CAPITAL & ECONOMICS

How To Ride The Currency Roller-Coaster

OVERVIEW

Investors called it the biggest roller-coaster ride in the world: the 10 percent plummet in the value of the British pound when news broke on June 24 2016 that the U.K. had voted to leave the European Union.

Volatility is driven by many factors. But most notably – in a year of elections in France, the U.K., Iran and South Korea combined with, of course, Brexit and the new U.S. administration – it's politics. We're already seeing some more evidence of this: the euro enjoyed a modest rebound following the May 2017 victory of the pro-trade Emmanuel Macron in the French presidential elections.

Learning to understand and navigate the complexities associated with currency fluctuations is critical to navigating an increasingly connected and politically uncertain world.

IN DEPTH

The Asian Financial Crisis of the late 1990s demonstrates the reach of currency volatility. Back in 1997, Thailand had a problem. Its currency, the baht, was pegged to the U.S. dollar, which protected it from wild fluctuations in value. However, as the U.S. economy and the dollar strengthened, the baht was also forced up – to a level where Thai exports were no longer competitive.

To remedy this, the Thai government unpegged the baht from the dollar and floated it on the global currency markets, hoping it would devalue and make exports more attractive.

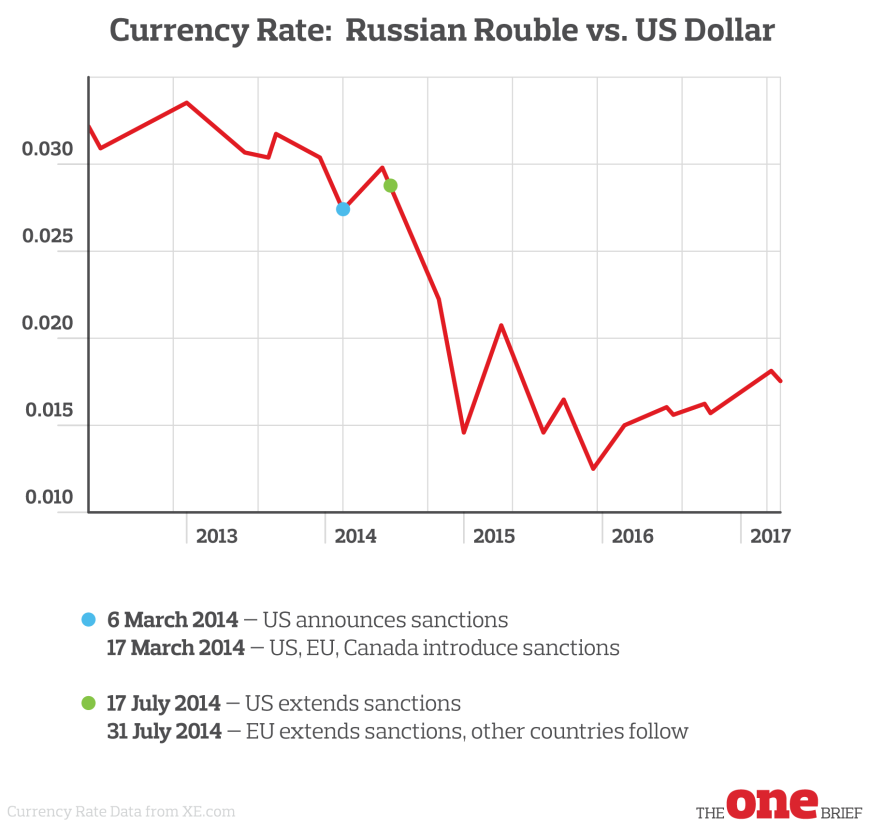
Unfortunately, the baht fell too far. The Thai stock market collapsed, quickly followed by currencies in Malaysia, Indonesia, South Korea, Hong Kong, the Philippines, and beyond. The region eventually had to be bailed out by a $40 billion relief plan from the International Monetary Fund (IMF).

