

Note: Reviewing the neutral currency hedge ratio

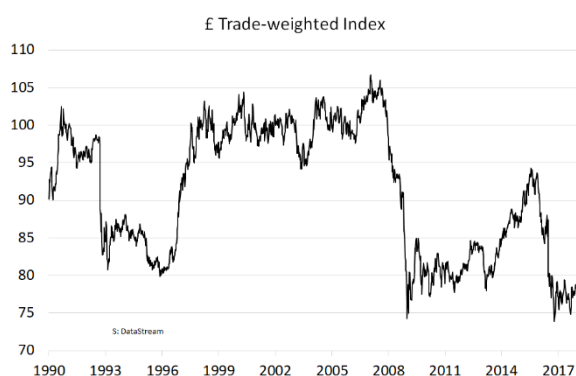
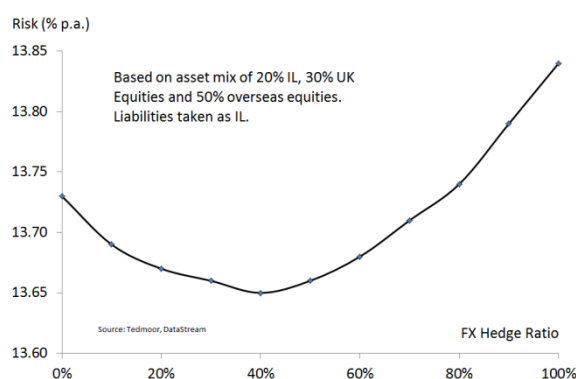
This note is addressed to the Local Pension Committee of the Leicestershire County Council Pension Fund (the 'Fund') as part of the general review of the Fund's investment strategy. The note focuses on the neutral hedge ratio provided to the manager of the existing currency hedging programme.

Background

The Fund maintains a significant weighting to non-UK financial markets; this generates foreign currency exposures that are often secondary to the main investment rationale. To manage these associated risks, the Fund retains Kames Capital (the 'Manager') to operate a foreign currency hedging programme. Within the programme the Manager has full discretion to hedge all or none of the exposure generated by the Fund's overseas equity benchmark weighting based on their prevailing currency views and considering the risk impact on the Fund. Until January 2017 the Fund advised the Manager that they should adopt a neutral (or benchmark) hedge ratio of 50%.

The rationale for a neutral half-hedge ratio is illustrated in chart opposite (which applies to a simpler asset structure than that of the Fund). In short, maintaining some degree of currency exposure is appropriate though, from a risk perspective, precision is spurious (note the narrowness of scale risk scale). The principle factor against fully hedging all exposure is that, in 'risk events' (i.e. sharply falling markets), defensive currencies (often those with substantial current account surpluses) rise in value against £ (which is burdened by a substantial current account deficit).

The 50% hedge ratio is widely used within currency hedging programmes for the reason discussed above. In addition, and put simply, 50:50 (or half-right, half-wrong) summarises most investors view on the likelihood of success from trying to manage currency risk (although the Fund's currency hedging programme has been a success). After the sharp decline in the broad, trade-weighted value of £ (shown opposite) that followed the EU Referendum, the 'odds' based on experience looked to be skewed to the upside.



It was in this context that, in the annual strategy review in 2017, the Fund agreed to increase the default hedge ratio to 70%, higher than 'theory' would suggest. The remainder of this note reviews this decision and proposes a fresh adjustment reflecting developments in the interim.

