2020 Currency Outlook

As FX volatility reached historic lows in 2019, carry remained a major factor in currency hedging as many central banks adopted dovish policies. As 2020 begins, geopolitical matters are at the forefront as Brexit, US elections, and tensions with Iraq and China bring more uncertainty into the marketplace.

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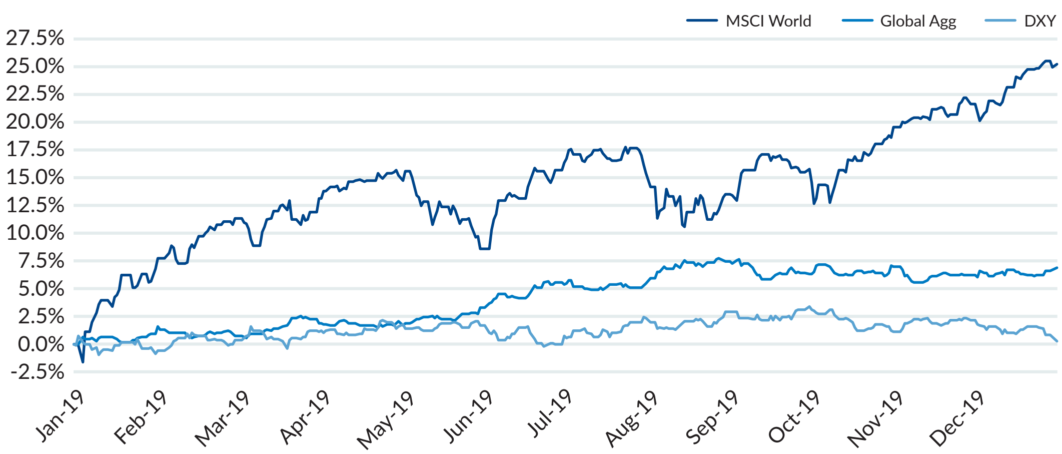
While equity and bond markets rallied in 2019, currency markets were notably quiet. The US Dollar Index moved a marginal 0.22% as currencies were range bound vs. the US Dollar throughout the year (Figure 1).

FIGURE 1: **MARKET RETURNS**



Source: Bloomberg. January 1, 2019 to December 2019. Past performance is not necessarily indicative of future results. Actual results may materially differ.

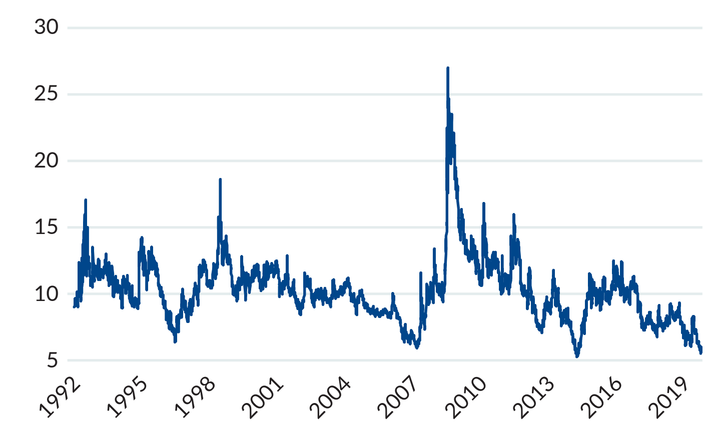
The major FX themes of 2019 centered around the political headlines of the US-China trade negotiations and Brexit, as well the dovish tilt of central banks. While these political events dictated much of the dialogue, the binary nature of their outcomes made market consensus challenging. Positive and negative sentiments were at odds, thereby muting the FX market reaction globally.

Reflecting subdued return numbers, FX volatility fell to historically low levels. The dovish tilts across central banks as global growth fell tightened interest rate differentials and forced volatility lower. One-month implied volatility for Euro vs. US Dollar, the most commonly traded currency pair in the world, reached its lowest recorded level by year-end, (Figure 2) and the JPM FX Global Volatility Index reached levels seen just three times previously over the last three decades (Figure 3).

FIGURE 2: **EUR 1M IMPLIED VOLATILITY**

Source: Bloomberg. January 1, 1999 to December 2019. Past performance is not necessarily indicative of future results. Actual results may materially differ.

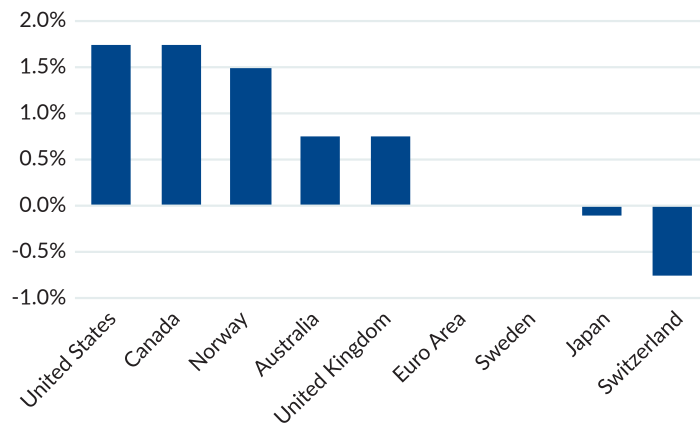
FIGURE 3: **JPM FX GLOBAL VOLATILITY INDEX**



Source: Bloomberg. April 30, 1992 to December 31, 2019. Past performance is not necessarily indicative of future results. Actual results may materially differ.