Recent Currency Wobbles – And Their Causes

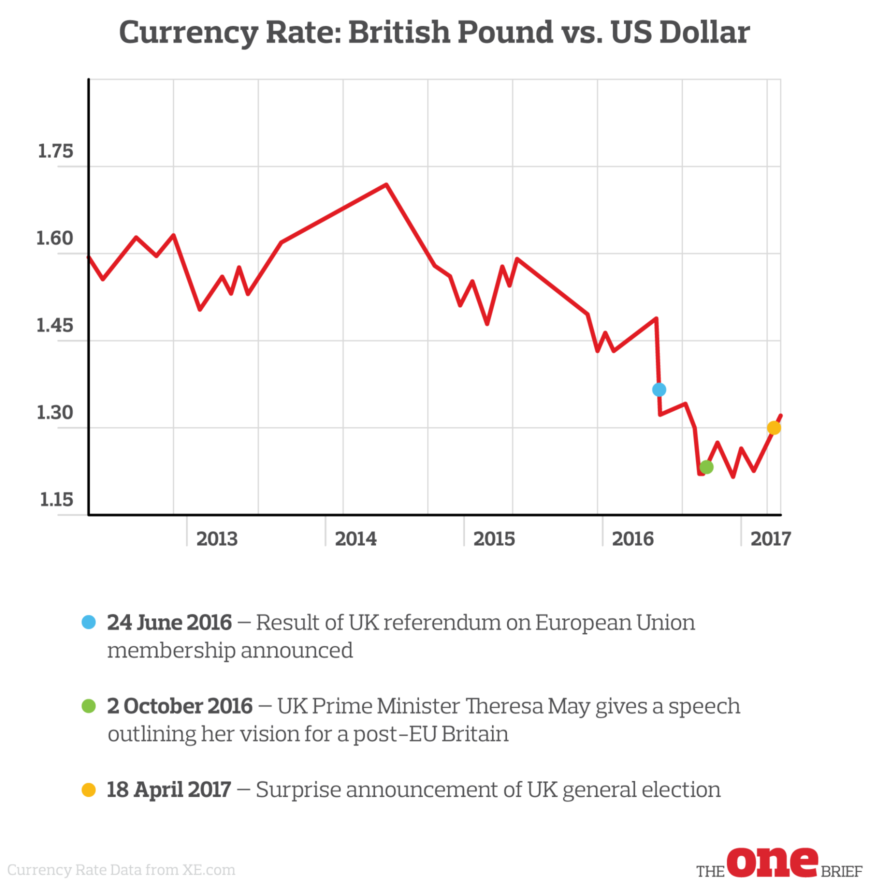
There are several reasons why currencies rise and fall. As Tapan Datta, economist and head of global asset allocation, Aon explains: "Currency can be a proxy to determine the health of a particular economy." For example, if economies appear healthy, the currency is attractive to investors and it increases in value. When economies are perceived as weak, currencies drop.

Take a look at the recent rises and falls in some of the world's leading economies:

The Russian rouble (RUB) – fell 57 percent between February 2014 and January 2016 following the imposition of sanctions over the invasion of Ukraine and decreasing oil prices.

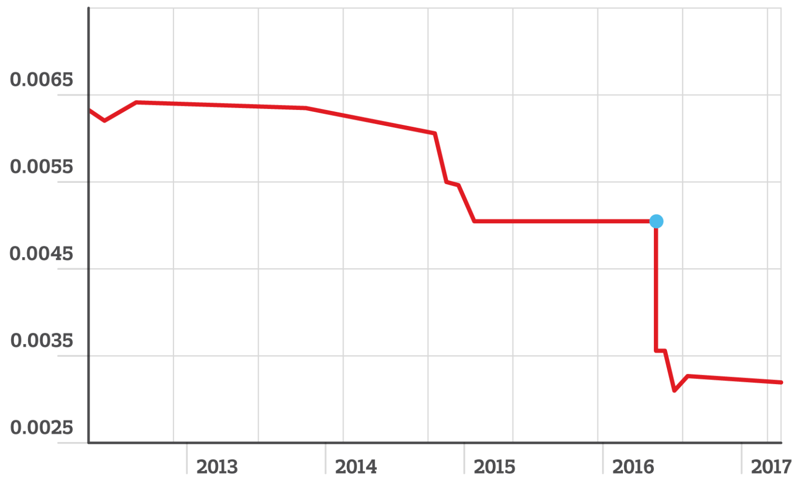


The British pound (GBP) – fell by a record amount after the June 2016 vote to leave the European Union as investors worried about the health of a British economy uncoupled from Europe.



