Investment Insights

Coordinated Currency Policy is Back

BESSEMER TRUST

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Highlights

- The last six weeks have seen a 4.5% decline in the trade-weighted dollar, largely on shifting central bank expectations
- Behind specific monetary actions has been a broader change in rhetoric: policymakers appear to be coordinating more than in recent years on exchange-rate policy and are now including China in the decision-making
- We believe currency markets, including the dollar, have shifted into a new, more range-bound regime; at the margin, this is good news for corporate treasurers, commodities and at least some emerging markets

Currency devaluations are out. Coordinated currency policy is back in.

The last several weeks have suggested a tectonic shift in the world of currencies, with policymakers from the U.S., Europe, Japan and China seeming to quietly agree that going forward, they will increasingly take each other's interests in mind when it comes to exchange rates.

That's not to say that these countries are no longer acting in their self-interests. The U.S. Federal Reserve, if and when it raises interest rates later this year, will do so first and foremost because it is the right thing to do for the U.S. But relative to recent years, we believe the Fed is now putting a greater emphasis during its deliberations on how higher U.S. yields, and a subsequently, potentially stronger dollar, might impact the rest of the world — which in turn can come back and impact the U.S.'s own policy targets. The same thought process, we believe, is increasingly true across Europe, Japan and China.

What does this change mean for investors? Different currency regimes will always have relative winners and losers, but overall, we see greater currency coordination as good news. A largely range-bound currency world means fewer surprises for corporate treasurers. That means less uncertainty around earnings, which in turn may help investor sentiment and cyclical assets broadly. In addition, a more range-bound dollar takes a degree of pressure off both commodities and emerging markets. Of course, not everyone benefits: investors clearly have been re-thinking Japanese and euro area equities in recent days as those currencies have risen against the dollar, with respective stock markets underperforming U.S. peers year-to-date despite continued local efforts to stimulate via monetary easing.

The Influence of China

Why the change? And why in particular would the euro area and Japan go along with something they know could work against their monetary goals?

In a word, China. Last August, China announced a policy change that would allow market forces to have greater influence over the renminbi. Then in December, China took another step in the development of its currency policy when it announced it would increasingly focus on its currency relative to a basket of major trade partners instead of just the U.S. dollar.

The fact that China is an increasingly important, integrated part of the global economy is well known. What may only recently have been truly understood, however, is how volatility in the renminbi could impact global markets and, indirectly, economies.

A weaker euro and Japanese yen were fine in a world where China's currency was largely guided by the central bank and had little influence on most overseas markets. But that world is gone: today, renminbi volatility can and does have global, cross-asset class implications; as of 2013, it was the ninth-most traded currency in the world, up from 35th in 2001 (Exhibit 1).

Exhibit 1: Global Ranking of China's Renminbi, 2001-2013

Year	Rank*
2001	35
2004	29
2007	20
2010	17
2013	9

*Represents percentage share of average daily currency turnover
Source: Bank for International Settlements Triennial Currency Survey

When the European Central Bank and/or the Bank of Japan try to weaken their currencies, pressure rises for China to let its currency weaken as well, in an effort to manage export competitiveness. But renminbi weakness, at least in recent months, has triggered fears of snowballing capital flight and a drawdown of China's foreign exchange reserves. The thought that China, the world's second-largest economy, could see destabilizing capital flows and sudden currency weakness has subsequently resulted in investors more broadly reducing portfolio risk, selling equities and commodities regardless of their direct ties with China's economy. Put another way, European and Japanese policy choices were exacerbating risks in China that in turn came back to indirectly undermine European and Japanese growth and inflation goals.

A More Collaborative Tone

Last month, finance ministers and central bank governors from the Group of 20 economies met in Shanghai. The resulting communique highlighted that "downside risks and vulnerabilities have risen, against the backdrop of volatile capital flows" and "a large drop of commodity prices." Further, the communique stated that policymakers "...will consult closely on exchange markets. We reaffirm our previous exchange rate commitments, including that we will refrain from competitive devaluations and we will not target our exchange rates for competitive purposes....We will carefully calibrate and clearly communicate our macroeconomic and structural policy actions to reduce policy uncertainty, minimize negative spillovers and promote transparency."

Even if the broad tone to the communique was not totally new, the emphasis on coordination and not targeting exchange rates was stronger than in previous statements. Two subsequent events, in our view, reinforced the G-20 missive. First, the latest Federal Reserve press conference proved more dovish than expected. U.S. yields and the dollar both weakened (lifting commodity and emerging-market valuations in turn). Second, European Central Bank (ECB) President Draghi, at his latest press conference, suggested that further reductions in key euro area interest rates were unlikely. Draghi appeared to be focusing his stimulus efforts more on market liquidity and credit channels — the currency had moved to the background.

The End of the Dollar Rally?

