CURRENCY QUARTERLY

Q3 2021

SUMMARY

The US dollar (USD) continued to trade in a narrow range, unable to gain meaningful momentum in either direction. Although the US Federal Reserve (Fed) indicated that they may start to taper their bond purchase programme sooner than previously expected, this was counterbalanced by a healthy level of global growth and a search for carry – a trend that is being reinforced by the current low level of volatility in the currency space.

We believe there are two key risks that could disrupt the current market dynamic. The first would be a potential change in the benign macroeconomic backdrop, and the second would be a repeat of the 2013 'taper tantrum' as the Fed start to tighten policy. However, any appreciation in the US dollar is likely to be tempered by a combination of expensive valuations and growing pressures on the US external balance.

In our educational topic this quarter we look at the role of Bitcoin in institutional investors' portfolios. Our main conclusion is that given its high volatility, low liquidity, operational challenges, governance challenges and ESG risks, we do not believe that Bitcoin is suitable for most institutional investors, even in a currency portfolio. For investors that do want to gain exposure, specialist funds may be the safest way to do so.

We also provide an update on the Global Code for FX markets, which has just been updated following a three-year review. Insight sees our continuing commitment to the Global Code as an important component of our approach to responsible investment, as it promotes a robust, fair, liquid, open, and appropriately transparent market.

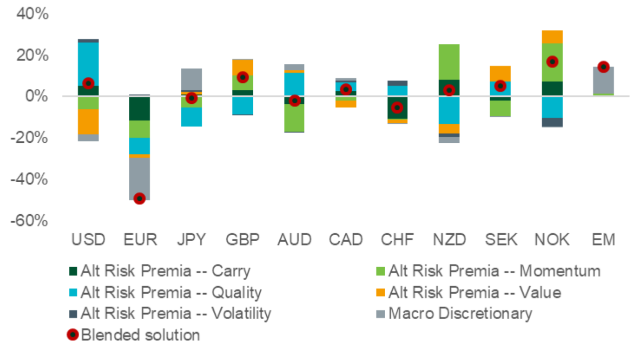
THE ALPHA VIEW

In our view, a combination of alternative risk premia and macro fundamentals are key drivers of currencies over short to medium term time horizons.

As we outline in more detail later in this document, our sense is that the current market environment where micro stories have played a greater role than macro stories in driving price action is likely to continue.

With this in mind, our blended alpha strategy of Alt Risk Premia and Macro Discretionary is currently most bearish the EUR and positive GBP, NOK, and emerging markets with a neutral USD bias.

Figure 1: Insight Currency Absolute Return Exposure



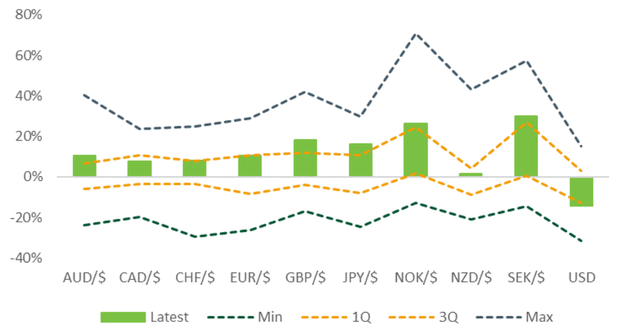
Source: Insight. Data as at 14 Sept 2021.

LONGER-TERM VALUATION OVERVIEW

As the investment horizon extends to a multi-year window, valuations are likely to dominate price action in currencies. We outline the highlights from our long-term valuation models below:

- The USD is moderately expensive;
- GBP, JPY, NOK and SEK are the cheapest currencies in the developed market space – NOK and SEK score as particularly good value;
- NZD is roughly at fair value;
- The AUD, CAD, and EUR are moderately cheap;
- Most of the deviations from fair value are roughly one quartile from median, suggesting the over and undervaluation are notable, but not extreme.

Figure 2: Local currency over (-) and undervaluation (+)



Source: Insight. Data as at 14 September 2021.