Discussion

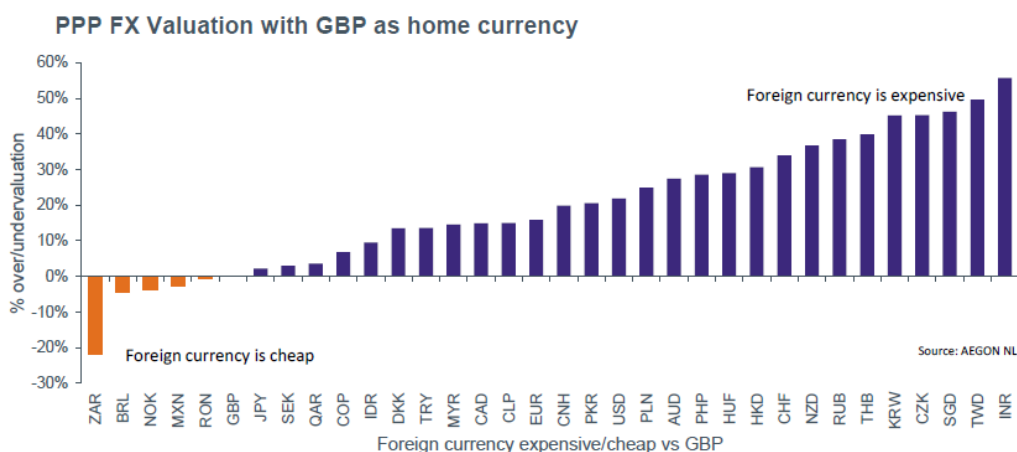
The decision to increase the neutral hedge ratio was implemented on 1st February, 2017. Since then, the £ trade-weighted index – the market's usual proxy for £ as a whole – is unchanged. The currency mix generated by the Fund's overseas exposures that fall under the hedge programme is quite different from that in the TWI¹. The movements (and weights) of the most significant currencies since Feb 1st (to Dec 23rd) are shown below. Based on these weights, the value of £ has risen 4.3% vindicating the increase in the hedge ratio.

	US	EZ	Japan	China	Taiwan	Australia	Canada	India	S Korea	S Africa	Swtiz	HK
% weight	47.4	11.9	8.6	4.9	3.4	2.5	2.3	2	1.9	1.4	3	1.4
movement	-6.9%	3.7%	-6.5%	-2.0%	-1.0%	-3.5%	-1.9%	-0.8%	1.2%	0.9%	-5.3%	-7.6%

¹ E.g. 47% of the Fund's equity mix is denominated in US\$ while the US\$ weight in the £ TWI is 19.4%.

Kames Capital manages the actual hedge programme on a day-to-day basis. The Manager strikes a balance between hedging costs and market conditions (opportunities and threats) to deliver a currency hedging programme that reduces overall Scheme risk for minimum cost (or even a profit!) In pursuit of this target the Manager will, in practice, apply a hedge ratio on each currency different from the neutral or benchmark setting when they judge it appropriate to do so. If they have no view then they will apply the neutral ratio (currently 70%).

In setting any programme's benchmark position, valuation should be the principle consideration (beyond the broader assessment of risk contribution). Valuation in currencies, as in all asset classes, is a notoriously problematic (and subjective) concept and valuation mis-alignments can persist for long periods which often stretch to years. The chart below summarises the latest valuation measurement of a wide range of foreign currencies (relative to £). The calculations have been based on purchasing power parity (PPP) and attempt to capture the interplay between currency movements and evolving inflation differentials. The inference from the chart is echoed across a range of other valuation approaches is clear: against almost all other currencies and despite the gains achieved in 2017, £ remains cheap. It was on this basis that the neutral hedge ratio was moved higher (from 50% to 70%) in the 2017 Strategy Review; the balance of risk and reward favoured £ moving higher.



Although £ rose over 2017, the nature of the risks changed. While 2017 has seen economic growth improve strongly in all regions, the UK economy has been a notable laggard as *Brexit* concerns are compounding slowing consumer activity driven by negative real wage growth and high debt burdens. A significant feature of the world economy in the past year has been the still low level of inflation; once again, the UK stands out as the only major economy to have an inflation problem. That £ hasn't fallen against this backdrop is testament to its cheapness; the economic merits behind other currencies however have improved relative to £.

The biggest change in 2017 arguably involves the political outlook. The outcome of the surprise General Election last June has weakened the Government's ability to govern (at a time of great upheaval) and has also, in the judgment of the investors, enfeebled Theresa May and created conditions capable of leading to a Labour Government. Regardless of the reader's political persuasion, there can be little doubt that, should the next Administration be led by Jeremy Corbyn on the current policy platform, then the impact on £ could be substantial and negative; Labour leaders have openly discussed the possibility of there being a sharp fall in Sterling² as global investors act in anticipation of much higher public spending and inflation. Further, the relationship between a Corbyn-led Labour Government and 'the City' is likely to be turbulent; the 'battle-field' for this tussle will be the foreign exchanges.

