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The Australian dollar

Is now the time to hedge?

At Crestone, we believe that global diversification should be at the core of each investor's strategy. A globally diversified portfolio is likely to be better positioned to weather large movements in markets, and provide a more stable set of returns over time. However, one of the implications of a globally diversified portfolio is that currency fluctuations can have an impact on investment returns—both positively and negatively, depending on which direction currencies are moving. As such, an important question for investors is whether they want to take this risk, or if currency risk is something they should consider hedging.

In this article, we ask whether an investor should consider hedging currency risk at all, and look at the key drivers of the Australian dollar in the months ahead.

Should you hedge currency risk at all?

This question depends on several factors. It depends on your tolerance for risk, how volatile the relevant currencies are, how volatile the underlying investment is, as well as the nature of the currency itself.

Consider your risk tolerance

The lower your risk tolerance, the more inclined you should be to hedge out currency risk. If you don't hedge your international investment exposure, you are taking on additional currency-related risk with no guarantee of increased returns. If you are more risk-seeking, you should be more inclined to take currency risk with the potential for it to add to returns.

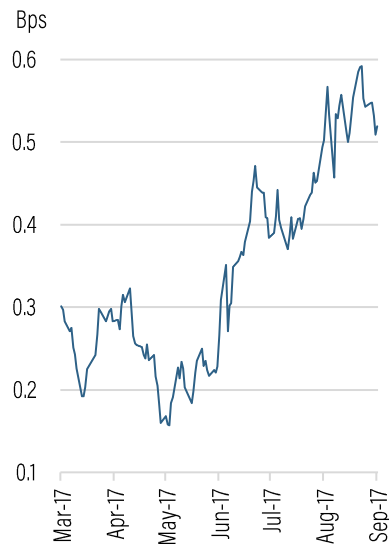
How volatile is the underlying investment?

The lower the volatility of an asset, the greater the need to hedge the currency—and vice versa if volatility is high. Fluctuations in the currency can easily overshadow the underlying return of the asset if currency volatility is high relative to the asset. This is a key reason why international fixed income is almost always hedged. On the other hand, a case for hedging equity exposure can be made either way.

What's the nature of the currency?

The Australian dollar is considered a 'risk-on' currency. This means that the dollar strengthens when global markets rise, and generally weakens when global markets fall. As such, the Australian dollar is, by nature, thought to be an inherent hedge—and this is one of the main reasons why many Australian investors don't hedge their international exposures. If global equities and the Australian dollar fall in unison, the weaker currency lessens the negative impact on investors in Australian dollar terms. This can be highly beneficial during a time of crisis, as witnessed in the months following the global financial crisis when the Australian dollar fell to a low of around USD 0.62.

Australian-US 10-year interest rate differential



Source: Bloomberg.

Currency risk is often overstated

The importance of hedging currency risk is arguably often overstated. As an example, if one considers a typical balanced portfolio in Australia, no hedging decision needs to be made for domestic assets (cash, domestic equities and domestic fixed income).

If you add in international fixed income, which should be hedged due its relatively low volatility, then almost 60% of the portfolio is essentially void of any hedging discussion.

The decision to hedge international equities is a bit more difficult to answer. But basically, for Australian investors, the incentive to hedge is less given the 'risk-on' nature of the currency and its implicit hedge. At Crestone, we are pragmatic about hedging depending on where the currency is trading, and we actively incorporate currency views into our investment decisions.

The alternatives allocation is akin to international equities, and should be treated pragmatically when considering currency hedging. Generally, we suggest that alternatives should be partially hedged—especially if the underlying investment exhibits low volatility. Alternative solutions, which are included in a portfolio primarily to dampen volatility or reduce risk, should be hedged as there is little reason to include them and then take additional currency risk.

Where to from here - a bias to the downside?

Currency markets are notoriously volatile and hard to predict. This is because there's a wide range of factors that can influence their performance. In predicting what the future has in store for the Australian dollar, we believe there are five key factors that investors should consider—all of which are likely to have a negative impact on the Australian dollar.

