Global Insights

Currency Chaos

Viewed through a narrow lens, a strong US dollar is a good thing. Indeed, a resilient dollar bolstered the purchasing power of US citizens travelling abroad this summer—rewarding some with double-digit discounts. Naturally, the dollar’s advance has also benefited American businesses that import foreign goods and the consumers who buy them.

However, the dollar’s rapid appreciation is a double-edged sword. For example, although a strong dollar makes imports cheaper for US buyers, it also makes America’s exports more expensive for overseas customers—hurting US multinationals that generate revenue abroad.

In this edition of Global Insights, we shine a light on volatility in some of the major currency pairs and reflect on the benefits of hedging currency risk and focusing on non-US companies with dollar-based revenue.
Currency Volatility Might Stick Around. Currency markets have grown more turbulent. In fact, the JP Morgan VXY-G7 Index is in the 99th percentile of its 10-year range. Although we have seen a marked rise in exchange-rate volatility, emerging market currencies have been less volatile than their G-7 peers (see Exhibit 1). While it is difficult to point to a single reason, we think disjointed central bank monetary policies should shoulder much of the blame for the increase in exchange rate volatility.

Policymakers in emerging markets rushed to tighten financial conditions in response to high prices last year. As a result, emerging market central banks are much further ahead in their tightening cycles. For example, Brazil’s central bank was approaching the end of its nearly 1,200-basis-point tightening cycle this spring just as the Federal Reserve was getting started.

We think there are multiple reasons for the exchange rate volatility. First, in our May 18 Global Insights, “Tokyo Drift: What’s Driving the Yen?” we explored the catalysts for yen selling. We focused on interest rate differentials—the differences in interest rates between two similar interest-bearing assets in two separate countries—to partly explain the yen’s weakness. Although we applied the analysis to the yen, it can be used to explain weakness in other foreign currencies, such as the euro and British pound. Second, Europe is contending with an economic crisis. In our Sept. 14 Global Insights, “Europe’s Energy Crisis,” we hypothesized that a recession in Europe may be unavoidable given the continent’s deepening energy crisis, which would make the dollar and US-based investments more appealing to overseas investors that are attracted to its safe-haven attributes.

US Dollar. The US Dollar Index, which measures the greenback’s value relative to a basket of six currencies—the euro, yen, British pound, Canadian dollar, Swedish krona and Swiss franc—has risen 17% for the year-to-date (see Exhibit 2). Geopolitical tensions, the eurozone’s economic crisis, hawkish Fed policy and a bearish global growth outlook have kept the dollar well bid. Against this backdrop, the near-term outlook for the dollar looks bullish. In fact, according to the Morgan Stanley & Co.’s foreign exchange strategists, two key criteria must be met before the USD finishes rising: 1) market expectations for Fed rate hikes must peak, and 2) expectations for global growth need to bottom. At the moment, we do not believe either has been met.

Moreover, speculators’ net long positioning in the US dollar remains elevated, suggesting that a large percentage of traders are long the dollar. In fact, according to Morgan Stanley & Co.’s foreign exchange strategists, the US Dollar Index will likely peak at 118 by the end of the year—5% above the current level. On the other hand, we are mindful that the dollar trade is looking one-sided—increasing prospects for bouts of volatility should tailwinds fade (see Exhibit 3).
Japanese Yen. In our June 29 Global Insights “Is a Weak Yen Hurting Japanese Households?” we explored the impact that a weaker Japanese yen could have on consumer spending and business sentiment in Japan. For a while, Japan’s policymakers demonstrated a willingness to tolerate yen weakness. However, in the face of a substantially weaker currency, last month Japanese authorities took decisive action to stem its decline. In fact, Japan’s intervention to strengthen its currency is a first since the 1998 Asian Financial Crisis. It is estimated that $20 to $25 billion was spent to shore up the yen (see Exhibit 4). Unfortunately, its impact was short-lived, and we think it is unlikely that future interventions will have the desired effect given the Bank of Japan’s offsetting bond purchases.

