Currency's Comeback

Seeking to Add Value from FX in the New World of Interest-Rate Volatility

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In Focus

Currency can be a crucial yet often overlooked component of investment returns. And in the stable, ultra-low interest-rate environment that defined the post-Global Financial Crisis period until early 2022, FX may have received scant attention from some investors. But in the wake of aggressive monetary-tightening by central banks in most developed and emerging economies to tackle the global explosion in inflation, interest-rate volatility has returned. This has led to gyrations in currency markets, awakening interest in active currency management and reminding investors, particularly fixed-income followers, that FX can be a potential source of alpha.

> The return of interest-rate volatility after rate-tightening across developed and emerging economies and associated sharp movements in currencies have reminded many investors of the potential for adding value through foreign exchange (FX).

> We continue to believe there are potential alpha-generating currency hedging opportunities that rely less on directional currency views to realize value.

> We believe the US dollar's overall weakness since Q4 2022 extends beyond cyclicality, with structural factors pointing to longer-term weakness in the US currency.

> In our view, the outlook for many emerging markets (EM) currencies looks comparatively positive: Contrary to market wisdom, we think rate cuts by EM central banks that run ahead of the next rate-cutting cycle by the Federal Reserve (Fed) need not lead to EM FX weakness. We believe the Brazilian real and Mexican peso look particularly well positioned for a positive outlook.

Peak US Dollar?

Interest-rate and economic growth differentials are major determinants of FX performance. Global activity and interest-rate divergence widened unusually in favor of the US currency last year, reflected in the historically remarkable performance of the Dollar Index (DXY), which measures the value of the dollar versus a basket of global currencies. The strong dollar was the headline story from the currency markets in 2022 (Figure 1).

We believe the rapid rise in US interest rates was the primary driver of the dollar's outsized performance. We have recently experienced the most remarkable period of US monetary policy tightening in 40 years, marked by an over 5% increase in the fed funds rate in just 16 months, taking it to its highest level since 2001 and leaving US real interest rates above 2%.[1]

In response, by Q4 2022, the dollar had appreciated by over 20% (on a DXY basis) and was 2.3 standard deviations rich on a real effective exchange rate (REER) basis. These extreme relative valuation levels are rare and had previously occurred on only six occasions—interestingly, the dollar peaked soon after breaching this threshold on five of these six occasions (Figure 2).

We believe the following central bank events in Q4 2022 marked this cycle peak while also setting the stage for a weak dollar cycle ahead:

- The Fed's shift from the previous 75-basis points (bps) hike per meeting to a 50 bps hike in December. This confirmed the beginning of the end for its aggressive tightening campaign.

Figure 1.

The Strong Dollar Story of 2022

As of 31 December 2022. Source: Bloomberg

- The Bank of Japan's (BoJ) yield curve control adjustment, when it made a small first step towards policy normalization by raising the yield cap on the 10-year Japanese government bond (JGB) by 25 bps.
- The European Central Bank's (ECB) continuation of its 75 bps rate hikes, up from 50 bps.

In other words, the previously aggressive Fed began transitioning to a period of moderation. This allowed other developed market central banks to effectively catch up and directionally reduce policy divergence.

From Cyclical to Structural Challenges

Our Longer-Term View on the Dollar

We believe the dollar's overall weakness since Q4 2022 extends beyond cyclicality and contains structural elements that suggest a weaker-for-longer dollar.

ECB President Christine Lagarde spoke in July about the impact of geopolitics on monetary systems.[2] She posited that the global economy is fragmenting into competing blocs, fronted by the US and China. This new global map is likely to have first-order implications for central banks. Most importantly, it may create opportunity for certain countries to reduce their dependency on Western payment systems and currency frameworks. Lagarde further added that the international reserve currency status of the dollar should no longer be taken for granted. This is a structural, though slow-moving, point of great significance.

Figure 2.

Historic Dollar Cycles
United States, Federal Reserve, Price-adjusted Trade Weighted Exchange Real Index Broad

As of 5 October 2023. Source: Deutsche Bank.

