The New Age of Currency Wars

Race to the bottom: Quest for a weaker exchange rate

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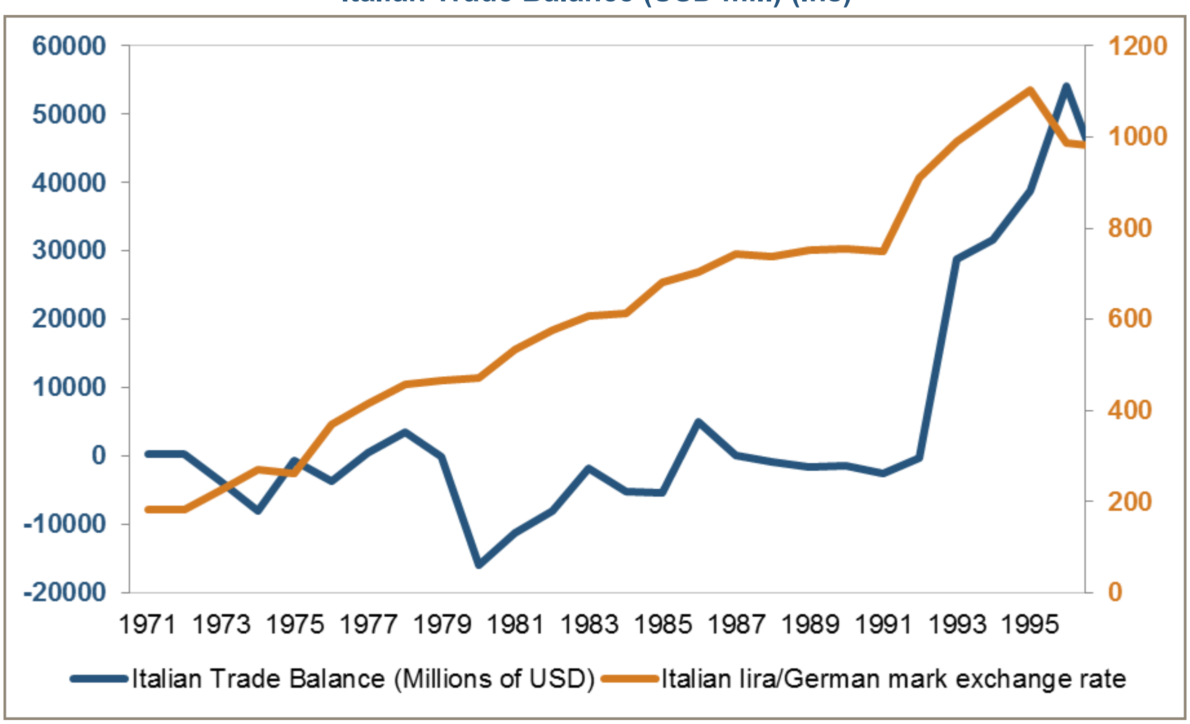
Key Points:

- The European Central Bank (ECB), Bank of Japan (BoJ) and the Federal Reserve (Fed) are marching in opposite directions. This divergence of global central banks has unleashed heightened currency volatility. In the last year, most G10 and emerging market currencies have lost ground to the U.S. dollar at a steady pace.
- Over 40 central banks in the last few months have implemented some measure of policy easing in order to prop up their economies, but also to prevent falling back in the “race to the bottom” to maintain their local currency and economic competitiveness[1].
- At Windhaven, we believe we are positioned to capture the opportunities offered by the quantitative easing policies of major central banks in the Eurozone (EZ) and Japan, as well as very low global interest rates, through exposure to Japanese and German equities, among others. However, it is important to note that we have decided to partially hedge those positions for currency risk. We have done so in an effort to reduce our exposure to the volatility that currency markets have been experiencing as a result of monetary and macro divergences, and not to express a specific directional view on those currencies.

