With central bankers around the world engaged in a frantic game of stealth currency depreciation, our chief currency strategist provides advice on how — and where — investors should think most about hedging the risk that the currency brinksmanship poses to their portfolios.

One of the biggest themes in today’s markets is monetary easing and its typical byproduct — currency depreciation — in many of the world’s major economies. Since the start of the year, central banks around the globe have chimed in with a combination of interest rate cuts (in some cases into negative territory) and bond buying in a not so subtle assault on currency valuations. The European Central Bank (ECB) led the charge when it announced €1 trillion worth of bond buying in January, and Japan’s ongoing ultra-loose, low-rate policy has factored in as well.

The impetus for these moves is clear. Global growth is muted and inflation is extraordinarily low in Europe and other regions, inviting action to lift growth and domestic price levels and stave off deflationary expectations (the inflation rate for the euro area stands at -0.3%). Meanwhile, policy rates are at zero or even below zero in many markets, meaning that any additional rate cuts will likely have a negligible impact on stimulating additional investment, and may cause other undesirable economic distortions.

As we have seen from the recent Greek elections and protests across the eurozone, it has become much more politically difficult to push through structural reform. While these reforms do carry long-term benefits, the short-term pain is much harder to swallow. As a result, central banks are employing ever more monetary easing by cutting rates further still and/or initiating quantitative easing (QE), to reach for one of the few stimulus levers they have left — currency depreciation — as a way of lowering the prices of their goods abroad and propping up economic growth and inflation. And there is evidence that the approach has worked to varying degrees (see figures 1 and 2). In the eurozone, for example, the trade balance reached record levels at the end of 2014, due in part to the declining euro that made German exports more attractive. In Japan, following monetary easing, inflation has moved closer to the Bank of Japan’s 2% target, ticking up to 1.6% in early 2014 before the distortive effect of the consumption tax increase.

With seemingly everyone jumping on the easing/depreciation bandwagon, the gunshot has rung out on a race for each central bank to keep up with the latest policy easing from outside its borders. If a country fails to ease along with the crowd, then it will likely see a currency appreciation, have higher relative prices than other regions, suffer a decline in its relative competitiveness, and see demand for exports slip away to its neighbors.

Recent announcements from the Danish Central Bank are some of the clearest examples of just how harried this low-yield contest has become. Danmarks Nationalbank cut interest rates four times in the span of just three weeks. Most recently, it reduced interest rates on certificates of deposit by 0.25% to -0.75%, joining Switzerland and Sweden in setting negative overnight interest rates for banks attempting to park cash in central banks. On February 4, Finland issued €1 billion of five-year debt at a yield of -0.017%, becoming the fourth eurozone country to carry five-year debt with a negative yield.
IQ Insights | Surviving the Currency Wars

Currency wars are nothing new. The term first came up about five years ago, when the US markets were just coming back to life after the Global Financial Crisis and the US was in the throes ofQE. Emerging markets (EM) saw the dollar weaken and EM finance leaders complained that EM exports were being made relatively more expensive. Still, those skirmishes pale in comparison to the gloves-off hostilities we see today. Back then, the US QE was more for domestic reasons, and the currency effect was simply a spillover. The difference in today’s war is that easing is occurring around the globe, and the target really is the foreign exchange rate — but don’t say it too loudly. It is frowned upon for a country to devalue its own currency outright, which could invite open retaliation or tariffs and sanctions from other countries. In addition, a country devaluing its currency outright could be seen as high risk, resulting in significant outflows of investment.

Whether a country devalues its currency explicitly or implicitly via monetary easing, there is a risk that investors will be concerned that the country is introducing depreciation as a recurring policy tool. In that case, market participants may refrain from investing because they do not want exposure to a currency that will inevitably decrease in value. As a result of reduced foreign direct investment, the currency may fall even further, creating a negative feedback loop from the initial devaluation.

Despite these risks, the currency war is in full effect and has had implications for all asset classes, including foreign exchange, fixed income, and equities. The dynamics are worth considering as we think about the future trajectory of these markets.

US Dollar: Could Have Been Higher

Two-time Olympic hurdles champion Roger Kingdom was known for brute strength that defied the norm for his sport; he won races despite often knocking over more hurdles than other runners. During a race in August 1989 in Zurich, Kingdom clipped three of 10 hurdles but still set a world record for the 110-meter race. The question, then, is what time would Kingdom have recorded without hitting those hurdles?

It appears that the US dollar has the same winning spirit, as it has seen a meteoric rise despite multiple rounds of aggressive QE since 2008. While the euro and other major currencies have fallen after easing — the US dollar weakened slightly at first, too — it has since climbed higher through two more successive rounds of QE. Similar to a Kingdom race, the important question is, where would the US dollar be without QE? We think that the US dollar was on a strong upward trajectory before QE, and without it, the dollar would be even higher. QE did not lead to depreciation, but it capped appreciation. In fact, we think that the dollar has significant room to run and is only at the 3.5-year mark of a typical 7- to 10-year dollar bull run.