One example suggestive of a potential long-term de-rating is how the rating agencies reacted during the brief US regional banking crisis and contentious debt ceiling debacle earlier this year. They raised the possibility of being more proactive than reactive, noting that if they assess that political brinkmanship has increased the possibility of missing an interest payment, they will likely place the US sovereign rating on "Rating Watch Negative," signaling a possible rating downgrade. In fact, in early August, Fitch actually downgraded the United States from AAA to AA+, citing a "steady deterioration in standards of governance over the last 20 years."

Interestingly, and somewhat surprisingly, it appeared that investors largely viewed the political brinkmanship surrounding the banking crisis and debt ceiling saga as strictly US-specific—it seemed EM banks did not experience similar stresses. This episode added to other data pointing to a challenge to the long-prevailing conventional wisdom in currency markets: that no matter where in the world stresses arise, investors tend to flock to the dollar or dollar assets. We are slowly observing the opposite reaction: US-specific stresses being met with the sale of the dollar and dollar assets.

We believe that this development bears watching, especially in a context where China is maximizing its efforts in internationalizing its currency. We observe:

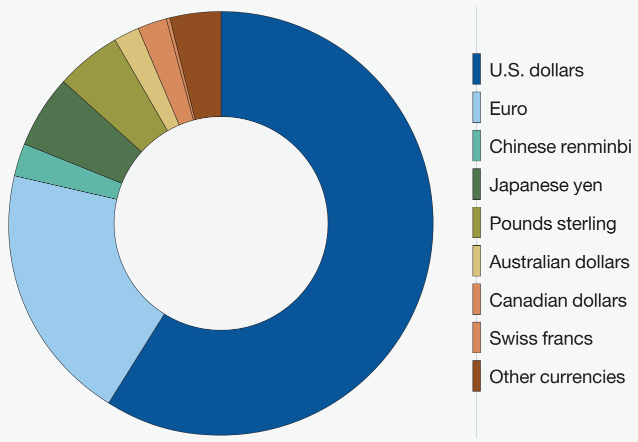
- **The risk of de-dollarization**—a recurrent theme through post-World War Two history—has moved back into focus with geopolitical and geostrategic shifts. In the medium to long term, the renminbi is typically identified as the clearest alternative to the dollar: China has both the ambition and the motivation.
- De-dollarization, while not a clear reality today, has recently come to be viewed as a probable risk scenario over the coming decades.

The dollar's slowly waning dominance is arguably reflected in observable trends. One commonly analyzed barometer of the dollar's ubiquity is the composition of foreign exchange reserves (Figure 3). Based on International Monetary Fund (IMF) official foreign exchange reserves data (COFER), the US dollar's share of allocated foreign exchange reserves grew from 59% in 1996 to a high of 73% in 2001, before declining steadily over time to 58% by the end of 2022.3 This decline is largely explained by increases in the shares of other developed market currencies, although the renminbi's share grew by approximately 2.5%.

Figure 3.

Global Curency Reserves Breakdown

World Allocated Reserves by Currency for Q1 2023



As of 31 March 2023. Source: IMF

It is not just central banks diversifying away from the dollar. We can see it in international lending, too. Dollar credit to international borrowers has fallen 2% in the past year, according to the Bank for International Settlements.[4] That is the biggest fall since the Global Financial Crisis, while international lending in the euro and yen rose almost 9% and 10%, respectively, over the same period.

EM Currencies

A Potential Shift

Three dominating themes in the FX market this year have been the US economy's outperformance, China's slowdown, and the bond market's reaction to increased government bond supply, particularly in the US. Added to this trio of factors has been a deteriorating outlook for global growth. Collectively, these themes would typically have led to significant dollar strength, while historically the EM FX market would have overreacted with elevated volatility. Instead, what has occurred is something quite different, and it speaks to our positive view on the outlook for EM currencies.