British Pound. The British pound is trading near an all-time low against the dollar. Many factors have influenced the drop, but it was the UK government’s recent emergency budget proposal that spooked markets. UK policymakers, who are already struggling with weak growth and high inflation, proposed cutting income and property taxes to offset the economic effect of higher prices. This, alongside recession concerns and energy price caps, sent the pound into a tailspin that forced the policymakers to walk back some of their proposals.

Immediate after the policy reversal, the pound rallied against the dollar. However, investors remain deeply worried that the British pound, like the euro, is vulnerable to energy shocks and policy mistakes. Since its rebound, the pound has resumed its downward trajectory toward parity versus the USD, in line with the Morgan Stanley & Co. foreign exchange team’s target.

Investment Implications

With the US Dollar Index near a two-decade high and currency volatility at extremes, many investors in international indexes are more exposed to currency risks than in the past. To be sure, a weakening currency can exacerbate already-negative portfolio returns (see Exhibit 5). For example, consider the MSCI EMU Index, which provides exposure to 10 developed market countries in the European Economic and Monetary Union. In years when the euro weakened against the dollar, like 2014, investors benefited from hedging the currency exposure to the US dollar. In 2017, when the euro strengthened against the dollar, investors benefited from owning the index unhedged and receiving returns in local currency. In fact, according to Bloomberg Intelligence data, over the past year, 94% of currency-hedged exchange-traded funds (ETFs) outperformed their unhedged versions while experiencing less volatility.
Exhibit 5: Currency Hedging Can Improve Risk-Adjusted Returns

The dollar could continue to strengthen from here. With that in mind, we explored which international indexes, on a USD-hedged and local-currency basis, are most exposed to movements in the dollar. To do this, we computed the relative beta of several indexes versus the Russell 3000 Index (see Exhibit 6). In the chart below, a positive relative beta implies that the index will experience greater directional exposure to the dollar than US equities. A negative relative beta implies that an index will experience greater inverse exposure to the dollar than US equities. In unhedged terms, international equities tend to exhibit strong negative sensitivity to the USD relative to US equities, with only Japanese equities showing a slightly higher beta.

Exhibit 6: The Sensitivity of Stock Returns to Dollar Strength/Weakness Varies

Finally, we see value in owning non-US companies that generate dollar-based revenue. Europe’s health care, consumer staples and industrials sectors should benefit from high exposure to dollar-based revenue. In Japan, the health care, consumer staples and consumer discretionary sectors could also benefit from higher exposure to dollar-based revenue. By considering geographical revenue exposure, investors can make more thoughtful international allocation decisions (see Exhibit 8).

Exhibit 8: Certain Sectors Could Benefit From High Exposure to US Dollar-Based Revenue

This means that when the dollar is falling, investors derive greater returns through exposure to unhedged indexes. Conversely, when the dollar is rising, currency hedging is beneficial. With this in mind, we find it surprising that dollar strength has not supported flows into currency-hedged ETFs (Exhibit 7).

Exhibit 7: Currency-Hedged ETFs Are Outperforming Unhedged Peers but Flows Remain Muted
Charts You Can't Miss

Exhibit 9: Japan’s Trade Deficit Has Widened on Higher Global Energy Prices and a Weak Yen

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 30, 2022

Exhibit 10: Bearish Sterling Sentiment Is Strongest on Record

Note: Risk reversal on the one-year tenor is a barometer of market positioning and sentiment. Risk reversal can be interpreted as the market view of the most likely direction of currency spot movements over the next maturity date.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Oct. 6, 2022

Exhibit 11: Global Foreign Exchange Reserves Are Falling at the Fastest Pace on Record as Central Banks Support Their Currencies

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Oct. 6, 2022

Exhibit 12: Most Major Currencies Have Declined Sharply Versus the US dollar

Current Readings From Our Quantitative Framework

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Levels

- Unfavorable
- Neutral
- Favorable

Changes

- Deteriorating
- Unchanged
- Improving


Ongoing Development Spotlight

Ongoing Development Spotlight will return on Oct. 26.

Please refer to important information, disclosures and qualifications at the end of this material.
GLOBAL INSIGHTS

Disclosure Section

Index Definitions

For other index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealthinvestmentsolutions/wmir-definitions

Glossary

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Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

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