Foreign Exchange

Major trends

Assuming near-term inflation risks continue to recede, further upside in the US Dollar index may be limited. In 2022, USD strength was driven by rapid monetary policy tightening by the Federal Reserve, falling global growth expectations, energy driven trade deficits outside of the US, and general risk aversion by investors. With inflationary pressures beginning to recede, the Fed close to their target terminal rate and other developed market central banks in catch up mode, it is likely that USD has peaked for this cycle. Moreover, if the US debt ceiling debacle is not resolved, it would likely place downward pressure on the Dollar.

A key risk for the EUR, GBP and JPY could come from rising energy prices. If natural gas prices begin to move sharply higher again it would likely lead to renewed inflation pressures. The response by most central banks will be limited by the adverse impact that higher rates will have on their respective economies. Separately, Sterling remains exposed to domestic political uncertainty and the Euro to the ongoing war in Ukraine.

The European Central Bank (ECB) and the Bank of England (BoE) are expected to increase interest rates more than the Fed in 2023. The ECB is expected to raise rates from 2% to 3.75% and the BoE is expected to increase rates from 3.5% to 4.75%. The market expects the Fed to lift rates to 5.3% in Q1 2023 before easing rates back to c. 5% by year end. However, the December 2022 FOMC minutes indicated that not a single member felt that it would be appropriate to lower rates at any point in 2023.

Golden Rules

- Currency markets are highly efficient and rapidly adjust to new information. The innumerable factors affecting FX prices mean they can be very volatile and are largely unpredictable.
- Investors are not compensated for the incremental currency risk they bear, and seldom have any knowledge that would give them an advantage in predicting future currency directions. As such, investors should seek to hedge as much foreign currency as is practical to minimise the differences between the currency mix of the portfolio's assets and the currency of the portfolio's liabilities, on the basis that they wish to narrow the potential range of portfolio outcomes.
- Investors should view hedging as a means to reduce currency risk even though this may come at a small cost. However, reasons to not hedge all foreign currency exposure include:
    i. Currency hedging requires additional portfolio liquidity as forward contracts require the posting of collateral and the funding of potential hedge losses.
    ii. Many of the underlying foreign currency investments, primarily public and private equity, will be in companies whose financial prospects are internationally dispersed already, so hedging 100% may amount to over-hedging.
    iii. Beyond a certain level of hedging the marginal reduction in portfolio volatility from additional hedging becomes less significant.
    iv. Certain currencies tend to appreciate in a crisis, such as the US Dollar, Japanese Yen or Swiss Franc. Having an allocation to these currencies may potentially act as a diversifying safety net in a large market drawdown for those clients with a different home currency.
    v. Most emerging market currencies are difficult and expensive to hedge. The additional risk should thus be incorporated into any consideration of investing in emerging markets.

2023 Strategic Priorities

We recommend that international investors with large non-home currency exposure adopt a hedging policy in which the home currency accounts for 60- 80% of the portfolio's overall look-through FX exposure. Some foreign currency exposure is appropriate within a portfolio due to the benefit of diversification, liquidity constraints and elevated cost of hedging certain currencies.

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