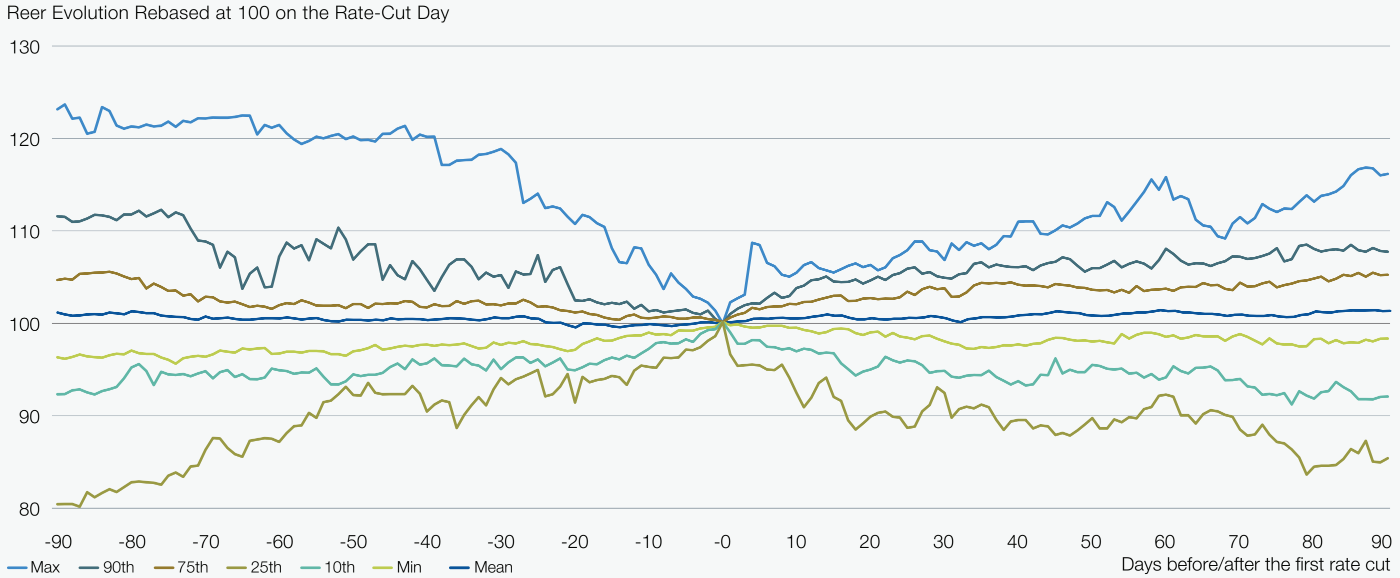
- **EM FX sensitivity** to the dollar has weakened, suggesting that idiosyncratic factors are increasingly playing a larger role in determining EM FX performance.
- **Orthodoxy in monetary policy** in emerging markets versus developed markets—policy decisions for economic rather than political reasons—ensured EM central banks were required to hike early, often, and aggressively to counteract supply side-driven inflationary pressures.

Recent data confirms that rapid disinflation is occurring in EM. Many investors are conditioned to assume that EM central banks cutting rates ahead of the Fed should induce volatility and weakness in EM currencies, primarily due to lower risk premia and rate differentials versus the US. However, we do not believe that impending rate cuts in EM will pressure EM FX performance, based on the following observations and factors:

- Contrary to market perceptions historical patterns do not indicate that rate cuts in EM coincide with domestic currency weakness (see Figure 4). There have been occasions when currency

Figure 4.

FX Performance at the Start of EM Rate-Cutting Cycles



As of 30 August 2023. The chart is REER changes of currencies +/- 90 days around the first rate cut. BRL, MXN, COP, CLP, INR, IDR, ZAR, TRY, RUB with data starting in 1990, 51 rate-cut decisions in total. Source: BNP Paribas.

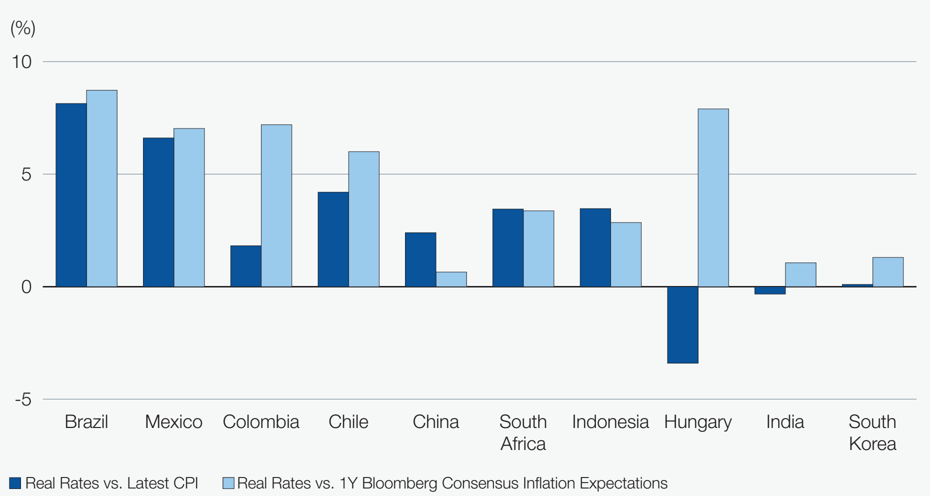
appreciations have even accelerated with rate cuts, possibly because of portfolio inflows triggered by the rate-cut cycle.

