The Case for Currencies as an Asset Class becomes Stronger

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[Marc Faber's Introduction: Last October, Mark Whitmore wrote for us an insightful report entitled "Currency Investing: An Alpha-Rich Environment" (see GBD report of October 2013). He now suggests that the case for currencies as an asset class is becoming even stronger — a contention I agree with, given the elevated level of most financial asset prices (see report below).]

In the October 2013 edition of the GBD Report, I penned an essay in which I: 1) argued that currencies offer investors with a longer-term time horizon attractive opportunities for profit; and 2) provided a couple of currency pairs that I thought offered solid risk-reward profiles, emphasizing that being long the Russian ruble versus the Turkish lire appeared particularly attractive. In the intervening six months since that essay, several developments, including the precipitous decline of a number of emerging market currencies, have thrust currencies to the forefront of many investors' minds. While both currencies have been punished by the markets, the lire has been hit particularly hard. A couple of months ago Turkey's central bank saw fit to raise intra-bank overnight lending rates 425 basis points in a single day in order to defend its plummeting currency! Since then, Russia's exploits in the Crimea have caused significant losses for the ruble as well. It thus seems timely to expand the discussion on strategic currency investing.

Just No Respect for Currencies

Currencies continue to be viewed as the Dan Quayle (the ignominious vice president during George H. W. Bush's administration) of asset classes. According to the CFA Institute Research Foundation, as of 2011, a miniscule 0.14% of hedge fund assets were in dedicated currency strategies. This percentage has likely fallen even lower in the last few years, as several of the larger currency funds have shut down after delivering miserable returns (this includes FX Concepts, at one time the largest currency hedge fund with $14 billion under management).

Poor performance is not unique to the past few years. Currency hedge fund managers have failed to generate decent returns for the last decade. Barclay's Currency Traders Index was up only an average of 1.6% per year in the period from 2004 through the end of last year. For comparison, the average increase in the Consumer Price Index – itself notoriously underreported – over the same time period was 2.5% per year. The result is 10 years of negative real returns for aggregate currency hedge fund investors. Clearly, the myriad of "black box," oftentimes high frequency, currency trading strategies deploying arcane algorithms have simply been a black hole for investor funds for quite some time.

I take the somewhat radical view that currencies behave like any other investible asset. Prices may deviate substantially from fair value for months, and even years, as everything from greed and fear to hedging and momentum trading impose their wills upon the pricing of currencies. Eventually, however, Mr. Market asserts his hand, humbling the mighty (recall the USD in 2001, the pound in 2007 and the yen in 2012) and elevating the exiguous (think the Canadian dollar in 2002, the yen in 2007 or the Norwegian krone at the end of 2008). Like any other asset, long-term investing success in the currency markets is predicated upon buying when prices are cheap, and selling when they are dear. The challenge, then, is to determine where a particular currency stands in relation to its fair value.

Fresh and Refreshing Looks at Forex

After years of maintaining the minority belief that one can use fundamental analysis to establish fair value and garner desirable returns in the currency markets, there is finally some excellent academic work supporting this view.

In 2012, the CFA Institute Research Foundation published *A New Look at Currency Investing*. The authors undertook an exhaustive review of the research on currency investing and found that when researchers had extended the time series to include twenty-five years of data (1985-2011) and expanded the number of currencies analyzed to twenty-five, returns for fundamentally based forex strategies were comparable to equity returns minus the risk-free T-bill rate. Moreover, the Sharpe ratios for such strategies were *higher* than those for equities. Finally, during times of market stress, these strategies provided critical diversification, with losses from the global financial crisis being recouped by April 2009, right when most other asset classes (that had moved in virtual lockstep with one another in the previous six months) were just bouncing off of their lows. The authors concluded that adding currencies as a part of a comprehensive institutional investment portfolio is desirable, as currency returns not only added to overall performance but tend to be uncorrelated to other assets.

A second publication, *Currency Risk Premia and Macro Fundamentals*, came out in the summer of last year. The authors looked at price movements of thirty-six currencies between 1974 and 2010. They then back-tested the data using various fundamental strategies, including real money growth, interest rate differentials, real GDP growth and value.

The authors found that *unlevered* average annual returns of 3% to 6% were achievable using the various fundamental strategies over the thirty-six year period studied. Moreover, each of the three most successful macro forex strategies produced annualized Sharpe ratios exceeding those of US equity markets. Better still, when equally weighting these strategies in a currency portfolio, the Sharpe ratio was 1.08. In the words of the authors, "[a] Sharpe ratio of this size for a strategy based on low-frequency macro data and annual rebalancing is remarkable."

A couple qualifications are in order. As we all know, past performance is not necessarily indicative of future returns. Relating to the second work discussed, returns did not factor in the real world costs an investor would incur, which would undoubtedly reduce returns a meaningful amount (particularly due to the inability to get the full spread in interest rate differentials from currency platform intermediaries).

The conclusions drawn in both publications are quite heartening for those of us who believe that a fundamental approach to currency investing can move us closer to the Holy Grail of investing - lowering correlation coefficients among the components of one's portfolio while increasing absolute returns.

