Note to LCCPF: Currency hedging programme

13 August 2019

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.

Programme's aim

The currency programme's overarching aim is to protect capital and to generate an excess return, whilst being watchful for developments that might adversely affect the value of the fund's underlying assets and the Scheme's solvency position. The neutral position for the currency hedging programme is to maintain a half-hedge over all the currency exposure generated by its equity investments.

As part of our investment approach, some of the factors important in our decision-making for the programme include:

(i) *Cost of hedging* - currency hedging is not a cost-free activity. The running cost of a currency hedge is based on the difference between the two countries' interest rates. Riskier currencies tend to have higher domestic interest rates and are thus more expensive to hedge. Minimising hedging (or 'insurance') costs incurred is an important part in our decision-making process

(ii) *Materiality* - there are several currencies that have a weight of less than 0.5% in the programme. Typically, we would not hedge these as they are deemed as immaterial, unless the threat on the currency is extreme. Currently, in the programme there are 17 currencies that have a weight of less than 0.5% which, in total, represent around 2.7% of the benchmark (as at 31 July 2019).

(iii) *Correlation* – the primary remit of the programme is to protect capital. Individual currency exposure can increase or reduce risk; a positive correlation (with equity markets) will add risk and vice-versa. It should be remembered that while cost of hedging will generally change slowly over time, correlations can alter sharply. For example, for a large period of time prior to the Financial Crisis in 2008, sterling-based investors were effectively adding risk to their international equity portfolio through maintaining exposure to the Japanese Yen (i.e. the Yen/sterling exchange rate was positively correlated with equity market movements). Since then, correlations have reversed and exposure to the Japanese Yen has acted to reduce risk from investing in international equities. A client with a static currency hedging policy of 100%, for example, would have gone from a position of reducing risk to adding risk without doing anything at all.

Sterling overview

Prime Minister Boris Johnson has promised that Britain will leave the EU on 31 October, and has filled the government with hardline Brexiteers. He is aiming to use the no deal as a credible negotiating strategy. The new government has therefore raised uncertainty in the Brexit process, which has been reflected in substantial weakening in GBP against both the USD and EUR in recent weeks.

We continue to view the most likely outcome as an orderly Brexit by year-end, but have raised our probability of a no deal outcome. The strategy of a no deal pursued by the new government is a credible threat. Even if this is not delivered we expect sterling to weaken further along the escalation path towards the Brexit deadline.

There are a number of events that will keep sterling weak. The Conservative Party conference is at the end of September and the EU summit is planned for 17-18 October. It is difficult to see any resolution before these events. In addition, the leader of the opposition party, Jeremy Corbyn, is expected to table a vote of no-confidence in the government early in September. If this no-confidence vote is successful, it is PM Johnson who controls when a general election would be delivered, and it is widely expected that this would be after 31 October and Brexit. This would be negative for sterling.

In our view the likelihood of a no deal Brexit continues to rise, as a new cliff-edge has been created for 31 October. We would estimate that the probability has now risen to greater than 50%. We do not believe that an election nor a hard Brexit is fully priced. If this comes to pass there will be downward pressure on GBP and gilt yields.

Below we discuss a number of scenarios.

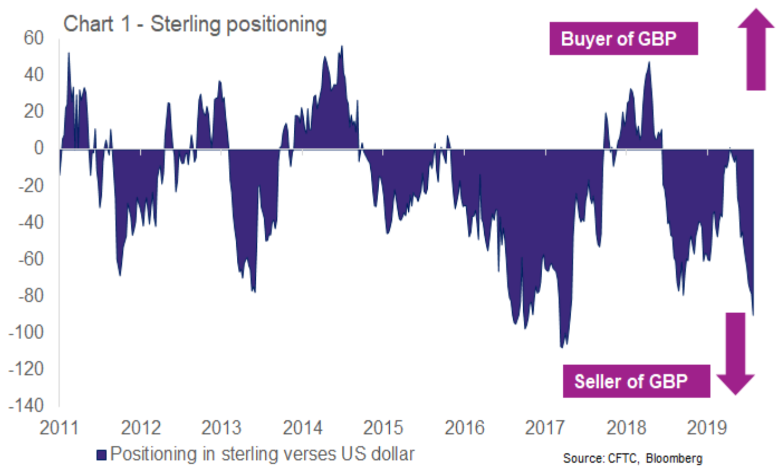
Scenarios

1. Deal reached by 31 October

   This is likely to trigger a sterling bounce from the current soft levels as positioning is squeezed. In terms of an exchange rate vs the USD the upside is estimated to be 8-10%. In a deal scenario, subsequent fiscal loosening presents additional upside risk to GBP.

