BNY MELLON INVESTMENT MANAGEMENT

Rethinking Currency Risk Amid Renewed Dollar Strength

Executive Summary

For as long as the US dollar was declining against major currencies, US investors with international exposures were less concerned with hedging currency risk, as the lower dollar often actually enhanced their total return. But following the nearly 13% rise of the US dollar in 2014, many institutional investors are beginning to rethink their views on currency hedging and the potential portfolio losses a stronger dollar could pose. And according to BNY Mellon's currency experts at Insight/Pareto, last year's biggest gain in the dollar in 17 years could be just the beginning of a multi-year period of growing dollar strength. Far from an impending correction, Insight/Pareto Currency Head Paul Lambert argues that a combination of strong US economic growth, lower energy prices, and weaker growth in Europe and Japan could lift the dollar much higher.

Since the end of the Bretton Woods system in 1971, he points out, the average dollar bull market has seen the dollar index rise by roughly 20%, suggesting the greenback has significantly more room to run.

In the attached commentary, Lambert describes how the macro stars are aligning in favor of a secular bull market for the dollar – a compelling set of UBPs (unique buying points) for the USD – and why institutional investors might want to reconsider that uncompensated currency risk lurking in their international portfolios.

Overview

Investors can view dollar strength as an opportunity to be exploited via a currency alpha strategy or a risk to be hedged. Either way it cannot be ignored: doing nothing is not a strategy. Our view is that the dollar strength we have seen so far is just the start of a secular trend and one which could persist for years to come. There will inevitably be periods when the dollar suffers reversals. But we believe investors should get used to a strong dollar and what it means for their portfolios.

Marketers coined the term unique selling point in the 1940s. It was designed to build brand value by indicating a clear point of differentiation. Currencies are the fast moving consumer goods of financial markets. $4 trillion each day is traded in the global foreign exchange market and to take a position an investor must differentiate one currency from another.

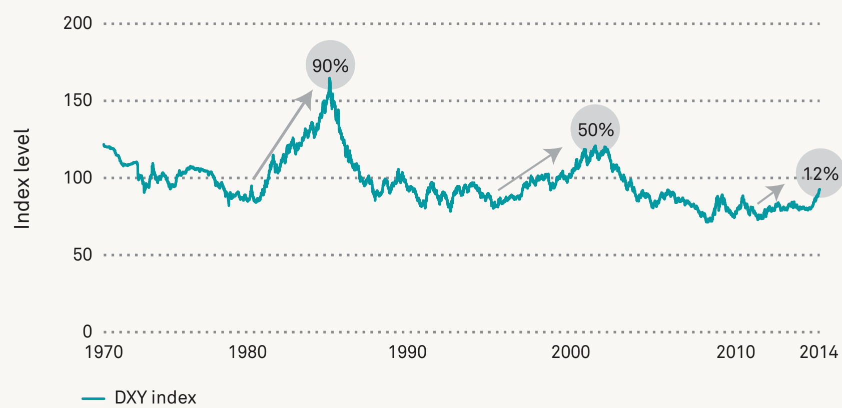
The starting point is often a view on the US dollar (USD), the world's reserve currency.

On a trade weighted basis the DXY (dollar) index rose by 12.8% in 2014, the biggest annual gain for 17 years. It has added a further 2% so far in 2015. Whenever a market rallies naysayers begin to predict a correction. Talk of crowded trades and consensus positioning fill the headlines. Every dip is regarded as the beginning of a correction. For the USD we do not believe this to be the case. There is a sound case that this is not even the end of the beginning. The dollar could be set for a multi-year secular bull market.

Since the end of the Bretton Woods system in 1971 the average dollar bull market phase has seen the DXY rise by approximately 20%. This rally has a fair way to go to be boringly average. The really big moves in the dollar have been far more dramatic. When Paul Volcker's Federal Reserve (Fed) was hiking interest rates to 20% to tame inflation in the early 1980s, the dollar almost doubled. More recently, at the end of the 1990s, the DXY rose by 50%.

The important thing to note about these secular bull markets is that they played out over long time periods, around five years in each case. The current dollar rally began only last summer. The DXY has traded in the 80s for the past six years, but was 50% higher in 2001/2 and more than double that level for a brief period in the mid-1980s. Having broken into the 90s at the very end of 2014 it seems premature to call time on this bull market. It may well have legs and if history is a guide run for a while yet. A decisive break above 90-92, the peak since 2004, would be the next landmark.

FIGURE 1: HISTORY OF DXY INDEX PUTS CURRENT RALLY IN CONTEXT



Source: Bloomberg as at December 31, 2014.

American exceptionalism

Though the drivers of exchange rates have long been debated by academics and market practitioners, few would argue with the basic premise that over the long-term economic fundamentals play a role along with interest rates, current account flows and perceptions of sovereign risk. Put simplistically, currency valuation is like a school report for an economy: a reflection of its credibility and soundness in the eyes of investors relative to its peers. By most measures the US looks like an "A" grade student.