- Carry will likely remain positive for most high-yielding currencies even after the initial cuts. Given the elevated level of EM interest rates, the initial rate cuts may still imply elevated real rates, as well as high carry against the dollar. This point is particularly relevant for Latin America (we explore the region in more detail above).
- For most EM FX fundamentals such as balance of payment dynamics are supportive due to improved current accounts.

Figure 4 captures how EM currencies perform ahead of and in the aftermath of interest-rate cuts by EM central banks. In the days immediately before and after a rate cut, there is historically little anticipation or reaction visible in EM currency levels. However, two to three months later, we begin to see relative weakness in these currencies versus developed market currencies due to rate cuts shrinking the carry differential. Based on this historical information, we believe it is wrong to expect immediate EM FX weakness following EM rate cuts. Moreover, history demonstrates that material EM FX weakness often only occurs after several rate cuts. We think the carry environment will remain supportive for EM currencies, especially for countries such as Brazil (discussed overleaf) currently providing investors with almost double-digit real yields. Furthermore, as captured by Figure 5, inclusive of current rate cuts in EM, there is ample cushion in current real rates to avoid currency weakness.

Figure 5.

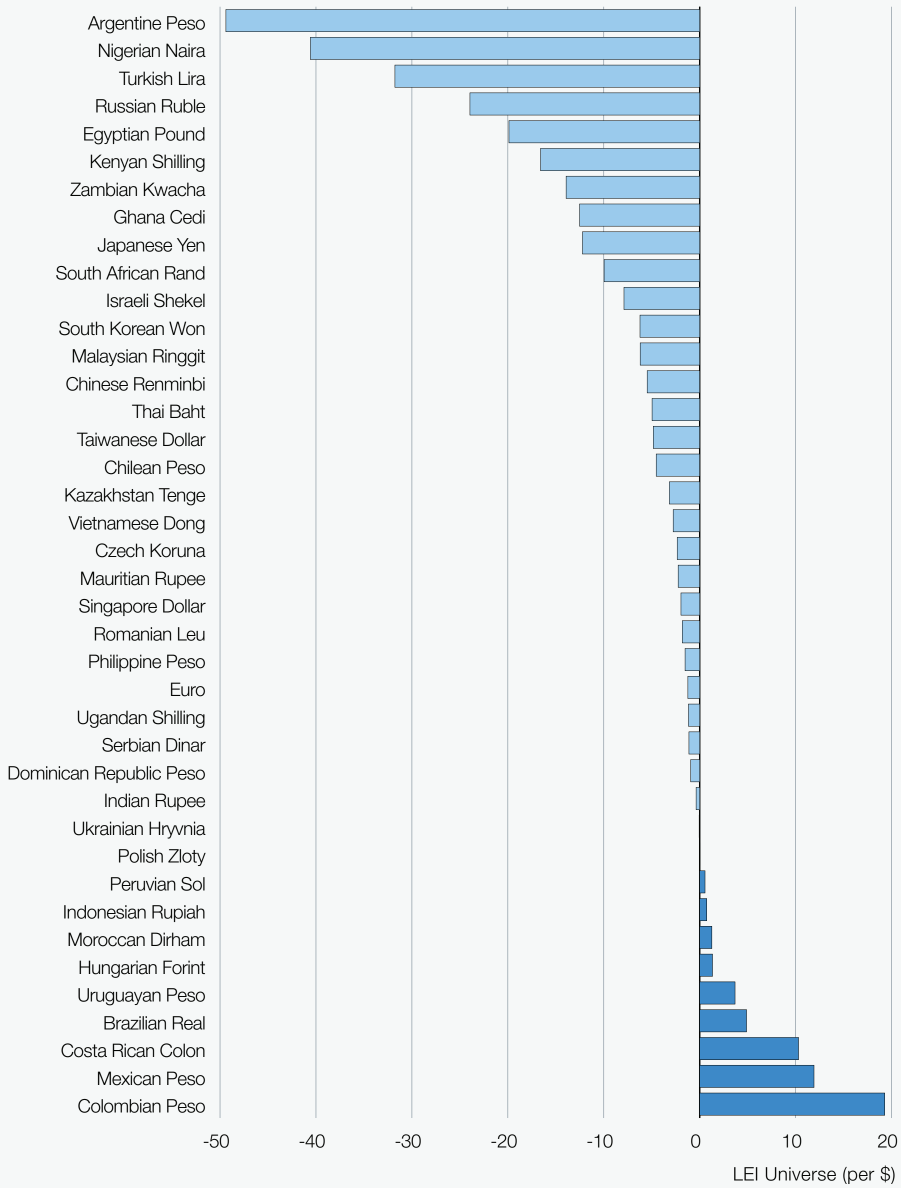
Select EM Real Rates vs. Latest CPI and One-year Consensus Inflation Expectations



