Currency outlook in the Coronavirus crisis

FOR PROFESSIONAL INVESTORS - April 2020

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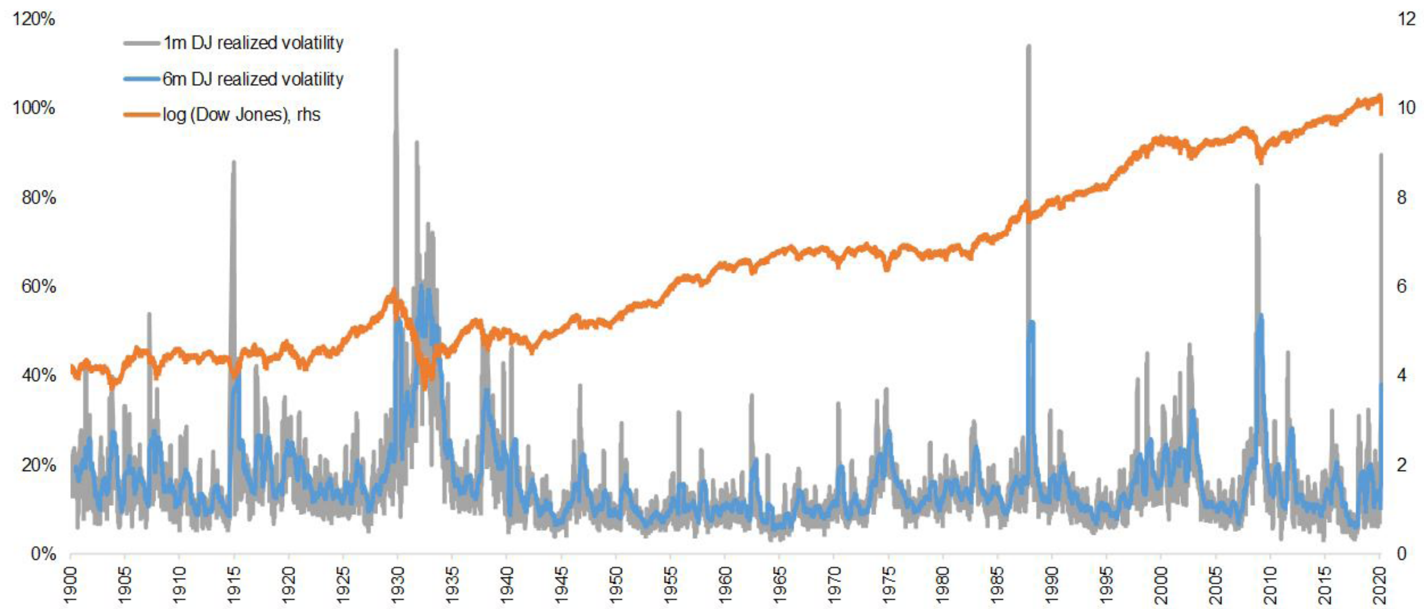
Key takeaways

- **The COVID-19 pandemic will have severe implications for the economy.**
- **Over the medium term, the US dollar is likely to remain well supported.**
- **The current crisis highlights the importance of hedging foreign currency exposures in institutional portfolios.**

For many investors, the coronavirus crisis calls to mind the “Black Monday” stock market crash of 1987 or the 2008 Global Financial Crisis (GFC). Indeed, the spike in volatility seen in March 2020 was last seen during the GFC, and in 1987 before that. Exhibit 1 shows the realized volatility of the equity markets using daily returns of the Dow Jones Index going back more than 100 years. Indeed, over the last thirty years, the volatility seen in March was matched only during the GFC and on Black Monday itself, when the Dow Jones Index fell more than 20% in one day. Prior to that, similar levels of volatility had not been observed since the Great Depression.