The Path of Least Resistance

If, by way of example, you grew up in Italy in the 1970s, 1980s and especially the 1990s like yours truly, you would be very familiar with the expression “competitive devaluation” and its impact on everyday life. Figure 1 shows the steady depreciation of the Italian Lira over the decades that lead up to the inception of the euro. The currency lost 77% of its value in the two decades between 1971 and 1992; and subsequently lost another 25% of its value between mid-1993 and early-1997[2]. That last leg of devaluation gave a boost to the trade balance (the difference between exports and imports of goods and services), which was also helped by the collapse in imports that came with the economic contraction of 1993.

Fig 1: Italian Lira/German Mark Exchange Rate (Italian Liras for 1 DEM) (rhs) and Italian Trade Balance (USD mill) (lhs)



Source: Bloomberg as of 12/31/1995

Currency devaluation can be associated with bursts of inflation and a reduction in the purchasing power of the domestic population of a country. However, it can also provide economic stimulus to a country that intends to pursue an export-led growth model. Competitive devaluations can be considered the path of least resistance for a government, given the immediate effectiveness on relative prices and on the competitiveness of an economy; in addition, political cycles are relatively short and implementations of reforms and policies are difficult.

One of the most obvious examples of export-led growth is China in the pre-crisis years of this century and since joining the World Trade Organization (WTO) in 2001. The export-led growth model was supported by intervention of the People's Bank of China (PBOC) in the foreign exchange market to preserve the competitiveness of the renmimbi (RMB) and support the export sector.

China might have joined the most recent currency war or attempted to started a new one. The PBOC has recently surprised markets by devaluing the RMB. While this can be interpreted as an effort to move in the direction of greater exchange rate flexibility and market based pricing, it is also open to the interpretation that China is increasing the competitiveness of its external sector to counter the slowdown in domestic economic activity. Cheaper Chinese exports could come at the expense of reduced competitiveness of other countries' exports. In this case, other exporter countries could react by trying to devalue their own currency in order not to remain behind in the race to the bottom.

Fig 2: Chinese Current Account and Real Effective Exchange Rate

Source: Bloomberg as of 12/31/2007

Quantitative Easing: The Silent War on Currencies

Generation Z (those born in the mid-90s) may be less familiar with the term "competitive devaluation," but they will likely recognize expressions like "currency wars" and "currency manipulation." The years before the global financial crisis were characterized by economic and political tensions around the loss of U.S. jobs to cheaper offshore destinations. China was front and center in a trade war that was supported by its currency policy. Five meetings took place from 2006 through 2008 between the most senior Chinese and U.S. officials under the auspices of the China-U.S. Strategic Economic Dialogue (SED), an initiative that took off under Presidents George W. Bush and Hu Jintao. The goal was to find common productive ground in the economic relations between the two economic powers and of course to deal with something near and dear to the U.S. Treasury: China's intervention in the currency market.

