Invesco Fixed Income Investment Insights

"Quality currencies" can potentially diversify against growth risk

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"Quality currencies" versus government bonds

Investments in stocks, bonds and other assets have historically delivered healthy returns over long time horizons. An investor in the Standard and Poor's 500 Index over the past 40 years, for example, could have turned USD1000 into nearly USD75,000 over the period.[1] Why then, at times, does investing seem so difficult?

We think there are two reasons. First, markets are volatile and investors do not always have the benefit of long time horizons to smooth out market ups and downs. Second, it is difficult to diversify portfolios away from growth. In other words, most assets that offer attractive return profiles (so-called "risky assets") are driven by the same underlying factor: growth.

Historically, government bonds have been considered to be one of the most effective diversifiers against growth. Government bonds have typically performed well when risky assets, like stocks, have performed poorly. However, this negative correlation cannot be relied upon; there have also been periods when stocks and bonds both performed poorly.

For this reason, Invesco Fixed Income (IFI) believes it makes sense to consider alternative diversifiers to growth. We believe "quality currencies" are a viable alternative. We have observed that adding "quality currencies" to credit portfolios can potentially help investors protect against growth-related risk.

What is a "quality currency"?

We consider "quality currencies" to be those that are likely to offer a good "store of value." This means we could expect quality currencies to maintain their purchasing power during times of stress. From an investor's standpoint, a foreign currency's value is defined by both its nominal and real (inflation-adjusted) purchasing power. For example, if goods prices are rising faster at home than abroad, the foreign currency should appreciate to maintain the same nominal purchasing power in both locations. This is the idea behind the well accepted and empirically researched theory of purchasing power parity (PPP). The real purchasing power of foreign currencies can also vary. A stable empirical relationship has been shown to exist since the 1950s in which countries with higher rates of productivity have tended to enjoy stronger real exchange rates.[2]

We view quality currencies, therefore, as currencies of those countries with stable to falling inflation and high or rising rates of productivity, relative to other countries. This framework indicates buying (selling) those currencies of countries where long-run inflation is falling (rising) and productivity is rising (falling). This investment approach allows investors to gain exposure to currencies that should be appreciating in both real and nominal terms based on positive fundamentals, relative to those currencies with poor fundamentals.

Quality currencies in action

A prime example of a quality currency was the Japanese yen during the decade leading up to the global financial crisis. Japan enjoyed consistently lower inflation than other developed countries while maintaining strong productivity growth over the period. On a nominal basis, the yen appreciated 44% from 1998 to 2008.[3] We believe this was because lower inflation led to higher nominal purchasing power while strong productivity growth supported real purchasing power.

On the other hand the South African rand was an example of a poor quality currency during the same period. During the pre-crisis commodities-fueled boom, South Africa experienced rising inflation and low productivity growth. We believe both factors led to a roughly 38% depreciation in the rand from 1998 to 2008.[3] In a quality currency overlay - adding currencies to corporate bond funds - we would favor owning the yen against the South African rand.

