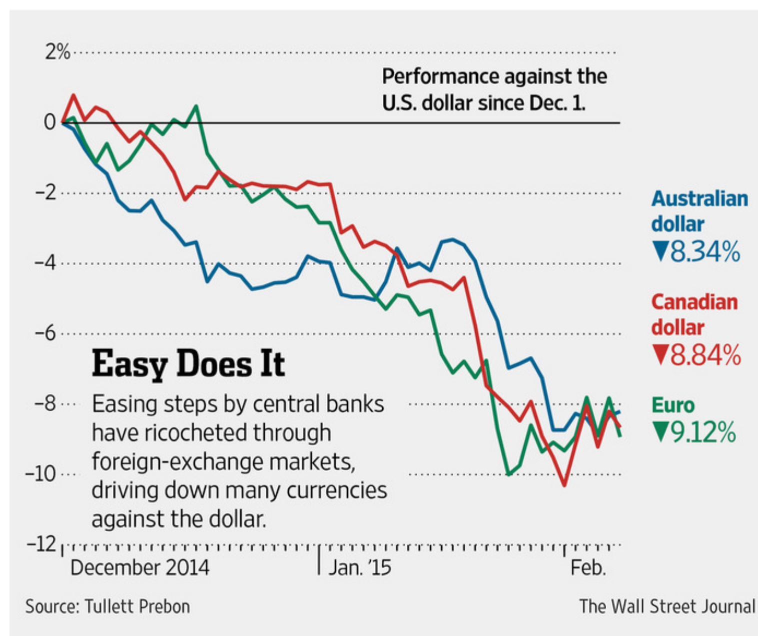
February, 2015

WHY CURRENCY MATTERS

Historically, currency markets are among the most stable in the world, usually moving only a few basis points on even the most volatile days. However, in 2015, the currency market has been anything but calm as the magnitude of its swings has hit its highest non-crisis level in 20 years. Currency fluctuations have far reaching effects on everything from what you buy at the grocery store to where you should plan your next vacation.

The Race to the Bottom: Central Banks' Rush to Devalue

Weak global demand and deflationary headwinds have pushed central banks from all over the globe to react to save their economies. Already this year countries representing a third of the world's economic output, from Eurozone to China, Australia, and Canada, have taken steps to drive down the value of their currencies. By cutting interest rates and injecting stimulus money into their economies, central banks are attempting to boost exports and spur growth. Yet, because movements in the currency markets are a zero sum game, while some currencies are depreciating, others, most notably the dollar, are appreciating at record rates.



Central banks are going to extreme measures to aid their own economies at the expense of their neighbors. Just last month, the first major fatality of the currency wars came at the hands of the Swiss. Switzerland had been pegging its currency, the franc, to the Euro since 2011. Over the past few months, the value of the franc soared as investors sought a safe haven from the distraught economies of Europe and Russia. The Swiss central bank bought massive amounts of foreign reserves to defend the peg, but the ECB's decision to pursue another round of quantitative easing spelled doom for the Swiss.

Unwilling to accumulate more foreign reserves, the Swiss gave up the peg and let the franc appreciate. Almost immediately the franc rose 30% against the Euro and wiped $100 billion off the Swiss stock market as shares of UBS fell -10% and Richemont, which owns luxury watchmaker Cartier, plummeted -15%.

While Switzerland was the first casualty of the volatile currency market, it almost certainly won't be the last. Already speculators are wondering if Denmark is doomed for the same fate. The Danes have cut interest rates four times in the last month to -0.75%, which means that you effectively have to pay Danish banks to hold your money. The Danish central bank has also spent 32 billion euros to defend the kroner, which is the fastest accumulation of foreign reserves in its history. A break of the kroner-euro peg would spell disaster for Denmark, a socialist country with a massive pension liability denominated in euros.