Exhibit 1. Volatility of the Dow Jones Index

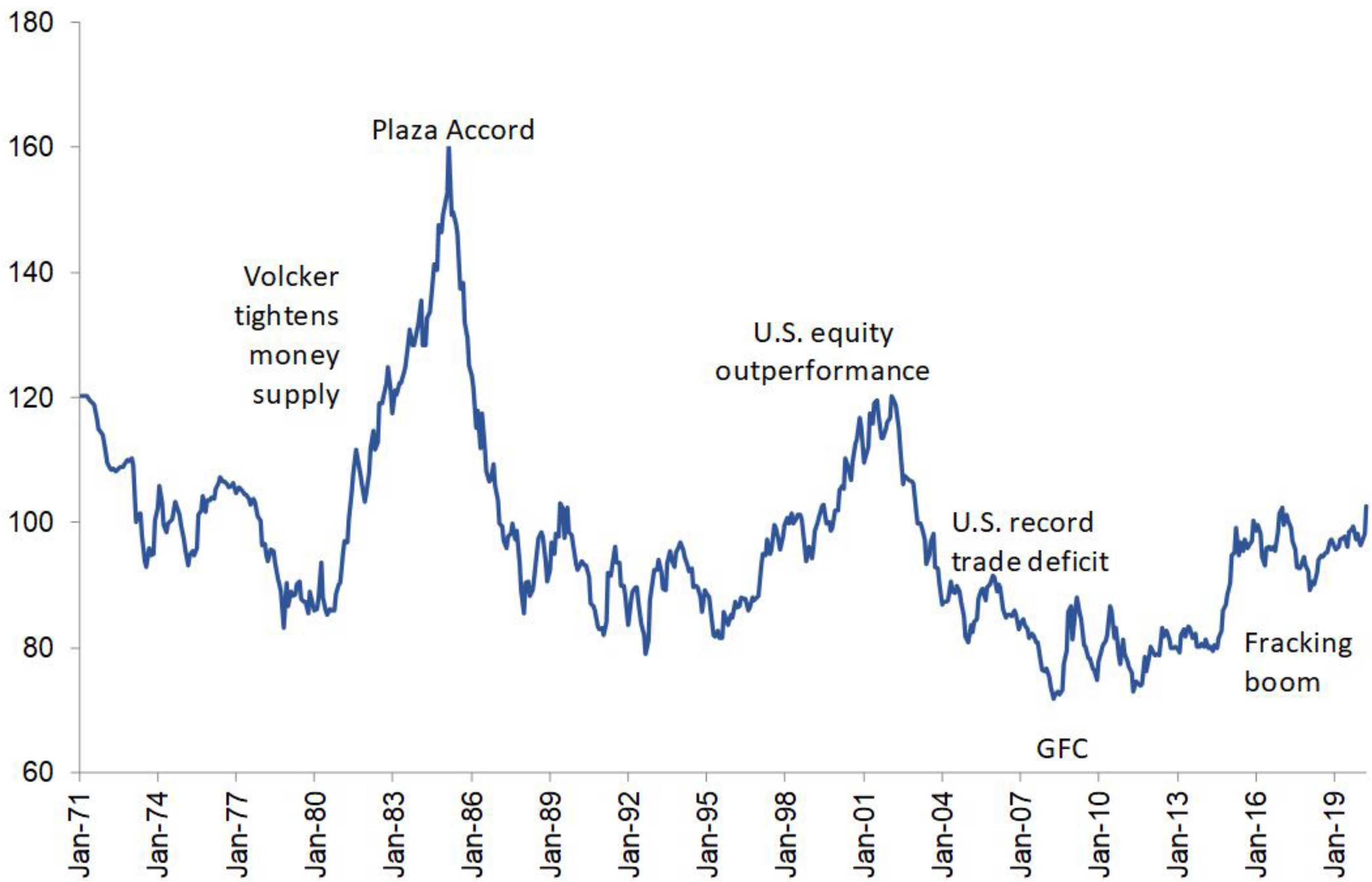


Source: BNP Paribas Asset Management, Bloomberg

We know already that the COVID-19 pandemic will have severe implications for the economy: the unemployment rate in the US is likely to exceed 20%. But it is difficult to gauge the medium- to long-term macroeconomic effects of the current pandemic. A recent paper by the Federal Reserve Bank of San Francisco looks at the macroeconomic impact of pandemics using data from the last twelve major pandemics, starting with the Black Death of 1347. The conclusion is that the impact of pandemics is long-lasting, expected to last not months, but multiple decades. A major caveat is that the Black Death and other pandemics affected the majority of the population below age 60, so this time could be different. What is clear is that the range of possible outcomes is extremely large—there are no more Black Swans. No future event should come as a surprise as we know only that little is known about the current pandemic at this stage. Data reported out of China have been met with skepticism in the West, and fatality rates vastly differ among different countries (Germany and Italy, as one comparison).

