerated after a report showed an unexpectedly sharp drop in U.S. durable goods orders in January, adding to speculation the Federal Reserve may cut interest rates later this year to prop up a slowing economy.

The biggest daily fall in Chinese stocks prices on Tuesday in a decade, tensions over Iran's nuclear program, and worries about rising defaults among high-risk borrowers in U.S. subprime mortgages combined to make investors wary of their exposure to risks.

The yen also rallied against the Australian dollar, New Zealand dollar and Canadian dollar, all popular targets of carry trades by speculators and individual investors in Japan.

RISK AVERSION

"What we're really looking at here is a big move away from risk," said David Durrant, strategist at Julius Baer Investment Management in New York. "The big fall in Chinese stocks especially has got some people nervous about the carry trade."

Durrant said an unwinding of carry trades, benefiting low-yielding currencies such as the yen and Swedish crown, was likely to continue if Chinese stocks resumed their sharp decline on Wednesday, driving global equity prices lower.

As evidence of investors' growing aversion to risk, emerging stock markets fell sharply and U.S. Treasury bond yields fell for a third straight session as some investors fled for the relative safety of fixed income.

"After months with absolutely no volatility in most markets, now we are seeing a jump in the Vix," said Merk. "The high volatility may lead to a sharp decrease in market liquidity, and that's when we may see a real reversion on carry trade bets -- if investors want to play safe, they'd rather put their money in Swiss francs."

The Swiss franc <CHF=>, another favored funding currency for carry trades that have been used to finance purchases of everything from high-yielding currencies to emerging market stocks, also rose sharply and traded at 1.2170 francs per dollar.

The dollar steadied momentarily after reports showed that sales of U.S. existing homes rose faster than expected in January and consumer confidence edged higher in February.

Investors were more focused, however, on earlier data that showed durable goods orders, a key leading indicator for the manufacturing sector, fell 7.8 percent in January, far more than economists had forecast. After stripping out defense goods, it was the biggest monthly decline on record.

Federal fund futures showed the market was now pricing in roughly a 50 percent chance that the Fed will cut interest rates from the current 5.25 percent by August, compared with about 30 percent on Monday.

Given signs that other central banks, including the European Central Bank, are set to raise rates, that would likely further erode the dollar's yield advantage, reducing the currency's allure.

(Additional reporting by David McMahon in New York)
