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CURRENCY QUARTERLY

Q1 2023

SUMMARY

After a tranquil start to the year, volatility returned with a bang in March as seemingly idiosyncratic problems in the US banking system spread to Europe, causing concerns about broader financial stability. Rate markets reversed sharply, and policy makers were forced to intervene to reassure investors.

With central banks still battling stubbornly high inflation, the required policy mix is becoming increasingly complicated, and the risk of misjudgment is elevated. Against this backdrop, the forces that have supported the US dollar (USD) are starting to fade. Although it may take some time for sufficient momentum to build to drive a meaningful decline, the extreme level of valuations means this is probably a good opportunity to start moving away from the dollar, especially for less agile investors.

In our educational topic this quarter, we celebrate more than 30 years of currency management with a look back at how markets have changed over this period. In our Traders Corner, we discuss the evolution of currency trading and how ever more sophisticated electronic trading systems have increased both price transparency and operational efficiency.

THE ALPHA VIEW

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

For a medium-term view, we would cautiously trade the USD from the short side, with the overall caution that we continue to view 2023 as favoring an environment for more tactical trading in 2023 than in 2022. Our tactical short USD bias can be seen in Figure 1. Elsewhere in the developed market space, we see more upside for currencies like the British pound (GBP), and the Canadian and New Zealand dollars (CAD and NZD). In Europe, we prefer long exposure to the euro (EUR) as well as the Swedish and Norwegian crowns (SEK and NOK).

Figure 1: Insight Currency Absolute Return Exposure

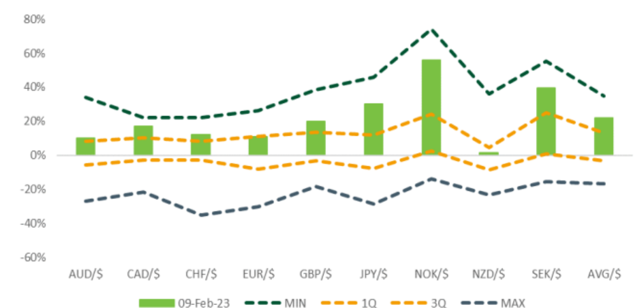
Source: Insight. Data as at 30 March 2023. Note: Black dot shows aggregate position.

LONGER-TERM VALUATION OVERVIEW

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

- USD remains overvalued, although less so than in H2 2022;
- EUR, CHF, GBP and AUD are only moderately cheap;
- CAD, JPY, NOK and SEK are very cheap; and
- NZD is very close to fair value.

Figure 2: Local currency overvaluation (-) and undervaluation (+) versus USD



Source: Insight. Data as of March 24 2023.

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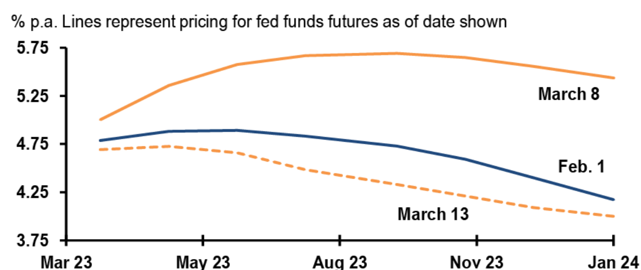
COLLATERAL DAMAGE

After a period of relative tranquility, market volatility made an abrupt comeback in the last couple of months. Stronger economic activity and inflation data in the US and in Europe pushed interest rate expectations in core markets to the highest levels since 2006. This move was then abruptly unwound within a few days as the bank run on Signature Bank (SB) and Silicon Valley Bank (SVB) triggered concerns about financial stability across the broader banking spectrum. US small banks – defined by the Federal Reserve (Fed) as banks holding assets of less than $250bn – having already lost close to $1trn in deposits in the last 12 months, shed almost a further $100bn in deposits in a single week. Europe was not immune, as deposit flight from the troubled Credit Suisse (CS) also meaningfully accelerated.

Although significant gyrations took place in assets linked to the banking sector, 'safe haven' assets also witnessed extreme price action: in early March, US Treasuries and German bunds witnessed the largest weekly fall in 2-year yields since 1987 and on record respectively. The extent of this whipsaw in price action can be easily seen in the market pricing of implied future fed funds rates (Figure 3).