December's non-farm payrolls figure saw US job creation in 2014 hit 2.95 million, the biggest growth in labour markets since 1999. The unemployment rate fell to 5.6%. That is lower than the average of 6.2% over the past 40 years. Five years of economic expansion has created 10 million new jobs. Third quarter US GDP growth was revised up to an annualized rate of 5%, the strongest reading since 2003.

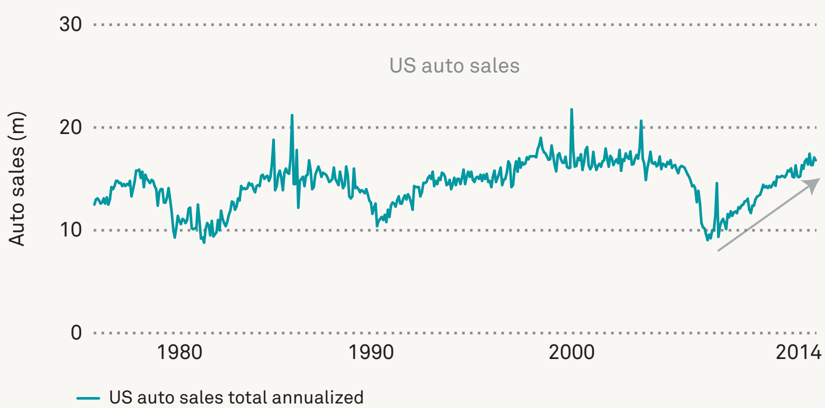
By contrast the Japanese economy slumped back into recession in the third quarter and the eurozone hobbled anaemically along, recording 0.2% growth, according to government figures. Official statistics showed the UK grew at an annualized rate of 2.8% in the third quarter. The World Bank expects growth in the US to reach 3.2% in 2015, versus 1.1% in the euro area, 1.2% in Japan and 2.9% in the UK. In short, we believe the US is the star with growth expected to outstrip both other high income economies and the global average of 3%. The average US growth rate over the past century is 3%.

Economic forecasting is an inexact science but there are sound reasons to believe above trend growth is attainable in 2015. The US economy is relatively immune from travails elsewhere. Exports make up only 14% of GDP. The equivalent figure for Germany is 51%, according to the World Bank. Lower oil prices are very supportive of US growth and will likely offset the effect of the stronger dollar.

The US spends $400bn on oil so the saving to consumers from the collapse in oil prices is around $150bn. Spending on energy represents a far larger part of the household budget for low income families, therefore falling prices disproportionately raise their real incomes. That money is likely to be spent rather than saved.

Deleveraging is also more advanced in the US than elsewhere with total household liabilities around $500bn below the cyclical peak of 2008. Lower interest rates have led to significant mortgage refinancing and household debt service levels are back to 1990s levels. There is potentially pent up demand in the US. For example, the average car is now 11 years old, compared to 6.5 in 1990. Car sales are now running at 17.2 million per month and GM CEO Mary Berra expects motor sales in 2015 to return to heights not seen since 2001.

FIGURE 2: US REAL ECONOMY REVS UP



Source: Bloomberg, as of July 1, 2014.

The great divergence

The robust health of the US economy is beginning to feed through to policy. In October the US Fed announced an end to its $85bn per month asset purchase programme. Its balance sheet is now $4.5 trillion. The Bank of England was the first central bank to have stopped quantitative easing: it has held its balance sheet at £375bn ($566bn) since the end of 2012. But the contrasting economic fortunes of the eurozone and Japan mean that more easing is on the way there.

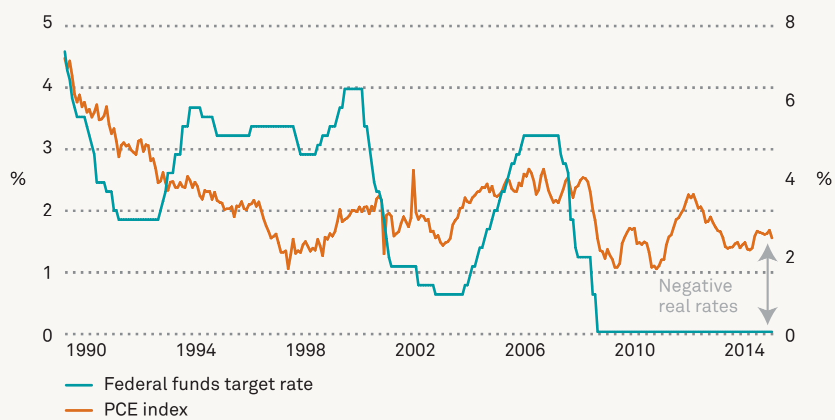
In Japan, Abenomics is already pushing the limits of central bank monetary experimentation. The Bank of Japan (BoJ) announced in October it will purchase ¥80 trillion ($339 billion) of Japanese government bonds a year, together with increased purchases of exchange traded funds and Japanese real estate investment trusts. Even before this announcement the BoJ's balance sheet represented more than 50% of Japanese GDP compared to around 25% for the US Fed and Bank of England (BoE).

