Revisiting currency

Currency in the wake of COVID-19

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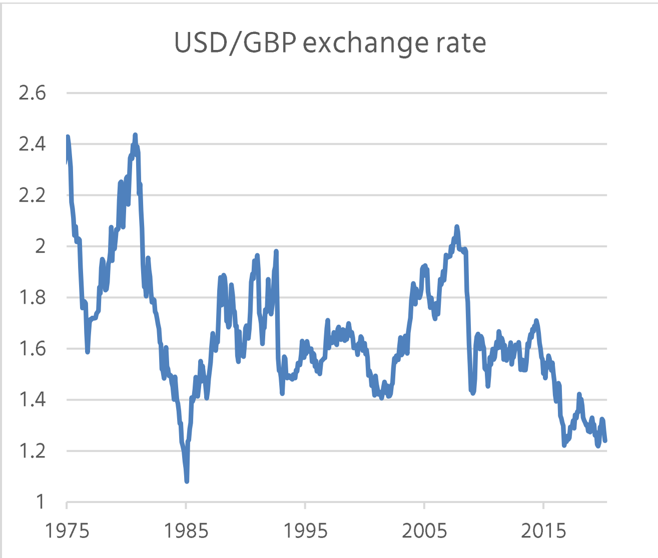
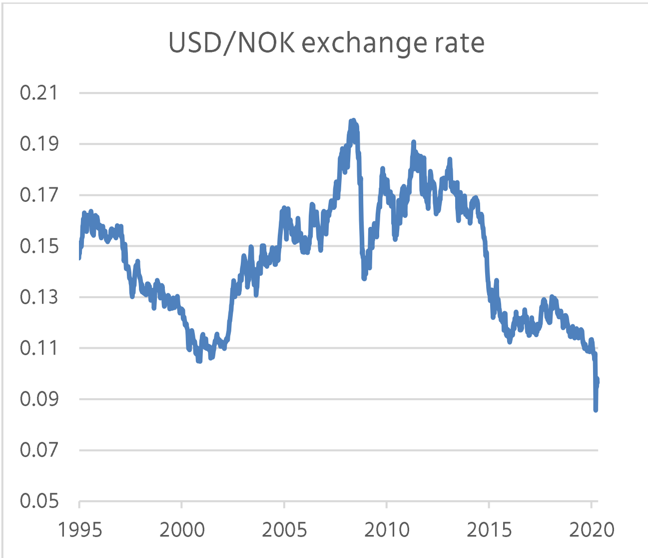
The extraordinary degrees of volatility caused by the COVID-19 pandemic led to dislocations in most currency markets, with sterling falling to levels last seen in 1985 and the Norwegian krone at an all-time low versus the US dollar[1].





Source: Thomson Reuters Datastream. Data to April 30, 2020.

As the markets entered panic mode, the US dollar and gold were the "risk off"[2] currencies of choice. We believe the main factors that influenced relative currency movements were as follows:

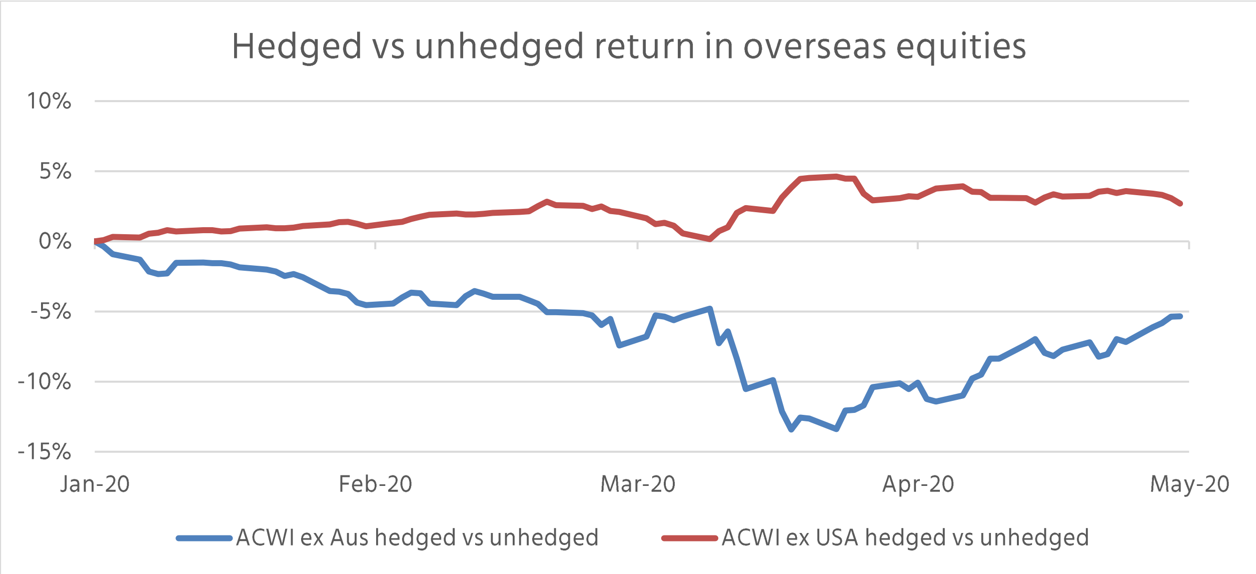
(1) Huge demand for US dollars as a safe haven asset.
(2) Currencies of commodity-exporting countries fell, as lockdown measures caused the "hard" economy and transport to slow to a crawl.
(3) Wealthy countries with significant overseas investment rushed to repatriate capital. Alongside the commodity impact above, this was strongly negative for emerging market currencies in general.