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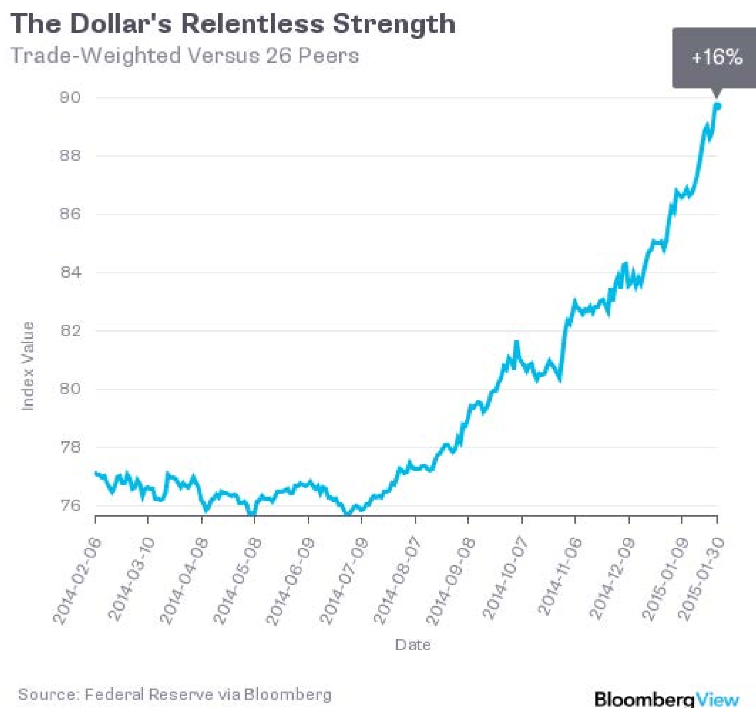
On the other side of the globe, East Asia is experiencing currency wars of its own. The strength of the dollar is becoming increasingly worrisome for China. This year the dollar is up +16% against the Fed's weighted index of 26 countries. Furthermore the dollar is poised for a multiyear surge against the rest of the world's currencies for the first time this century. The WSJ Dollar Index is up +32% over the past four years and analysts are predicting a further 30-40% upside.



A strong dollar is usually beneficial for emerging markets, such as China, as their exporters gain a comparative advantage. China, however, uses a floating rate exchange system, which ties the renminbi to the dollar. As the dollar strengthens against the rest of the global currencies, so will the renminbi, which will crush Chinese exporters. Additionally, if the Fed hikes interest rates, capital inflows from East Asia could knock the air out of the Chinese economy, which is already looking vulnerable.

The Winners and Losers of the Currency Wars

While the most recent purge of the Euro may make a getaway to The French Riviera more enticing, not everyone is walking away a winner. The most recent round of earnings reports has exposed US companies who have been hit the hardest by the strengthening dollar. Consumer products giant Proctor & Gamble said currency fluctuations could reduce its profits by $1.4B this year while Microsoft saw its stock plunge -9% after disappointing overseas sales. The strong dollar is not only affecting individual companies but the US economy as a whole. First quarter GDP estimates have fallen to the 2% range after being as high as 5% at the end of Q3 2014.

Companies with large overseas operations are most at risk to the appreciating dollar. Even if sales in overseas markets are expanding, they look smaller when converted back to dollars because it takes more of the foreign currency to buy back stronger dollars. This translation effect can also lead to mismatches in costs and revenues because of different currency weights.

Meanwhile, European exporting companies are humming as the depreciation of the euro has made their goods more competitive in foreign markets. For example, both beer manufacturer Anheuser-Busch (ABI), and drug

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manufacturer Bayer (BAYN) are up over +10% for the year, and German auto manufacturer Daimler (DAI) is up over +15% YTD.

Investing with Exchange Rate Risk

Currency risk is a significant contributor to overall risk when investing in foreign equities. Currency movements can potentially detract at or add value to returns depending on which way exchange rates move. Usually, these movements are slight, but recently they have been sharp and should remain volatile in the near future.

The following table elucidates the effects of currency risk on foreign investments. In all three scenarios, your foreign investment makes 10% in euros, but the returns are drastically different after you convert back to dollars. In the first scenario, the euro depreciates 25%, and so instead of making a solid return, you walk away from the investment with a double-digit loss solely due to currency movements. In the last scenario, the euro only depreciates 5% and you are left with a +4.8% return. The table exemplifies why it is important to understand currency movements when investing abroad.

Scenario	Initial Investment ($)	Beginning Exchange Rate	Initial Investment (€)	Holding Period Return	End Value (€)	End Exchange Rate	End Value ($)
25% depreciation	**$1,000**	$1/€1	**€1,000**	10%	**€1,100**	$1/€1.25	**$880**
10% depreciation	**$1,000**	$1/€1	**€1,000**	10%	**€1,100**	$1/€1.1	**$1,000**
5% depreciation	**$1,000**	$1/€1	**€1,000**	10%	**€1,100**	$1/€1.05	**$1,048**

One way investors and companies minimize currency risk is through hedging techniques. Hedging techniques involve locking in a future exchange rate. Using the previous example, if you had locked in exchange rate of €1.05 to $1 (5% depreciation of the Euro) at the beginning of the investment, you would end up with a positive return.