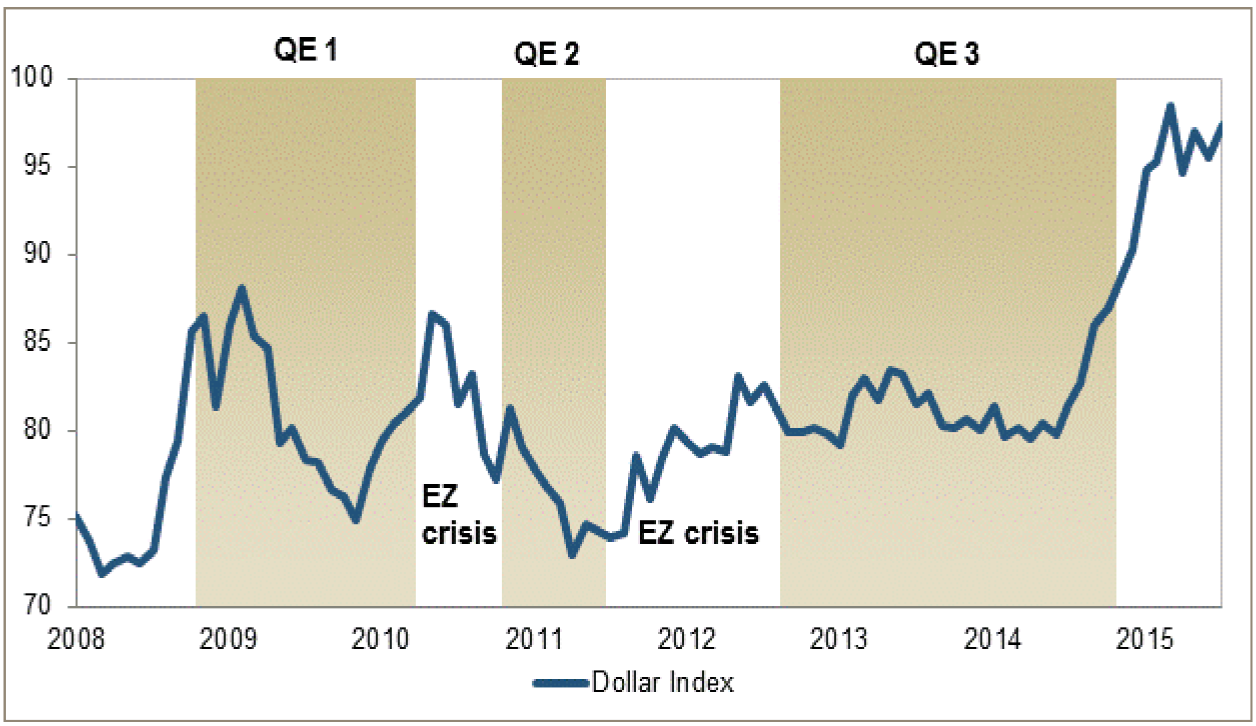
Then came the Great Recession and Global Financial Crisis (GFC); somehow the reins of the G7's rhetoric on central bank policy and the effect on currencies changed. An extreme situation, like the GFC, required extreme policy measures.

In 2008-2009 the Fed engaged promptly in policy easing by setting up an alphabet soup of facilities like Term Asset-Backed Securities Loan Facility (TALF), Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) and Money Market Investor Funding Facility (MMIFF), to unclog credit markets, cut interest rates aggressively and aggressively injected liquidity in the system via quantitative easing (QE) once the zero bound was reached.

We will not analyze Fed policy in detail here, but the weakening of the U.S. dollar was a welcome side-effect of QE in the attempt to reflate assets, support inflation expectations and the export sector. Moreover, it was also beneficial for the 40% of S&P earnings which come from abroad.

Figure 3 illustrates that when the GFC erupted, investors that were in search of safe haven assets poured money into the U.S. dollar, sending the currency and U.S. Treasury securities into a steep climb. The trade-weighted U.S. dollar index (DXY) rallied by 18% in the few months between July and November 2008[2]. Then the world watched the first round of QE unfold—with the goal of reflating collapsing equity markets, inflation, economic activity and credit growth. The DXY fell nearly 14% between the beginning of the first round of QE and the end of the second round of QE (November 2008-June 2011)[2]. However, there was a break between November 2009 and May 2010; during this span, the dollar strengthened abruptly as investors' concerns started mounting as the Fed moved prematurely towards the exit of the first round of QE, without another round of QE in sight. Then came the EZ crisis and the U.S. debt ceiling debate in the summer of 2011 which resulted in the downgrade of U.S. sovereign debt and caused the U.S. dollar to rally as investors sought its safe haven status. The DXY then entered a period of relative stability as ECB's head, Mario Draghi, told the world that the ECB would do "whatever it takes" to save the euro. At the same time, the Fed announced another QE program that was open-ended, which eventually concluded in October of 2014. Note that as the end of the third round of QE was in sight, the DXY resumed its steep climb—as it did at the end of every QE program—to start the current era of U.S. dollar strength.