Figure 3 shows that through 2012, the expected relationship between central bank balance sheets and currencies held — relative monetary expansion led to a weaker currency and vice versa. However, since 2012, even as the Fed’s balance sheet expanded while the ECB’s contracted, we see the relationship flip and the US dollar strongly rally.

Put simply, countries in today’s currency war can be divided into two camps: those whose currency is already weak and getting

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**Figure 1: Eurozone Trade Balance with Non-eurozone Countries**

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Source: Bloomberg, as of February 27, 2015.

**Figure 2: Japanese Nationwide CPI, All Items**

Annual Percent Change

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Source: Bloomberg, as of February 27, 2015.
weaker due to monetary easing (the euro and the Japanese Yen being the best examples); and those whose currency is actually appreciating, and monetary easing is just putting a cap on how high it can go. We think the US represents the latter camp.

**Some Major Currencies Just Getting Started?**

The question is not just who is next to target foreign exchange weakness through easing, but who will step it up from what they’re already doing. Who will adopt the most aggressive policy and see their currency fall the most?

Indeed, currencies can move significantly based purely on speculation or, in the case of the Turkish Lira, “pre-announced” possible rate cuts. In late January, after the Turkish Central Bank (TCB) cut rates and the lira fell by 2%, the TCB announced that it was considering cutting rates further at an emergency meeting, at which point the lira promptly dropped another 3%, reaching record lows against the US dollar (the TCB eventually scrapped the emergency session following moderate inflation data, but cut rates at its regularly-scheduled February 24 meeting). But the lira is just one of many currencies that will be affected as the currency war continues. Some of the world’s biggest and most influential economies could just be at the outset of new plans for easing and depreciation in a global race to the bottom.

**China**

China has the potential to make further moves to depreciate the Chinese Renminbi (RMB). The country’s economy slowed to a 7.4% growth rate in 2014, the lowest level since 2009, with the International Monetary Fund’s forecast for 2015 coming in at 6.8%. Despite outperformance in the Shanghai stock index in late 2014 due partly to a People’s Bank of China (PBOC) rate cut last November, Chinese growth continues to struggle due to the ongoing property glut and other fundamental issues in the economy.

In addition, the real trade-weighted RMB, or the real value of the currency weighted relative to the currencies of its major trading partners, has been appreciating strongly alongside the dollar. This makes sense — after all, some of China’s biggest partners include European and Asian countries that are watching their currencies tumble. Given that the RMB is tightly managed versus the US dollar, China is seeing itself lose competitiveness around the world as its currency moves up virtually in tandem with the dollar — reason enough to consider depreciation.

Just this month, the PBOC cut RMB benchmark loan and deposit interest rates for financial institutions by 0.25% to 5.35% and 2.5%, respectively. Concurrently, the upper limit of the floating range for deposit rates was raised from 1.2 to 1.3 times the benchmark level. This follows the PBOC's cut of the required reserve ratio for financial institutions by 50 basis points, effective February 5.

These moves were widely viewed as a way to stave off deflationary trends and stem capital flows resulting from slowing growth. China is just one of many emerging market currencies that has seen investment outflows on expectations of higher US rates. The slowdown in China is also decreasing Chinese demand for exports from other EM nations, causing further damage to currencies in countries such as Thailand and Chile. For China, the recent announcements could be just the start of more easing measures to boost Chinese growth.

While we do think that the PBOC is headed for more easing — with RMB depreciation as a key intended side effect — there are, of course, risks of capital flight from too much depreciation. Due to the importance of foreign investment in China and the government’s well-telegraphed efforts to increase the use of the RMB in international markets, the PBOC is therefore expected not to go too far in devaluing the currency in order to avoid prompting volatility in the RMB.
Eurozone

We think the eurozone also seems ripe for further easing. Although the ECB has already announced a roughly €1 trillion asset purchase program (which will take many months to play out), we question whether €1 trillion of purchases is really enough based on the experience of US QE.

The US and European Union (EU) economies are roughly the same size: US GDP was nearly $17 trillion in 2013, compared to about $18 trillion for the EU. However, the US enacted nearly $4 trillion of asset purchases during its three rounds of QE, beginning in 2008 — almost twice the size of the ECB’s balance sheet as of February 2015. While the newly announced balance sheet expansion by the ECB will close the gap, we think the ECB will have to do at least as much as the US, especially considering that when the US started its QE, US growth and inflation was actually in better shape than the eurozone’s is today. Even now, US growth still remains sluggish and wage inflation has yet to turn enough of a corner to satisfy the US Federal Reserve, suggesting that even the nearly $4 trillion of US QE was probably a bit light.

That said, the current ECB plan is larger than expected, so it may be difficult for the ECB to increase the number of bonds purchased in 2015. However, the ECB may seek further easing another way. In that case, the ECB may be forced to move benchmark interest rates even lower.