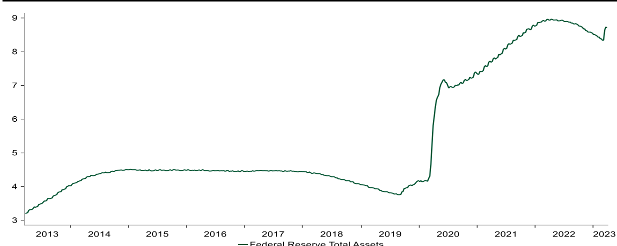
While the details of the idiosyncratic risks surrounding SB, SVB and CS will take some time to fully come to the fore, the macroeconomic trigger for the increased instability can be traced back to the resilience of inflation. The corollary of our somewhat partial understanding of the transmission mechanism that links monetary policy to activity and then to inflation – as Rudi Dornbusch once said, "In economics, things take longer to happen than you think they will, and then happen faster than you thought they could"

Figure 3: Fed funds futures implied rates



Source: Daily Economic Briefing, March 13, 2023, JPMorgan.

Figure 4: Federal Reserve total assets ($tn)



Source: Federal Reserve, March 30, 2023.

In other words, significant swings in monetary policy, particularly in rate-hiking cycles, often create collateral damage. One could argue that the first ripple stemming from the most aggressive developed market rate-hiking cycle in decades bubbled to the surface in 2022 with a few notable failures of cryptocurrency-linked businesses. The recent banking worries created a more meaningful wave that threatened to turn into a tsunami if policymakers didn't act promptly and aggressively. So, they did. In Switzerland, the government hastily orchestrated a merger between the 166-year-old CS and its rival UBS, while in the US, the Treasury moved to guarantee all previously uninsured deposits of SVB via the Federal Deposit Insurance Corporation, and the Fed allowed banks to post collateral at a new and very advantageous window called the Bank Term Funding Program. Since then, senior US officials indicated that, although a formal guarantee of non-insured depositors was unlikely, they believe that all deposits are safe, suggesting a more ad-hoc but nonetheless significant financial backing.

GAUGING THE FALL OUT

So far, actions by policymakers have hit the right spots. The liquidity provision to banks has been notable and highlighted by the fact that the size of the Fed's balance sheet has expanded by roughly $400bn in a couple of weeks – or roughly one fifth of the total uninsured deposits held outside the top five banks. The big question is whether the measures taken will be sufficient to ensure the idiosyncratic risks of a few banks don't turn systemic. The initial indicators suggest that officials have managed to stabilize the financial system – stocks outside the banking space have rallied, credit has tightened, and interest rate markets are pricing less aggressive monetary policy easing.

Our core assumption is that recent banking woes will not spiral into a more significant crisis akin to the global financial crisis as banks are far better capitalized than they were in 2008, and policymakers have a greater understanding of how to manage a banking crisis. It is also worth noting that the banking sectors of other core countries, such as those within the euro area, are likely to be on more solid footing. This is so for a couple of reasons:

- first, as can be seen in Figures 5 and 6, European banks are better capitalized and hold larger amounts of liquidity; and
- second, euro-area banks are likely to be less impacted by mark-to-market losses on their bond portfolios as their holdings of debt securities are smaller at roughly 12% of total assets vs roughly 24% of total assets in the US (Source: Flows & Liquidity: A repeat of 2018/2019?, March 15, 2023, JPMorgan.) European banking regulation also requires more stringent hedging of banks' interest rate risk.

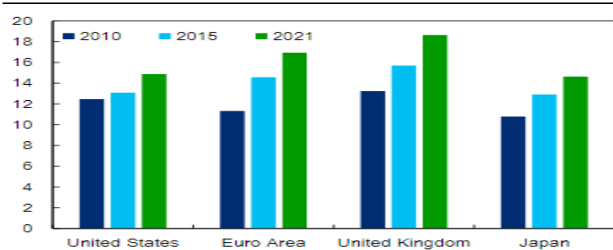
This does not, however, mean we should underestimate the risks that lie ahead as market confidence is vital for the survival of any bank. Although a repeat of the global financial crisis is unlikely, our sense is that a wave of significant credit tightening is on its way, particularly in the US.

As can be seen in Figure 7, lending standards – along with weaker credit demand – tightened well before the current turbulence hit. Our sense is that pressure on loan growth will intensify, especially in US small banks, for three key reasons:

- the significant fall in deposits at small US banks is likely to put pressure on balance sheets;
- smaller banks can expect greater regulatory scrutiny; and
- regardless of the perceived safety of depositors, banks will likely be facing higher funding costs as they try to stem the sharp pick-up in investment in money market funds (Figure 8).

