All Quiet on the Currency Front, But For How Long?

PERSPECTIVES ON CURRENCY RISK FROM BNY MELLON INVESTMENT MANAGEMENT

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EXECUTIVE SUMMARY

Currency markets have been relatively free of volatility recently, but currency risk has been and remains an important consideration for global investors. In recent months, several episodes of currency volatility have raised concerns about whether the calm conditions may be changing. Many investors believe the perceived current account exposure to foreign exchange moves was a primary cause of the emerging market rout in the summer of 2013. At the start of this year Chinese authorities introduced two-way risk into trading of the renminbi, wrong-footing many market participants in the process. Already, markets have observed currency as the transmission mechanism for political risk events in Russia, Brazil and Turkey, to name a few. Looking forward, interest rates have been so low around the world that the choice of funding currency has not mattered much for carry trades. But the anticipated tightening from the Federal Reserve and the Bank of England will likely raise developed-market currency risk, and will most likely increase the risk in emerging market currencies.

We recently surveyed our dedicated currency experts from across our global investment affiliates for their views on the prospects for currency risk and how investors might consider managing their currency exposures as monetary policies across developed economies begin to diverge.

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RENEWED VOLATILITY?

Our experts agree that low volatility in currency markets is unlikely to be with us much longer. Jack Malvey, chief global markets strategist at BNY Mellon Investment Management, describes the current environment as a "mid-cycle volatility void" and says that this type of calm period has historically lasted anywhere from one to five years. Constantine Ponticos of Insight Pareto agrees that change is on the way. "We're in a holding pattern. Over the past 18 months, we've seen visions of how the return of volatility might play out, but we're waiting for divergence in monetary policy to be the trigger. Where we've seen markets begin to price in divergence, we've seen volatility as we saw briefly in emerging markets."

Simon Derrick, chief currency strategist at BNY Mellon Global Markets explains the forces that have kept volatility quiet. "Over the last few years, in a low rate environment, investors have been hunting for any place they can find yield. One of those places has been the selling of currency options. Typically, this leads to lower volatility and option prices and when coupled with low interest rate differentials it can lead to an extremely quiet trading environment."

Now, Derrick believes that investors are becoming increasingly aware of how stretched risk appetite has become. "Less than two years ago, Greece appeared on the verge of leaving the euro. Now people are lending it money." Malvey concurs that risk-taking is back. "I think it's a standard cyclical thing that's manifesting itself in a grasp, or what I'd call 'gasp' for yield that's prompting some people to do desperate things and taking on more risk while claiming they learned their lesson from 2008-9."

Derrick says the impact of the Federal Reserve's stance on monetary policy cannot be underestimated. "Investors were concerned that the scaling back of asset purchases by the Federal Reserve would lead to a significant rise in volatility. However, the slow pace of tapering combined with repeated hints that interest rates will not start to rise until the summer of 2015 at the earliest have soothed these concerns. As a result, the risk is that the current low volatility environment could last until next year."

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Other experts agree that central bank policy will largely determine when volatility returns to currency markets. Paul Brain, head of fixed income at Newton explains that "for a long time, the zero-rate policies of the Fed, the European Central Bank and the Bank of Japan have meant we've not seen very much volatility. The various currencies move around but the direction has been more or less sideways. We could see the beginnings of divergence in interest rate paths over the next 12 months and maybe the U.S. economy will be stronger over the next 12 months than the eurozone or Japanese economies."

> "The same factors that drive currency volatility drive volatility in other asset classes."

Constantine Ponticos of Insight Pareto says, "Divergent monetary policies and interest rates are major sources of currency volatility. Looking forward, one can easily imagine volatility from rate curves feeding into the currency market. Currencies that are further from what the market views as fair value will probably see these moves amplified. In addition, as we are contemplating an environment of policy tightening, economies that have current account deficits will potentially be required to offer higher risk premia."

Federico Garcia Zamora, Senior Portfolio Manager of Currency Strategies at Standish Mellon Asset Management says that the course of QE tapering and policy changes from the European Central Bank could also generate market-moving surprises. "Those sorts of surprises can move one pair of currencies and that could create a spike of volatility that would cascade across a lot of other currencies. The same factors that drive currency volatility drive volatility in other asset classes. These include geopolitical risk, mistakes in the process of normalizing monetary policy and unknowns emerging from China's shadow banking system."

Derrick draws parallels between the situation now and the one that existed prior to the global financial crisis. "The market has looked very similar to 2007 in terms of the options market and in currency pairs in terms of yield chasing and risk taking. Option prices have recovered marginally, but they're still extremely cheap by historical levels and compared to the last 15 years, they're still implying that the next year will be quiet. I don't think that's likely. Historically when options are at these sort of lows, markets typically return to normal prices six to twelve months later."