What does this mean for the Foreign Exchange market? The US dollar typically benefits in periods of global recessions. Over the medium term, the US dollar is therefore likely to remain well supported. But Exhibit 2 suggests that US dollar bulls need to be cautious. The current US dollar bull market started during the GFC—more than ten years ago—and is the longest in history as the previous bull markets lasted about seven years (from 1980 to 1987, and from 1995 to 2002).

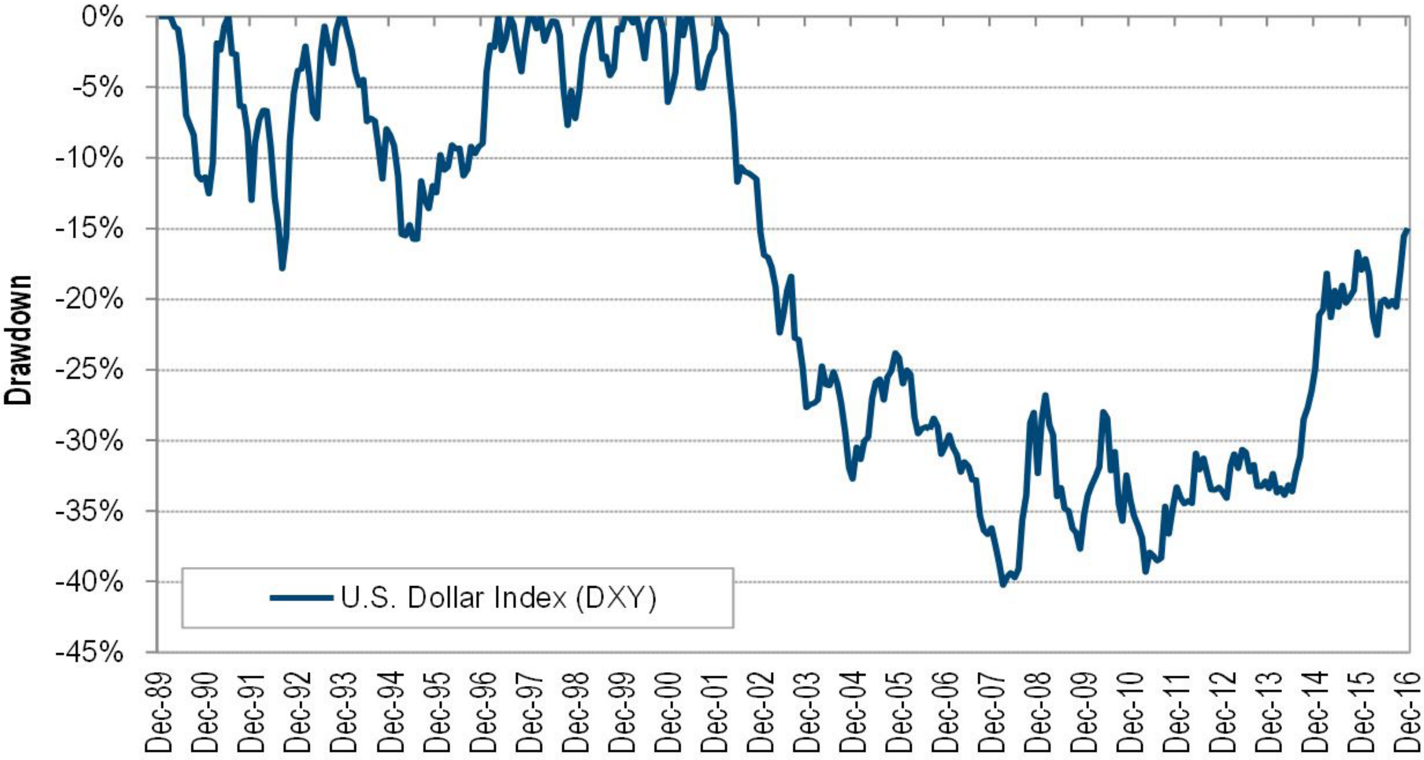
Exhibit 2. The US dollar index (DXY)