[1] The Norwegian krone is a currency that has a strong link to oil production. It suffered from a collapse in the oil market when Russia and Saudi Arabia failed to reach an agreement to curb production following the reduced demand for oil, as a result of the COVID-19 demand shock.

[2] Risk-off currencies are those that serve as safe havens when conditions are bad and equities fall.

(4) With the exception of the US, currencies of countries that announced quantitative easing packages fell (Australia announced easing a few days before New Zealand, accounting for the spike in the AUD/NZD currency pair).[3]

Many investors approach currency from the perspective of risk reduction, the benefits of which are often highlighted in a crisis. The approach taken depends on what an investor's base currency is, as can be seen by the chart below, showing hedged versus unhedged overseas equity returns for Australian and US investors during the pandemic to the end of April. US dollar investors who hedged their overseas exposure saw some cushioning of their losses, whilst Australian investors would have seen their losses magnified by hedging, potentially receiving capital calls on their hedges at the worst possible time, depending on the type of hedging arrangement. It is therefore crucial for investors to understand what the relationship between their base currency and their assets will be in a future crisis.



Source: Thomson Reuters Datastream. Past performance is no guarantee of future results.

[3] The US announced the most ambitious quantitative easing package of all developed countries but due to its safe haven status, this did not have a negative impact on global US dollar demand.

A question of "risk-on" and "risk-off"

In practice, particular currencies have clear relationships with financial markets, highlighted by the current situation and other crises. We can broadly label currencies as "risk-on" and "risk-off", that is, those that tend to appreciate in times when conditions are good for business and equities rise, and those that serve as safe havens when conditions are bad and equities fall.

There are a number of currencies that we would call "risk-off" or safe havens but their characteristics can vary to some degree. In general terms, countries with risk-off currencies tend to be wealthy, and with large amounts of capital invested abroad. When this capital is repatriated during a crisis, demand for that currency rises, as does the price. Currencies that fit that category would be those of wealthy export nations that run persistent current account surpluses and thus "export capital" in the form of foreign investments, often to fund current account deficits of other countries. The archetypal risk-off currencies of this type are the Japanese yen and the Swiss franc.

The US dollar is arguably the most important risk-off currency (61% of official global currency reserves are dollars[4]), although it does not fully follow the general profile. It tends to behave as the ultimate safe haven currency, and since the early stages of the COVID-19 crisis has acted as such. This may be surprising, given that the US has been relying on foreign capital to finance its persistent current account deficit over the last few decades.

What explains the US dollar's historical safe haven status is its status as the global reserve currency. Investors from all over the world hold the US dollar because it is widely used in international trade transactions (such as commodities), it is deemed a stable currency under the control of a relatively independent central bank, and has debt issued by a government that has one of the strongest credit standings in the world. Therefore, when markets sell off, investors often flee into US Treasury bonds, which is often a self-enforcing reaction.