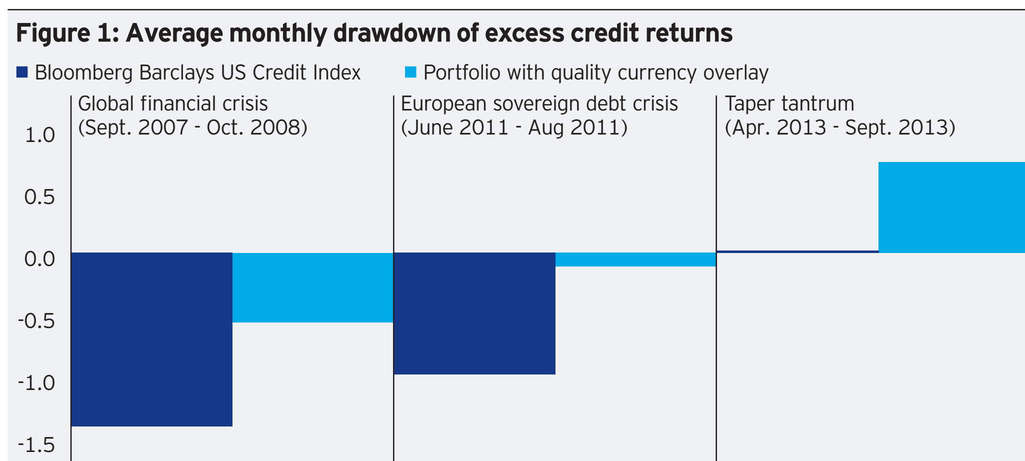
We have observed that, especially during periods of global recession or risk aversion, high quality currencies, such as the yen, have dramatically outperformed poor quality currencies. In periods of financial stress, when growth expectations have tended to fall, we believe markets have differentiated between high and poor quality currencies. We believe this has resulted in the rapid appreciation of quality currencies and rapid depreciation of poor quality currencies during these periods, as investors have sought stable stores of value in times of stress.

How quality currencies can potentially benefit investors

Historically, credit excess returns have been sensitive to growth risk, similar to other risk assets like equities. We have observed that incorporating quality currencies in a credit portfolio has provided an effective, efficient and operationally straightforward solution to this sensitivity. By improving diversification, we believe adding quality currencies to credit portfolios has improved risk-adjusted returns and reduced tail risk.[4]

Figure 1 compares the average monthly drawdowns, or losses, on an excess return basis, of the Bloomberg Barclays US Credit Index, with and without a quality currency overlay in different crisis periods. For example, during the global financial crisis, the Bloomberg Barclays US Credit Index averaged monthly losses of 1.4% between September 2007 and October 2008. With the addition of a quality currency overlay during the same time period, the average monthly loss was 56 basis points (bps). During the European sovereign debt crisis, the index alone lost an average of 98 bps per month while the overlay portfolio lost an average of 11 bps per month. Finally, during the 2013 taper tantrum, the Bloomberg Barclays US Credit Index was, on average, roughly unchanged, while the currency overlay portfolio gained an average of 73 bps per month.

Figure 1: Average monthly drawdown of excess credit returns



Source: Bloomberg L.P., Invesco Fixed Income. Financial crisis: Sept. 1, 2007 to Nov. 1, 2008. Euro sovereign debt crisis: June 1, 2011 to Sept. 1, 2011. Taper tantrum: April 1, 2013 to Oct. 1, 2013.

Further improving results

We believe the investment results of a basic factor such as quality currency can be improved by adding other uncorrelated currency trading strategies. For example, the quality currency basket can be tilted toward a focus on being long currencies with strong momentum or short currencies with poor capital flow fundamentals. At IFI, we employ a combination of factor-based strategies, as well as econometric and policy analysis to augment the quality currency strategy.

Why is IFI uniquely positioned to implement the quality currency strategy?

IFI's Currency Portfolio Management team has managed currency overlays for over a decade. Historically, while our currency overlay strategies have been accretive to overall portfolio performance, we believe they have also helped to protect portfolio performance during periods of acute volatility.[4] We believe IFI's extensive experience implementing currency overlays coupled with our robust research and factor platforms provide the building blocks to achieve repeatable and consistent results. Since 2014, we believe our currency strategies have consistently provided diversified alpha to IFI's multi-sector strategies utilizing the currency investment process we have developed based on our quality currency framework.[5]

1 Source: Bloomberg L.P., investment between March 31, 1977 and March 31, 2017. Assumes reinvested dividends.
2 Source: Obstfeld, Maurice and Rogoff, Kenneth, Foundation of International Macroeconomics, MIT Press, 1996.
3 Source: Bloomberg L.P., Dec. 31, 1997 to Dec. 31, 2008.
4 Invesco Fixed Income calculations, Feb. 1, 1995 – Sep. 30, 2016.
5 Invesco Fixed Income attribution data, Jan. 1, 2014 to March 31, 2017.

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