Currency

To Hedge or Not to Hedge

By Aaron Hurd, *Senior Portfolio Manager*

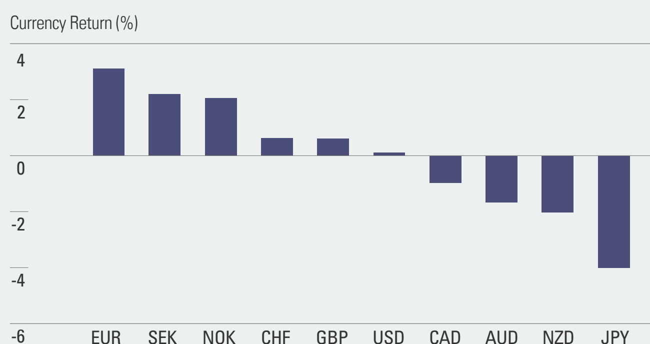
At the start of 2017 we saw significant downside political risk to currency markets as we anxiously awaited the outcomes of milestone elections in the Netherlands and France and sought to understand whether President Trump would behave differently from Candidate Trump. Moreover, uncertainties around the Brexit process overshadowed the UK and the Eurozone.

In each case, however, the outcome during the first half of the year has been more benign than expected. Emmanuel Macron was victorious by a wide margin in the French elections, removing a potential, near-term, existential threat to the EU order. President Trump has pulled back from promises of aggressive protectionist trade policy, reducing the chances of an all-out trade war. Brexit remains a significant source of uncertainty following the UK's hung parliament vote in June.

Overall, short-term political risk is lower and global growth is improving. The result has been a low volatility environment supporting high-yielding currencies, particularly in emerging markets.

The coast, however, is far from clear. President Trump has demonstrated a tendency to change policy abruptly and may once again target global trade or launch policies that could hurt market sentiment and economic growth. Secondly, the ECB looks set to begin tapering its QE program at year end. While initially this could be positive for the euro, it is likely to spur substantial volatility as markets will question the ability of the eurozone economy to withstand higher yields. Italian elections next year could also be quite disruptive. Finally, China's economy has been rather strong. However, China has tightened policy somewhat, indicating that they remain committed to slowly restraining the excessive build-up of credit to drive growth. The potential for another flare-up of concerns over China is meaningful, especially if the global economy falters or the Trump administration takes a harder line on trade policy. In short, currency investors should enjoy the current low volatility environment but remain wary.

Figure 1: Much of the EUR Political Risk Premium Has Been Priced Out Since the French Election
Return vs. G10 Average Since French Election
April 21, 2017–May 16, 2017



Source: Bloomberg

Figure 2: USD Relative to PPP Fair Value, MSCI World Ex US Average

Source: Bloomberg

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Key Currency Views for H2 2017

US Dollar

The trade-weighted US dollar has given up about half of its post-election gains since November, prompting calls for the end of the bull market. We agree that the dollar rally is in its late stages, but it is premature to call the end and position for a bear market. We expect the dollar to trade sideways for the remainder of 2017. US yields are rising as the Fed tightens and the US could easily become the highest-yielding G10 currency by mid-2018. Moreover, the continuing loss of faith in US dollar strength has cleared out a number of speculative long positions, paving the way for further leg up. To the extent that the dollar is entering a topping phase, we expect that to be a volatile and long 18–24 month process, which may very well be marked by fresh highs.

