Navigating the currency wars February 2015

Currency volatility is making headlines, with a number of very abrupt movements occurring in both major and minor currencies during recent months. Investors have shrugged off these events but the volatility is symptomatic of the ever-greater doses of stimulants that are being applied in order to dispel the hangover from the financial crisis. Of particular importance to us is the emerging trend of a stronger US dollar, which brings both risks and opportunities.

A race to the bottom

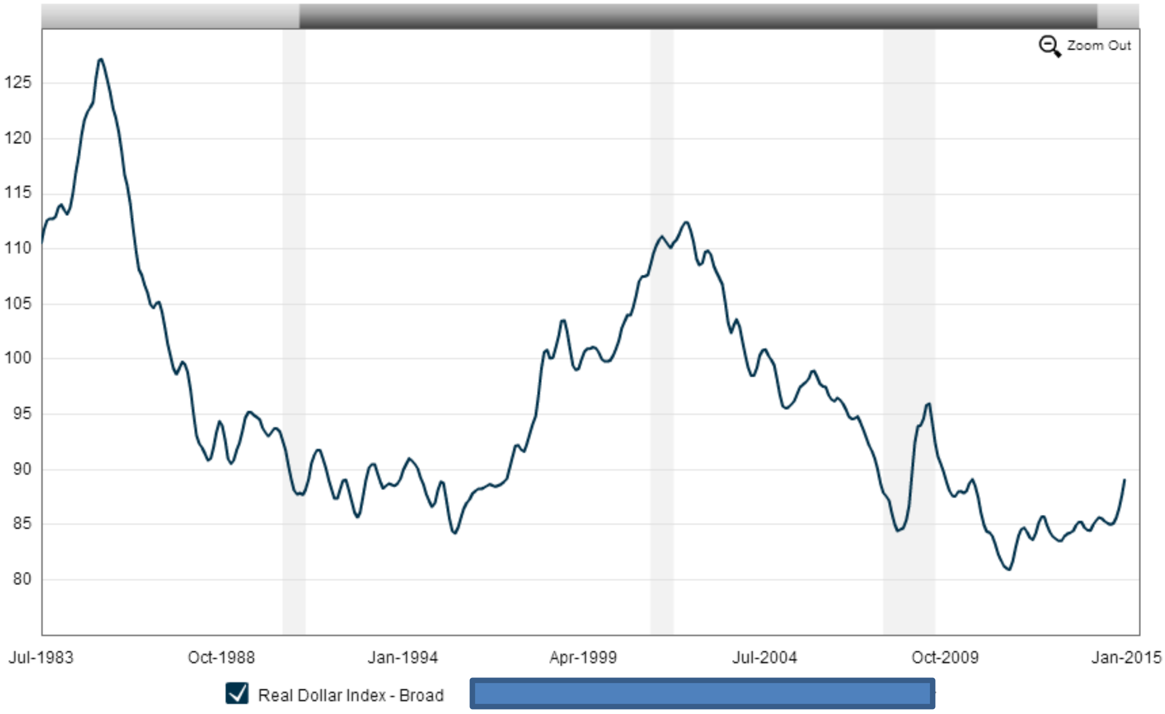
Over the last six years, attempts to engineer an economic recovery have basically involved dumping liquidity into the financial system by lowering interest rates and quantitative easing (QE). Although highly experimental, the process of QE (often referred to as 'money printing') has become an accepted part of the central bank toolkit and one consequence has been to exert significant downward pressure on the currency. But currency shifts are a zero sum game, so when one nation tries to lower or devalue their currency (using QE, for example) it essentially imposes a tax on their trading partners, who see a commensurate rise in their currency, the net result being a game of 'beggar-thy-neighbour'.

What we now appear to be witnessing is a race to the bottom, or 'currency war', with a succession of QE programs aimed at stealing short term growth. This may only be the start, with more than 12 central banks slashing rates this year and in some cases into *negative territory* – if this fails to work then presumably they will also initiate QE of their own. But recent events in Switzerland highlight the potential limits of these interventions when the central bank was forced to abandon its commitment to suppress strength in the Swiss franc – the result was a c.40% jump in the franc versus the euro in minutes (and near bankruptcy for some speculators on the wrong side of it).

