BNY MELLON INVESTMENT MANAGEMENT

The Case for Currency in 2015

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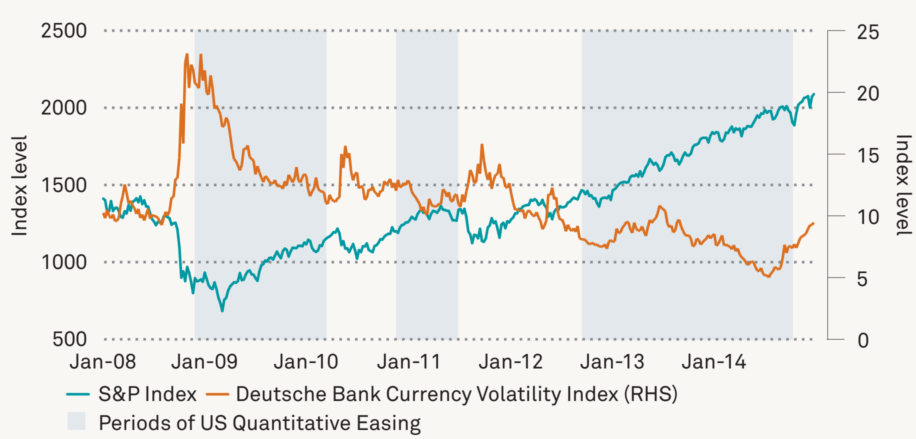
Overview

Currency market volatility has started to pick up and the normalization of monetary policy in countries such as the US and UK should mean there will be further volatility to come, providing attractive opportunities for active currency management.

The years following the financial crisis have been difficult for currency investors. The prolonged period of zero or near-zero interest rates, particularly across the G7 economies, has meant little carry is available in currency markets relative to other asset classes and interest rate differentials have all but disappeared. Liquidity in currency markets has been squeezed further by the Volcker rule, a new regulation designed to curtail the activity of bank proprietary trading desks. As a result, volatility in currency markets has steadily fallen, reaching multi-year lows in mid-2014, further curtailing opportunities for active currency investment.

In August, we predicted that this perfect storm of depressed volatility, minimal carry and low interest rate differentials could not persist forever and that volatility would start to increase. We believed that the catalyst would be the US Federal Reserve ending its bond-buying program, the first step towards the normalization of monetary policy, which could potentially lead investors to start to price in the rate-hiking cycle.

FIGURE 1: QE, CURRENCY VOLATILITY AND THE S&P 500



Source: Bloomberg as of December 31, 2014.

Please note the value of investments and any income from them will fluctuate and is not guaranteed (this may be partly due to exchange rate fluctuations). Investors may not get back the full amount invested.

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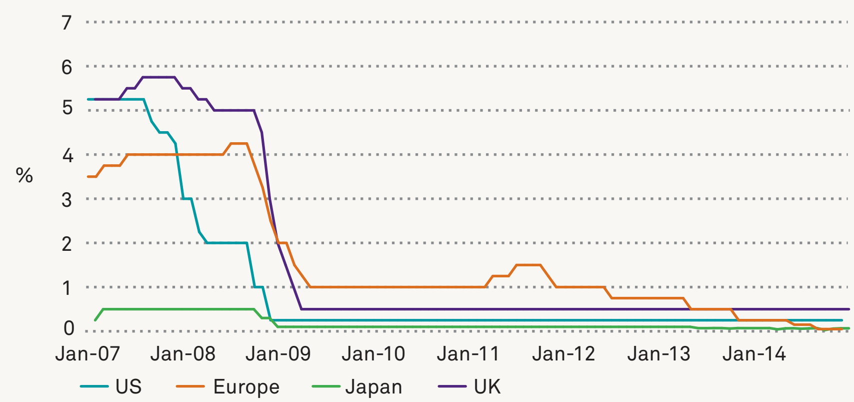
Currency market volatility did indeed pick up in the final months of 2014, but not for the reasons we expected. Instead, markets were influenced by a number of factors. Weaker economic data from Europe and China sparked concerns about global growth slowing, causing sharp moves in bond markets in October. The steep fall in the oil price had a dramatic impact on oil-producing nations, particularly Russia. Emerging market assets suffered in the resultant sell-off of risk assets.

Meanwhile, a divergence in G4 monetary policy was developing: while the Fed was winding down its quantitative easing program, the Bank of Japan and the ECB were scaling theirs up. The resultant increase in volatility has improved conditions for currency investors, but we believe that there will be even better opportunities to come.

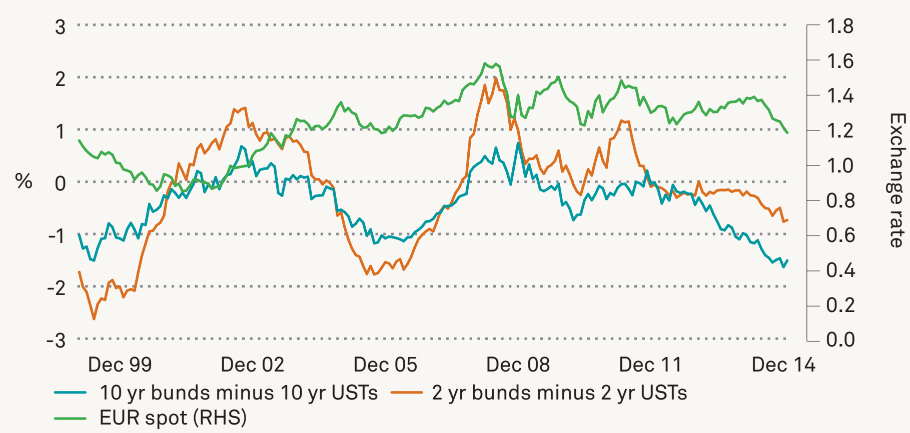
FIGURE 2: SHORT RATES IN EUROPE, US, UK AND JAPAN



Source: Bloomberg as of December 31, 2014.