Sterling

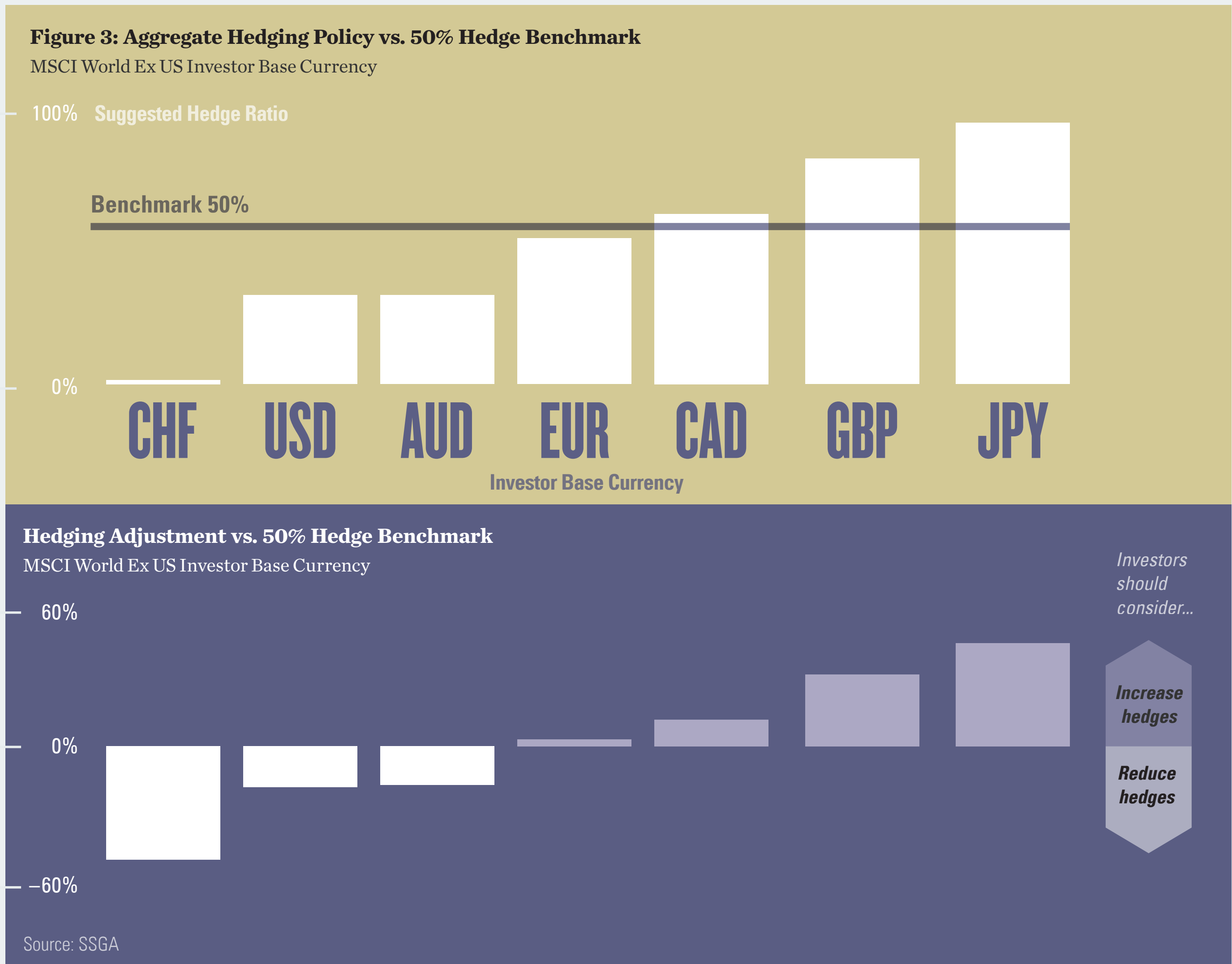
The rally off the January low is a strong sign that the market is content that a level of 1.18–1.22 reflects an appropriate discount to reflect Brexit risk. However, near the top of the recent 1.22–1.30 range the prospects for the pound appear biased lower. Manufacturing production and retail have been consistently weaker in 2017 and we expect the first six months of direct negotiations with the EU to be contentious, suggesting a lower currency.

