QIC

Five Currency Themes

for 2020

Our annual 'Five Currency Themes' series helps Australian investors navigate through all currency market environments - including severe market downturns. The issues here are those which should be on investors' radars for 2020, especially as COVID-19 continues to upend communities, economies and markets.

1 Essentials of managing liquidity risk in a hedging program

While we can't eliminate the necessity of funding hedge losses short of eliminating the entire hedging program, there are some ways for investors to mitigate the effects.

During a crisis, liquidity risk in hedging programs can undermine investment opportunities across the entire portfolio

A very simple solution is to spread out the hedging program's maturity profile

An even more holistic approach will ensure you can gain a strategic advantage through periods of adversity

2 How impactful is your FX policy in the COVID-19 crisis?

There is a strong argument to elevate the currency decision in the asset allocation process, and recognise the material impacts it can have on investor outcomes.

Currency exposure can easily represent the second biggest risk factor in a diversified portfolio after equities

Simple modelling can highlight the impact changes in foreign currency exposure can have, with a 15% divergence between hedged and unhedged equities

Foreign currencies have been a reliable source of diversification through the COVID-19 crisis

3 Trading at London 4pm and the illusory benefits of maximum liquidity

For best execution, Australian investors need a considered approach rather than methodically and naively trading at the fix.

There are many motivations for market participants to execute referencing the London 4pm 'fix', including elevated liquidity and narrow bid-ask spreads

However, market impact costs from herd behaviour completely overwhelms any benefits that accrue from the surge in trading volumes

These very material and avoidable costs are invisible to those only assessing their trading costs against that fixing rate

4 Re-visiting the importance of effective implementation

Avoiding the 'set and forget' approach of rebalancing currency hedges at month-end will generate a materially better outcome.

Monthly rebalancing systematically disadvantages Australian investors, and even more so during stressed market environments

It's essential to maintain the efficacy of the hedge by tracking underlying assets and rebalancing the hedge

Alongside the avoidance of the London 4pm fix, this represents another implementation strategy where avoiding industry standards generates a materially better outcome

5 The price-insensitive market participants that may define the AUD low

Just as AUD buying by reserve managers helped define the highs for the previous cycle, they could also help define the lows for this one and remain a profound influence on exchange rates.

Immense FX turnover belies a more balanced market structure where persistent flows can have a material influence on exchange rates

Investors need to watch out for factors which drive repatriation of capital and reverse the exchange rate impact from 2002-2014

Current economic conditions can barely be more polarised to those accompanying the build-up of reserves

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