CURRENCY MARKET OUTLOOK

While core market stock prices and commodities have recorded double digit increases, the trade weighted USD has been stuck in a 3.5% range through 2021 and implied volatility amongst developed market currencies has fallen back towards the lows. At the same time, the almost pervasive USD bearishness that was the hallmark of many 2021 outlook pieces has been largely washed out and market positioning is a lot more neutral (Figure 3).

Figure 3: USD net IMM exposure (5y Z Score)

Source: Macrobond. Data as at 14 September 2021.

Before looking ahead, it is worth spending a few moments understanding how we got here. In a nutshell, two key forces have driven currency markets:

- Perceptions of Fed hawkishness versus other central banks – usually exhibiting a positive relationship with the USD through the carry channel;
- Perceptions of global growth – usually exhibiting a negative relationship with the USD through increased capital flows higher beta countries such as emerging markets;

Although the interaction of these two factors is what drives currency movements at most times, the fact that the US registered the fastest GDP growth in H1 2021 as well as the unusually quick changes in perception of growth driven by changes in COVID-19 infections has helped to limit momentum in the USD and cause the rangebound price action. Indeed, periods of perception of faster (slower) growth caused a limited move lower (higher) in the USD as they were accompanied by more hawkish (dovish) expectations of Fed policy.

This pattern has led to mini up and down cycles for the USD that have lasted a couple of months and extended only 3% to 3.5%. Looking ahead, although market expectations of Fed rate hikes have been pared considerably, there are reason to think we may be close to another mini-USD top.

As mentioned earlier, USD positioning is back to neutral. Furthermore, although the COVID-19 crisis is likely to continue to ebb and flow, our sense is that the impact lockdowns are having – if they happen at all as in the case of the UK – is likely to be progressively more limited as the vaccination campaign continues to expand globally.

WHAT COULD CHANGE THE CURRENT OUTLOOK

Not surprisingly, the current low volatility environment has favoured currencies with higher expected changes of interest rates, especially in the developed market space. Looking ahead there are two key risks that could disrupt currency markets and cause a significant increase in volatility.

[1] A change in the benign macroeconomic backdrop

A combination of record fiscal and monetary easing coupled with easing of mobility restrictions has meant that economic growth in the last 12 months has been exceptionally strong. Although this economic backdrop has been accompanied by well-heralded bottlenecks and heightened inflationary pressures, policymakers have remained resolute in their view that the spike in inflation is likely to be temporary. This has allowed central banks, particularly in the developed market space to hint at a gentle withdrawal of liquidity. This equilibrium could be upset in several different ways:

- Inflation could turn out not to be temporary and force central banks to withdraw monetary stimulus at a faster than expected pace. Given that the Fed Funds rate is considered to be the risk-free rate, any faster rate hikes than currently telegraphed could be particularly disruptive for currency markets and beyond;
- An adverse growth shock stemming from either an unforeseen event or, more likely, as a result of a policy mistake. Although most countries are trying to find a happy balance between withdrawing significant policy support and fostering endogenous growth, the recent sharp sell-off in Chinese equities as a result of renewed regulatory crackdown on FinTech, Ecommerce, and other private industries such as for-profit education companies, needs to be monitored. This is so for both the impact of slower Chinese growth on global growth, but also the potential spill over effect equity withdrawals from China could have on flows to the broader emerging market complex.

Both these scenarios would be likely to support the USD.

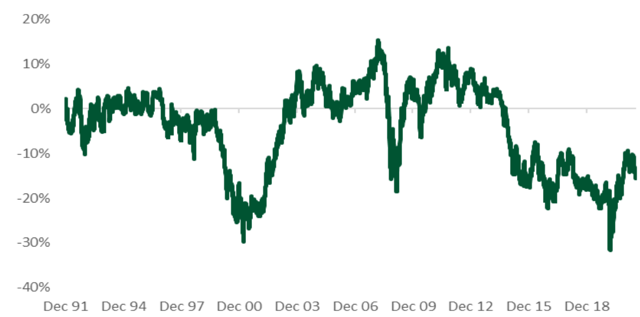
[2] A repeat of the 2013 taper tantrum

The taper tantrum caused the USD to appreciate sharply and heralded a multi-year period of strong USD performance. Although some moderate USD strength is likely as the Fed starts to withdraw monetary stimulus especially in comparison to countries that are likely to have a more dovish reaction function similar to the European Central Bank (ECB) and the Swiss National Bank (SNB), we do not expect a significant appreciation of the USD comparable to the strength seen in 2014 when the Fed last embarked on a rate hiking cycle and the DXY rallied 26% in less than a year.