Risk-on currencies can also differ but one common characteristic is often a high reliance of the respective country on one or more commodities as its primary source of economic output. The Australian dollar, for example, is considered such a risk-on currency due to Australia's exposure to commodity cycles. As a commodity exporting country, it sees much demand for its mineral wealth during an economic expansion, but similarly, when business conditions deteriorate, so does demand for commodities. As we have seen recently, this makes the currency cyclical. Yet, as the country exports a variety of different commodities and has a sizable domestic economy, it is less volatile than say the Colombian peso (Colombia also has a high exposure to energy exports).

The relationship between global equity markets and investors' base currency is therefore a critical input to the investors' currency hedge decision. It is also worth noting that history does not always repeat itself:

[4] Source: IMF, as at 31 December 2019

economic relationships change over time, and currency characteristics change too. The pound sterling, traditionally a safe haven, has behaved as a "risk-on" currency since the global financial crisis. This may reflect it being less favored as a reserve currency by central banks around the world, particularly while the UK faces continued uncertainty over its future trading relationships with the EU and the rest of the world. Over the same period, the Australian dollar's risk-on characteristics have become more muted, with lower valuations and less sensitivity to fragile "carry trade" support than seen in the global financial crisis[5]. These examples highlight the need for investors to re-evaluate assumptions on a regular basis.

Different approaches to currency

1. No action. Currency risk is accepted as part of investors' portfolio return. This might suit investors whose fixed income mandates are domestic only and therefore require no hedging, and those investors who have a risk-off base currency and are investing in overseas equities. However, investors with an unhedged policy position may still benefit from active currency management.

2. Basic/asset-class specific strategic hedging. Approaches include keeping defensive assets hedged, growth assets unhedged or partially hedged according to a "hedge ratio". Investors here sometimes implement currency hedging via currency-hedged share classes in pooled/commingled funds. Defensive assets viewed in isolation are there to reduce risk and offer relatively modest returns; with these assets, currency risk can dominate the portfolio value and so hedging is often preferred. For additional risk-off currency exposure, some investors may look at the unofficial global risk-off currency, gold.

3. Advanced strategic hedging. This is a total portfolio approach, targeting an overall foreign exchange exposure, built around multiple currency hedges versus the investor's base currency. In practice, this can be similar to the basic approach in 2. The advantage of a total portfolio approach is that investors view the effect of currency exposure on the entire portfolio value, which is usually what matters most. If implemented via an overlay program, active strategic positions can be taken, including full, partial, or additional exposures to a currency, to minimize total portfolio risk. Whilst this option could be fairly static, the position would be reviewed periodically.

4. Dynamic hedging. For investors with the governance capacity and a belief that returns can be made in the currency markets, this involves implementing an overlay, perhaps benchmarked at a 50% hedge or a full

[5] During the global financial crisis investors could borrow in yen at near zero rates and invest in Australian dollar bonds at 10 year yields ranging between 4%-6.5% (a so-called carry trade, where you gain yield, but also are exposed to the risk of depreciation of the currency you invest in, in this case the Australian dollar). This meant that there was strong demand for Australian dollars. By contrast, at the end of 2019, Australian yields were much lower, with the 10 year yield at 1.4%.
Source: https://tradingeconomics.com/australia/government-bond-yield.

hedge, with an overlay manager who is given discretion to take positions away from the benchmark. Some investors may have the ability to do dynamic hedging in-house.

5. Active currency management. This involves full active management of currency exposures for both risk and return purposes, employing multiple foreign exchange positions, including positions in currency pairs that are not an investor's base pair, for example a US investor going long sterling and short yen.

Conclusion

The COVID-19 crisis has caused huge currency fluctuations that were risk additive for some portfolios and smoothing for others. US investors may be pleased to see that their currency hedging programs recently went deep into the money or their currency-hedged funds performed better than their unhedged peers. Others may be tearing their hair out as capital calls were issued from their currency hedging programs at exactly the most inopportune time[6], or their currency-hedged funds went down significantly.

Now is a good time for investors to reassess their overall approach to currency management. Investors should consider the following items:

- What relationship their base currency has with risk assets.
- Their governance capability.
- Their beliefs about whether active currency management can reduce risk, and/or enhance returns.
- Whether they should diversify their currency portfolio both on the long and short side, and consider a more active overlay program that adds more dynamism and a deeper thought process, by considering currency as an asset class.

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[6] For currency-hedged equities, the hedge needs to be rebalanced frequently. As it may have become more costly to hedge some currency pairs, the rising costs of the hedge have to be financed by automatically selling underlying equities.

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