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CURRENCY WARS HIGHLIGHT RISK AND OPPORTUNITY

After a positive first half risk assets are now on the back foot. Heightened volatility in currency markets has been particularly unsettling for emerging markets. Whether investors view currencies as a risk to be managed or an opportunity to be exploited the message is clear: doing nothing is not an option, writes Insight Investment's head of currency Paul Lambert

Year-to-date the MSCI World equity market index has fallen 6% in US dollar terms. Strategists are now predicting the worst year for equity and bond returns since the current bull market began in March 2009. But these moves seem modest when compared to what has been happening in currency markets. Emerging market FX is now at the lowest level since September 2009. The Brazilian real and Turkish lira have hit all-time lows versus the US dollar. Currencies from the South African rand to the Indonesian rupiah and Australian dollar have recorded double digit percentage declines.

Shock changes to policy have also rocked currency markets. In January the Swiss National Bank abandoned its peg to the euro, catching out many investors who thought they had identified a safe carry trade. In a move that also caught markets off guard, the People's Bank of China (PBoC) devalued the yuan in August. It was a move the PBoC portrayed as market friendly. The market regarded it as another reason to fret about Chinese growth and sell equities.

The moves by the Chinese and the Swiss should not have come as a surprise. Around the world monetary authorities are looking to currency adjustment as a legitimate tool of policy faced with below target inflation, growth headwinds and in commodity producing countries a glut of supply and scarcity of demand. The problem for investors who feel the effect of these violent moves via international equity or other exposures is how to manage the risk and opportunity that currency presents.

A POINT OF VIEW

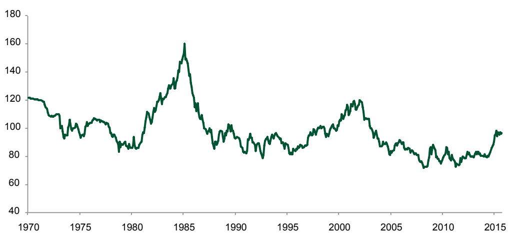
That decision rests on what an investor wants to achieve and what their objective is. If the goal is to seek to maximise returns available from currency then investing in a standalone specialist fund with the aim of adding alpha could make sense. Another approach is to treat FX as an unrewarded and unintended risk in an international portfolio and attempt to hedge that via a currency risk management program. Currency risk management (CRM) can be executed in a passive way via a pre-set hedge ratio or actively where the amount of hedging back to a base currency reflects the market environment.

In an era of historically low yields the losses from unwanted currency exposure can have a significant impact at the overall portfolio level. For example, if a fund has invested 20% in international markets, is unhedged and there is a 10% decline of those currencies relative to an investors' base currency, it equates to a 2% currency loss to the overall portfolio.

Similarly, a portfolio that fully hedges international currency exposures when foreign currencies rise by 10% would also experience a 2% loss in the form of realised negative cash flows paid to banks for the hedging. That could be enough to force sales of strategic risk assets. These return and cash flow risks argue for a dynamic hedging approach.

The currency alpha and currency hedging approaches can be complementary. Active currency risk management can be thought of as a prudent investment approach akin to liability driven investing (LDI) because the starting point for making a hedging decision is an existing portfolio of exposures. The goal is not to maximise an expected return but to manage portfolio and cash flow risk. An opportunistic absolute return approach to currency might fit more comfortably in an alternatives allocation as a source of diversified returns.

Figure 1: US dollar could have further to go



CHANGING DYNAMICS

Whatever approach a pension scheme decides to take, it is clear that currency management is becoming an imperative. The volatility we have seen in 2015 is in marked contrast to the quiescent markets of the past few years. Last summer the JP Morgan global FX volatility index languished at record lows. The world's most actively traded cross – US dollar/ euro – was stuck in a 1% trading range for more than four months. This dramatic contrast begs two questions: what has changed and will current volatility persist? The answers are: a lot and yes.

There are several feasible explanations for the dampened volatility in FX markets in the aftermath of the global financial crisis. The first is reserve accumulation, particularly by emerging markets. Reserves held by emerging markets central banks were around $450 billion during the Asian financial crisis of late 1990s. By the time the next financial crisis hit in 2008, these had grown to $3.8 trillion (excluding Chinese reserves that peaked at $4 trillion in 2012).

The Bank of International Settlements estimates that in aggregate, adjusting for growth, EM reserves now amount to 30% of GDP, triple the figure in the late 1990s. That is a lot of firepower to deploy in smoothing currency fluctuation and adjustment.

The corollary to reserve accumulation in emerging markets has been balance sheet expansion by developed market central banks. Policy has been remarkably coordinated. Rates around the world were slashed to zero and since then the US, UK, Japan and now Europe have engaged in various brands of quantitative easing (QE). We are now living through an era of policy normalisation and cyclical divergence. The UK and US have exited QE and even though the Federal Reserve did not raise rates in September, there is still the possibility that rates will move upward this year. That will be well in advance of the UK, while rate rises in the eurozone and Japan remain a distant prospect.

Reserve accumulation has also gone in reverse, which is an effective tightening of financial conditions.

Historically, currency managers have been able to add most value in turbulent market periods when other asset classes suffer. QE has created a false world where beta is rewarded at the expense of alpha. A rising tide has lifted all boats in asset markets. That era is now at an end. The extreme volatility in currency markets may well be the harbinger of how financial markets behave as the super-abundant liquidity of the past five years gets withdrawn via an end to QE and reserve accumulation and rising policy rates. All investors should buckle up for what promises to be a hairy ride.