The currency hedging programme acts to maintain strong domestic exposures within the assets. The Scheme's greatest protection against disadvantageous developments in the UK is nonetheless the international reach of its investments. At times of heightened domestic uncertainty, it is appropriate to avoid being overly exposed

² E.g. <http://www.bbc.co.uk/news/uk-politics-41393021>

to Sterling. A move in the hedge ratio back to 50% would restore the theoretical neutral position and lock-in the gains of the action taken last year (before they might evaporate).

Summary

Overall, the Fund's action to raise the neutral hedge ratio early in 2017 was timely, exploiting conditions which favoured £, and of benefit to the Scheme. When the change was made it was not anticipated that, just a year later, thought would be given to lowering it once again. Much has changed and while £ still appears undervalued, the balance of risk and reward is no longer skewed in favour of Sterling; the Pound should continue to appreciate slowly, as the valuation mis-alignment corrects itself, but could fall a lot. A move back to a 50% hedge ratio is considered appropriate. If implemented the Scheme will still retain substantial UK currency exposure.

As mentioned in this short note, Kames Capital will adroitly adjust the actual hedge ratio on each currency, above or below the neutral level, consistent with their views. The Appendix to this note has been provided by Kames Capital and relates to the outlook for £.

Appendix – Currency Outlook (by Kames Capital)

This note is addressed to the Members and Officers of the Leicestershire County Council Pension Fund (LCCPF) and relates to the currency hedging programme operated by Kames Capital. Below we discuss the strategic outlook for sterling in 2018 against US dollar, euro, yen and emerging markets.

Detail

Before looking forward to 2018, it is worth spending a moment reviewing 2017. At first glance 2017 looks to have been uneventful despite the drama of an unexpected UK election and, more recently, the late night negotiations with the EU. Looking at sterling on a trade weighted basis the currency ends the year very close to the levels it started the year. There was more volatility against the major cross rates with sterling strengthening along with many other currencies against the US dollar but weakening against a resurgent euro.

The positives and negatives for sterling throughout the period were finely balanced. Valuation was a key support, for example sterling has fallen in recent years where many models, including the Purchasing Power Parity record the currency as cheap. The exchange rate is weaker than one would expect given the past performance of the economic variables such as growth and inflation. However, the outlook materially changed with the vote to leave the European Union, which is why a ‘cheap’ valuation can be justified. In 2017 the economy performed much better than many had predicted thus preventing much further weakness. A rise in interest rates in the autumn also helped. What prevented sterling from performing better was the continued uncertain outlook and lack of clarity around the UK’s departure from the EU, something that we don’t expect to become clear anytime soon.

Looking into 2018, we start the year in a similar vein, UK economic growth is likely to underperform other developed economies. Inflation is expected to be relatively higher and key interest rates are expected to rise again in 2018. The Bank of England has signalled only gradual increases and by the end of 2018 the European Central Bank (ECB) may also be not too far from doing the same. The key source of volatility in 2018 is again likely to be focused on the terms of the UK’s departure from the EU and the UK’s political landscape. Until that is clear we would expect the UK economy to continue to underperform internationally and the political climate to deteriorate. A change of government, although not our central case, remains a possibility. Sterling could weaken again as the uncertainty increases and as the implications of a Corbyn Labour government are assessed.

Conversely, Brexit negotiations may reveal that the attitudes towards the EU and trading arrangements have softened sufficiently in the government to anticipate that the UK’s exit is not going to be quite as ‘hard’ as expected. The single market and customs union, for example, might be replaced by something that looks very similar to the current set-up, except in name. We would expect a development such as this to boost the value of sterling significantly as confidence returns.

As 2018 progresses, the results of the political negotiations will become evident but, for the moment, the fundamental picture remains negative. Valuation is still supportive, as are interest rate differentials. Market positioning is still cautious but much less extreme compared to the start of 2017.