1. A divergence in central bank monetary policy

Although the Reserve Bank of Australia (**RBA**) is expected to keep interest rates on hold well into 2018, many other central banks have begun to turn 'hawkish'. The US Federal Reserve (**Fed**) and the Bank of Canada have already raised interest rates, while the Bank of England looks set to hike by the end of the year. In addition, the Fed has announced a passive unwind of is quantitative easing (**QE**) program, and the European Central Bank is highly likely to announce a tapering of its QE program in the coming months. This divergence in monetary policy is expected to weigh on the Australian dollar over the near term, but only marginally. This is because other central banks are expected to be conservative with their hiking strategy, and currency markets will quickly look to price in any RBA rate hikes in H2 2018.

2. A shrinking Australian-US interest rate differential

The Australian 10-year bond yield is currently 2.85%, which is 50 basis points (**bps**) higher than the yield on US 10-year bonds. This makes Australian bonds very attractive for global institutional investors, who need to buy Australian dollars to purchase these bonds. This has been a major factor supporting the currency in recent years. However, the Australian-US interest rate differential is expected to shrink given the hiking path of the Fed. In fact, Commonwealth Bank of Australia (**CBA**) forecasts the differential will turn negative late next year. The last time the yield differential approached zero (it reached 15 bps in March 2001), the Australian dollar fell below USD 0.50.

3. A softer iron ore price

The iron ore price has been very volatile in recent years, and there is little to suggest the future will be any different. Although it's difficult to forecast, both of our key research providers, UBS Research (**UBS**) and CBA, think iron ore prices will fall this year and next. UBS forecasts a price of USD 54/tonne 62% cfr by the end of 2018, while CBA forecasts a price of USD 45/tonne. If they are correct, a softer iron ore price should weigh on the Australian dollar over the next 18 months, as it will impact demand for dollars, our trade deficit and hence our current account.

Australian dollar versus the US dollar over the last 10 years

Source: Bloomberg.

4. A widening current account deficit

Over the past three months, Australia's current account has been improving due to higher export prices and volumes and this has been a major reason for the recent appreciation of the currency. However, recent data shows that the current account deficit is widening once again. If this trend continues, it may not have the same positive influence on the currency that it has had in recent months.

5. The possibility of US fiscal reform

When looking at exchange rates, factors which influence the counterpart currency also need to be taken into consideration. At present, the delay in US tax reform and fiscal spending is weighing heavily on the US dollar, which is seeing almost all currencies, including the Australian dollar, strengthen versus the US dollar. Going forward, US political uncertainty is likely to continue weighing on the US dollar, but given it is already 10% off its recent high, it can be argued that much of this fiscal pessimism has already been priced in. If this is the case, the future impact of any uncertainty will be much less than in the past. Conversely, if the US can implement fiscal reform, it is expected to be a major positive for the US dollar—and detractor for other currencies.

How much will the currency move?

The above factors suggest that the bias for the Australian dollar should be to the downside over the next 18 months. However, both UBS and CBA expect the Australian dollar to appreciate between now and the end of 2018. UBS is forecasting it to end the period at USD 0.83 and CBA is forecasting USD 0.85. Their main rationale is that they expect US dollar weakness (due to delayed fiscal spending) to outweigh all other factors. Further improvement in the current account has also been identified as a future support for the currency.

Credit Suisse, however, is forecasting a different scenario. It sees the currency falling to USD 0.72 by the end of 2018. This is one of the key reasons why currency hedging is a major point of conjecture for investors.

At present, with the Australian dollar hovering around USD 0.80, we think that it's near the top of its forecast band for at least the next six months. There is, therefore, little incentive to hedge at current levels. If the Australian dollar trades below USD 0.70, then it is a much more pertinent question that needs to be answered, and we would generally say that at this level, hedging would be recommended—especially if it falls below USD 0.65.

In summary

Currency fluctuations can have a major impact on parts of a portfolio and, therefore, a portfolio's overall performance. For this reason, we suggest hedging international fixed income exposure, partially hedging alternatives exposure, and being pragmatic with international equity exposure depending on the level of the Australian dollar.

If you follow this approach, this should greatly reduce the impact currency fluctuations have on your investment returns. At the same time, you will be taking advantage of the Australian dollar's implicit hedge, and be allowing yourself the opportunity to gain an enhanced return if the currency moves in your favour.

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