The Nigerian naira (NGN) – fell 27 percent after being allowed to float against the U.S. dollar in June 2016, following a collapse in oil prices, uncertainty over the 2016 elections, and political and religious unrest.

Currency Rate: Nigerian Naira vs. US Dollar



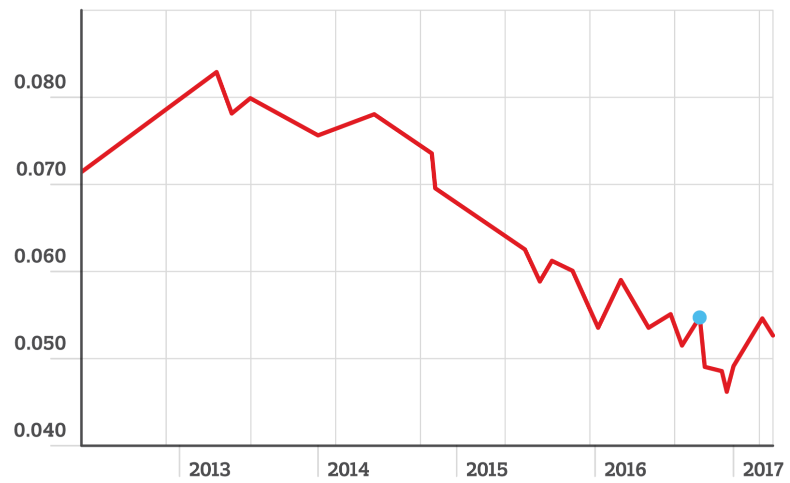
20 June 2016 – Central Bank of Nigeria allows the Naira to float after 16 months pegged to the U.S. dollar

Currency Rate Data from XE.com

THE one BRIEF

The Mexican peso (MXN) – has fallen by more than 12 percent since the 2016 U.S. presidential election on fears that President Donald Trump is looking to renegotiate the North American Free Trade Agreement, threatening Mexico's economy.

Currency Rate: Mexican Peso vs. US Dollar



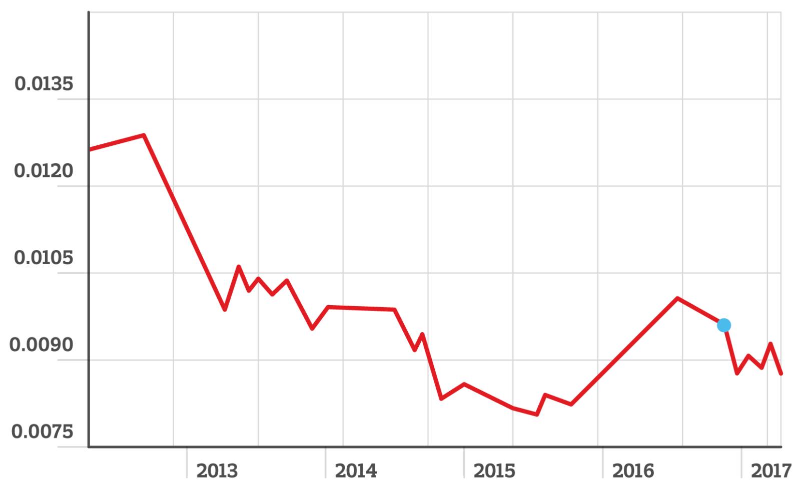
8 November 2016 – Donald Trump wins U.S. presidential election; he had expressed plans to renegotiate trade terms with Mexico during the campaign

Currency Rate Data from XE.com

THE one BRIEF

The Japanese yen (JPY) – rose steadily in 2016, despite government efforts to weaken its value and help its exports. The yen's apparent strength was down to fears about political stability in the U.K. and the U.S. However, following the U.S. election, these gains have been erased.