Fig 3: QE and DXY

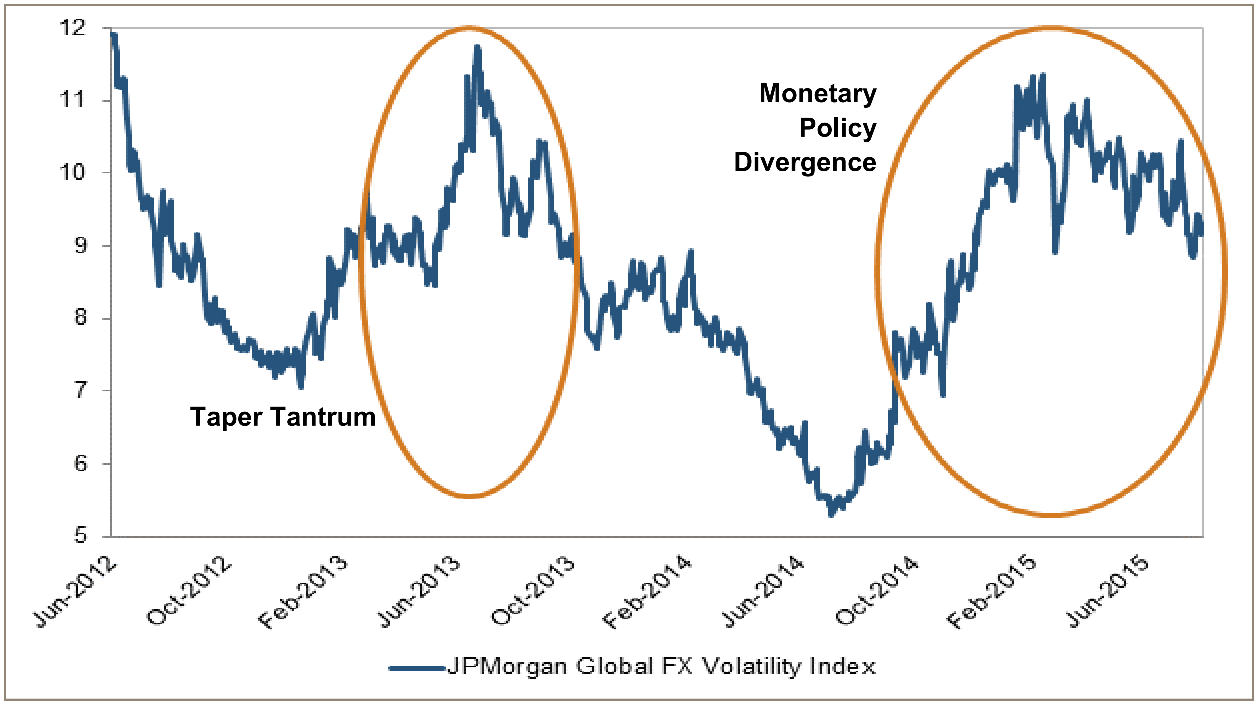


Source: Bloomberg as of 7/31/2015

The Fed had engaged in a massive balance sheet expansion to shore up the economy and markets, with the welcome side effect of a weaker U.S. dollar. This was not currency intervention, supposedly it was the needed monetary medicine to reflate the U.S. economy and provide legitimacy to the future action of other central banks. It unleashed a global desire to fight deflation, stagnation and recession with a similar medicine – with the understanding that the effect on currencies would just be an indirect side-effect of the medicine.

Fast forward to May 2013, the month of the taper tantrum. Fed Chair Ben Bernanke announced the upcoming tapering of the purchases of securities and global market went into a tantrum which showed up in currency volatility, among other asset classes.

