



AA View

Sterling Weakness and Portfolio Implications

19 March 2020

Summary

- Currency market volatility has risen over the last month with US dollar strength and sterling weakness the two most significant moves
- Sterling breached post-Brexit lows against both dollars and euros yesterday due to its vulnerabilities to Coronavirus concerns that arise from the UK's current account deficit. Its weakness against the US dollar specifically is a result of dollar strength from its safe haven status
- Even though we consider that failure to negotiate an EU trade agreement is a risk, we do not think that the virus has created extra Brexit risks
- Sterling's sudden weakness has softened the blow from the sharp virus-driven losses of UK investors' overseas unhedged exposures. Investors with currency hedged positions have not benefited from this currency windfall and also face cashflow and rebalancing issues
- We believe that sterling will appreciate over the next few years once the virus is overcome and therefore we advise that investors who can withstand any short-term volatility, and particularly those with no currency hedging already in place, should build up currency hedges



Whilst the recent focus of financial markets has been primarily on the impact of the Coronavirus on equity markets, where volatility has exceeded historical highs (reaching above 80 on 17 March), the virus' impact on other markets should not be ignored. Currency markets have been strongly impacted. Currency volatility, which has been low for years, has also risen sharply.

Currency volatility has shot up in the last month



The US Dollar

The initial reaction to the Coronavirus was one of US dollar weakness as US rates were expected to be cut whilst other currencies were supported by very limited ability to cut rates given their already low levels. Euro strength was also caused by a rewind of the carry trade which uses the euro as a funding currency (effectively buying back euros). However, as the threat of the virus intensified, the dollar turned around from the start of last week and the Dollar Index is now close to its 2016 high as it benefits from being the world's major transactional currency.

The US dollar has been yo-yoing in 2020



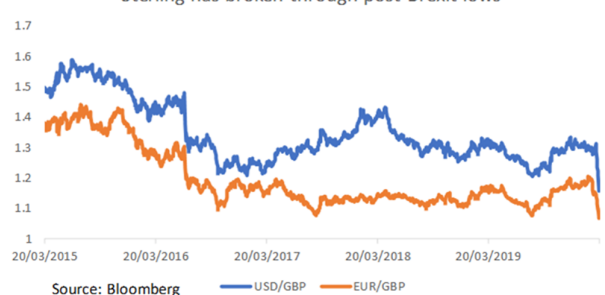
Sterling

Since the start of last week, 9 March, sterling has fallen by a large 12% against the US dollar, 4% of which was made yesterday. Against the euro, the size of the move has been similar since February highs but the more recent moves have been smaller.

Yesterday's intra-day exchange rate lows were around \$1.15, a level last reached more than 30 years ago in 1985 when sterling was weaker than that for less than 3 months (reaching a \$1.05 low) and €1.0550, not quite as low as 2008's €1.02.

Yesterday's moves were significant as they breached the post-Brexit lows in dollars and euros which had been tested several times since then, most recently in August 2019 when concerns over a no-deal Brexit peaked.

Sterling has broken through post-Brexit lows



Drivers of Sterling Weakness

We think that this sterling move is driven by Coronavirus fears in two key respects:

- The UK's current account deficit makes sterling vulnerable at times of risk aversion as capital flows tend to dry up when investors are concerned over economic growth and financial market stability. The deficit has shrunk a little since the Brexit referendum in 2016, helped by greater competitiveness caused by a weaker pound. However, it remains stubbornly high as many of the U.K.'s exports are insensitive to relative price changes and many exports also have a high import content. The easier fiscal policy announced to combat the virus in the UK is likely to increase it.

UK current account deficit makes sterling vulnerable



- Demand for US dollars, driven by the economic effect of the Coronavirus and its impact on lower banking system illiquidity explains why sterling has fallen more against the dollar than the euro.

Other reasons why sterling has fallen could be:

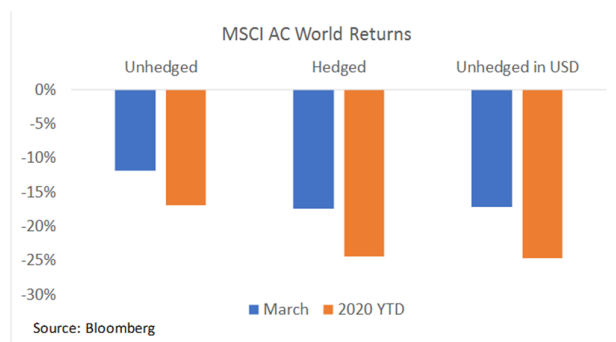
- The UK government's response to the virus has been muddled, despite the synchronised Treasury/Bank of England policy response last week. The importance of the financial sector to the UK economy may also play a part.
- The rocky start to Brexit negotiations and the risk that the UK can still leave the UK on WTO terms is keeping downward pressure on sterling. We consider, however, that the coronavirus may well take the pressure off the UK government to reach a EU deal by this year's deadline. Therefore, even though we do consider a WTO Brexit a risk, we do not think that the virus has created extra Brexit risks.

Portfolio Implications

For UK investors, the sudden weakness of sterling over the last week and particularly yesterday, has various ramifications.

- Sterling weakness is acting to soften the blow from the sharp virus-driven losses of UK investors' overseas unhedged exposures.

The return of MSCI All Country World Index since the start of the year is -17% as of 17 March, compared to -24% in sterling hedged terms - without the benefit of sterling weakness. For US investors, even though US equities have held up relatively well, their overseas holdings will have been also painful with the MSCI ACWI falling by 25% in US dollar terms.



- Investors with currency hedges implemented by forward foreign exchange (FFX) contracts will need to pay out losses when the contracts expire which requires careful consideration of which asset is best to sell if cash reserves are not at hand with all markets suffering from lack of liquidity. Investors who implemented hedging through shifting from unhedged share classes to hedged share classes do not face this cashflow challenge. It is worthwhile remembering that FFX contract payments are offset by increases in the spot currency moves from the underlying asset which effectively means that investors are just not benefitting from the boost to equity values from a weaker sterling.

- Investors with direct currency hedges (not implemented through the share class route) in particular will have seen a currency hedge ratio increase above target as their equity holdings' values have fallen. Questions about whether to rebalance currency hedges back to target arise.

Our Sterling View

The US dollar will continue to act as a safe haven currency until virus fears subside which makes increasing US dollar hedges quite risky at this stage. The Eurozone's current account also means that the euro also has some fundamental support. However, the Eurozone has more difficulty to provide a fiscal response to the virus. Concern over the stability of the Eurozone has also arisen in the last few weeks due to ECB President Lagarde's clumsy comments indicating a lack of support for Italy.

However, sterling has fallen to cheap levels. See the chart below of sterling against a broad range of trading partners, adjusted by inflation, which gives an indication of long-term value.



We do not suggest that investors with hedges in place should lift their hedges at these levels. We do not envisage that there will be much further sterling downside although a poor virus scenario would mean that sterling could fall further, particularly against the US dollar. Neither do we suggest that currency hedges that have grown vs underlying loss-making assets should necessarily rebalance their hedges.

We remain confident that sterling will appreciate over the next few years once the virus is overcome and therefore we advise that investors who can withstand any short-term volatility, and particularly those with no currency hedging already in place, should build up currency hedges. We encourage investors, who have not done so, to currency hedge 50% of their overseas equity exposure on a strategic basis. We think that, over the long-term, this will minimise the volatility of the sterling value of a global equity portfolio. Our preference remains to implement this through currency hedged share classes where they exist.

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