Hedging has paid dividends for investors in the past during currency swings. WisdomTree Japan Hedged Equity ETF (DXJ) gained +42% in 2013, even though the yen depreciated 18% due to a massive stimulus cycle by the Bank of Japan. A comparable ETF that did not hedge the yen was iShares MSCI Japan ETF (EWJ), which was up only +26% over the same time period.

Hedging also applies to more recent currency swings. WisdomTree Europe Hedged ETF (HEDJ) is up +14.4% YTD even though the Euro has depreciated 7% versus the dollar. Vanguard FTSE Europe ETF (VGK) is a comparable ETF that does not hedge the euro and it is up only +6.9% YTD. As you can calculate, the difference in returns between the HEDJ and VGK can almost solely be attributed to the currency hedge.

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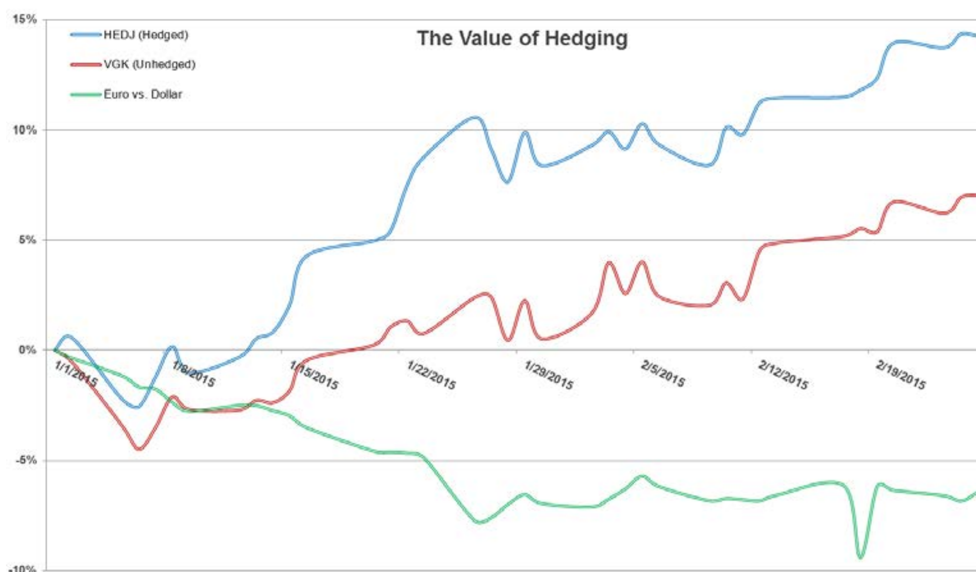

Two Sides of the Coin: Managing Risk while Pursuing Returns

The combination of oil's free-fall, deflation in Eurozone, and weak global demand has set the tone for a volatile year in the currency markets. We expect the steady rise of the dollar to continue in 2015. The US continues to be the sole bright spot in the global economic picture, deeply contrasting slower growth in Europe and an increasing slowdown in China. This disparity will further set the dollar apart because the Fed is expected to pursue a rate hike this summer while the rest of the world seems keen to keep cutting their rates to boost growth.

We are sticking by our positive 2015 views on European equities. Although there remain significant hurdles to long term growth in Europe, we do believe that recent ECB actions and relatively cheap valuations are encouraging signs in the short run. Our recent decision to add the Europe Hedged Equity ETF (NYSE: HEDJ) to the portfolio shows our renewed comfort in European markets. The fact that we chose HEDJ with a euro/dollar currency hedge also illuminates our belief that US dollar strength could be a reality for some time to come.

There are other regions, specifically emerging markets, that have been plagued by currency woes and may entice investors but they also come with large warning signs. Political instability coupled with the crippling drop in oil prices has driven the value of the Russian ruble down more than 50% in the last 12 months. Similarly, commodity giant Brazil saw its currency, the real, drop to a ten year low against the dollar on February 11th. As a result, we continue to underweight emerging markets in our core portfolios.

The Strength of Uncle Sam

While a strong dollar may take a toll on some American businesses, especially exporters, it is not all bad. As a consumer it is a fantastic time to take advantage of travelling abroad. The Euro recently hit a 7-year low versus the dollar, meaning that it is cheaper to travel to Europe now than it has been in almost a decade.

As global investors managing money in US dollars, we are consistently monitoring the fluid activity in currency markets. While the volatility may persist, the silver lining is that the same central bank policies that are affecting the currency markets should also spur growth in the rest of the world, setting up a brighter global economic environment for the future.

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