As of 30 September 2023. Source: Bloomberg.

Figure 6.

EM FX YTD Returns



As of 31 December 2022. Source: Bloomberg

In our view, not every EM central bank is in the same position. Currency sensitivity to interest-rate cuts differs for each country, depending on its level of real interest rates, balance of payments, and the tolerance of its central bank to underlying currency weakness. The dispersion of EM FX year-to-date returns indicates idiosyncratic and fundamental factors play a larger role in this increasingly diverse asset class (Figure 6).

Signs of Positivity on Latin American FX

The turn in the dollar cycle should mean steady flows into EM asset markets and particularly EM local-currency bond markets (Figures 7 and 8). Brazil and Mexico have relatively large weights in these benchmarks, and their currencies could perform well as this asset class comes back into fashion.

Differentiation in EM FX

In Brazil, welcome reforms and the start of a significant rate-easing cycle are improving the outlook for asset markets. On the former, the new fiscal framework and consumption tax reforms are supporting the narrowing of Brazil's sovereign risk premium. Low inflation, currently slightly above the central bank's 2023 inflation target, has raised expectations that the bank can cut rates aggressively; indeed, the bank implemented a larger-than-expected 50 bps cut in early August and a further 50 bps reduction in September, taking its benchmark rate down to 12.75% (Figure 9). Around 400 bps of easing is expected over the next year.

The Mexican peso remains one of the top EM FX performers of the year, only surpassed by the Colombian peso.[5] Investors like the high carry in Mexico, the well-run economy, and the country's exposure to this year's surprisingly strong US GDP growth—worker remittances back to Mexico from the US hit a record $5.7bn high in May (Figure 10). Mexico is particularly important for the US economy, given its geographical proximity; low labor costs and logistical advantages are the two pillars of a near-shoring phenomenon that has transformative long-term potential for Mexico.

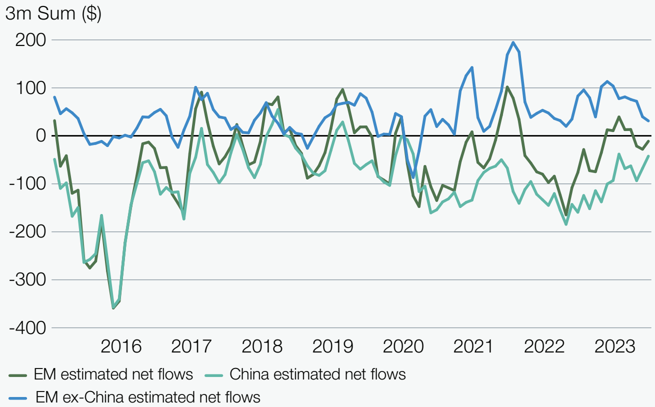
These structural forces in Mexico appear to be reshaping market perceptions about the currency's valuation. While the Mexican peso has been considered a high-beta risk-proxy currency for much of the past two decades, we think it is time for investors to shed this outdated view. We believe the peso has entered a new chapter that will likely be accompanied by lower-for-longer volatility and a decoupling from the risk profile of its peer currencies in Latin America.