This is so for several reasons:

- When the Fed started tightening monetary policy in 2014/2015, most other central banks were still easing monetary policy. This time around, the Fed will not only be one of several developed market central banks to reduce monetary stimulus, but it will probably lag other central banks. This suggests that it is not clear that rate differentials will move to be as aggressively USD supportive as they were in the years that predated the COVID-19 crisis;
- The USD is still expensive. As can be seen in Figure 4, in 2013, the USD was roughly 5/10% cheap relative to traditional long-term valuation metrics like Behavioural Equilibrium Exchange Rate (BEER). On those same metrics, the USD is currently 14% expensive;

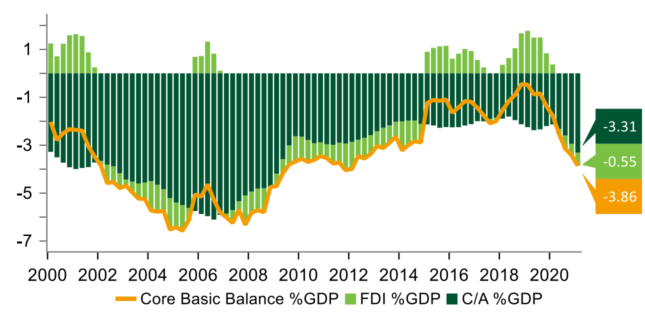
Figure 4: USD percentage over (-) and undervaluation (+)



Source: Insight. Data as at 14 September 2021.

- The US balance of payments is likely to be less supportive than it was in the Trump years partly because impact of foreign earning repatriation has faded – this can be seen in the Foreign Direct Investment (FDI) numbers – and partly because US fiscal easing is starting to put pressure on the US current account.

Figure 5: US external imbalance



Source: Macrobond. Data as at 14 September 2021.

This turnaround in the US Basic Balance highlights the increasing dependence on capital inflows at a time when the external vulnerabilities of many countries in both the developed and emerging market space have been greatly reduced. The flip side of the deterioration in the US's external position has been a notable improvement in other countries' external positions. Indeed, back in early 2014 the five countries were labelled the 'fragile five' (i.e. Turkey, Brazil, South Africa, India, and Indonesia) had an average current account deficit of 4.5%, now those same countries run roughly balanced external accounts.

REGULATION UPDATE: GLOBAL CODE FOR FX MARKETS

We are sure that many of you will be familiar with the historical issues that have beset the FX market, and which led the regulators to issue significant fines to many banks. It is hard to underestimate the significance of the Global Code which sets out principles of good practice in the FX market and is designed to apply to all wholesale FX participants including sell-side and buy-side participants.

For those who are not familiar with the Global Code, it was facilitated by the Bank of International Settlements (BIS) Markets Committee consisting of central banks from 16 jurisdictions around the globe and was supported by a market participants group made up of sell-side, buy-side and FX infrastructure providers. The purpose of the Global Code is to promote a fair, robust, liquid, open and transparent market in which a diverse set of market participants can interact, supported by resilient infrastructure. These participants should be able to confidentially transact at competitive prices that reflect available information and most importantly, in a manner that conforms to acceptable standards of behaviour.

The Global Code has just undergone a three-year review and the latest version was published in July 2021, including updates on several areas that the Currency Trading Team has been working on. One area close to our heart is the topic of sell-side disclosures. Those of you who execute trades will be all too familiar with these highly legalistic documents that usually hit your inbox in the middle of the night and contain many pages of different disclosures. As a result of the work we have been directly involved in, the Global FX Committee will be issuing templates in August which should allow you to more easily compare key disclosures from different providers published on a global register[1].

