
INVESTMENT

# Lessons learnt

**As the world tentatively emerges from the worst of Covid-19,** Lynn Strongin Dodds **reflects on the pandemic's impacts on currency markets and lessons learnt for the future**

**WRITTEN BY** LYNN STRONGIN DODDS, A FREELANCE JOURNALIST

Over the past three years, FX markets have had a tumultuous ride. However, understanding macroeconomic factors is one thing but navigating a pandemic is another. Suddenly traders, well versed in fundamentals, had to become armchair experts in herd immunity and vaccine rates.

"One of the issues is that the scenarios were playing out faster than anyone had imagined," Millennium Global co-chief investment officer, Richard Benson, says. "The market moved in February 2020 from one where the Fed was expected to hike interest rates to one where there was a pandemic leading to de-risking and de-leveraging and a volatility spike."

Mesirow Currency Management managing director, Richard Turner, also notes: "March 2020 was a good reminder that markets can transition very quickly between regimes, both in terms of risk sentiment and general uncertainty, leading to increased volatility. The high level of government intervention in the first few months of the pandemic also meant typical economic indicators were often too slow to capture real time effects and we found measures based on economic sentiment were more useful."

### Swift action

Many analysts believe that the swift action by central banks went a long way in mitigating some of the major concerns. They wasted no time in turning to the global financial crisis playbook, which helped dampen down volatility. Estimates are that the US Federal Reserve and its major counterparts in Europe, Japan, the UK and elsewhere pumped around USD 12 trillion into the system to offset the economic fallout of the coronavirus pandemic. They bought a bountiful array of assets and in some cases offered long-term loans to banks in a massive bout of quantitative easing.

These actions changed the rules somewhat for the so-called safe haven assets. As J.P. Morgan Asset Management FX portfolio manager and macro strategist, Neil Weller, put it, "during the initial bout of market stress in March 2020 the dollar surprisingly weakened, before swiftly recovering as it regained the role of a global safe haven asset. The initial underperformance reflected the unusual rise in US yields, where bonds briefly failed to act as a safe haven amid a liquidity driven squeeze on all asset prices".

He says: "The role of the dollar as a safe haven asset is important for investors considering their strategic currency hedging approach, and doubts about the reliability of the correlation between bonds and equities could argue for lower FX hedge ratios on foreign holdings of US assets going forwards."

Russell Investments global head of currency, Van Luu, adds: "In the beginning of the pandemic, the safe haven currencies did benefit from risk aversion, but it was brief. The US Fed, Bank of England and Bank of Japan moved quickly which calmed markets down and added liquidity."

### Pandemic influence

One difference between the financial crisis and the pandemic is that the health of nations and not just their respective economies were brought into sharper focus. Traders turned their attention to any correlations between inoculations and currencies for trading signals.

A so-called vaccine spread trade emerged that rewarded those countries with the fastest vaccination programme. The thinking at the time was that defeating the virus was a prerequisite to a country reinvigorating its economy and thereby bolstering its currency.

For example, Australia's dollar took a dive versus its New Zealand counterpart in February 2021 after Germany cast doubt on the effectiveness of AstraZeneca's Covid-19 shot, which formed part of Australia's vaccination programme.

Britain's pound was particularly sensitive as the country was among the hardest hit with one of the highest death rates. Its inoculation progress offset elevated case rates propelling the pound to new heights while the European Union's chaotic distribution weighed heavily on the euro.

Sterling started 2021 bumping along the bottom as one of the weakest currencies in the G10. However, there is no doubt the currency got a boost due to the success of the vaccination rollout.

Emerging market currencies fared much less well as traders raised concerns about the progress in different regions, sending red flags over the Singapore dollar, Malaysian ringgit and Indonesian rupiah.

Now that the dust has settled, "the linkage between these economic effects and foreign exchange rates is a little weaker, as the stimulus responses varied quite widely between countries," says Turner. "But in general, in the first Covid-19 waves currencies depreciated as the number of cases was peaking and then recovered once cases began to fall."

Although vaccination rates were important, many analysts believe economic drivers were equally as important. For example, the dollar, which was on the other side of the euro and sterling trades, defied expectations and held its own. This was more to do with the resilience and diversity of the economy because responses to the pandemic varied across the country.

"FX markets did at times respond to the daily updates to Covid-19 statistics, but only during a few periods of acute focus on differing speeds of vaccination or differing policies on lockdowns," says Weller.

Trium Capital global macro portfolio manager, Peter Kisler, also notes that the pandemic triggered economic activity that was not expected. "For example, some countries benefitted from higher consumer spending as people turned to online shopping while others were hit by supply chain issues. Also, commodity producing countries had an advantage although they were hurt by the stronger dollar."

**"THE PANDEMIC IS NOT OVER YET, WE ARE STILL SEEING LOCKDOWNS HAVING AN EFFECT IN CHINA, FOR EXAMPLE"**

Turner adds: "Obviously, each country is unique in terms of its economy, demographics, the severity of the Covid-19 outbreak experienced and the response." He cited the firm's white paper, *Covid-19, Economy and FX: Past, Present and Future*, which shows that countries where services accounted for a higher proportion of the economy experienced a greater economic shock due to lockdowns than those where manufacturing comprised a greater proportion of the economy.

"Intuitively you would expect this, as service industry relies more on interpersonal contact, and it is borne out by the data," he says. "Also, countries that had strong border controls such as New Zealand and Australia, were also able to recover faster after the initial economic shock."

## Looking ahead

Looking ahead, Mesirow's white paper shows that the economic effects of future Covid-19 waves would expect to be less pronounced in countries that have a good proportion of the population vaccinated and for Covid-19 to not be such a strong driver of foreign exchange rates for these countries going forward, according to Turner.

"However, the pandemic is not over yet, we are still seeing lockdowns having an effect in China, for example, and the secondary economic effects of the pandemic, with supply chain disruption persisting and the increase in money supply from government stimulus driving inflation, are likely to persist throughout 2022," he adds.

Weller believes there will be a greater focus on the pandemic's lasting impact on global trade, causing major disruptions to globalised supply chains amid heightened demand for consumer goods. "Going forward, there is debate about whether we have passed peak globalisation as focus has shifted towards supply chain resilience, potentially offering some support for 'near-shoring' currencies, such as the Mexican peso," he adds.

Lessons have also been learnt about having the right data and risk management controls in place. "The foreign exchange market is constantly evolving, and the models need to keep up," says Turner.

Not surprisingly, for now, Covid-19 albeit lurking in the background, has taken a back seat to the tragic events in Ukraine and the reverberations it is having across the world in terms of supply side disruption, higher interest rates and soaring commodity prices.

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