The role of the US dollar

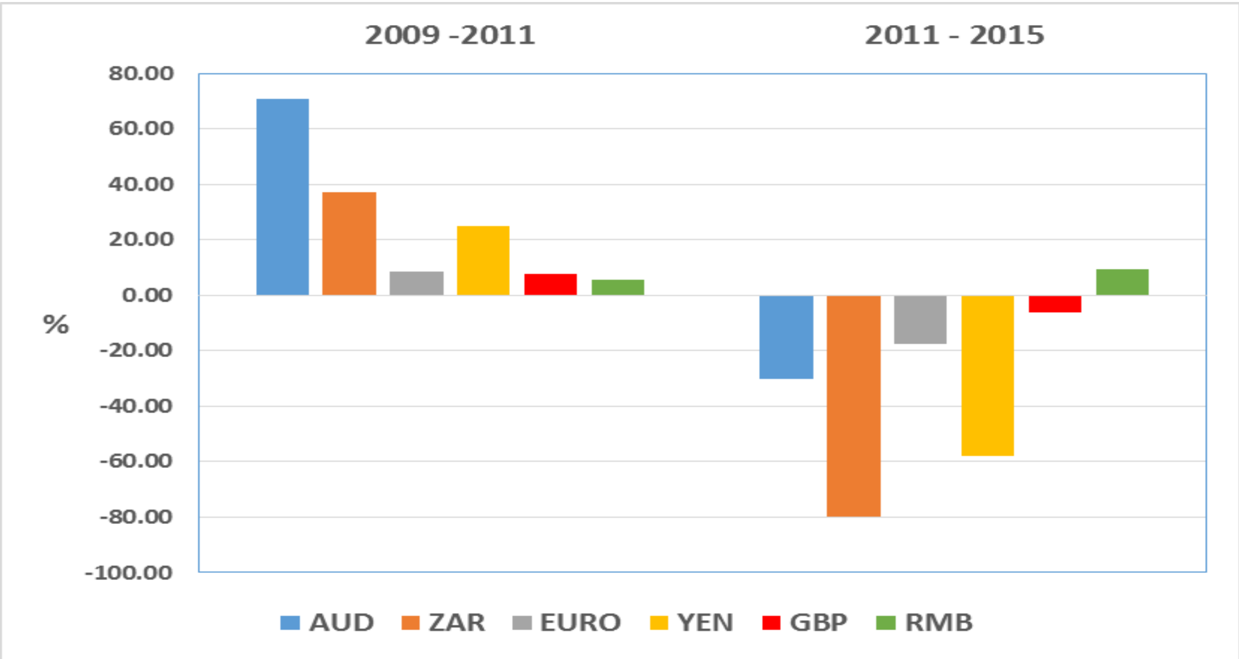
The US dollar remains the world's dominant reserve currency, representing more than 80% of daily trade finance and around 90% of volume in the foreign exchange markets. All other currencies are priced against it, as are commodities such as oil, copper and gold. The US central bank, the Federal Reserve (Fed) is therefore effectively the world's central bank, hence the 'price' and availability of dollars permeates everything.

The persistently weak dollar trend seen in 2002-2007 helped the US pull out of its post-TMT bust recession but it also contributed to the emergence of asset bubbles in commodities and emerging markets (as cheap dollars flowed into these areas). The 2008 crisis interrupted this trend but thereafter it continued once the Fed intervened through lower interest rates and QE. The chart below details the value of the dollar judged against a trade-weighted basket of other currencies. (Source: www.macrotrends.net)



During the last two years the declines that we have seen in major currencies such as the yen, euro and sterling have happened against the US dollar, so that *the weakening trend in the dollar has started to reverse*. This is heavily linked to the fact that QE in Japan/Europe has been started, whereas in the US it has been suspended. The table below shows in more detail the reversal taking place against some specific currencies.

Table: peak-trough currency gains/losses versus US dollar for each period. Source: www.ig.com
AUD - Australian Dollar ZAR - South African Rand RMB - Chinese Renminbi YEN – Japan EURO - EC



IFPC Limited, Faulkner House, Victoria Street, St Albans, Herts, AL1 3SN
T: 01727 837128 E: info@ifpc.co.uk www.ifpc.co.uk
IFPC Limited is authorised and regulated by the Financial Conduct Authority.
Registered in England and Wales, no. 2282838. Registered office: Faulkner House, Victoria Street, St Albans, Herts, AL1 3SE

Note that:

