Foreign Exchange

Major trends

Developed market central banks are expected to ease monetary policy. The increase in interest rates by the Federal Reserve between Q1 2022 and July 2023 was one of the fastest on record, raising rates from 0.25% to 5.50%. While inflation remains somewhat stubbornly above target, the risk of runaway inflation appears to have receded, and central banks are now contemplating "insurance cuts"; lowering interest rates before their impact on economic growth becomes too suppressive. As of late January 2024, investors are pricing in greater than 1% of rates cuts in 2024 by the Federal Reserve, European Central Bank (ECB) and the Bank of England (BoE).

The Bank of Japan (BoJ) stands alone. Many analysts have highlighted that 2024 has the potential to be the "Year of the Yen". This is because the BoJ stands alone as the only major developed market central bank expected to increase interest rates in 2024. Interest rates in Japan have remained negative despite above target inflation. The BoJ has been reluctant to alter rates given decades of anaemic growth, flirtation with outright deflation and fears over debt sustainability given their debt-to-GDP ratio of over 200%. Since the Federal Reserve began raising interest rates in 2022, the Yen has depreciated by roughly -25% against the USD. The BoJ has begun the process of moving away from its yield curve control program by raising the yield target and by replacing the term "cap" with "reference rate". The full removal of yield curve control is believed to be a precursor to lifting interest rates.

The People's Bank of China (PBoC) faces a delicate balancing act. The structural issues facing the Chinese property sector coupled with lackluster investor confidence has led the Renminbi to weaken substantially since early 2022, sitting close to its weakest level against the USD since 2008. The PBoC has been reluctant to stimulate the economy via significant rate cuts and has instead sought to maintain investor confidence by stabilising the Renminbi. Outright deflation has, however, meant that real rates are now at their highest level since 2009. If relative economic weakness continues the PBoC will face a difficult choice between additional monetary stimulus and maintaining stability in the currency.

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, we believe 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.
- We believe 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 result in over-hedging.
    - iii. Beyond a certain level, 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.

2024 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.

Your capital is at risk, the value of investments may fall and rise and you may not get back the full amount you invested. Past performance is not indicative of future returns.