We do not think that this shift means the dollar cannot strengthen further, or that other central banks will sit idly by if currencies move against policy goals in an aggressive way. Most Japanese exporters have been budgeting with a USD/JPY exchange rate, for instance, around 118 (USD/JPY is currently trading around 112). A much stronger yen (i.e. lower USD/JPY rate) can substantially threaten corporate profit outlooks at a time when the Japanese government is already struggling to

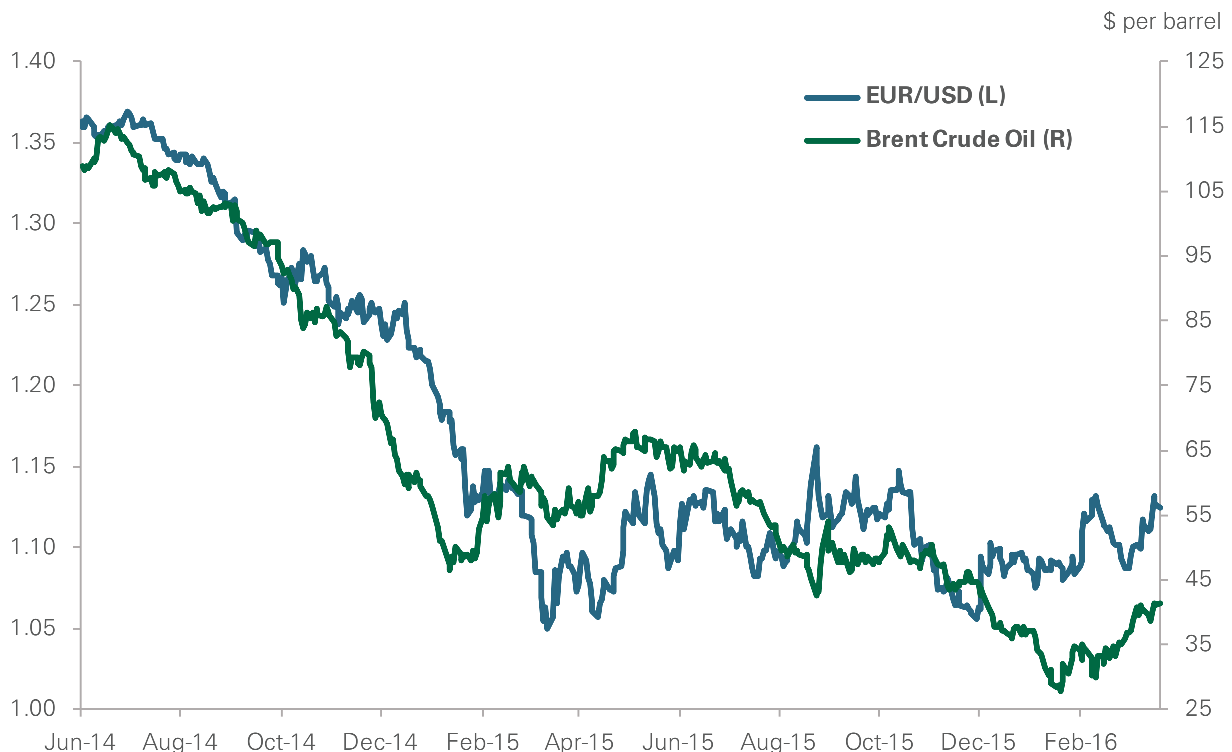
generate growth momentum. What may prove different is how policymakers respond to currency overshoots. Instead of "shock and awe" quantitative easing or currency intervention, more subtle efforts could occur, accompanied by other means of boosting growth (fiscal stimulus or different types of asset purchases within a QE policy).

Meanwhile, even if the Fed is going slowly, in part to manage dollar appreciation and its side effects, we could see the dollar lifted, albeit within a range, by a variety of forces. The dollar and crude oil have been trading inversely in recent years, with falling oil prices boosting the dollar and vice versa (Exhibit 2).

Should U.S. oil inventories (already at record high levels) rise further and other major producers suggest no rush to reduce supply, oil prices could see another bout of selling, lifting the dollar in the process (albeit more against commodity-focused currencies such as the Canadian dollar and Norwegian krone). Separately, any faster-than-expected inflation gains in the U.S. could quickly change the consensus view around the Fed, helping to push the dollar higher. Finally, greater risks of a British exit from the European Union (the "Brexit" vote is due June 23; today's tragic events in Brussels may increase the probability of a "yes" vote) could lead investors to tilt away from European assets. A flight to U.S. securities (especially government bonds) could result in dollar strength.

Again, we are not calling for an abrupt end to the strengthening dollar trend that has been in place since mid-2011 — at least any time soon. Rather, we would say the global currency regime has shifted, with the dollar more likely to trade within a range going forward. The changing currency landscape warrants a fresh look at other parts of our portfolios, across asset classes. Over the coming days our Investment Department will share in more detail how we think our asset allocation might shift to better reflect this coordinated-currency world.

Exhibit 2: Brent Crude Oil Prices versus the U.S. Dollar



As of March 21, 2016
Source: Bloomberg

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