Euro

Reduced political risk after the French election, resilient growth, relatively less expensive equity markets, recovering corporate earnings and the prospect of QE tapering at year end increase upside risk for the euro in H2. The case for a sustained bull market for the euro is much weaker. Widening yield differentials with the US (which could reach as much as 2.5% before the ECB begins to raise rates), likely concerns regarding the ability of EU growth to withstand tighter monetary policy and the 2018 Italian elections are among the constraints that should limit longer-term euro gains.

What Should Investors Consider?

Currency risk is one of the largest structural sources of risk in portfolios. Not only should it not be ignored, investors should ensure it is working for them, not against them. The bulk of the currency risk comes from global equity allocations and the market cap-weighted basket of foreign currency exposures that come with that. Not only does this introduce tremendous risk, it concentrates exposures in the most liquid currencies, which tend to have a negative risk premium. At best, investors face a nearly uncompensated risk; at worst, a negatively compensated risk. Figure 3 provides a guide to our views on increasing or decreasing hedges according to base currency.



With real yields at historic lows, equities near fully valued relative to historical norms (if not expensive), and credit spreads increasingly tight, investors cannot afford the deadweight structural risk from currency. Rather, the need for diversifying sources of positive return has seldom been more pressing. Factor-based currency portfolios can meet this need. In particular, value-based currency portfolios have a long-term track record of success and a zero to negative correlation to global equities and credit. While it is immensely difficult to find a stable, low turnover portfolio with those features, currency value portfolios are readily available at a low cost.

Currency value may be taken as a pure factor portfolio or combined with a passive hedge within a dynamic hedging framework. This kind of hedging strategy would encourage euro, Canadian dollar, yen and sterling investors to hedge a greater proportion of their foreign assets, while US dollar-based hedgers would be prompted to realize some profit on existing hedges. To be fair, many US dollar investors have avoided hedging and lost nearly 30% on a typical foreign equity benchmark from currency alone as the dollar has strengthened. It is difficult to begin hedging now. However, the need for diversifying sources of return is as high or higher for US investors. A pure, value-based currency factor portfolio would fill that need while the question of a benchmark hedging policy could be revisited at a more advantageous phase of the dollar cycle.

Glossary

Base Currency In the forex market, currency units are quoted as currency pairs. The base currency – also called the transaction currency - is the first currency appearing in a currency pair quotation, followed by the second part of the quotation, called the quote currency or the counter currency. For accounting purposes, a firm may use the base currency as the domestic currency or accounting currency to represent all profits and losses.

Currency Hedging Involves taking offsetting positions intended to substantially offset currency losses on the hedged instrument. If the hedging position behaves differently than expected, the volatility of the strategy as a whole may increase and even exceed the volatility of the asset being hedged. There can be no assurance that the Fund's hedging strategies will be effective.

Currency risk Arises from the change in price of one currency in relation to another. Investors or companies that have assets or business operations across national borders are exposed to currency risk that may create unpredictable profits and losses. Currency risk can be reduced by hedging, which offsets currency fluctuations.

Group of Ten (G10) Group of Ten is made up of eleven industrial countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States) which consult and co-operate on economic, monetary and financial matters.

MSCI World A broad global equity benchmark that represents large and mid-cap equity performance across 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country and does not offer exposure to emerging markets.

Purchasing Power Parity (PPP) An economic theory that compares different countries' currencies through a market "basket of goods" approach. According to this concept, two currencies are in equilibrium or at par when a market basket of goods (taking into account the exchange rate) is priced the same in both countries.

Quantitative easing (QE) An unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply. QE increases the money supply by providing financial institutions with capital in an effort to promote increased lending and liquidity. It is considered when short-term interest rates are at or approaching zero, and does not involve the printing of new banknotes.

Trade-weighted US dollar A weighted average of the foreign exchange value of the US dollar against a subset of the broad index currencies that circulate widely outside the country of issue. Major currencies index includes the Euro Area, Canada, Japan, United Kingdom, Switzerland, Australia, and Sweden.

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