Currencies

With a portfolio approach that is global in nature, currency volatility is playing an important role in the reported returns to clients on a quarter-by-quarter basis. The last two years has seen some substantial US dollar, British pound and euro volatility as confidence in the respective economic regions ebbs and flows. This has a profound effect on how the overseas assets' performance is reported in an investor's base currency, based on their individual circumstances.

US dollar - The US dollar has been a safe haven in times of increased economic uncertainty. In the first few months of Donald Trump's presidency, the US dollar strengthened on the presumption that tax cuts would stimulate the economy. This has subsequently reversed, as the realisation of many false or premature promises have taken hold.

British pound - The British pound has seen its value fall significantly against the US dollar and euro due to Brexit uncertainty. Until the exact path of Brexit and the economic ramifications of this are known, it is likely that the pound will remain weak. There will be many twists and turns along the way until March 2019, not least with the Conservative's General Election result and subsequent reliance on the Democratic Unionist Party. The current status quo is very vulnerable to further turmoil and the weakness of sterling is a by-product of this.

Euro - At the turn of 2017, markets were focussing on the possibility of anti-establishment vote in both The Netherlands and France. At the time, both countries had parties with anti-European Union policies in opinion poll ascendency and thus the consensus was to remain underweight in the Eurozone. Since that time, the euro has undergone a substantial recovery of over 14% against the US dollar as political risk subsided and economic confidence in the Eurozone improved. Against sterling, it is up over 7% this year in addition to the weakness after Brexit of 2016. Both of these currency movements have had the impact of weakening the value of US and UK assets for euro investors.

Translation effects

Performance of globally diversified funds and portfolios has been affected by each of these currency movements. For example, had a US investor bought euro assets at the start of 2017 the translated value would be increased by 14% due to the currency effect along, but a euro investor who bought US assets at the start of the year would be seeing a translated loss of over 12%. Investors in sterling will have seen the value of overseas assets increase markedly during the Brexit process as the pound has weakened significantly, but euro investors with sterling exposure have seen a corresponding fall. Over the long-term, we would expect the impact of shorter term currency movements to average out. For the pound particularly, some thoughts on the longer-term direction are below.

When managing portfolios in Euros, Sterling and US dollars, we ordinarily have a degree of home-country bias to a client's base currency. However, this is dependent on a client's unique circumstances. Portfolios are globally diversified, where we are striving to gain exposure to a portfolio of high-quality global franchises in order to reduce risk to any one particular economic region. Indeed, currency analysis can be somewhat circular, as the underlying investments in each region are typically multi-nationals that have a global spread of currencies. This can mean that an individual portfolio may deviate against a certain measure or benchmark over the short-term, which can be transitory, but we feel this spread of global investments will serve clients well over time.

Hedging

Almost all investment professionals admit that forecasting future direction of foreign exchange is a thankless task, as currencies are largely influenced by future unknown events which are, by definition, unpredictable. As with most investments, volatility can also be driven by speculative investors such as hedge funds.

Hedging currency risk, i.e. eliminating the currency impact of portfolio returns and focussing on the underlying overseas investment return, is sometimes considered by investors. This can add to certainty but also cost. In many cases, due to the

Avenida Jose dos Santos Farias,
Lote 83/84, 8135-167, Almancil, Portugal.

Telephone: +351 289 392 484
Facsimile: +351 289 392 483

info@privatefund.management
www.privatefund.management

inherent unpredictability of foreign exchange markets, hedging not only detracts from returns but often proves to be the wrong action in hindsight. The additional cost and operational risk complexities of hedging currencies of hundreds of individual, tailored client portfolios means that this option cannot be offered on an individual's portfolio.

However, in some cases, a hedged class of fund is available within a private client portfolio. For example, we do often access to sterling hedged classes of JP Morgan US Equity Income, Findlay Park American and Blackrock European Dynamic funds, enabling to offset the currency effect of these three funds at a cost. We do consider the use of these funds when we consider a currency to be excessively weak or strong.

Thoughts on the pound

Using a long term macroeconomic framework, sterling looks to be significantly undervalued versus the euro (see chart opposite) in our view. Without Brexit, we would be looking at what we call an 'equilibrium' value of around 1.50 euros to the pound, taking into account economic fundamentals only (relative prices, relative productivity and relative expected savings). Assuming Brexit, we're working on the basis of circa €1.3 to the Pound - but it could take a few years to get there.

Source: Datastream

Past performance should not be seen as an indication of future performance. Changes in rates of exchange between currencies may cause the value of investments to decrease or increase.

Productivity is a key driver to the long term framework – particularly productivity in the tradable goods sectors. This is likely to suffer after Brexit due to non-tariff barriers to trade (think complying with overseas regulation and customs regimes).

That said productivity growth on the Continent has been weak, and is unlikely to surge ahead while the UK economy recalibrates, somewhat limiting the damage to the equilibrium rate. If the European project revivifies around a new Macron/Merkel nexus, then further gains from integration may lower the equilibrium rate a little further via improving Eurozone productivity.

Although the long-run economic value of the pound would shift lower in a 'hard Brexit' scenario (i.e. no special deal), primarily due to the impact on productivity, the actual exchange rate is so far below the economic equilibrium value that we expect the pound to rise on a long-term basis in any scenario. It is really just a question of speed. Unfortunately, such long-term analysis does not help us forecast currencies on a 6-12 month view, and the newspaper headlines generated by ongoing Brexit negotiations could well drive exchange rate volatility.

Until June, the EUR/GBP exchange rate over the last couple of years has closely tracked changes in relative interest rate expectations (i.e. what the market thinks interest rates will be in Europe in 3 years time relative to what they think they will be in the UK). This lends some shorter-term support to the pound, and indeed could favour sterling further if the run of strong macro data in the Eurozone starts to roll over.

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