December 2014

Investment Publications Highlights

Why Currency-Hedge Foreign Developed Equities?

Jeremy Schwartz and Christopher Gannatti, *The Journal of Investing*, Fall 2014

Currency hedging is not as costly as many investors think, and interest rate differentials between the US and developed economies may actually lead to income-generating currency hedged investment strategies. With the potential for a US dollar secular rally on the horizon, investors should consider hedging their currency exposure in other major developed markets.

Investors in foreign equity securities often assume a secondary currency exposure on top of local returns. This currency exposure can increase or decrease returns depending on whether the foreign currency is appreciating or depreciating against the investor's base currency. Investors without strong convictions on the possible directions of currencies could benefit from hedging at least a portion of their exposure.

Schwartz and Gannatti believe the possibility of a long-term secular trend strengthening the US dollar provides further incentive to avoid taking on currency exposures of major developed markets. With the European Central Bank (ECB) and Bank of Japan (BOJ) maintaining interest rates near zero, and the possibility of the US Federal Reserve raising rates, US investors could receive the relative interest rate differential to hedge foreign currencies, allowing them to earn income while also reducing a potential source of risk from their portfolios.

The authors lay out several common myths about hedging foreign currencies that can lead investors to shy away from hedging strategies. The first myth is that hedging foreign currencies is expensive. While true for certain currencies—those with high short-term interest rates—for developed markets with low interest rates, hedging currencies is generally not expensive. In fact, the costs for hedging the euro, pound, and yen are quite low.

The second myth common to hedging is that adding euro or yen exposure on top of US dollar returns can be a hedge against a declining US dollar, helping to maintain the purchasing power of the dollar. The euro and yen are not always a good hedge against high US inflation rates and the declining purchasing power of the US dollar, as seen during the high inflation period of 1978–85 when major foreign currencies depreciated versus the US dollar.

A third myth is the argument that currencies offer no expected returns in the long run, as purchasing power parity adjusts exchange rates so that goods and services are comparable among countries. While this may theoretically be true, in practice the volatility of currency exposure can be undesirable for investors. As there is no expected return for assuming currency risk, there is little argument against hedging this risk.

In this period of low short-term interest rates, the arguments for not hedging currency exposure are more difficult to justify. Hedging strategies are currently inexpensive, and given a Fed rate hike, could generate income for US investors. The potential for a secular US dollar rally grants investors further incentive to hedge at least a portion of foreign currency exposures.

The New Rules for When to Hedge a Currency

Collin Crownover, State Street Global Advisors, Fall 2014

Purchasing power parity is one of the most widely used models to value currencies, but it can be enhanced by including productivity and terms of trade in the equation.

Deciding when to hedge currency is often a difficult call, which discourages some investors from hedging altogether. Currency hedging ratios have recently reached record highs in developed markets, due to the low cost of hedging and relatively clear signals of when and what direction to hedge. Crownover asserts that as clearly misvalued currencies begin to mean revert, the strong signals for hedging will start to fade. Yet he argues that currency hedging is still important. According to the author's calculations, a US investor in the MSCI All County World Index from 1995 to 2002—the last period of large US$ appreciation—could have earned a return of ~50% absent the effects of currency repatriation. Including currency conversion, that investor would have pocketed less than 10% with no hedges in place.

Purchasing power parity (PPP), which assumes that the exchange rate between two currencies must reflect the same purchasing power, is one of the most typical approaches for valuing currencies. However, the PPP model does not account for all variables.

Crownover highlights two variables that contribute to a currency's fair value and are not accounted for by PPP: productivity growth and terms of trade (the ratio of the country's export prices to its import prices). Increased productivity attracts foreign investment, which pushes up the value of local currency, and terms of trade denotes whether a country is a net importer or net exporter, which impacts the wealth of the country and spending power of its citizens.

SSGA's research shows that productivity is half as important as inflation and terms of trade is half as important as relative productivity. Crownover outlines a dynamic hedging model that takes relative productivity and relative terms of trade into account when determining the valuation for the currency market and the optimal hedge ratio.

Looking at historical data for ten developed markets and 22 emerging markets currencies, the new model improved the results for the majority of the portfolios and, according to this research, would represent an increased annual return of more than 50 bps from January 2000 to present. Given high US productivity relative to other countries and the country's improved economic environment, this model values the US dollar almost 10% higher than does the PPP method. Thus, US investors may have an even stronger argument to hedge their foreign investments. Using the same model, the fair value of the Chinese yuan increases approximately 20% due to productivity growth in China. On the other hand, when accounting for the low level of productivity growth, valuations for the euro and the yen are much weaker using this model.

Allocating in a Stronger US Dollar Environment

Jim McCormick, Keith Parker, Guillermo Felices, Barclays, October 2014

The building blocks are in place for a sustained dollar rally. Buying dollars versus other major currencies still looks like a good bet, especially against the euro. Dollar strength is unlikely to lead to common-currency outperformance of US equities during this cycle given tighter Fed policy and the sustained equity rally over the past three years.

The US dollar has strengthened in recent months. While exchange rates can be volatile and extremely difficult to predict, all of the pieces appear to be in place for a sustained US$ rally. However, investors should be mindful that some asset classes that traditionally benefit from a stronger US dollar might not benefit to the extent that they have in prior cycles.

The authors put forth three arguments to support continued strength in the US dollar versus other major currencies. The first is the diverging course of monetary policies among the world's largest central banks. The ECB and BOJ remain extremely accommodative while the Fed is set to hike rates as soon as the middle of 2015, which could put additional upward pressure on the US dollar. The second argument is that the recent upward trajectory of the US dollar comes after a prolonged period of weakness. Even with the current rally, the real trade-weighted US dollar index remains well below its long-term historical average. The third argument is that currency cycles for the dollar are typically large and persistent, though this is not a strong case in and of itself for further dollar strength.

Some commentators have argued that the strength of the US dollar could slow the pace of Fed tightening due to lower inflation and weaker exports. While this risk certainly should not be ignored, the US economy is far more dependent on consumer spending and much less dependent on exports than other major economies such as China and Germany. The authors believe that a combination of a stronger US dollar and lower oil prices should help to provide a tailwind to the US economy through increased consumption, reducing the likelihood that the Fed will slow its pace of tightening.

Dollar appreciation is not always uniform against global currencies as different economic environments tend to produce divergent results. Real US yields, for example, tend to dictate the strength of the dollar against most developed markets currencies while the global growth cycle is a more important factor in determining emerging markets currency strength. In general, macro forecasts imply continued divergence of US real yields from other developed markets, but also modestly better global growth. This could translate to further US$ strength against the euro and the yen and more modest appreciation against most emerging markets currencies.

A rising US dollar has traditionally been linked with the outperformance of US equities compared to other regions. But given ultra-loose Fed policy in recent years and the subsequent rise of US equities relative to other regions, the authors contend this connection is unlikely to persist. More often than not, risk assets such as commodities, commodity-related sectors, and emerging markets equities have fallen during periods of a rising dollar. However, the path of China's slowdown is reducing the importance of the dollar link among these assets. Weakness in resource-related stocks reflects the downward re-pricing of China's growth and the negative effect on commodity prices. The structural decline in China's growth in recent years has coincided with the significant underperformance of dollar-sensitive equity sectors such as energy and materials. While path of the dollar will likely have an effect on the energy and materials sectors, China's growth rate is a much more important factor. ■

CAMBRIDGE C|A ASSOCIATES