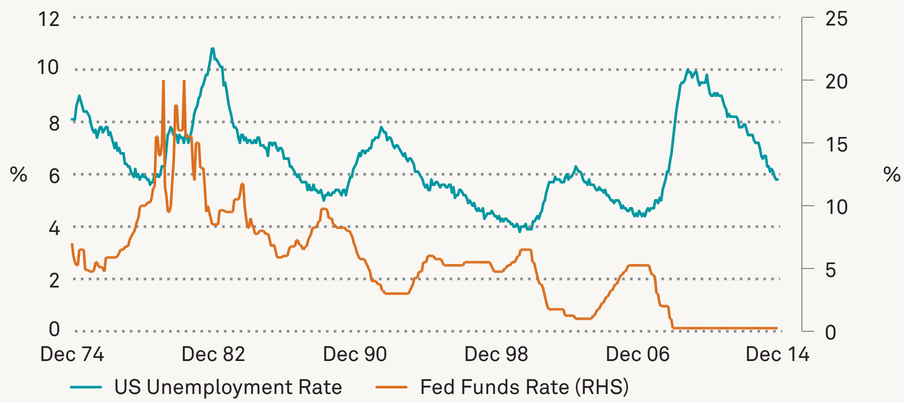
While markets have absorbed the end of quantitative easing in the US, they are yet to start pricing in a normalization of the interest rate cycle. The Fed funds rate has been at zero since December 2008 at the height of the global financial crisis and QE has started and stopped in the context of a large output gap in the US. The output gap now appears to be much smaller. We are now at a point where, historically, the Fed would be raising rates and raising them from a far higher level than they are at now. The same could be said for the UK and, arguably, Canada. Once short rates start to rise, relative interest rate volatility should possibly start to pick up, further boosting volatility in currency markets. This scenario could possibly provide attractive conditions for active currency investors.

FIGURE 3: RATE DIFFERENTIALS – KEY DRIVER OF CURRENCIES



Source: Bloomberg as of December 31, 2014.

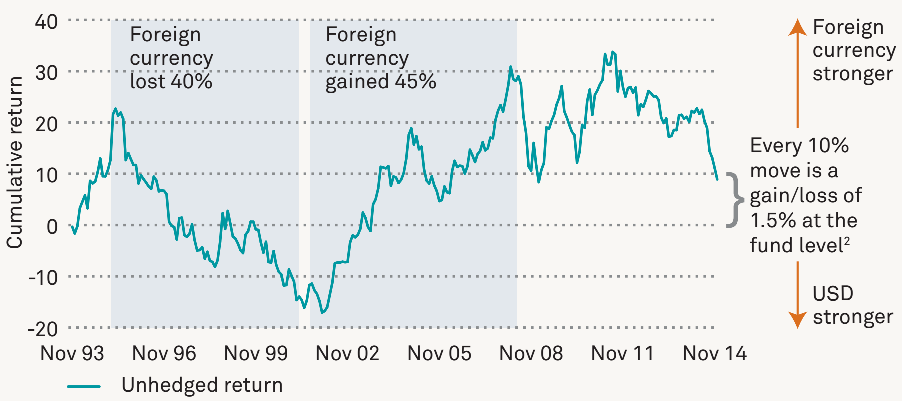
FIGURE 4: IN OUR OPINION THE FED CANNOT DELAY TIGHTENING FOREVER



Source: Bloomberg as of December 31, 2014.

A return of volatility to global currencies could also carry a risk for international investments as currencies de-couple and return to the pre-crisis pattern of large extended moves. During the decade of the 1990s, US investors with a typical developed market allocation saw foreign equity returns eroded when translated back to the US dollar. For a multi-year period in the 2000s until 2008, dollar weakness was a benefit to the international allocation. The post 2008 period of low volatility ushered in the recent range for currencies.

FIGURE 5: US DOLLAR IMPACT OF BASKET OF DEVELOPED MARKET CURRENCIES[1]



Source: Insight Pareto. 1Monthly data from November 2, 1993 to December 31, 2014. 2 For a fund with 15% allocation to international.
Currency contribution to returns for US investor with typical developed market allocation; does not reflect interest rate differential. A typical US investor developed market allocation is comprised of currencies from Euro Region, United Kingdom, Japan, Switzerland and Australia.

Summary

While it is hard to think of a time when things could have been much worse for currency management on an absolute and relative basis, we believe now is not the time to chase returns from asset classes that have been artificially buoyed by QE. On the contrary, the need to diversify could prove to be paramount in the months ahead, including protection of some of the foreign currency gains achieved from a Fed policy induced weakening of the US dollar.

Find out more

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