With this backdrop sterling should make some progress in 2018 if the political minefields are avoided.

Below we provide a short summary on sterling verses US dollar, Euro, Japanese Yen and Emerging Markets (the major exposures within the LCCPF currency hedging programme).

US Dollar

We expect the US dollar to continue its downward trend over 2018. The currency remains overvalued compared to its long-term average (as measured by the real effective exchange rate (REER)). As global growth increases, the drivers which undermined the US dollar in 2017 will continue to contain the currency further in 2018: for example, there will be a continued shift to slightly less accommodative policy elsewhere in the world. We think these trends will extend into 2018 and expect a gradual, rather than sharp, decline in the currency in the next 12 months.

However, there is the potential for the US dollar to have some near-term upside. First on tax reforms; the anticipated tax reductions for business and higher income households, successfully implemented, will add further stimulus to the US economy, potentially boosting the dollar. Second, a more hawkish Fed: the market continues to price in fewer hikes than the Fed dots, although given the amount of change in the Fed membership in the coming months the current dot plots are perhaps not as relevant. For example, Jerome Powell will replace Janet Yellen as the new Chairman of the US Federal Reserve. There will also be four additional appointees to the board of the central bank in the coming months, and in addition a vacancy at the New York Fed, after Bill Dudley's recently announced retirement. A more hawkish rhetoric from this committee may bolster the dollar in the short term.

The current programme has a 50% US dollar hedge, over 2018 we will continue to monitor this closely.

Euro

The euro has performed well re-rating post the French elections but has been contained by dovish ECB guidance. We expect the euro to strengthen in 2018. Firstly, on valuation, whilst EUR undervaluation has declined since the start of 2017 it is still not stretched. Secondly, data in Europe remains robust, economic growth is now being forecast to outpace the US in 2018 and in addition recent PMI's have been strong, accelerating faster than in the US. Furthermore, the current account surplus remains strong and core inflation is grinding higher. With supportive data continuing, this calls into question the extent to which the ECB retains its very accommodative monetary stance. Thirdly, it is unlikely that politics will stand in the way of a euro appreciation. The breakdown and restarting of coalition talks in Germany is proving smoother than expected, and tail risks associated with the Italian election in early 2018 appear to be lower.

Whilst the programme currently has a neutral EUR hedge we will continue to monitor the developments of the eurozone and adjust the mandate accordingly.

Yen

We are positive on the Japanese yen in 2018 for two main reasons. First, on valuation, the real-trade exchange rate highlights that the yen remains undervalued and remains below its long-term average; within the G10 it remains below its long-term average. Second, Japanese economic data is showing signs of structural strength. If growth continues and inflation rises to levels closer to target, the Bank of Japan (BoJ) may begin to reduce its aggressive easing policy; this is not discounted by investors. With positioning of the yen (against the US dollar) at extreme short levels, any unwind in these positions could be a further catalyst to strengthen the currency further. We believe it is an attractive trade in the current 'risk on' environment. In the event of any risk-off event, it still remains the most likely of the major currencies to outperform.

We are positive on the Japanese yen in 2018 and expect to move the programme from neutral (70%) to unhedged (0%) if this improvement in the Japanese economy continues.

Emerging markets

Emerging markets have generally outperformed the US dollar in 2017 with the strongest performing region being Central and Eastern Europe. In general, strong global growth and a weaker US dollar have supported emerging market currencies. However, the tightening of monetary policy by the US Federal Reserve and political uncertainty in some countries (for example, Turkey) has weighed on the sentiment towards some emerging market currencies.

In 2018, we expect emerging market growth to continue and along with commodity price momentum we continue to favour many emerging market currencies. In addition, valuations are close to neutral, in aggregate, emerging market REER are just slightly below their long-term average. There remains value in some LATAM and EMEA, while Asia remains the most expensive. Finally, emerging market external positions are improving, for example many of these countries' current accounts have continued to improve since the 2013 taper tantrum, with the exception of Turkey and South Africa.

Over the medium term we expect sterling to underperform emerging markets. We would favour those currencies that are embarking on a path to normalisation, continued strong growth and high yielders, and would avoid those currencies that have increased political instability.

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