Managing emerging market currency exposures

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Conventional wisdom says long-term investors in emerging market assets will benefit from the respective currencies appreciating as these economies grow. Hedging this risk makes little sense as it would wipe out a potential source of returns.

The same wisdom also argues that even if currency created a risk rather than a return for investors, it would be pointless to put hedging in place as the costs are too high and these markets are too illiquid.

Neither perception is as accurate today as it was just a few years ago. Our analysis shows emerging market currencies have not, on average, appreciated against the US dollar over the last decade.

Figure 1: FX contribution to EM equities returns

Source: Bloomberg, January 2003 to December 2017, based on the monthly returns of the currency exposure in the MSCI Emerging Market Index. This has been calculated by taking the difference between the MSCI Emerging Market Local Currency Index Returns and the MSCI Emerging Market USD Index Returns.

Instead emerging market currencies have exhibited long and large cycles, experienced extended periods of depreciation and been negatively impacted by the financial crisis.

Hedging would have been beneficial for much of this period and it would have been relatively cost effective to have put this approach in place as the structure of developing nations' foreign exchange markets has changed over the last ten years.

Bid-offer spreads in US dollar/emerging market currency pairs have compressed progressively and liquidity has increased. The Bank for International Settlement's Triennial Survey of foreign exchange turnover in April 2016 shows that daily turnover in Mexican Pesos and Korean Won is now comparable with the New Zealand Dollar and the Norwegian Krone for example.

An increased resemblance to developed markets

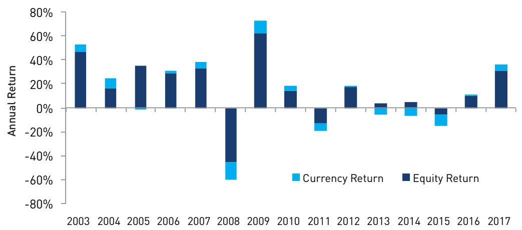
Not only has the behaviour of developing currencies started to resemble their developed counterparts but so too has the liquidity of these FX markets and the range of affordable hedging instruments.

These changes are not surprising: they reflect the success of the large emerging economies such as Korea, Taiwan, Mexico and Brazil. Fifteen years ago these nations could be accurately described as emerging markets but that's probably no longer the correct term.

These economies used to behave as conventional wisdom predicts for emerging markets. Between 2003 and 2010 the average absolute annual return for the MSCI Emerging Market Equities Index – in US dollars – was 42%. In seven out of these eight years, EM currencies and EM equities moved in the same direction.

But since 2010, the relationship has changed. Annual emerging equity returns have been reduced and the impact of currency returns has frequently been negative. In other words, the asset class has started to behave more like a developed market index.

Figure 2: Equity and Currency Contribution to MSCI EM Index (2003 to 2017)



Source: Millennium Global and MSCI, January 2003 to December 2017. Currency Return calculated by taking the difference between the MSCI Emerging Market Local Currency Index Returns and the MSCI Emerging Market USD Index Returns.

Investor dissonance

But most institutional investors appear unaware of these changes, which has allowed a dangerous dissonance to emerge in their perception of the risks and returns associated with emerging market assets.

Many now take a sophisticated approach to investing in emerging markets, for example by allocating to local- and hard-currency debt as well as using a variety of equity strategies. This attitude, however, is not reflected in their approach to foreign exchange.

Investors often still assume emerging market currency performance will be homogeneous and ignore the increasingly diversified performance over the past decade. The currencies of larger economies have started to resemble those of developed countries while smaller ones still behave like old-fashioned emerging market economies.

This divergence means a one-size-fits-all approach is no longer fit for purpose. Many investors understand currency movements in developed markets are usually a source of risk rather than return and have well-established strategies to mitigate these impacts.

Adapting strategies to emerging markets

These strategies could be applied to emerging market currencies to ensure these risks do not erode returns on these assets.

While developed currency strategies can be applied to their emerging market counterparts, they need to be adapted. When establishing a hedging policy for developed markets, institutional investors assess whether a passive or a dynamic hedging strategy is preferable.

Both approaches have their merits, and different investors will reach different conclusions depending on the specific characteristics of each organisation and their portfolios.

Considerations may include a pension scheme's risk capacity and return objectives, the contribution of currencies to the overall risk budget and the ability to manage cash flows resulting from the hedging process.

Although volatility has abated over time, emerging market currencies do still experience significant swings in value. As a result, there will be periods when a static hedging strategy could be so costly it would more than wipe out any underlying asset returns.

Dynamic approach

As a result there is an even stronger rationale for using an opportunistic and dynamic strategy in emerging market currencies. Ideally, this solution could be triggered when the value of a particular currency depreciates and then switched off when it appreciates or moves sideways.

For the best results, such an approach should do more than simply analysing momentum as is the case for many standard dynamic hedging strategies. Instead it should take into account forward-looking inputs such as option-market volatility and skew as well as past FX-price movements.

Recent academic studies and Millennium Global's own analysis have shown that option volatility surfaces can provide useful information about currency behaviour. In particular, there is evidence that changes in option volatility skews are good advance indicators of potential reversals and market gaps.

This type of dynamic hedging strategy gives better results than a binary approach of either not hedging at all or maintaining a static hedge ratio. It enables investors to benefit from the appreciation of emerging currencies while being protected against their depreciation.

Conclusion

It is sensible and increasingly feasible in practice for investors to establish a risk management policy for their emerging market currency exposure. This is underlined by the sharp decline that has recently hit certain EM currencies. A dynamic hedging strategy can improve the return profile of unmanaged currencies and reduce drawdowns and volatility. This may be particularly effective and increasingly applicable for emerging market currencies.