Source: BNP Paribas Asset Management, Bloomberg

The current crises highlighted the benefit of hedging foreign currency exposures as the US dollar surged in Q1. Positive cash flow generated from hedging was certainly beneficial as liquidity was much needed in March. But passive hedging alone will generate significant negative cash flows when the US dollar bull market ends. Exhibit 3 illustrates that between 2000 and 2007, the cumulative negative cash flow would have been as high as 40%, forcing investors to sell international assets in order to cover the losses on the currency forwards. Indeed, when experiencing this significant negative cash flow, some US institutional investors who used passive hedging liquidated their passive hedging program at the worst possible time, as the US dollar bottomed in 2007 after locking in significant losses on the short foreign currency forwards. Any hedging program should be structured in a way to generate positive cash flow over the long run. There should be two objectives for hedging: outperforming passive hedging but also outperforming zero (no hedging). Outperforming passive hedging only could still lead to significant negative cash flows in periods of US dollar weakness and therefore the emphasis on generating positive cash flow (beating a zero benchmark) is very important.

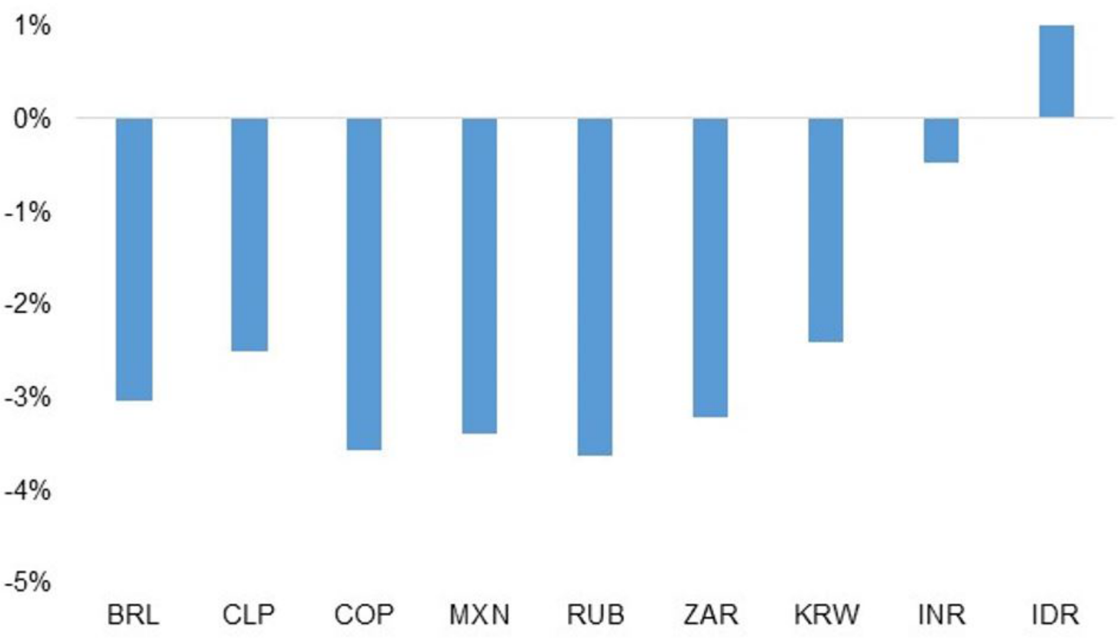
Exhibit 3. Drawdowns in US dollar



Source: BNP Paribas Asset Management, Bloomberg

Many hedging programs have been implemented only against developed market currencies. This is perhaps due to a perception that emerging market (EM) currencies appreciate over the long run and therefore hedging will be costly, especially considering the higher interest rates in these countries. But Exhibit 4 illustrates that high yielding EM currencies have declined against the US dollar after the GFC, impacting long-term investors. Furthermore, the coronavirus may hit EM countries especially hard. For many emerging markets, the current crisis means a compounding blow from domestic outbreaks, declining global demand, and less capital inflow. Importantly, disregarding EM currencies ignores typically 25% of a portfolio's foreign exchange exposure, and the contribution to risk is even higher than that.

Exhibit 4. Performance of emerging market currencies from Dec 2007 until March 2020



Source: BNP Paribas Asset Management, Bloomberg

To conclude, currency risk has long bedeviled investors, who have been faced with many opinions and recommendations as to how and whether investors should ever hedge their currency exposure. The current coronavirus crisis highlights again the importance of hedging foreign currency exposures in institutional portfolios. And while much of the impact of the pandemic is difficult to gauge, one thing is sure: its effects are not likely to be short lived.

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