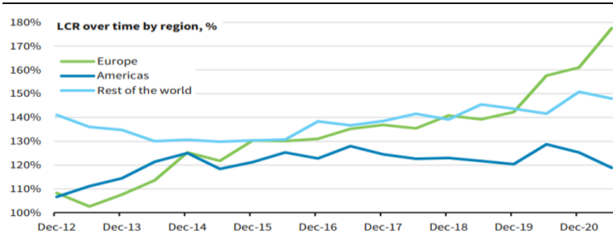
Considering the importance of small banks in the US credit creation process – they account for roughly 50% of the US commercial and industrial lending, 60% of the residential real estate lending, 80% of the consumer lending[1] and 38% of the system's loan book[2] -- the impact of slower loan growth on activity could be meaningful. It is also worth highlighting that even an unlimited supply of liquidity and a blanket guarantee of all deposits does not guarantee healthy credit creation. As highlighted in the mid-1980s in the US and in the 1990s in Japan, balance sheet deleveraging and undercapitalization can create 'zombie' banks that are safe for depositors, but not healthy enough to extend lending. The silver lining is that the upcoming credit tightening is taking place against a background of moderately improving growth momentum (Figure 9), thereby cushioning the blow of the impact of slower loan growth.

Figure 5: Bank Tier 1 capital (%)



Source: Global Economic Outlook and Strategy, March 22, 2023, Citi.

Figure 6: Regional liquidity coverage ratios

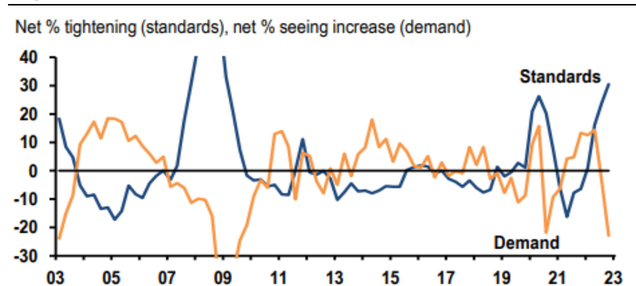


Source: US and European Banks: Shaken, and stirred, March 30, 2023, Barclays.

It is also worth highlighting that while recessions are nearly always associated with decelerating credit growth, credit tightening is generally not the prime catalyst for recession. Indeed, there have been several episodes in which a significant credit tightening has taken place within periods of sustained economic expansion[3].

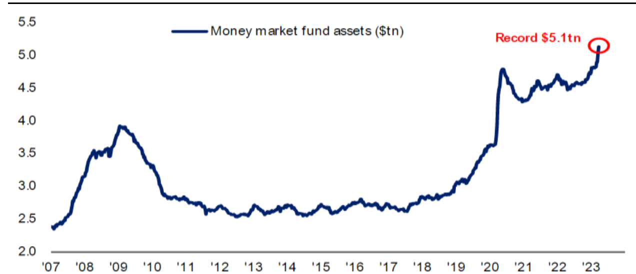
Although the uncertainty is high, if we assume the banking crisis is broadly contained, estimates of a reduction of 0.5% to 0.75% from 2023 US growth and a more modest negative 0.25% to 0.5% impact on Europe seem reasonable. Outside these two areas, the impact is likely to be even smaller. This suggests that global growth in 2023 is likely to be roughly 0.3% smaller than the previous consensus baseline of 2.4% but with greater tail risks.

Figure 7: G4 business credit standards vs loan demand



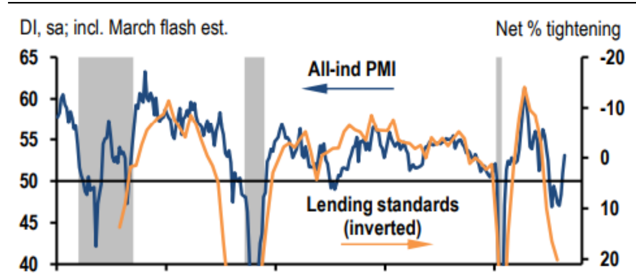
Source: Hamburgers for Wimpy? Gauging the credit shock, March 30, 2023, JPMorgan.