The European Central Bank (ECB) has also announced plans to boost the size of its balance sheet from €2 trillion to €3 trillion. It has said it will do this with a combination of purchasing covered bonds, asset-backed securities and sovereign debt, as well as the provision of long-term funding for banks.

The end of quantitative easing (QE) in the UK and US, its inception in Europe and increase in Japan, marks the beginning of clear policy divergence in the G4. But it may not end there. In previous cycles, at these levels of employment and growth, the Fed and BoE would have been raising interest rates already. Of course, the aftermath of the long recession and Global Financial Crisis do argue for a different policy response. Low inflation also buys policymakers breathing space.

But there is no doubt that monetary policy looks extremely accommodative in the US. The Fed's preferred measure of core inflation is the PCE (Personal Consumption Expenditures, which excludes energy and food) index. The Federal funds rate has been held below PCE since 2008. In other words, real short-term rates have been negative for six years. This is highly unusual relative to history.

FIGURE 3: LONG PERIOD OF NEGATIVE REAL RATES HIGHLY UNUSUAL



Source: Bloomberg, as of January 1, 2015.

The US economy has experienced five years of impressive expansion in both growth and employment. This brings the day that policy rates rise ever nearer. In 2015 it could come sooner rather than later, in spite of the benign inflation outlook. A rise in Fed funds rate would make the policy divergence between the US and the rest of the G4 even more explicit and give the dollar a further boost.

The strong dollar is also a safety valve for the rest of the global economy. Japan and the eurozone want currency weakness because monetary policy is all but played out. In Europe, QE is the last roll of the dice. What has become increasingly clear is that the credit transmission mechanism is broken. Banks spent 2014 building up their capital ahead of the ECB's stress tests and Asset Quality Review. 2015 promises more of the same as Basel III's minimum capital requirement and Liquidity Coverage Ratio are introduced.

While policymakers in Europe, Japan and many emerging markets are using currency weakness as a policy tool, US assets are looking more attractive. At the height of recession the US budget deficit was -10% of GDP. That has fallen to -3%. And though the US is still a net importer of oil (which means the falling oil price is a positive terms of trade shock) lower levels of imports are helping the current account.

The US has increased its production of oil from 5.5 million barrels per day five years ago to around 10 million. The current account deficit as a percentage of GDP has fallen from a peak of 6.5% at the end of 2005 to 2.3%. This is the mirror image of what happened in China over the same period as the real value of its currency increased. China's current account surplus peaked in 2008 at more than 10% of GDP and has since fallen to 1.9%.

Viva vol

The strong dollar theme was the big change in currency markets in 2014. It may also foreshadow a period of higher volatility. One of the by-products of coordinated macro policy has been a remarkable bear market in volatility. The early summer of 2014 just before the DXY began moving upward felt eerily like the run up to the 2007 credit crunch. The Vix index was trading barely in double digits and carry trades (high yield debt, cov-lite, PIK bonds) were all the rage.

Since then US high yield has sold off, the oil price has collapsed and emerging market assets have taken a battering. The Vix index is trading above its long-term average of 20. In an era of central banking when transparency and the clear articulation of policy have been the norm, the Swiss National Bank (SNB) rudely reminded investors of the capacity to shock. The unilateral decision to abandon its Sfr 1.20 cap against the euro in January led to an intra-day appreciation of 39% against the euro and the biggest one-day move in any G10 cross in the post Bretton Woods era.

In our opinion, the multi-decade lows that FX volatility hit last summer looks to be in the past. When most of the G7 are pursuing the same policy of zero interest rates, there are no interest rate differentials to trade and no carry. Relative interest rate volatility is now picking up and so is volatility in currency markets. That is an inevitable by-product of macro divergences in the global economy.

Though the SNB caught the markets by surprise the harbinger of increased volatility has been emerging markets. In 2014 the Russian rouble fell 42%, Argentine peso 24%, Hungarian forint 16%, Colombian peso 16%, Chilean peso 15% and South African rand 10% against the dollar. As well as diverging economic fundamentals market structure is also likely to play a role. The willingness and ability of banks to take risk has been severely curtailed by new capital requirements and the Volcker rule in the US. Increasing volatility and periods of rising risk aversion also tend to be positive for the dollar.

Investors can view dollar strength as an opportunity to be exploited via a currency alpha strategy or a risk to be hedged. Either way it cannot be ignored: doing nothing is not a strategy. Our view is that the dollar strength we have seen so far is just the start of a secular trend and one which could persist for years to come. There will inevitably be periods when the dollar suffers reversals. But we believe investors should get used to a strong dollar and what it means for their portfolios.

Find out more

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