Against this low FX volatility backdrop, carry remained a major factor in currency hedging. Although central banks were broadly dovish this year, the US and Canada ended the year with rates at 1.75%, a significantly higher rate than other G10 currency pairs (Figure 4). As a result, currency hedging by US and Canadian portfolios benefitted from their higher interest rate differentials, whereas European and Australian portfolios faced a headwind, due to the cost of carry, when hedging against their largest exposure, the US Dollar.

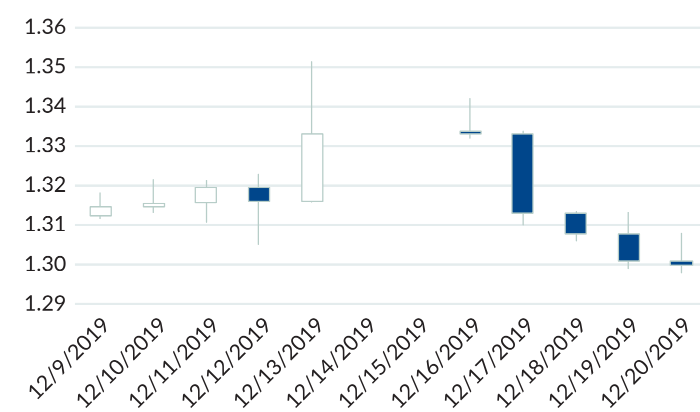
FIGURE 4: **CENTRAL BANK RATES**



Source: Bloomberg. As of December 31, 2019. Past performance is not necessarily indicative of future results. Actual results may materially differ.

As low volatility environments are reflective of smaller deviations in price, active hedging opportunities were more limited in 2019. When opportunities did occur, prices often moved suddenly and quickly following news releases surrounding day-to-day political turmoil. Sterling's December performance exemplified this behavior behind the Brexit backdrop, as strength leading up to the Tory majority in the general election on December 13th was quickly reversed as hard Brexit fears resurfaced a few days later (Figure 5).

FIGURE 5: **GBP VS. USD**



Source: Bloomberg. December 9, 2019 to December 20, 2019. Past performance is not necessarily indicative of future results. Actual results may materially differ.

While currency movements in US portfolios were modest overall for 2019, the path was far from smooth. Over the first three quarters, currencies followed a saw-tooth pattern (with a downside bias) with hedges helping to buffer the eventual decline. Q4 saw a reversal; currency gains flowed through to the portfolios partially offset by hedge positions.

For portfolios based out of Europe and Australia, the reverse was true. Currencies appreciated over the first three quarters of the year against EUR and AUD, and Q4 revealed the need for more hedging protection from the retracement towards depreciation. For Swiss portfolios, significant currency strength over the first four months allowed partial gains to flow through, followed by the benefit of hedging protection as currencies fell in late spring into summer and again in December. For Canadian portfolios, the bulk of the weakness that happened in 2019 occurred in a short-term move over the first six trading days of the year. The rest of 2019 remained predominantly range bound, with periodic bouts of weakness in early summer and in December where hedges helped cushion the drop. For UK portfolios, early weakness gave way to foreign currency appreciation as Brexit weighed heavy on Sterling. The path switched in mid-August as optimism prevailed, currencies depreciated, and hedges helped offset the weakness.

As 2020 begins, concerns over US-China trade negotiations and Brexit have given way to more pressing risks stemming from the rising geopolitical tensions in Iran, the Australian bushfires, and the US primaries and general election. While FX volatility begins the year near historic lows, each of the three previous periods that the JPM FX Global Volatility Index hovered near these levels, activity increased leading to larger price swings, increased volatility, and more opportunity for effective hedging (Figure 3). While the Federal Reserve (in December) signaled no plans to cut rates in 2020, other major regions are forecast to either cut further or remain at existing 0% or sub-zero levels.[1] Therefore, carry will remain an influential factor in currency hedging, with positive or negative effects depending upon base currency.

Happy New Year from our team at Mesirow. We wish you a successful 2020 and look forward to fostering our relationships and partnerships through our thoughtful approach to currency risk management within your international investments.

About Mesirow

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To learn more, visit mesirow.com or contact Joseph Hoffman at 312.595.7019 or joseph.hoffman@mesirow.com.

1. Source: Bloomberg, Analyst Forecasts.