

INVESTMENT

Currency: The multi-tasker

Increased market volatility has sparked greater interest in return seeking currency strategies but hedging remains a significant part of currency strategy as pension schemes continue to allocate more to global equities particularly in the US

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Currency management is not a new theme for European pension funds. They have been hedging their FX exposure to global equities over the past 20 years, but more recently alpha generating opportunities are back on the table as volatility has spiked.

It certainly has been a roller coaster ride since 2020, starting with the outbreak of Covid, followed by Russia's invasion of Ukraine, a mini banking crisis in the US and the more recent war in the Middle East. FX has been caught in the crossfire as interest rates have increased to curb stickier than expected inflation, while growth in the UK and on the continent has stalled. The prevailing view is that central banks will no longer move in tandem, opening the door for return-seeking prospects.

"Central bank policy differences influence interest rates, which in turn influence currencies," says Mesirow Currency Management managing director and senior strategist, Uto Shinohara. "The

challenges lie in conditions where central bank policies are all in lockstep where there is less opportunity due to limited divergence, promoting sideways, non-trending environments. More recent divergence in policy between the Federal Reserve and European Central Bank (ECB) promote FX price movements."

"The US presidential election is another risk event on the horizon that can drive currencies, with ramifications affecting geopolitics and global economies," he adds. "These price swings reveal opportunity. The FX market is large and liquid, where the majority of market participants are not speculative but central banks and corporations trading FX as part of their operations, so less crowding."

Making predictions

One of the main issues, though, is predicting which central bank is likely to make the first interest rate cut move. This is not easy given that

forecasts have vacillated over the past two years. For example, at the start of 2024, all bets were on the US, but expectations have been pushed back as inflation climbed to 3.7 per cent, which was higher than the 3.4 per cent consensus. As a result, analysts changed their outlook from the six to seven quarter-point rate cuts to perhaps one or two later in the year. In the options markets, many participants put a probability close to 20 per cent on the next move being a rate rise instead.

The European Central Bank (ECB), on the other hand, has been making noises about June, provided there are no nasty surprises in wage or price developments. The latest set of results show that things are going to plan with inflation unchanged in April from March at 2.4 per cent. Some policymakers though are more cautious, concerned over rising energy costs and the ongoing conflicts, which threaten to disrupt shipping and push up commodity prices.

ECB President, Christine Lagarde,

encapsulated the mixed sentiment by stating that eurozone inflation is likely to decline further, and interest rate cuts are on the horizon if its long-standing price growth criteria are met. However, “at the same time, the Governing Council is not pre-committing to a particular rate path”, she said. “Risks to the inflation outlook are two-sided. Upside risks include heightened geopolitical tensions, as well as higher wage growth and more resilient profit margins than anticipated.”

Reaping rewards

Despite the uncertainty, many schemes are adding currency to the portfolio to reap the rewards. As Russell Investments global head of solutions strategy, Van Luu notes, currency return-seeking strategies are a good diversifier because they are uncorrelated to equities and bonds. He points to 2022 when there was a big sell-off in both markets, and FX was one of the few asset classes that performed well for the first three quarters of that year.

“At the moment, with interest rate differentials staying stable we believe that the carry trade, which has done quite well, will continue to do so,” he said.

One of the most popular is the yen carry trade, whereby investors cheaply borrow the Japanese currency to fund investments in higher-yielding assets, such as the US dollar. Although Bank of Japan recently intervened in the market after it plunged to a four-year low, analysts do not see interest waning in the yen/dollar trade until the Fed starts cutting rates.

Emerging markets

Emerging market (EM) currencies are also sparking interest, according to Luu.

“Investors did not look at emerging markets in the past

because of the risk but now they are taking a closer look because of performance,” he adds. “Our emerging market carry trades has risen 16 per cent over the year and they are still going strong. Some of the trades we are doing are going long on the Mexican peso and South African rand and short on some of the lower interest rate currencies, such as the Korean won and Thai baht.”

Record Currency Management chief investment officer, Dimitry Tikhonov, echoes these sentiments: “Exposures to EM currencies generate additional returns because they are exposed to faster growing economies. They also offer access to diverse economies which display different behaviours, with attractive interest and growth rates in some countries. However, you need a very

“CENTRAL BANK POLICY DIFFERENCES INFLUENCE INTEREST RATES, WHICH IN TURN INFLUENCE CURRENCIES”

disciplined approach to analysing these countries.”

This is particularly true with reverse carry trades, which are more complicated but have recently appeared on the investment radar screen given the returns have been as high as 9 per cent this year. This entails dollar bets funded by emerging market currencies such as the Chinese yuan, Thai baht, Malaysian ringgit and the Czech koruna.

Hedging strategies

Although there has been a renewed focus on alpha generation strategies, hedging remains an important part of the FX equation, especially as European pension funds have been

whittling down their domestic exposure for the past 20 years. The approach to both depends on the country, its pension fund framework and national legislation. As Tikhonov points out, active FX management is popular in the Nordic region while Swiss pension funds tend to use a passive approach. Meanwhile, the UK and Germany are interested in both hedging and active management to generate additional returns. Most Swiss and German pension funds have a regulatory obligation to hedge a certain amount of FX risk.

RBC BlueBay Asset Management senior fixed-income portfolio manager, Kaspar Hence, agrees, adding: “European pension funds are highly regulated and are only allowed to take a certain amount of risk. In the FX space, most of this comes from their exposure to global equities. If you look at the typical global FX basket, the US dollar accounts for 40 per cent followed by 30 per cent in euros, 10-15 per cent in the Japanese yen, 10 per cent in China with the rest in other emerging market countries.”

This year has been especially difficult due to the strength of the dollar. “With US investments making up the lion’s share of international allocations, euro against US dollar has a meaningful influence on the portfolio,” says Shinohara. “The swings can be large – euro weakened -20 per cent in 2021 through most of 2022, followed by an +18 per cent retracement into 2023.”

The latest figures from the European Fund and Asset Management Association (EFAMA) shows that regardless of these challenges, US equities remain the favourite. This is not surprising not only due to the increased share of US companies in the world equity index, but also robust economic growth and the leading role of its technology companies.