Currency Rate: Japanese Yen vs. US Dollar

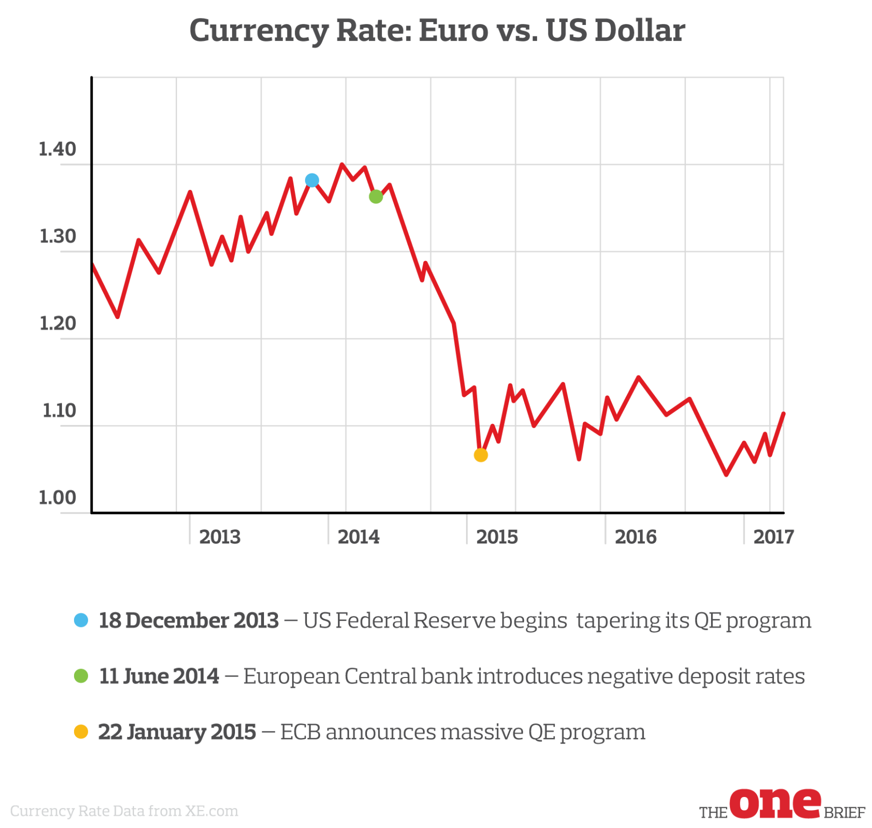


8 November 2016 – U.S. Presidential election

Currency Rate Data from XE.com

THE one BRIEF

The Euro (EUR) – posted modest gains last week after the pro-EU, pro-trade Emmanuel Macron beat the anti-EU, nationalist Marine Le Pen in the 2017 French presidential elections.



1) On Trade

One central part of a country's economy that can be impacted by a volatile currency is trade. For example, if the U.S. dollar increases in value against the euro, then that one dollar can buy more goods being imported from the eurozone. It also means that U.S. citizens traveling abroad can get more for their dollar in euro countries.

On the flipside, however, those buying and selling in their own currency will then need to pay more for U.S. goods, making U.S. exports less attractive. This in turn can impact economic growth, wages, and even employment levels in the affected countries. This was among the factors that prompted the Thai government to float the baht at the outset of the Asian financial crisis, and the Swiss franc to unpeg from the euro at the start of 2015, after a year of falling euro exchange rates had pushed down the value of Swiss exports. If your profit is dependent on the value of a currency you don't control, then unsurprisingly, your profits can be seriously impacted by currency volatility.

