January 2017 Investment Publications Highlights

Covered Interest Parity Lost: Understanding the Cross-Currency Basis

Claudio Borio et al., Bank of International Settlements, *Quarterly Review*, September 2016, pp 45–64

The authors examine why covered interest rate parity (CIRP) has not held since the global financial crisis (GFC), arguing that the violation is due primarily to the increase in demand for foreign exchange hedges and the new constraints on arbitrage activity.

CIRP holds that the interest rate differential between two currencies in money markets should equal the differential between the forward and spot exchange rates. If not, arbitrageurs could borrow the cheaper currency and enter into an FX swap—selling the cheap currency today and agreeing to buy it back at a future date—and make a seemingly riskless profit.

But, CIRP has not held since the GFC. Since 2007, the difference between borrowing dollars through the FX swap market and borrowing directly from the cash market has been negative, not zero as CIRP suggests. Initially, the difference, or basis, was seen as a response to the financial crisis, with many expecting the divergence to subside over time. However, in recent years the basis has only widened.

The authors believe that the increases in US dollar hedge positions following the crisis have put pressure on CIRP. In addition, new limits on arbitrage, largely due to changes in regulations, have emerged in recent years. As a result, costs to exploit the opportunity have increased, making it difficult for the relationship to return to balance.

The authors find evidence that across currencies the size and sign of the basis is directly related to the amount of US dollar hedges. They suggest that the basis will likely evolve over time based on the demand for US dollar hedges. Constraints to arbitrage from heightened counterparty and liquidity risks are likely to amplify the effect of hedging demand on the basis during periods of market dislocation. The authors conclude that CIRP violations are likely to be the new normal in an environment where the demand for currency hedges is abnormally high and uneven across countries.

FX Markets Weekly

John Normand et al., J.P. Morgan, Global FX Strategy, December 16, 2016, pp 2–7

The authors discuss expectations for foreign currency markets in 2017. Among major US dollar currency pairs, the pound is expected to finish the year flat, with the euro and the yen strengthening.

The authors believe the US dollar could appreciate on a trade-weighted basis, if the Federal Reserve's rate increases follow its projections. However, the authors think this is unlikely for three reasons: first, the Trump administration would have to avoid canceling out any fiscal stimulus gains with either protective trade policies or sizable increases in the federal debt; second, any growth lift from simulative fiscal policies would have to be enough to outweigh continuing dollar strength; third, monetary policy outside the United States would need to be relatively dovish, which does not seem to be the case, as the Bank of Japan and the European Central Bank (ECB) appear to be in the early phases of tapering asset purchases.

Looking at major currency pairs, the UK pound is expected to finish essentially flat against the dollar in 2017. Since early November, the pound has benefitted from persistently positive data and a rotation of political risk from the United Kingdom to Europe. The main issue in the mid-term is how the UK Supreme Court will decide the fate of the government's right to trigger Article 50 to leave the EU. A judgement making it easier for the government to trigger Article 50 would be sterling-negative, whereas a judgement requiring a broader Act of Parliament would be sterling-positive because it could delay exit negotiations with the European Union.

The euro is expected to appreciate in 2017. The biggest foreseeable issues have already been priced into the currency, including the ECB's first phase of tapering and the failed Italian referendum. It's too early to tell how upcoming European elections will play out in the coming quarters. According to the authors, the driving force of the currency pair in the coming months is likely to be US policy decisions.

Lastly, the Japanese yen is expected to appreciate against the dollar in 2017. The authors believe this is the case because it is cheap (according to their fair value model), Fed expectations appear to be aggressively priced into the currency, and trade tensions are expected to surface with the incoming Trump administration.

The Case for Not Currency Hedging Foreign Equity Investments: A US Investor's Perspective

Catherine LeGraw, GMO White Paper, April 2015

In recent years, investors have earned high returns from hedged equities, particularly as the dollar has strengthened. Yet, investment firm GMO argues that in the long run hedging can add cost and unintended risk to a portfolio.

Hedging equity allocations may reduce volatility in the short term but, the authors argue, it can add unintended risk for USD-based investors in the long run. Consider that companies increasingly generate revenues from abroad, exposing them to multiple currencies. A company may, in fact, have little exposure to its home currency. For these equities, shorting a currency may add a layer of risk to the investment.

Easier access to global markets also means most portfolios have exposure to multiple currencies, creating a natural currency hedge. By focusing on a currency's impact on part of the portfolio, investors may miss the impact on the portfolio as a whole. From 1970 to 1989, hedging reduced volatility in portfolios over certain timeframes, according to GMO data. However, since 1990, the volatility for hedged portfolios is higher than unhedged portfolios when looking at periods longer than two years.

Still, the author notes that a hedging strategy may be prudent in some cases. The author argues that investments in domestically focused companies can benefit from a currency hedge. Currency hedging should also be considered for long/short investments, where short-term volatility could force an investor to realize losses to cover a short position.

In general, the added volatility from hedging can increase the risk of large losses. According to the authors, USD-based investors should be particularly wary of hedging European equities, given the possibility that a country could leave the European Union. This could strengthen the euro at the same time as the equities decline. ■

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