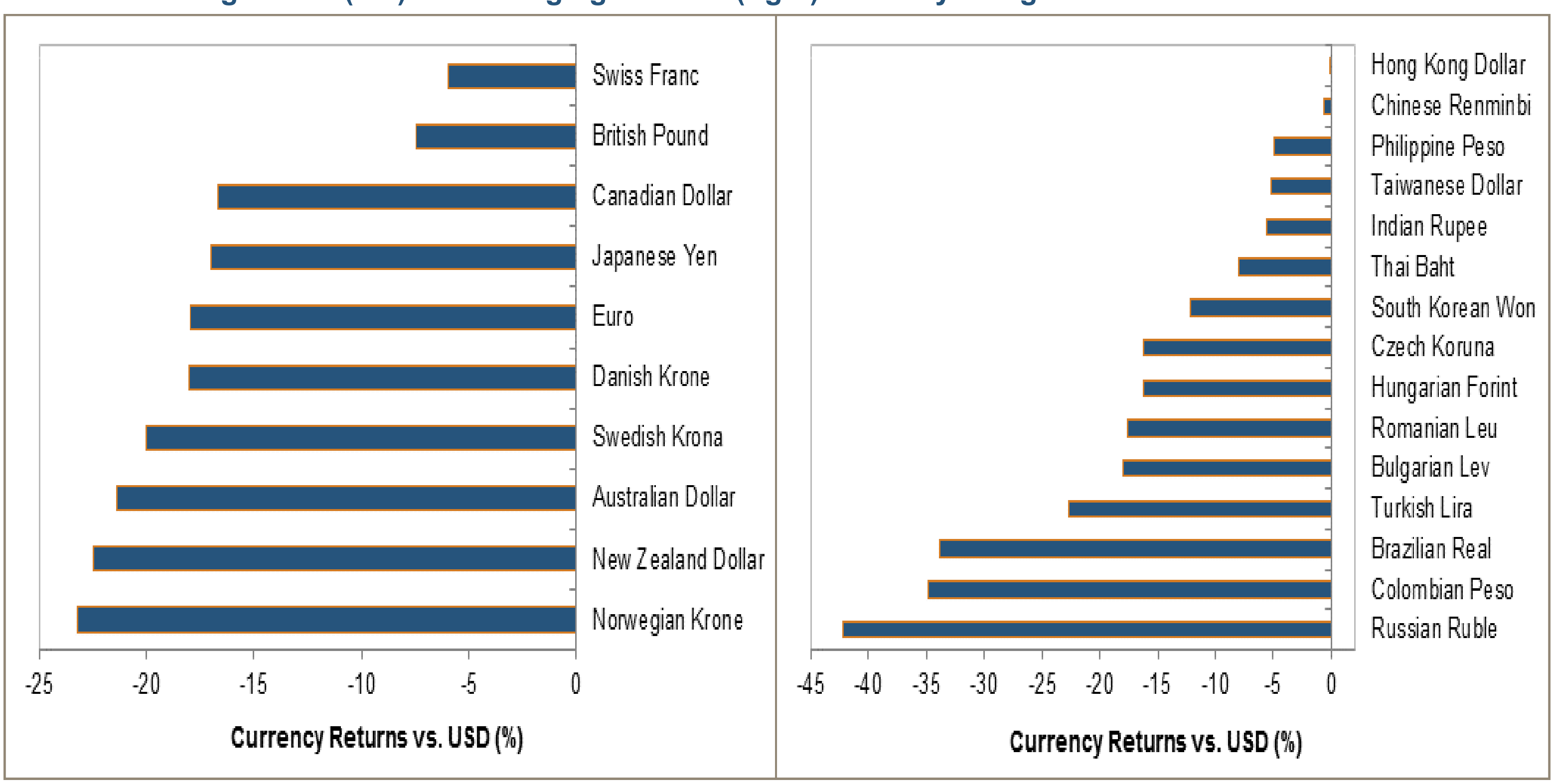
Fig 4: FX Volatility Back



Source: Bloomberg as of 7/31/2015. JPM Global FX Volatility Index is an index of global foreign-exchange volatility that tracks options on currencies of major and developing nations in percentage points.

Fast forward again to the second half of 2014. While the EZ was in deflation and Japan was doubling down on its QE program (which began in April 2013 as a crucial piece of "Abenomics"), the Fed was moving in the opposite direction. October 2014 marked the end of the Fed's QE and the beginning of the dance between the Fed and markets to get on the same page as to the initiation and subsequent path of interest rate hikes. Needless to say, this divergence of global central banks' policies has brought with it heightened currency volatility. In the past year, many currencies of the G10 and emerging market economies have lost ground to the U.S. dollar at a steady pace: the U.S. dollar is certainly losing the race to the bottom.