HEDGING CURRENCY RISK

The impending return of currency volatility creates risk for investors, especially those with large fixed income allocations. Zamora says those investors are more aware of currency volatility than they were before the crisis and are looking more for hedged solutions than they used to. "Fixed income investors should consider hedging 75 to 80 percent of their portfolios. Doing so may provide a strategic fixed income investment with a much higher Sharpe ratio than an unhedged fixed income portfolio. Short-term investors are more likely to hedge as much as possible, while longer-term investors can tolerate more volatility." He advises fixed income investors to think carefully about their time horizons and investment objectives in order to select the most appropriate strategies for increasingly volatile currency environments. For some investors, Zamora says, currency presents an opportunity for return as well as a risk to be managed.

"The objectives of managing risk and seeking alpha are very different," he says. "We believe currencies should be managed actively and used as relative value opportunities." Ponticos also emphasizes the importance of active management. "We have always held the view that currency exposures represent a largely unrewarded risk that needs to be managed directly," he says. "Although we view this as axiomatic, we think this is a particularly dangerous time to be complacent about currency risks. Investors should satisfy themselves that they are comfortable with their currency stance ahead of the start of monetary policy normalization."

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Brain agrees on the effectiveness of hedging to manage risk, but he also looks to take positions in currencies, either from an absolute perspective or against an index by looking to have a different currency position than the index itself. He says Newton looks at the direction of currencies to add value, rather than using volatility itself as a pure source of alpha. "We think that currency markets are driven by fashions that change over time. At one point we may follow the carry trade; at another we may follow the current account deficit trade. We may also look at capital flows and central bank intervention." Brain notes that the direction of these markets has been hard to judge over the past few years, but says that, "If you don't have a view on the direction of foreign exchange markets, you shouldn't be playing. The fundamentals that should have been driving foreign exchange haven't always worked over the past few years. Until we have clear interest rate differential or growth differential, we won't see more established trends."

FURTHER DOWN THE ROAD

All of our experts emphasize that while predicting long-term behavior of currencies is difficult, certain secular trends bear watching for their potential impact on currency. Brain says political uncertainty could creep into the sterling trade not only due to the Scottish referendum but also the upcoming U.K. election, which could challenge the existing coalition. Looking further ahead, he says, "We're going to see economic and interest rate divergence building over the next couple of years which might lead to some opportunities. Within that opportunity set, we might see EMs, especially in Asia, come back more into play. Since 2008, we've seen major currencies not move much against each other, but there has been more opportunity among the minor currencies. There are always surprises though."

In Derrick's view, the biggest long-term question is what China will do with its currency policy. "China has been its own worst enemy in reform and has accumulated huge foreign currency reserves. That matters because China is earning very modest (at best) returns on those reserves and the government has to fight intermittent bursts of inflation when the U.S. changes monetary policy. China is keen to liberalize its currency policy and interest rates. A free-floating currency and liberalized capital account would reduce China's need to intervene frequently to manage its currency. If it needs to intervene less, it doesn't have to put some of those reserves into non-U.S. currencies such as the euro and Canadian dollar. China's reserve buying has kept currencies such as the euro stronger than they would otherwise be. As China's policy changes, the value of the euro and other non-U.S. currencies will decline, though not collapse, resulting in higher borrowing costs and less valuable currencies for developed countries."

Ponticos says that a lot of unknowns exist around the tapering of QE. "It won't be a smooth ride. I hope the bumps won't be big enough to derail the train, but we don't know where they will be."

Malvey points out that if currencies blow up, there will likely be a lot of other things blowing up in investors' portfolios at the same time. He cites potential sources of disruption as geopolitical risk, the aging of the business cycle and demographics. "There are also unknowns that materialize out of thin air, such as Crimea and resurgent nationalism in Europe," he says. "There could be unforeseeable events that are idiosyncratic to currency markets, but it's more likely that a surprise would be felt more widely. Investors should make sure they spend as much time on risk management as on anything else they do in their portfolios."

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Derrick also takes an expansive view of where trouble may lie further down the road. "My biggest concern is that over the course of the last 30 years, we've moved through booms and busts, driven partly by the Fed's asymmetric response. It has been hesitant to deflate bursting bubbles and very wiling to jump in to clean up after the bubble bursts. Fed action has managed to reinforce the expectation that they will always clean up burst bubbles. I'm hoping we're not still locked in this pattern. We're seven years removed from the previous peak and I'm concerned that we may be approaching another one."

All of our experts agree that the current benign conditions can't continue. The systematic selling of volatility will eventually end, either in a gradual rise in implied volatilities, or in a calamity. Diverging monetary policies will reverse or at least erode some carry trades and it is not clear that markets fully anticipate that eventuality. After a very good run since the financial crisis, asset markets may suffer reversals. Those reversals could also ricochet through currency markets, impacting clients' portfolios in unpredictable ways.

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