Figure 8: Money market fund assets ($ trillion)



Source: The Flow Show, March 23, 2023, BofA.

Figure 9: DM PMI and G4 lending standards



Source: Daily Economic Briefing, March 30, 2023, JPMorgan.

[1] Source: The Macroeconomic Impact of Small Bank Stress, 15 March 2023, Goldman Sachs.

[2] Source: US: Move fast and break things, 16 March 2023, JPMorgan.

[3] Source: Hamburgers for Wimpy? Gauging the credit shock, 30 March 2023, JPMorgan.

WHERE DOES THIS LEAVE MONETARY POLICY?

From the policymaking perspective, the events of the past few weeks have made the challenging task of slowing persistent inflation without generating a recession more difficult, as the central case is that the hit to growth will be manageable – but with a larger negative tail risk. The standard monetary policy response to increased banking fears is to err on the cautious side and either pause or sometimes end and reverse rate-hiking cycles. The current situation is, however, more challenging as policymakers are having to deal with a potential banking crisis against a backdrop of high inflation.

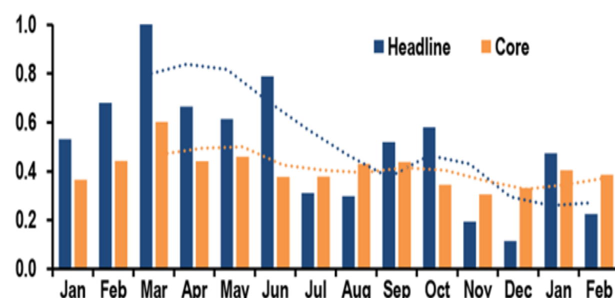
If we look at the challenge through the lens of the Fed, the global financial crisis unfolded as US core inflation was less than 3% versus the current level of 5.5%. We have to go back in time to the failure of Continental Illinois in May 1984 – then the largest bank failure in US history – to find a banking crisis that unfolded against a backdrop in which core inflation is comparable to that today. This is relevant as, over the last couple of decades, low inflation has allowed central banks to quickly come to the rescue in periods of financial stress by using all available tools to support the economy and markets. This time it is different as they face two conflicting goals: maintaining financial stability and bringing inflation back to target. In theory, this can be achieved through Ben Bernanke's 'separation principle', which suggests using liquidity measures – along with regulation, although once a crisis starts to unfold, it becomes less relevant in the short term – to tackle financial stability, while using monetary policy to deal with inflation.

The Bank of England (BoE) used this very principle when it purchased gilts at the height of the market volatility in late September 2022 and then proceeded to unwind the purchases a few months later once market conditions had stabilized. Around the same time, the BoE hiked rates twice in September and November as it also dealt with high inflation. Although this appears to support the view that central banks can efficiently use different tools to achieve different goals, the reality is not quite so simple. Indeed, in parallel to the BoE's intervention, a new and more fiscally orthodox government was put in charge, and it is not clear if it, or the BoE's actions, calmed markets. Even Ben Bernanke has acknowledged that "The distinction between macroeconomic and financial stability objectives will always be blurred to some extent, given the powerful interactions between financial and economic conditions."[4]

In practice this leaves several uncertainties:

- **Will the Fed cut rates as soon as July as is currently priced into the market?** If we look back at history, financial stability problems often interrupt Fed hiking cycles, but they don't always reverse them, at least not quickly. In the case of the Continental Illinois failure, the Fed paused, but then resumed hiking rates in July and in August. Our sense is that the markets are underestimating the probability that rates might move higher still and stay higher for longer, particularly if recent banking jitters are contained. The strength of the most recent flash US PMIs is a timely reminder that activity and inflation remain stickier than expected (Figure 10).

Figure 10: Global CPI (%m/m sa, dotted line is 3mma)



Source: Daily Economic Briefing, March 28, 2023, JPMorgan.

- **What will happen to quantitative tightening (QT)?** As can be seen in Figure 4, the recent provision of liquidity brought about an expansion of the Fed's balance sheet, effectively wiping out more than half of the reduction orchestrated in the last 12 months. While this might seem inconsistent, our sense is that this is not the case and that QT will continue – at least until rate cuts are warranted. Pursuing QT and liquidity injections amounts to supporting curve steepening akin to a reverse operation 'twist', a policy actively encouraged by the Fed in the early 1990s to bring profitability back to the banking sector following the savings and loan crisis of the late 1980s, of which Continental Illinois was a part.