Fig 5: G10 (left) and emerging markets (right) currency lost ground to the U.S. dollar



Source: Bloomberg from 7/31/2014-7/31/2015

The wave of QE programs has now firmly shifted its epicenter to the EZ and Japan and away from the United States. The Japanese yen (JPY) has lost over 50% of its value against the U.S. dollar since the third quarter of 2012 when the BoJ's QE was being conceived[2]. The euro has depreciated over 20% against the U.S. dollar since summer of 2014 in wake of expectations of further ECB easing. Over 40 central banks in the last few months have implemented some measure of policy easing in order to prop up their economies, but also to prevent falling back in the "race to the bottom" to maintain their local currency and economic competitiveness[1]. Those kinds of devaluations constitute today's silent central banks' currency war; where currencies are pushed down under the weight of central banks with the goal of sparking inflation and growth, but with the silent understanding that currency depreciation will play a role in it. Monetary easing has essentially resulted in a redistribution of growth from the latest region to introduce monetary stimulus to the next, via currency devaluation.

Seizing Opportunities While Managing Risk

We believe we are positioned to capture the opportunities offered by the quantitative easing policies of major central banks in the EZ and Japan, as well as very low global interest rates, most recently through exposure to Japanese and German equities, among others. We are partially hedging those positions for currency risk in order to potentially reduce some of the volatility that currency markets have been experiencing as a result of monetary and macro divergences; these positions do not express a specific directional view on those particular currencies. We recognize that there are forces that can drive currencies in very different directions over time and we aim to be well-positioned across a broad spectrum of potential outcomes, though the forthcoming Fed interest rate hiking cycle may likely continue to result in U.S. dollar strength.

In Europe, the euro could continue to suffer from:

- The aggressiveness of the ECB's QE program, sending investors in search for yield outside the EZ and related to that, an interest rate differential in favor of the U.S. dollar.
- The beginning of an interest rate hiking cycle in the United States, which would exacerbate the interest rate differential with the EZ.
- A potential return of negative sentiment around Greece or other fragile peripheral countries in the EZ that could raise risk aversion and cause flights to U.S. or Japanese safe haven assets.

Conversely, the euro could benefit from:

- A delay in the beginning of the Fed interest rate hiking cycle, which could put the brakes on the U.S. dollar's appreciation. This is something that we have seen recently after sluggish U.S. economic growth in the first quarter of 2015.
- An improvement in the EZ outlook for both inflation and growth; again something that we have actually witnessed in the first quarter although it still appears to be more cyclical than structural.
- A widening of the already large, current account surplus of the EZ, which could lead to a rebound of the euro.

Similar considerations could be made for Japan with the added feature that the Japanese yen can act as a safe haven currency in times of risk aversion and financial stress.

- Further easing measures by the BoJ could cause another leg down for the yen. Many commentators are speculating that further easing measures might come in the summer or fall in wake of the BoJ missing its inflation target.
- As in the case of the euro, if further BoJ easing were to coincide with the beginning of the Fed's interest rate hiking cycle that could cause a relative strengthening of the U.S. dollar against the yen.
- A scenario in which commodity prices rise substantially and tip the Japanese trade balance back into deficit could also result in a weakening of the yen.
- Another scenario in which the yen could weaken substantially is one in which the yen carry trade comes back. This could come with the back drop of an improvement of global macro conditions that boost global growth and sentiment, inducing investors to benefit from borrowing cheap money in Japan to be put to work in higher yielding currencies.

Conversely the scenarios that could result in a strengthening of the yen:

- General risk aversion could strengthen the yen, no matter what the drivers of it are. The yen has historically behaved as a safe haven currency in times of risk aversion and has strengthened during events of financial stress. There are no shortage of factors that could contribute to negative global sentiment and to a strengthening of the yen as investors seek safe haven assets: a return of financial fragility across the EZ periphery, a negative geopolitical event, a monetary policy mistake in the United States, and a significant worsening of financial stress and slowdown in Chinese economic activity are all examples that could fuel risk aversion.
- If the BoJ were not to ease monetary policy further while the ECB continues with its aggressive QE program and while the Fed maintains a dovish tone (i.e. delaying interest rate hikes) on poor U.S. economic performance and outlook, relative policy stances could also be supportive of yen appreciation.

Sources:
[1]Central Bank News, www.centralbanknews.info [2]Bloomberg

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