2) On The Global Economy

Then we come to government, or sovereign debt, usually denominated in dollars. A rise in the value of the dollar can make it more difficult for countries to service their debts, which could cancel out any gains from having cheaper exports. Similarly, a lower dollar, while making a country's exports relatively more expensive, would make it easier to service debt.

This can exacerbate existing currency crises, as Miles Johnstone, Head of Structured Credit and Political Risk, Asia, Aon, explains: "When it becomes harder for their governments to continue to service their dollar debt obligations to international lenders, the risk of currency controls being implemented increases, ultimately leading to a sovereign debt default. Right now, continuing low oil prices mean several oil-exporting countries no longer have such robust foreign exchange reserves. This is putting pressure on their currencies, bringing them close to or into actual debt default."

There is also the risk of a "currency war", where multiple economies competitively devalue their currencies – the usual outcome being an overall decline in global trade and economies . For example, between 2009 and 2011 major global economies like the U.S., China, Japan and the EU all devalued their currencies in an effort to prop up their export sectors in the wake of the financial crisis.

3) On Investments

Currency volatility can also impact the value of investments. When the value of currency changes, so does the value of investment portfolios dealing in securities denominated in that currency.

Businesses can protect themselves from currency fluctuations by hedging – taking an offset position in another currency or asset, such as a futures contract. By doing this, investors can go some way to shield themselves against negative developments. For instance, in the run-up to the Brexit vote, UK companies betted against the pound to cover themselves if Britain left the event and the currency dropped – which was ultimately what happened.

Hedging can also be used to mitigate risks beyond currency exposure. "Reducing currency risk has historically helped to reduce overall portfolio risk and, looking forward, some currency hedging makes sense from a risk reduction perspective" says Christopher Inman, UK-based Defined Contribution Investment Leader, Aon.

Managing The Risk Of Volatility

There is no formal way to "protect" against fluctuations in currency. Instead, businesses should have a good understanding of the challenges as well as opportunities posed by such external forces – occurrences that, for the most part, are not controllable.

Foreign exchange markets are vast, complicated, and change all the time. If a country's currency plummets in value, the political and economic impacts to local businesses can be massive, particularly to businesses involved in that country, and these risks can radiate up and down supply chains. For instance, a multinational corporation based in the U.S. but with operations in Germany might have to foot a significant bill if the euro appreciated against the dollar to extent that salaries in German operations suddenly became more expensive

There are many factors that play into business decisions, and currency fluctuations can impact those decisions and how an organization chooses where and how to invest – and even where to operate. That investment, whether it be a new business venture, location of a new headquarters or plant, or specific strategies related to talent recruitment or their global supply chain, is reliant on how and in what currency that certain investment is being fulfilled.

In our globalized world, exchange rates are increasingly core to major business decisions. A rise in currency volatility can mean that strategies may need to be revisited as old assumptions and forecasts no longer apply. But there can also be a positive flipside – currency fluctuations can provide an opportunity for leaders to quickly make decisions that allow them to benefit from such fluctuations that result in outcomes in their favor – both today, and with strategic planning – 10 years from now.

TALKING POINTS

"There is a risk of the global economy plummeting into a crisis beyond the normal economic cycles. Any drastic fluctuation in exchange rates will have a major impact on trade-related Japanese companies which is not desirable. In the markets there are speculative movements." – Shinzo Abe, Japanese Prime Minister

"With bond and currency volatility measures also at low levels, it does seriously question those who claim the outlook is highly uncertain. The market certainly doesn't think so and pricing of vol and risk would actually suggest a more certain outlook than usual prevails." – Jason Wong, Currency Strategist, Bank of New Zealand

FURTHER READING

- Making sense of the currency market's strange reaction to the French election – CNBC, May 8, 2017
- Venezuela's 99.5% currency plunge shows why protest rage – Bloomberg Markets,
- China opening up its bond markets, but currency seen as a major barrier – Reuters, May 10, 2017
- Trump softens stance on China's currency practice – Omaha World Herald, April 13, 2017
- Dollar weakens after Trump fires FBI director – The Telegraph, May 10, 2017

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