Currency tailwind losing force?

Dominic McCormick | Select Asset Management | 19 February 2015

For some time, I've been a strong proponent of increasing global exposure at the expense of a home bias (see "Global investing trend has much further to go" 11 March 2014 and "Trend to global Investing still has further to go" 5 December 2014. While some investors have been slow to move, investing globally has become an increasingly popular theme with commentators and advisers, with the expectation of a continued weaker Australian Dollar (AUD) being a big driver behind this trend.

However, I've begun wondering whether the significant kicker for global investment returns that has come from weakness in the AUD has already largely already played out, at least against the US dollar (USD). Following the latest Reserve Bank of Australia interest rate cut and February 2015 unemployment statistics, the AUD had already fallen over 30% against the USD since peaking at $US1.10 in mid-2011. Much of the fall occurred over the last year. The weakening currency has therefore been a major tailwind for unhedged global strategies over that period.

Of course, currency is not the only reason to build and hold significant global exposure. Greater diversification via accessing different stages of the economic cycle or countries/sectors with better growth prospects and gaining exposure to industries not well represented in Australia's more concentrated market are the primary reasons to invest overseas.

However, given the AUD decline, a key question to considered at this point of time is whether investors should be hedging more of their global exposure. In practice, for fund managers, this generally means putting more forward currency hedges in place. For financial advisers and direct investors, this usually means using more of the hedged rather than unhedged versions of global equities (although not all managers offer both options).

Many less sophisticated investors are simply looking backwards and focusing on past performance and therefore going for unhedged funds. However, if the concerns expressed in this article are valid, this approach is flawed - the easy gains from the weak AUD may have already been had.

Currency prediction is notoriously difficult, especially in the short term. However, one can look at the major drivers of valuation, sentiment and momentum to get some sense of the risks and probabilities around longer term directional currency moves, even if short-term timing is near impossible.

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Against the USD, it is hard to argue the AUD is now as substantially overvalued as it was when it was trading above parity with the USD and even in the USD0.90s. Indeed, measures of purchasing power parity suggest that the AUD is now around fair value. Yet, we are now seeing calls for the currency to keep falling into the low USD0.70s and USD0.60s. Other elements are suggesting that the additional downside move potential is limited. In particular, the increasing complacency around views that the AUD has only one direction to go should be concerning to contrarians. Indeed, this complacency exists on both sides of the AUD/USD pair.

Speculative shorts on the AUD via futures contracts on Chicago Mercantile Exchange's International Money Market (IMM) have recently built to near record levels. On the other hand, long futures positions on the USD against a range of currencies (especially Euro) are also at record highs. From a sentiment perspective, the speculators are already heavily short AUD and heavily long USD, so the increasing risks from a contrarian perspective are a significant move the other way.

Downside momentum also seems to have eased, as demonstrated by the fact that the AUD bounced back from initial weakness around both the recent RBA interest cut and higher unemployment announcement (albeit both helped by a weaker USD generally.) Meanwhile banks and investment banks are downgrading their forecasts for the AUD into the low 70s or high 60s. But, are these the same investment banks that were forecasting gold to go to USD2,200 when it was USD 1700 in 2011 or to sub USD1,000 last year when it was at USD1,300? My theory is that by very nature of their primary activities (actively trading and/or talking to clients every day in the market) banks and investment banks come under enormous pressure to "forecast" future currency levels that are just an extrapolation of the recent major trend. Forecasting the turning point, or even offering more useful assessments of risk and return potential, seems much less of a focus.

Indeed, it seems that the conviction with which these views of a weaker AUD (or stronger USD) are held (by both professionals and investors) are stronger now than at any time in recent years including when the AUD was clearly well overvalued above parity. One major bank recently revised its forecast for the AUD to USD0.73. However, assume this projection proves correct and that USD0.73 is the bottom. This bank is encouraging investors to maintain an unhedged position to "benefit" from further AUD weakness, after almost 90% of the move (from USD1.10 to the recent UDS0.765 low) has already happened. And, this assumes that one makes and implements the re-hedging decision precisely at that 73 cent bottom. Of course, it could easily go lower but investors need to think about the probabilities and magnitudes they are playing with here.