In short, although policymakers have had to deal with quite a few challenges in the past few years, the next three to six months might be the toughest yet. Inflation fears are likely to keep the Fed and other developed-market central banks more defensive than they would otherwise like to be, thereby increasing the chances both that monetary policy stays tighter for longer than is currently priced into markets and of a 'hard landing' later in the year.

WHAT DOES THIS MEAN FOR FX?

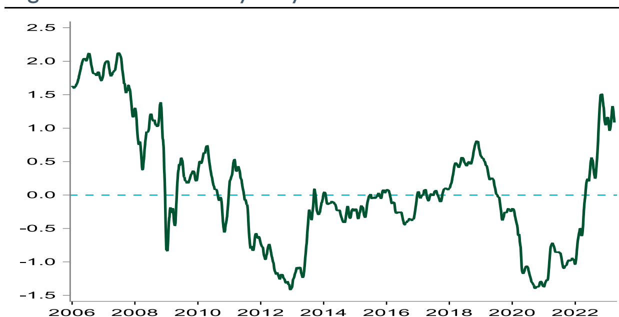
In our last FX Quarterly, we talked about how we thought the USD had peaked and about our expectations for a "volatile and messy" 2023. Indeed, the DXY Index – a proxy for the USD – is roughly where it started the year but has traded within a 5% range. Our view remains that some of the forces that were supporting the USD are fading – most notably, the end of the Fed's aggressive hiking cycle – but the preconditions for a significant decline will be slow to gather pace. Our sense is that two factors will be key to bringing about a more sustained USD decline.

[4] Source: US: Move fast and break things, March 16, 2023, JPMorgan.

- First, more conclusive evidence needs to emerge that US growth is slowing, dampening inflationary pressures, and allowing the Fed to bring the rate-hiking cycle to an end without an economic hard landing. The news on this front has been mixed as US economic data has been surprising to the upside since mid-January, and momentum in core inflation has picked up from 0.4% month-on-month (mom) in December to 0.5% mom in February. The recent banking jitters – if they remain contained – support our expectation that the Fed is very close to ending its tightening. Although this would help to push the USD lower, our sense is that expectations of rate cuts in 2023 will not materialize. This disappointment, combined with high US real rates (Figure 11), suggests that carry is likely to stop the USD from having a meaningful decline.
- Second, US economic performance needs to remain less 'exceptional' than its peers. This is probably where the argument in favor of a lower USD is strongest. As can be seen in Figure 12, the gap between US business sentiment and that of the rest of the world has narrowed sharply. This trend should be reinforced by the recent banking jitters, which, as mentioned above, we expect to have a more negative impact on the US than in Europe. It is also worth highlighting that regions like Asia will benefit from the ongoing improvement in Chinese growth.

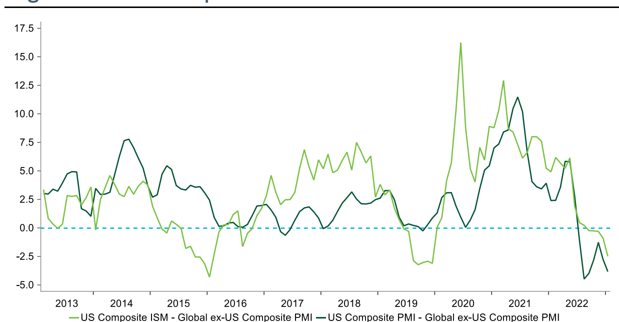
This suggests that although USD valuations remain excessive (Figure 13), the move lower in the USD is likely to be a gradual and jagged one.

Figure 11: Real US 10-year yields



Source: Macrobond, as of March 30, 2023.

Figure 12: US exceptionalism



Source: Macrobond, as of March 30, 2023.

THE RISKS

While thinking of the risks to a central-case scenario has always been important, the events of the past few years – pandemic, war, and the return of inflation to name but a few – have made managing tail risks vital. With this in mind, we think there are a few notable risks that need to closely watched over the next few months.

