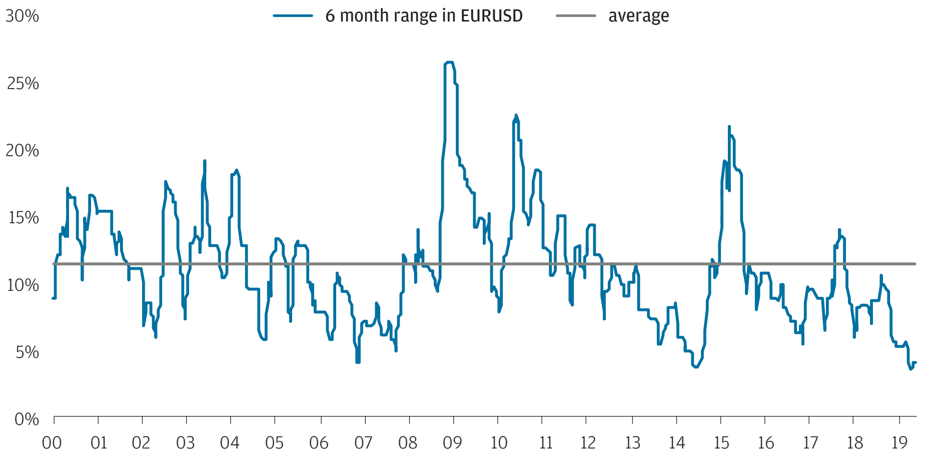
Stability masks rising risks in currency markets

June 2019

Major currencies have been as stable as at any time in the past few decades. The range from high to low in the EURUSD exchange rate over the last six months, for example, has been only 4%, which is nearly a third of the average range since 2000. The options market expects the current tranquility to continue, with implied volatility for the next three months over a third lower than its average over the last five years and close to all-time lows. We believe this serenity masks rising underlying tensions that could eventually spark larger moves in currency markets.

THE SIX-MONTH RANGE IN THE EURUSD RATE HAS FALLEN WELL BELOW AVERAGE



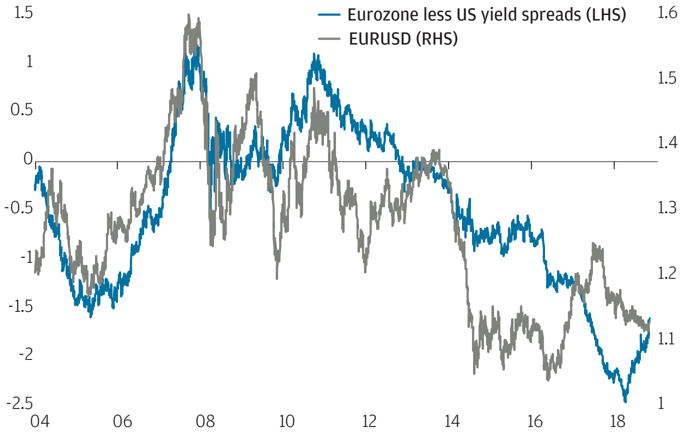
Source: Bloomberg, 4 June 2019.

Dollar looks vulnerable to rate cuts

Risks to the US dollar are rising, thanks to growing expectations that the Federal Reserve (the Fed) will cut interest rates. With Fed Funds futures pricing two cuts this year, the typical relationship between currencies and rate spreads suggests that the dollar ought to already have fallen by around 7% against the euro over the last six months.

In some respects, it is remarkable that the US dollar has strengthened back towards cycle highs even as Fed rate pricing has moved from discounting 2019 year-end rates at around 3% to closer to 1.5%. However, the actual delivery of a rate cut could see the dollar rapidly fall back to levels more consistent with rate spreads, which would be around 1.15 for the EURUSD rate according to our modelling.

THE DOLLAR COULD FALL BACK ON FED RATE CUTS



Source: Bloomberg, 4 June 2019.

A broad range of risks exist for the Euro

Risks to the euro also remain high from a variety of sources. Italian spreads have widened on fears of a conflict with the European Commission similar to the situation last May, where the euro fell 3% in the last two weeks of May. Growth remains at risk due to the eurozone's high exposure to global trade, which remains very weak and continues to weigh on the performance of European equities.

The perception that the European Central Bank can't ease much further may be limiting the fall of European rates in short maturities, but declining inflation expectations are pulling long maturity Bund yields lower—a scenario that our research has shown can have a disproportionately negative effect on the euro. Brexit uncertainty also lingers, posing greater economic risk to Europe than more distant regions. These risks are reasonably well understood, if difficult to quantify, so investors should also remain wary of any improvement in the situation in Europe, as flows out of European assets over the past year have been significant.

The risks of sharp moves in Renminbi and Yen

The renminbi is under pressure from trade tensions and a domestic slowdown but is being held back by the political desire to avoid the USDCNY rate breaking 7, as the Chinese authorities wish to avoid being seen to benefit from a weak currency.

With less stark policy divergence between China and the US, as the market discounts a more dovish Fed, and with Chinese capital controls remaining quite effective in limiting capital flight, there is a good chance that stability could persist for some time. In contrast, our economic analysis highlights that a significant further escalation in trade tensions could see Chinese growth fall as low as 4.5%. In this scenario a sharp weakening of the renminbi well beyond 7 would likely be inevitable.

The yen would typically benefit in the current environment, but its strength has recently been muted by an exodus from domestic fixed income by Japanese institutional investors. Any reversion back to domestic assets could therefore spark a very sharp yen appreciation. However, it appears that the low rate of return on domestic fixed income has led to a longer-term strategic move by Japanese institutions into foreign assets as the only way they can achieve actuarial return targets.

Be prepared for volatility

The lack of volatility in currency markets does not reflect stability in currency fundamentals. Rather, it reflects the difficulties that investors are having weighing up the effect of significant, but offsetting, new developments.

While it remains difficult to judge the eventual outcome of political events in particular, investors should ensure they are prepared for more volatile currency markets. They should also be aware that currencies may not hedge equity markets in the same way as they have in past drawdowns.

Currency Management

Since our first segregated currency overlay mandate funded in 1989, J.P Morgan Currency Group has grown to manage a total of USD 361 billion in bespoke currency strategies. Our clients include governments, pension funds, insurance clients and fund providers. Based in London, the team consists of 20 people dedicated exclusively to currency management with an average of over 15 years of investment experience.

We offer a range of hedging solutions for managing currency risk as well as a tailored optimal hedge ratio analysis:

- Passive currency hedging serves to reduce the currency volatility from the underlying international assets. It is a simple, low cost solution designed to achieve the correct balance between minimising tracking error, effectively controlling transaction costs and efficiently managing cash flows.
- Dynamic 'intelligent' currency hedging aims to reduce currency volatility from the underlying international assets and add long-term value over the strategic benchmark. A proprietary valuation framework is used to assess whether a currency looks cheap or expensive relative to the base currency and the hedging strategy is adjusted accordingly.
- Active 'alpha' currency overlay strategy offers clients' passive currency hedging, if required, combined with an active investment process to deliver excess returns relative to the currency benchmark. Our approach is to build a global currency portfolio combining the output of fundamental models and incorporating the qualitative views of our strategy team.

All external data sourced from Bloomberg as at 4 June 2019.

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