Insight sees our continuing commitment to the Global Code as an important component of our approach to responsible investment, as it promotes a robust, fair, liquid, open, and appropriately transparent market. As part of this commitment we have made a conscious decision to interact predominantly with sell-side participants that have signed the Code. We believe this is particularly significant when using algorithms to trade your flow because it is very easy for anonymous high frequency 'liquidity providers' to interact with these orders causing significant market impact and cost. This is another topic we will look to revisit in future publications.

[1] Pls see: Accessible FX market disclosures: Transparency for a virtual environment - speech by Rohan Churm | Bank of England

TRADERS CORNER: THREE MEN AND A WEASEL

We thought we would start this first episode by introducing you to the Currency Trading Team at Insight. We have had the pleasure of meeting many of you over the years, either in person or more recently via the digital channels of Webex, Zoom or Teams and are delighted to be given the opportunity to share our thoughts on topics we hope will be of interest to you.

The team has worked together as a unit for over 16 years, something that is unique in our industry, and is headed by Richard Purssell who is often referred to, very unfairly in his eyes, as a veteran of the currency markets. He is supported by Adam Hunter and Richard Turner who joined him at Pareto Partners from Deutsche Bank and Cargill respectively back in early 2005. It is often said that sportspeople who have played together for several years develop a deep understanding of what their colleagues are about to do and anticipate accordingly and this was how it felt in March 2020 when the markets were rocked by the COVID-19 pandemic. After a couple of frantic days of securing new screens and stands from Amazon and having ergonomic chairs delivered in taxis from the office, three fully functioning trading hubs were established in Guildford, Richmond and Wimbledon, respectively. These were fully tested during some highly volatile trading days that followed and we were incredibly thankful for the work that our technology teams did as well as the longevity of our own working relationship.

One of the key responsibilities of the team is to deliver ‘Best Execution’ for our clients on every order through time and this requires strong relationships with our banks based on mutual trust and respect. As a team, we believe that we need to use the leverage that client flow affords Insight to improve the FX ecosystem for all Real Money and Corporate clients irrespective of their level of interaction and sophistication.

Insight was one of the first buy-side clients to publicly sign a statement of commitment to the FX Global Code in March 2018 and both Richards have been involved in working groups set up by the Global FX Committee to look at buy-side adoption, improving the disclosures landscape, algorithmic trading and transaction cost analysis (TCA). Adam sits on the Investment Association FX Committee and has been working on a project to standardise the provision of reject reasons from liquidity providers. Insight also recently issued a public comment to the Global FX Committee on their draft guidance paper on the thorny issue of Last Look.

Whilst we are proud as a team to have demonstrated strong trading outcomes in challenging markets as well as our efforts to improve the FX ecosystem, we do have one confession to make. There is a saying in the military that you should never leave a man behind. In our haste to set up our alternative trading operations last year we forgot to take our desk mascot, Tony the Estonian Weasel with us. He has been with us for 16 years and has even survived kidnapping and ransom by a Reuters’ journalist. We can only hope that when life returns to normal we shall all be reunited at Queen Victoria Street in London.

EDUCATION CENTER

Bitcoin: Why investors need to think beyond the price

A string of high-profile investments, coupled with a meteoric price rise, has catapulted Bitcoin into the spotlight, and at one point its market capitalisation was comparable with some of the major technology names. We examine the Bitcoin and Blockchain phenomena, the potential positives this technology will bring, and outline our concerns about Bitcoin as an investment.

- Given its high volatility, low liquidity, operational challenges, governance challenges and ESG risks, we do not believe that Bitcoin is suitable for most institutional investors
- Central banks are learning from cryptocurrencies and considering their own digital and cryptocurrencies
- A combination of central bank digital currencies and other private cryptocurrencies are likely to take an increasing share of the global payments sphere

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. Funds which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Currency risk management

- Currency hedging techniques aim to eliminate the effects of changes in the exchange rate between the currency of the underlying investments and the base currency (i.e. the reporting currency) of the portfolio. These techniques may not eliminate all the currency risk.
- Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.
- Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.
- Where leverage is used through the use of swaps and other derivative instruments, this can increase the overall volatility. Any event that adversely affects the value of an investment would be magnified if leverage is employed by the portfolio and losses would be greater than if leverage were not employed.

FIND OUT MORE

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