- **The economic soft landing does not take place, and ultimately, a more severe secession ensues.** This would happen either if US inflation does not ease and the Fed needs to move interest rates meaningfully higher, or if we are wrong about the moderate impact of credit tightening on US growth. Both scenarios are likely to be USD-supportive, although we still do not believe the USD would make new cyclical highs.
- **The US debt ceiling negotiations lead to a missed coupon payment on US Treasuries.** Although our central-case scenario is that, with some last-minute brinkmanship, the ceiling will be raised, a technical default would have severe market repercussions and give notable boosts to currencies like the JPY and CHF, in our view.
- **The Bank of Japan (BoJ) decides to abandon its yield curve control policy and end its negative interest rate policy.** A combination of a new BoJ governor and higher wages and inflation suggests there is a material risk that the BoJ will step away from intervening in the Japanese government bond (JGB) market and allow the term structure to be market-driven, and possibly remove negative interest rates. Although market estimates for 10-year JGB yields are roughly only 50bp higher than where they currently trade, there is notable uncertainty around these figures. Equally uncertain is the impact across a broader set of markets stemming from reduced purchases of foreign assets by Japanese investors and possible investment repatriation.

HOW TO POSITION IN THE CURRENCY SPACE

For those with a medium-term view, we would cautiously trade the USD from the short side, with the overall caution that we continue to view 2023 as favoring an environment for more tactical trading than 2022. Our tactical short USD bias can be seen in Figure 1.

Elsewhere in developed markets, we see more upside for currencies like the GBP, the CAD and NZD. In Europe, we prefer long exposure to the EUR as well as the SEK and NOK.

For less agile longer-term investors whose investment decisions lean more heavily on valuation metrics, current levels of extreme exchange rates (see Figures 2 and 13) represent good opportunities to start fading the strength in the USD, in our view.

Figure 13: USD valuations (negative figures signal overvaluation)

Source: Insight, as of March 23, 2023.

TRADERS' CORNER: EPISODE 7 – THE AGE OF AQUARIUS

Richard Purssell, Head of Currency Trading

I can't believe it is 30 years since Insight began actively managing currency risk for our clients. Our latest paper (see overleaf) got me thinking about the evolution of trading processes over that time. Now, before anyone starts rolling out the 'veteran' tag, it is a mere 25 years since I joined the then Pareto Partners at their offices in Oxford Circus situated above the flagship H&M store.

The world of currency trading in the late 1990s was far removed from the high-frequency world that exists today. For a start, all transactions were executed over the phone, with details jotted down on a paper deal slip and timestamps recorded in minutes rather than milliseconds. Client positions were managed on a 24-hour basis, which meant the poor trader on duty took home a mobile phone, a pager, a printed ladder of risk positions and a list of phone numbers for bank contacts in New York, Sydney, Hong Kong, Tokyo and Singapore. It was tough work, especially when the pager, or 'death rattle' as it was affectionately known, went off in the very early hours leaving you trading all night, then travelling straight to the office to book everything out. I lost track of the amount of currency traded on the number 8 bus travelling down Oxford Street while getting some very strange looks from fellow passengers. It was safe to assume that none of our sales contacts from the banks would be seen travelling on this mode of transport, so our secrets were safe.

There was clearly an information asymmetry that favored the banks at this time with trades executed bilaterally over the phone, and soon, there was demand from buy-side participants like us for change. I remember being invited to a meeting at a restaurant near the Bank of England where a group of banks were proposing a multilateral trading system where prices would be delivered over the internet. This was to become Atriax, which was competing with another, wider, consortium of banks that went on to create FxAll. Insight was asked to join the Customer Advisory Board of both entities, and we played our part in the development of what was to become the future of buy-side FX trading. We executed the first-ever trade over Atriax in April 2001 with Citibank, and one of the first trades over FxAll in June 2001. While Atriax closed in 2002, we integrated FxAll into our Currency Trading System to provide competitive real-time pricing for our clients with full straight-through-processing and associated risk management, a model that still exists today.

These developments in electronic trading had given us scale and we could manage significant volumes for our active currency clients with a relatively small team. While FxAll provided us with greater price transparency, it didn't solve the issue of larger orders where limiting market impact was key. These orders were typically sliced up and worked with a single bank, with the trader using an Excel spreadsheet to calculate the average and to capture a range of timestamps. We felt there had to be a better way, and when we spoke to our banks, they disclosed that they had started to clear some of their own internal risk using trading algorithms. While these were quite widespread in the equity space, agency algorithms were relatively new in FX, yet clearly offered a solution if you had the necessary skills and resources required to manage the risk – rather than simply transfer this to the bank, most likely at a premium. Insight started to make widespread use of these tools from as early as 2003, and it was clear they offered price improvements to our clients as well as greater transparency and operational efficiency.