The consequences of these structural forces are that investors should consider re-assessing how they perceive the Mexican peso and its risk profile.

The Mexican peso is a prime example of why we believe in traditional approaches to FX valuations in EM, where macro fundamental factors—such as balance

Figure 7.

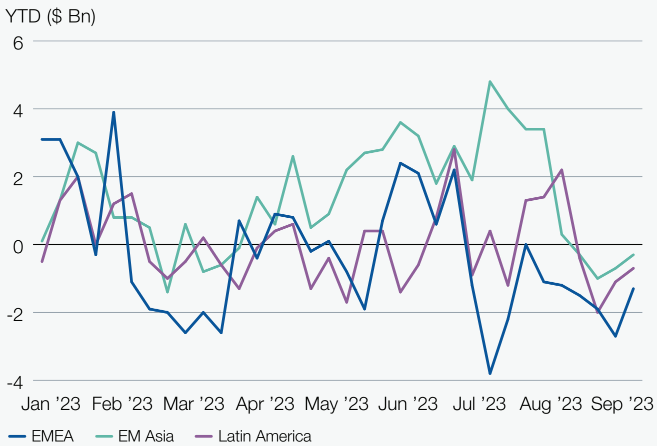
EM Net Capital Flows



As of 30 September 2023. Source: JPMorgan.

Figure 8.

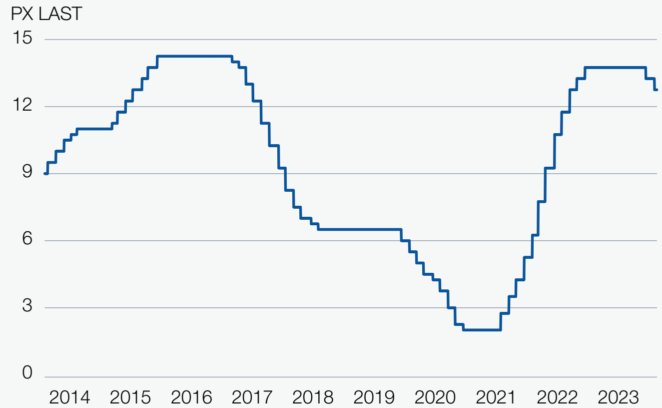
EM Portfolio Flows by Region 2023



As of 30 September 2023. Source: JPMorgan.

Figure 9.

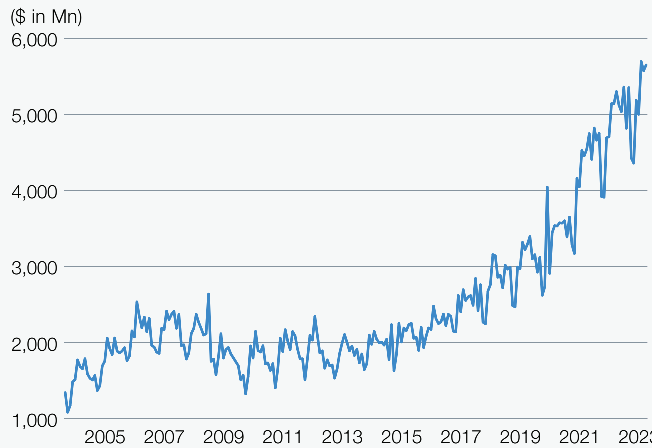
Brazillian Central Bank Rate—the Cutting Cycle Commences



As of 30 September 2023. Source: Bloomberg.

Figure 10.

Mexican Overseas Worker Remittances



As of 31 August 2023. Source: Banco de México.

of payments analysis—investor flow dynamics (Figure 11), and monetary policy analysis, drive FX performance. We believe that active managers are in the forefront of this opportunity.