2. No deal

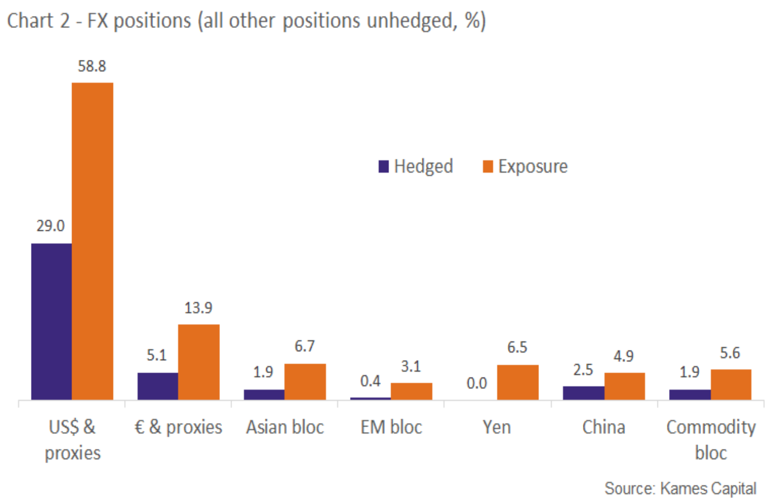
   The UK leaves the EU without a deal on 31 October and sterling falls sharply due to expectations of sharp economic contraction and easier monetary policy. Leaving without a deal amid political chaos is probably the worst case short term scenario. We estimate the downside to the exchange rate to be nearer 10% against the USD, against European currencies it is likely to be less as the European economies will also be adversely effected by a chaotic exit.



The political aspect is only one input into our investment decision and there remains other reasons to be cautious on sterling. Firstly, in the coming months we expect the UK economic data to remain weak. The economy has recently posted its first quarterly contraction since 2012. Business surveys also confirm a continued decline in activity, especially in the manufacturing sector, partly as a result of UK related issues but also as a result of a global deceleration in growth. Secondly, in the next few months we expect the Bank of England to start to reconsider the level of interest rates with a view to cutting bank rate as the economy stays weak and inflation rates fall in to the year end. The combination of weaker growth, easier monetary policy and lower inflation are all expected to have a negative influence on the currency in the medium term. Thirdly, whilst valuations continue to point to sterling being undervalued we expect this to persist until the twin uncertainties of politics and the economy have been removed and that looks increasingly unlikely in the medium term. Finally, although positioning has moved sharply it is not at extreme levels. As such sterling remains vulnerable to negative news. Chart 1 shows current positioning and this suggests there is potential for GBP shorts to build further adding pressure to the currency.

Current positioning

Ten currencies are currently hedged – Hong Kong dollar, US dollar, the Euro, Swedish krona, Korean won, Taiwanese dollar, Thai baht, Chinese renminbi, Australian dollar and Canadian dollar at neutral hedge. All the remaining currencies in the benchmark are unhedged (0%), including the Japanese yen. Chart 2 details the current positions in the various blocs, and table 1 provides further granularity. Earlier in the year the programme was underweight sterling by over 20% due to risks around sterling. Currently, the programme is 9% underweight sterling, as such will add value if sterling was to depreciate.



Rationale for current positioning

US dollar & proxies

The largest weight in the index is the US dollar (56.9%). Earlier in the year we moved the USD from neutral to 25% as we judged the risks to sterling were increasing as Brexit and the political outlook deteriorated. In addition we believed the probability of a "no deal" was increasing. On 23 May we moved the US dollar from 25% hedged position to neutral (50% hedged), as sterling had sold off sharply due to the deteriorating political environment, and we expected some short term consolidation.

Currently we are neutral the US dollar however we will continue to monitor the political development and if the probability of a no deal increases we would reinitiate this position.

Euro & proxies

We are neutral the euro (EUR) and Swedish krona (SEK). Specifically on the EUR, activity data continues to be soft in the euro area as indicated by the continued disappointing manufacturing data and soft inflation. In addition the easing regime shift by the ECB and soft growth momentum will weigh on the currency. The EUR would also be impacted, although in our view not to the same extent as GBP, in a no deal Brexit.

We recently unhedged the Swiss franc (CHF) due to ongoing trade uncertainty, slowing global growth and we expect the currency to perform strongly on a no deal Brexit outcome given its 'safe haven' status by investors. Whilst the currency is expensive on our valuations measures, and there is a small cost of hedging we judge it prudent, balancing risk and reward, for the programme's CHF exposure to be unhedged.