I'd like to think that the Insight Currency Trading Team has remained at the forefront of developments to deliver better outcomes for our clients and to ensure that our processes continue to evolve. Further examples include the first option traded over electronic platform Digital Vega with UBS in November 2010, early adoption of the TCA platform BestX in March 2017, and being one of the first asset managers to sign the FX Global Code in March 2018.Transparency and market behaviors have improved immeasurably and clients now have access to trade data timestamped to the nearest millisecond for their electronic trades that can be used to hold their managers and banks to account.

Our first active currency portfolio was called Aquarius. When I think back to the old diesel-powered bus rattling up Oxford Street with a pager that updated every 20 seconds in one hand, a Nokia 5110 wedged under my chin and a pad for the order fills spread out across the next seat, I wasn't to know how close we were to a new age of electronic currency trading.

WHY INSIGHT FOR CURRENCY SOLUTIONS?

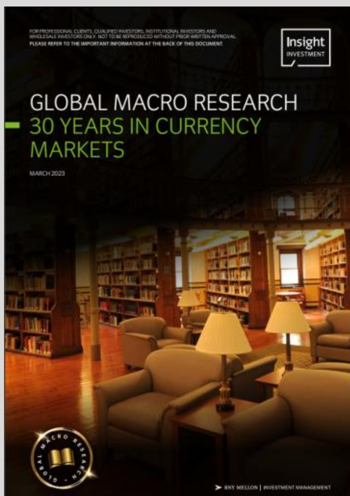
Full scale currency solution provider with extensive experience in currency markets. Insight has a proven track record for delivering both quantitative (since 1991) and discretionary solutions (since 2005). We offer a broad spectrum of currency capabilities ranging from passive hedging, dynamic hedging, to unconstrained quantitative and discretionary alpha strategies. Our modular approach allows for fully customized solutions to meet specific client objectives.

Experienced and highly regarded currency team. The investment team is well-established and has an average experience of 18 years. Our dedicated client relationship team will work in partnership with you and our local offices offer client service, quantitative research and product specialist/solution design capabilities.

Best execution and efficient trading. Insight's dedicated and experienced currency trading team can provide access to multiple sources of liquidity to ensure competitive pricing. Insight is an independent transaction cost analysis (TCA) provider, utilizing technology and analytics through BestX.

Proven and scalable technology infrastructure. We have the flexibility to implement highly tailored client solutions with risk control at each step of the process.

EDUCATION CENTER



30 years in currency markets

In 2023 Insight will have been actively managing currency risk for its clients for over 30 years. Our currency team looks at the incredible changes that have occurred in currency markets over this period and how approaches to currency management have evolved as a result.

- As the world has opened up, there has been an explosion in cross-border transactions, from portfolio flows and trade to remittance flows and tourism, all contributing to ever greater currency market liquidity – dwarfing that found in both equities and bonds
- With investors embracing a global opportunity set, currencies have become an increasingly important driver of investment returns
- The strategies used for currency management have become more complex, evolving to deal with volatile capital flows
- Currency markets are no longer just a potential source of risk or of alpha, but are increasingly used to add diversification

FIND OUT MORE

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Performance numbers used in the analysis are gross returns. The performance reflects the reinvestment of all dividends and income. INA charges management fees on all portfolios that they manage, and these fees will reduce the returns on the portfolios. For example, assume that $30 million is invested in an account with INA, and this account achieves a 5.0% annual return compounded monthly, gross of fees, for a period of five years. At the end of five years that account would have grown to $38,500,760 before the deduction of management fees. Assuming management fees of 0.25% per year are deducted monthly from the account, the value at the end of the five-year period would be $38,022,447. Actual fees for new accounts are dependent on size and subject to negotiation. INA's investment advisory fees are discussed in Part 2A of its Form ADV. A full description of INA's advisory fees are described in Part 2A of Form ADV available from INA at www.adviserinfo.sec.gov.

Targeted returns intend to demonstrate that the strategy is managed in such a manner as to seek to achieve the target return over a normal market cycle based on what Insight has observed in the market, generally, over the course of an investment cycle. In no circumstances should the targeted returns be regarded as a representation, warranty or prediction that the specific deal will reflect any particular performance or that it will achieve or is likely to achieve any particular result or that investors will be able to avoid losses, including total losses of their investment.

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