Yield Enhancements with Potential Additional Diversification Benefits

Although it may make sense to engage with specific currency situations, we also currently identify interesting hedging opportunities that could help to manage portfolio risk and add value, even without a directional view on currencies.

The over-the-counter marketplace for both fixed-income and FX investments can provide potential opportunities for perceptive investors. Mixing and matching local and global interest-rate exposure with the inherent inefficiencies built into the FX forward market can effectively increase the net yield (bond yield to maturity plus implied FX forward yields) to provide a superior expected return potential.

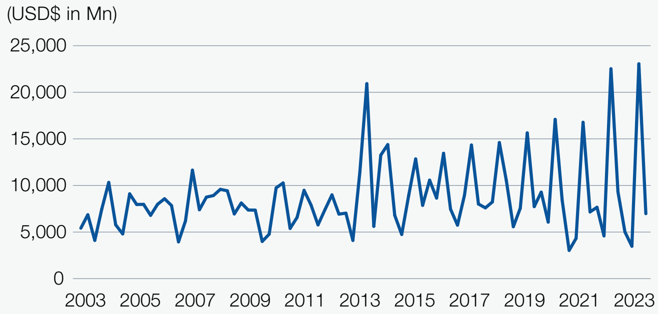
Figure 12 compares German Bund yields to Danish government bond yields in local terms (Danish krone-denominated) and on a euro-hedged basis. As a reminder, both countries carry a AAA credit rating, and the EUR/DKK currency pair has a conventional currency peg arrangement.6 While the local yields are very comparable, the addition of the hedge from Danish krone to euros increases the yield of the total package from a euro perspective.

Attractive Hedging Opportunities

As a result of divergent monetary policies between the BoJ and most other developed markets central banks (Figure 13), the interest rate differentials potentially create an attractive hedging opportunity for both fixed-income and equity investors. While the BoJ has taken some steps to normalize policy through its aforementioned recent modest changes in its yield curve control policy, the Japanese base rate is still expected to stay close to zero for the foreseeable future.

Figure 11.

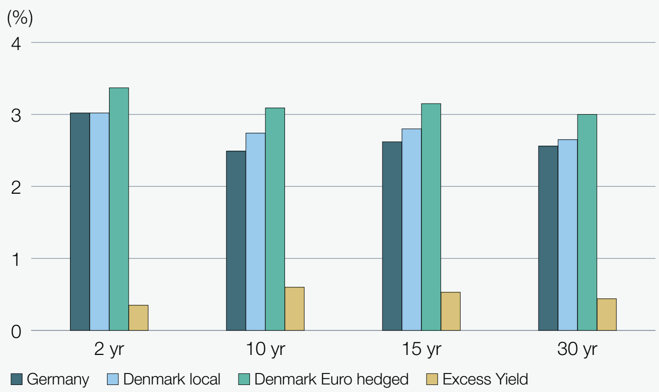
Mexican Foreign Direct Investment



As of 4 August 2023. Source: Banco de México.

Figure 12.

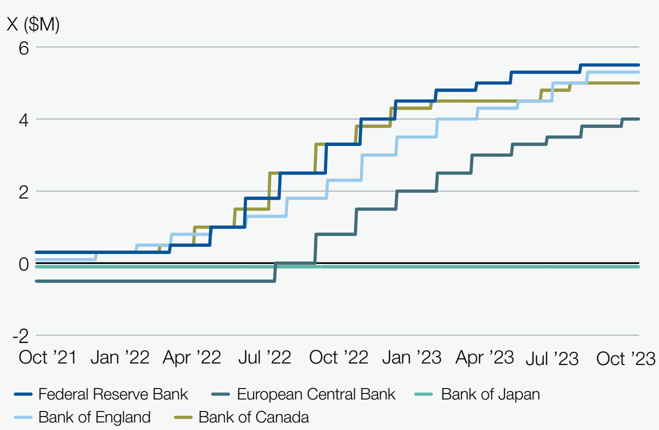
Enhancing Yield with FX Hedging Opportunities



As of 4 August 2023. Hedged examples are using the implied yields based on a three-month annualized FX forward. Actual hedge pricing and impacts may change over time, in particular when matched with longer-duration assets. For illustrative purposes only.
Source: Bloomberg.

Figure 13.