Asia and emerging market bloc

The overall weight of these combined bloc is around 10%, and many of the currencies within it would not be hedged due to associated costs. In addition there are a number of currencies that have a weight of less than 0.5%. Typically we would not hedge these as they are deemed as immaterial, unless the threat on the currency is extreme.

Japan

Earlier in the year we had been unhedged (0%) Japanese yen as sterling had rallied sharply on more positive Brexit news. We judged this to be an overreaction and added protection by reinitiating an unhedged Japanese hedge position. At the end of May we returned the Japanese yen to neutral, we believed that much bad news was priced into safe haven assets, and the JPY had been one of the safest and best performing currencies in G10.

Table 1 **Current positioning**

Date

Country	Currency Code	Global equity % Wgt	Current hedge ratio
US dollar & proxies			
UAE	AED	0.2	
Hong Kong	HKD	1.1	50%
Qatar	QAR	0.2	
Singapore	SGD	0.4	
US	USD	56.9	50%
Euro and proxies			
Switz.	CHF	2.7	
Czech	CZK	0.0	
Denmark	DKK	0.5	
Eurozone	EUR	9.5	50%
Hungary	HUF	0.1	
Norway	NOK	0.2	
Poland	PLN	0.1	
Sweden	SEK	0.8	50%
Asia bloc			
Indonesia	IDR	0.3	
India	INR	1.7	
S Korea	KRW	1.2	50%
Malaysia	MYR	0.6	
Philippines	PHP	0.2	
Taiwan	TWD	2.7	50%
Emerging market bloc			
Brazil	BRL	1.4	
Columbia	COP	0.1	
Israel	ILS	0.0	
Peru	PEN	0.0	
Pakistan	PKR	0.0	
Russia	RUB	0.7	
Thailand	THB	0.8	50%
Turkey	TRY	0.2	
Japan			
Japan	JPY	6.5	
China			
China	CNY	4.9	50%
Commodity bloc			
Australia	AUD	2.0	50%
Canada	CAD	1.8	50%
Chile	CLP	0.2	
Mexico	MXN	0.5	
New Zealand	NZD	0.1	
S Africa	ZAR	1.1	

Source: Kames Capital

Recently we have become more concerned on sterling, and as the programme is to mitigate risk we reinitiated the an unhedged (0%) Japanese yen position. In addition the JPY should perform well if there is any escalation of trade tensions. Having an unhedged exposure remains consistent with the programmes aim of adding value and reducing risk to the pension fund as a whole. Below we detail how we use our framework to assess our currency decisions.

Recapping the **fundamental** view, the primary objective of the programme is to protect capital. The JPY is negatively correlated to equities an unhedged position will dampen the risk profile of the programme. From a macro perspective the Japanese economy continues to show signs of improving, with the latest print of 1.8% (year on year) GDP growth, was the third straight quarter of expansion. Also, in G10 the Bank of Japan is one of the most constrained central banks to ease policy further – all of which should benefit the currency.

On **valuations** we examine the aggregate values of Purchasing Power Parities (PPP), Behavioural Equilibrium Exchange Rate (Beer) and the Fundamental Equilibrium Exchange Rate (FEER). The analysis concludes that the yen is one of the world's cheapest currency. Valuations do not always correct quickly but the analysis confirms that the yen is well supported.

Within this framework we also evaluate the cost of hedging. As detailed previously hedging is not a cost free activity. Japanese interest rates are lower than those in the UK so in this case the 'cost' is actually a 'benefit' and the investor is paid to hedge the yen. The 'benefit' foregone by not hedging is not meaningful and is not seen as an impediment to the decision to lift the yen hedge.

On **sentiment**, positioning is neutral on the JPY after being underweight earlier in the year, but positioning could shift long, as it has in the past when bond yields have dropped.

Finally the **technical** support is moving favourably for the yen. If equities soften due to trade tensions or fears of global growth Japanese investors will repatriate overseas capital that is invested overseas and that will benefit the currency. In addition the yen has momentum over sterling when we compare the currencies to various moving averages.

China

We are neutral on the Chinese Renminbi (CNY), the currency is expensive, there would be a cost to fully hedge the currency and it continues to be at the forefront of any trade war.

Commodity bloc

We are neutral on both the Australian dollar (AUD) and New Zealand dollar (NZD), as both these currencies have a positive correlation to equity markets. If we were to unhedge these currencies we would be increasing the risk profile of the programme. On the remaining currencies we are unhedged, due to small weight or we deem there is a unnecessary cost in hedging – as detailed previously we would not hedge these unless the threat on the currency is extreme.

Overall

Ultimately, we remain aware of the current changing UK political landscape and we will seek to unhedge the programme further if our probability of a no deal Brexit increases.

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