- The commodity currencies AUD and ZAR have seen large reversals since 2011 due to substantial declines in global commodity prices (iron ore, oil, copper and coal have fallen 40 - 60% in dollar terms)
- The decline of >50% in the yen in just 2 years means that Japan is forcing its deflation problem to the rest of the world and putting significant downside pressure on consumer prices everywhere
- The euro has declined markedly recently as Europe stagnates and then resorts to QE
- China's Renminbi (RMB) has been largely 'pegged' to the dollar through this period, and so its exporters are now facing substantial competitive pressure from the devaluations in Japan and Europe

The net result is that we are seeing the start of a rebalancing process which inevitably means that the US now has to bear the burden of a strengthening currency so that many of its trading partners can weaken theirs. A secular shift such as this might continue for years, with significant consequences for investment outcomes.

Implications of a strong dollar

There are both positive and negative implications arising from a period of persistent dollar strength going forward:

Positive

- A stronger dollar exerts downward pressure on US inflation, meaning that interest rates in the US could stay lower for longer. An extended period of non-inflationary growth in the US could be positive for investment markets everywhere, providing much needed relief to Europe and Japan
- Emerging market investments are currently underperforming due to the dollar and commodity price headwinds. This should eventually yield portfolio opportunities in which we can enter long term recovery stories at sensible valuations
- The devaluation of the dollar during the post-2000 Alan Greenspan era was excessive, creating asset bubbles and distortions. A rebalancing will create short term dislocation but is positive in the long run.

Negative

- Debt levels in emerging economies have grown substantially in the last decade due to abundant, cheap dollar liquidity. As the dollar rises it tightens global liquidity conditions, forcing borrowers to repay their dollar debt. Recessions in some emerging markets look likely
- China's currency is 'pegged' to the dollar and so they are strengthening together. China may reassess the level of the peg given that its exports must compete in the global market. Such a move would exert even more upward pressure on the dollar
- Commodity prices look set to remain lower and commodity-producing nations appear particularly ill-prepared for an extended period of lower prices and slower growth in China

Investment strategy

It is not possible to predict with certainty that the secular trend in the US dollar has turned but conditions appear to be falling into place that make it *probable*. Therefore it has been necessary to prepare portfolios for a different set of outcomes in order to both capture the opportunities and also mitigate the risks. Examples of the actions taken are as follows:

- A reduced exposure to emerging market equities in the short term, due to their exposure to US dollar debt and the reliance of certain countries on commodity exports
- An increased exposure to equity markets that stand to benefit from cheapening their currency against the US dollar, and also from lower energy costs, such as Japan
- The removal of a currency hedge on our US stock/bond market positions (so that we benefit from rise of the US dollar versus GBP)
- The sale of emerging market bond exposure other than that which is denominated in US dollars
- The introduction of long-dated US or UK government bonds in order to manage deflation risks that arise from a persistently strong US dollar, or a move by China to devalue its currency (which would exacerbate further the deflationary pressures on the US)
- The introduction of a specialist hedge fund where the manager is explicitly positioned to profit from weaker currencies and increased recession risk in commodity producing nations such as Australia and South Africa
- An increased exposure to passive funds such as exchange traded funds, which allow us to take advantage of volatility due to their liquidity and pricing arrangements.

Bottom line

Financial markets generally remain optimistic and well supported by an ever-rising tide of cheap liquidity. Indeed, central bank largesse remains the primary determinant of asset prices. But the post-credit bubble undercurrents of recession and deflation remain stubbornly in place. As a recent report from McKinsey* pointed out, debt levels in nearly all countries continues to rise and since 2007 a staggering $57 trillion has been added to the total debt pile. Meanwhile, with interest rates around the world breaking all historic records and converging on zero, a currency war is in full swing as nations attempt to steal some growth and/or inflation through competitive currency devaluation. China and the US are currently bearing the brunt of this, leading to a significant strengthening in the US dollar, which in turn dials up the pressure on those with US dollar borrowings. Volatility levels are rising and will likely rise further if, as seems likely, either China or the US themselves are forced to respond. We believe that caution is required.

*McKinsey Global Institute report February 2015

http://www.mckinsey.com/insights/economic_studies/debt_and_not_much_deleveraging

Disclaimer: Please note that this document represents investment commentary of a general nature and should not be taken as a personal investment recommendation. It is not an invitation to invest with IFPC Ltd. It does not take into account any individual or personal objectives or circumstances. You should contact a financial adviser if you require specific financial advice.