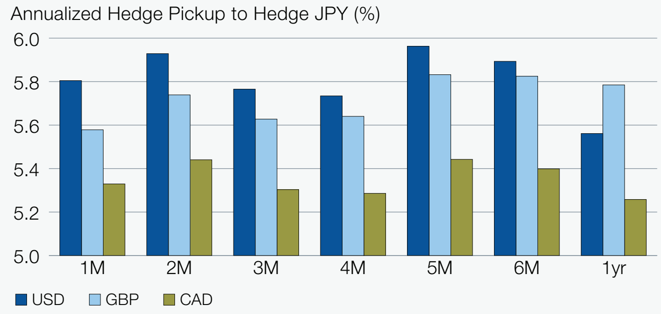
Japanese Interest Rates—Out of Step with Other Major DM Economies



As of 30 September 2023. Source: Bloomberg.

Figure 14.

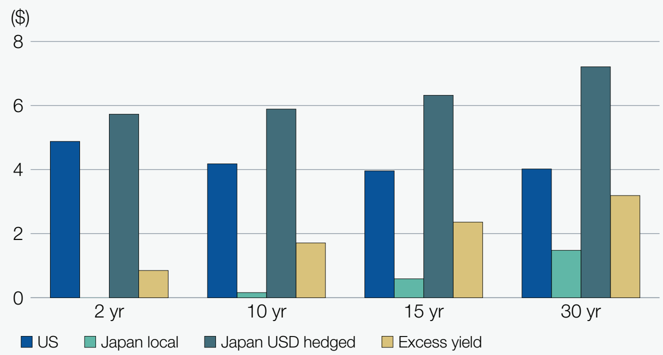
Annualized Hedge Pickup to Hedge Japanese Yen



As of 4 August 2023. Source: Bloomberg.

Figure 15.

Seeking to Enhance Yield with FX Hedge Opportunities



As of 4 August 2023. Hedged examples are using the implied yields based on a three-month annualized FX forward. Actual hedge pricing and impacts may change over time, in particular when matched with longer-duration assets. For illustrative purposes only. Source: Bloomberg.

Japanese equity investors can potentially take advantage of this dynamic, mitigating currency risk and receiving an attractive implied yield in the process. In other words, and while it depends on the market at play, the market is arguably rewarding global investors to reduce or eliminate the Japanese yen risk factor in their Japanese equity investments.

Figure 14 illustrates the annualized implied yields for US dollar, British pound sterling, and Canadian dollar investors across different forward tenors. Like the previous Danish bond example, Figure 15 compares US Treasury yields to Japanese government bond yields in local terms (JPY) and on a US dollar-hedged basis.

While US Treasury yields appear to be more attractive from a yield perspective than local JGB yields, this dynamic changes dramatically when a US investor buys JGBs and hedges them back to US dollars. The hedged package has historically provided a greater yield than the US Treasuries across the entire term structure, enhancing the yield by 85 bps in the two-year bond and rising to an over 300 bps yield pickup in the 30-year bond. In addition to the yield enhancement, this synthetic dollar-denominated bond can provide an opportunity to diversify away from issuer-specific concentrations.

In Summary

The views expressed above are reflective of the diverse and idiosyncratic nature of the FX market. Whether considering broad-based US dollar perspectives, specific regional and country drivers, or hedging opportunities presented by monetary policy differentials and pricing anomalies, it is vital to understand that these disparate markets should not be viewed through a monolithic lens.

Important Information

Notes

1. Source: Bloomberg
2. https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230417~9f8d34fbd6.en.html
3. https://data.imf.org/regular.aspx?key=41175
4. Statistical release: BIS international banking statistics and global liquidity indicators at end-September 2022
5. Source: Bloomberg
6. The formal framework for the Danish fixed exchange rate policy is the ERM II. Denmark participates in the ERM II with a central rate of DKr746.038 per €100. The central rate is a conversion of the central rate versus the deutsche mark before the third stage of European monetary union and was last adjusted in January 1987. Denmark has entered into an agreement with the ECB and the euro area member countries on a narrower fluctuation band of ±2.25%. In recent years, the Danmarks Nationalbank (DN) has consistently maintained a stable krone within less than 1% of the central rate.

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