Some foreign currency exposure usually makes sense as a diversifier and hedge for Australian investors. However, after the big fall over the past year, the probability is considerably reduced that the AUD will provide this risk mitigation in stressful periods as it has done in the past.

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So if we accept this currency outlook, what does it mean for investors?

- Don't expect significant AUD weakness to be as big a driver for overseas asset returns from here. The easy gains from currency, especially against the USD, may have already been made.
- Don't rely on a weak AUD to be as effective as a hedge in stressful market periods for global markets as it has been in some periods in the past, such as 2008.
- While further weakening is certainly possible, such weakness could be used as an opportunity to introduce or stagger increases in currency hedges.
- The AUD has fallen less against other currencies in recent times as the USD has strengthened against most currencies – if possible, consider maintaining a reasonable proportion of remaining FX exposure in other currencies (e.g. Euro, GBP, various Asian currencies)
- This currency view clearly does not preclude maintaining high exposures to foreign assets. Investors should just be cognisant of how much of those assets are exposed to currency movement. Indeed, the decision on allocations to global assets and currency exposure should be largely de-linked.
- Managed futures has been a big beneficiary of strong trends in currency recently, albeit benefiting from trends in other financial assets also. However, investors need to recognise that if we do see major turning points in currencies (and other markets), it could create short term challenges for managed futures as a strategy.
- While currency volatility has picked up, it could be a more permanent feature of markets in a world of ongoing currency wars for the next few years. Certain hedge funds that play such volatility could be well placed.
- This world of currency wars and minimal (sometimes negative) interest rates also means the opportunity cost of holding some gold exposure is low and the upside potential is significant, if investors lose confidence in current central banks current policies.

A concern I have is that many investors are only now beginning to embrace global investing, and are simplistically chasing the two elements that have resulted in the best returns in recent years. That is:
1. The strong performance of the US sharemarket; and,
2. The strong USD/weak AUD.

A global index fund or funds with a relative return focus are largely dominated by these two factors, given the size of the US in world markets. The combination of a bear market in the US (even a modest one – say 20% to 25%) and a sharp rally in the AUD/USD (say 10% to 15%) would be enough to cause some extremely poor returns from such funds.

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Of course, there are ways to get exposure to global markets that are either much more active in country exposure or more dependent on stockpicking, and therefore less exposed to these risks. This is particularly important given that the US sharemarket is arguably currently one of the most expensive markets globally.

In practice, the amount of hedging incorporated in a portfolio is not an all or nothing decision. Generally, the best approach is to re-introduce more hedging in stages as the AUD weakens. (Assuming your starting point is a large unhedged FX exposure). For example, you could add to some hedges now with a view to adding to hedges on further weakness, especially following sharp moves to the downside.

The potential for large moves and high volatility in currency markets is likely to be a continued feature of markets vulnerable to currency wars in coming months and years. Some argue that these currency effects largely wash out in the long term so whether one hedges or not is largely irrelevant. However, over the time frames that most investors and advisers focus on from a practical perspective (rarely beyond two to three years) this approach is flawed, as the last few years have shown.

Clearly, over the time frame that matters to investors, currencies can have a major impact on returns and risks. While short-term timing is extremely difficult, having a medium- to long-term sense of currency direction and, particularly, risks is feasible using simple measures of value, momentum and sentiment, particularly at times when the market moves towards extremes. In my mind, those elements are now increasingly suggesting that the risk/reward equation has begun to move against betting heavily on further significant AUD declines against the USD. Beginning to lock in at least some of the significant benefits that unhedged (especially USD) exposure has provided in recent months and years seems to be an increasingly sensible strategy.

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