United States

Will the US engage in more easing to stay in step with the trend and remain competitive in exports? If it does not, the currency war will continue to drive a strong dollar, and consequently exports will become more expensive relative to those beyond US shores. Recent earnings from companies like Pfizer, PepsiCo or Avon — all negatively impacted by foreign exchange — show the adverse effects of the strong US dollar on domestic companies with a large share of profits overseas. Given declining unemployment and overall improvement in economic data prints, we do not think that the currency wars will have a negative impact on the US economy or financial conditions that the Fed will enact a new round of QE. However, we do think that the trade wars may push anticipated rate hikes later than initially expected, suggesting a first federal funds rate hike in September versus June.

Brace for Volatility

One outcome of the currency wars is that foreign exchange volatility, which has already increased significantly, will likely continue to climb. A grand display of this came in January, when the Swiss National Bank (SNB) decided to abandon its floor (the cap on appreciation of the Swiss franc) of 1.20 on the euro/Swiss franc (EUR CHF) rate. The SNB would have had to use Herculean efforts to maintain the floor in the face of an ECB QE program specifically geared to push down the euro. Following the SNB's announcement, intraday, the CHF rose by as much as 28% relative to the euro, and ended the day up roughly 17%. The move was one of the biggest one-day currency moves in the last 100 years and one of the most surprising currency announcements in recent history. At the same time, the SNB lowered interest rates by 50 basis points, to −0.75%.

For most investors, perhaps even more pertinent is the effect of higher volatility could have on other asset classes. In a foreign currency-denominated fixed-income portfolio, currency volatility contributes about 80% of total risk; for equities, this number is about 33%. So roughly 80% of the risk for a UK investor investing in, say, Australian sovereign debt comes from the risk of decline in the Aussie dollar. Similarly, if you’re a US investor investing in shares of Toyota, about a third of the risk is from currency risk. Beyond explicit currency risk, a number of US-based companies, such as clothier Ralph Lauren and tech giant IBM, have announced that they expect a significant negative impact from foreign exchange in upcoming quarters and the next fiscal year. As an investor, this could mean you are also taking on a significant dimension of implicit risk above and beyond the company’s operational performance, particularly in emerging markets. It’s true, multinational corporations tend to hedge their currency risk, but the vast majority hedge only part of it. So investors are left to ask themselves how much additional volatility from currency risk — both explicit and implicit — are they willing to assume before they consider hedging that risk?

Along with volatility comes a search for stability, and we are already seeing signs of a flight to quality with strength in gold. A strong dollar generally makes gold more expensive for non-US buyers in their home currencies. However, due to risk aversion, investors are shrugging off the lack of yield and the strong US dollar, and flocking into both gold and dollar-denominated assets at once. The currency war has also increased demand for low-yielding sovereign debt that can serve as a safe haven, such as German or US government bonds.

Importance of Hedging on the Rise

As investors seek to continue investment in international securities to capitalize on strong fundamentals or growth trends, it’s more important than ever to consider the currency volatility attached to these investments. As the currency wars...
continue and volatility increases in the world's FX markets, investors should play close attention to the currency risk attached to foreign securities.

Fortunately, with appropriate hedging strategies, investors can take on exposure to foreign assets without being forced to hold the increasingly volatile foreign currency exposure. We encourage investors to examine their investment goals and consider more sophisticated, dynamic hedging strategies that can allow them to maintain international investments while seeking better protection against rising currency risks.

1 European Central Bank, as of January 22, 2015.
2 Harmonised Index of Consumer Prices (HICP) Inflation - Overall index, Estimate, Annual rate of change, Eurostat as of March 2, 2015.
3 The Federal Statistical Office, Wiesbaden, Germany, as of February 9, 2015; Bloomberg, as of December 31, 2014.
4 Bloomberg, as of March 31, 2014.
6 Bloomberg, as of February 4, 2015.
7 USA Track & Field, as of March 10, 2015.
8 US Federal Reserve, as of November 25, 2008; Bloomberg, 2008-2015.
11 International Monetary Fund, as of January 19, 2015; The World Bank, as of March 3, 2015.
12 People's Bank of China, as of November 24, 2014.
14 People's Bank of China, as of March 2, 2015.
15 People's Bank of China, as of February 5, 2015.
16 The World Bank, as of February 25, 2015.
19 Swiss National Bank, as of January 15, 2015.
20 State Street Global Advisors (SSGA), as of January 16, 2015.
21 Swiss National Bank and State Street Global Advisors, as of January 15, 2015.
22 State Street Global Advisors, as of March 3, 2015.
23 Ralph Lauren Corporation, as of February 4, 2015; IBM, as of January 20, 2015.
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Investing involves risk including the risk of loss of principal. Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Risk associated with equity investing include stock values which may fluctuate in response to the activities of individual companies and general market and economic conditions.

Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates rise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

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