Currency Investing Makes a Comeback

Extraordinary macroeconomic events are reviving attention to the world's largest asset class.

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These days when investors talk about investing in currencies, they often think of crypto. But the hype over digital assets has diverted attention away from opportunities in trading traditional currencies, including the euro, the pound, and the Australian, Canadian and U.S. dollars.

In the 1990s, George Soros made billions trading currencies. First, he shorted the pound, betting the Bank of England wasn't going to keep its over-valued, high interest-rate currency in lockstep with the precursor to the euro as the U.K. fell into a recession. Later, he shorted Southeast Asian currencies, anticipating they could no longer sustain their dollar pegs and the huge foreign debt such linkage had attracted.

While present conditions don't portend returns anything like Soros achieved, currencies are presenting compelling investment opportunities. Trading for alpha in the largest asset market — partly due to geopolitical unrest, soaring commodity prices, and rising interest rates — is back in vogue, according to longtime currency traders.

The size of fiat currency markets dwarfs crypto, with daily trading exceeding $7 trillion, according to estimates derived from the Bank for International Settlements data. Trading fiat money is also not as dynamic as it once was. Consolidation of western European currencies into the euro eliminated a whole host trades once triggered by the actions of various independent European central banks. Expansive liquidity, trading efficiency, and market transparency have also helped reduce foreign-exchange volatility.

Further, 90 percent of currency investments are not designed to move currencies like Soros and others did. Multinationals, central banks, investment managers, and travel-related activities simply seek to hedge future foreign exchange risk.

Still, significant macroeconomic events can spark currency moves. According to many industry observers, including long-time currency investor Jeremy O'Friel who runs Belmont Investments, "we're seemingly at a major inflection point in foreign exchange rate moves."

O'Friel sees three factors collectively driving volatility. First, central banks have begun to raise interest rates, which will distinguish yields where they had been non-existent across the board. Second, rising commodity prices are favoring countries (and their currencies) that are exporters of energy, metals, and food. And third, the war in Ukraine and all the uncertainty it brings are driving volatility
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In early March, *The Economist* reported, "Russia's invasion of Ukraine is unleashing the biggest commodity shock since 1973. The turmoil unfolding in energy, metals and food markets is broad and savage...with commodity prices up now 26% higher than at the start of 2022."

A recent poll conducted by Reuters found 90 percent of currency analysts surveyed expect many currencies "are in for a bumpy ride with already heightened volatility expected to increase" at least through spring.

Collapse of the Russian ruble has also refocused attention on exchange rates. As a result of a remarkably unified and aggressive response by the developed world against Russia, the ruble has lost 40 percent of its value against the U.S. dollar in just two weeks. This decline shadows the shutdown of a wide array of foreign business activity in Russia and Russian business activity abroad. This has transformed Russian bonds — sovereign and private — into highly distressed debt, which has attracted a select number of institutional investors to buy such deeply discounted paper.

NBC News reported that Goldman Sachs "is acting as a broker between Moscow's creditors and U.S. investors, pitching clients on the opportunity to take advantage of Russia's war-crippled economy by buying its debt securities low now and selling them high later, according to four financial world sources familiar with the strategy...On March 4, as Russia was attacking Ukraine, (J.P. Morgan's) investment bank research team issued a report recommending that clients buy Russian corporate bonds."

This is a high-risk and morally challenged example of currency investing because it's based on the world reintegrating Russia into the global economy in the not-too-distant future and no meaningful war reparations paid by Russia to Ukraine. But there are an expanding number of more palatable trades from which investors can easily access and potentially profit. The attraction of these investments: they are pure alpha and uncorrelated to broad equity markets. And the use of leverage can substantially boost small nominal returns (as well as risk).

In the weeks since Russia invaded Ukraine, the dollar has rallied by more than 5 percent as investors are moving to haven currencies that are far from the war. With most observers believing the conflict will get more violent, the dollar is expected to continue its rally.

U.S. investors, with portfolios that are overweight domestic securities, don't benefit from this move. In fact, they could suffer from a stronger dollar. By making them more expensive, a stronger greenback could hit international sales of American-made goods and services while reducing the dollar value of repatriated foreign-based profits. Gaining long exposure to the dollar through various currency pair trades involves making a distinct investment in the greenback.

There's also been a sharp rotation out of euros into Swiss francs because of Switzerland's historical status as a haven — despite the country's unusual participation in sanctions against Russia. The move from the euro to Australian dollars has even been more pronounced given Australia's distance from the war, its limited exposure to Russia, and support the Aussie is receiving from soaring commodity prices. Spreads between Aussie 10-year sovereign yields versus U.S. 10-year Treasurys have traded places now in favor of Down-Under debt.

Belmont's O'Friel thinks one of the most compelling trades driven by expanding interest rate differentials will be the U.S. dollar and Yen. "This cross rate was $1=103Y in December 2020 when markets started to think the Fed would need to start raising overnight rates," explains O'Friel. He notes the dollar recently hit 118Y and within a year he thinks the greenback could reach 130Y.

Investors should note daily exchange rate moves are being driven by headlines. Craig Erlam, senior foreign-exchange analyst at Oanda, a global currency specialist, notes a recent break in trends "is being driven by premature optimism that cease fire talks between Russia and Ukraine may bear fruit." But short of a demonstrative withdrawal of the Russian military out of Ukraine, most observers believe the prevailing move to haven, commodity, and higher interest rate currencies will continue.

Gaining Foreign-Exchange Exposure

Institutional investors can gain pure exposure to many cross rates by buying currency forwards, futures contracts, and currency swaps. These are sophisticated leveraged trades that are marked to market daily.

Retail investors can gain substantial exposure to currencies several different ways. But they require in depth research before investing.

Every time one buys foreign American depository receipts for companies such as British beverage maker Diageo or Australian mineral giant BHP, they gain direct exposure to the local currency. Buying the ordinary shares in a stocks' home market is a purer play, devoid of any U.S.-market variation. Purchasing foreign corporate debt and sovereigns is also an efficient way of gaining exposure. Same goes for purchasing mutual funds and ETFs that track specific foreign country shares whose underlying prices are based on specific currencies.

But foreign stocks, bonds, and funds come with exposure to the underlying issuers and related markets, which could add or subtract from currency performance.

For more focused currency exposure, Invesco, PIMCO, iPath, WisdomTree and ProShares offer currency funds that are long or short a particular currency and if you're so inclined, some funds offer leverage in either direction. Currency funds deliver such exposure by establishing cross rates that in all cases are long (or short) the desired currency. But these funds come with material fees.

Finally, any investor can buy major foreign currencies and store them in a domestic brokerage account. It won't pay any interest. To achieve that, investors would need to set up foreign savings account in a specific country, which might not be easy to do. It may involve actually being in country to establish and there's paperwork. But if you return to such places for work or holiday, you can always use such accounts to pay your way — hopefully at a better exchange rate than at which you purchased the currency.

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