A Cautionary Word about Leverage

Now to a US equity investor used to garnering high double digit returns over the last five years who is also unfamiliar with how the currency markets operate, returns of 3 to 6% per year may seem distinctly underwhelming. Setting aside the issue of how sustainable those equity returns are (although I suspect investors who hold US stocks for the duration will be quite disappointed a decade from now), it is not uncommon for currency platforms to offer investors access to leverage of up to 50:1. Clearly, while providing wild-eyed investors the prospect of transforming humdrum low single digit returns into supercharged performance, this also provides more than ample rope with which investors can use to hang themselves.

In general, I think it is quite dangerous to exceed 10:1 leverage, and this is assuming that one maintains a broad basket of currency holdings, including currencies that have offsetting performance characteristics. For instance, some currencies perform well in a "risk-off" environment, while others tend to shine in a "risk-on" environment. To the extent that investors have more concentrated currency holdings, their leverage should decrease accordingly, approaching the 5:1 range.

Annual returns of 3 to 6% unlevered returns can thus become highly attractive when even a modest, prudent amount of leverage is utilized. [1]

A New Opportunity – The Singapore Dollar against the British Pound

I have been a long-time proponent of holding the Singapore dollar (SGD). Over time, the currency has been quite good to me, having appreciated more than 20% versus the dollar in the last five years, and more than 30% in the last ten years. Typically, such a sustained run-up would be a red flag. However, the fundamentals undergirding the currency are so compelling that I expect sustained appreciation in the years ahead. I would argue that a particularly opportune currency against which to pair a SGD investment is the British pound (GBP).

On the surface, there seem to be a great deal of macroeconomic similarities between Singapore's economy and that of the UK. Both countries have overnight lending rates approaching zero, inflation of about 2.5%, ten-year bonds yielding in the 2.5% to 3% range, comparable per capita incomes, and debt-to-GDP levels around 110%. Furthermore, both economies are huge banking and finance hubs for their regions (although Singapore is also a massive entrepot). However, the similarities largely end there.

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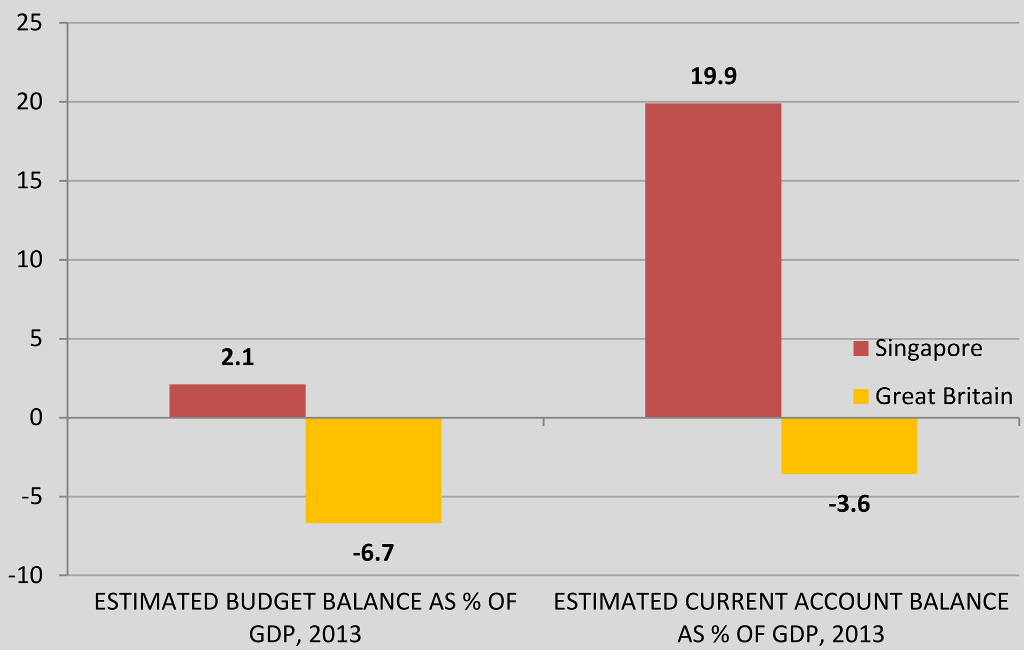
[1] The use of leverage may increase the magnitude of investment losses as well as gains.

Regarding their high debt levels, Singapore is in a vastly better position to service its obligations. Whereas Singapore's GDP is increasing in the mid-high 3% range, the UK is still feeling significant overhang from the 2008-09 financial crisis and is growing at barely half of Singapore's rate. Moreover, while Singapore has tightened its fiscal belt and is running an impressive budget *surplus* which is expected to exceed 2% of GDP for 2013, the spendthrift Brits are racking up budget deficits approaching a stunning 7% of GDP (see Figure 1), making the US Congress and the Obama administration look almost miserly in comparison.

Figure 1. Singapore and Great Britain: A Study in Contrasts



(Source: The Economist)

The real point of divergence between the two economies lies in their current accounts. The UK has the highest current account deficit of any major, non-developing economy at -3.6% of GDP. Contrast that with Singapore's current account surplus of almost 20% of GDP! Among the world's largest sixty-five countries, this is by far the biggest surplus.

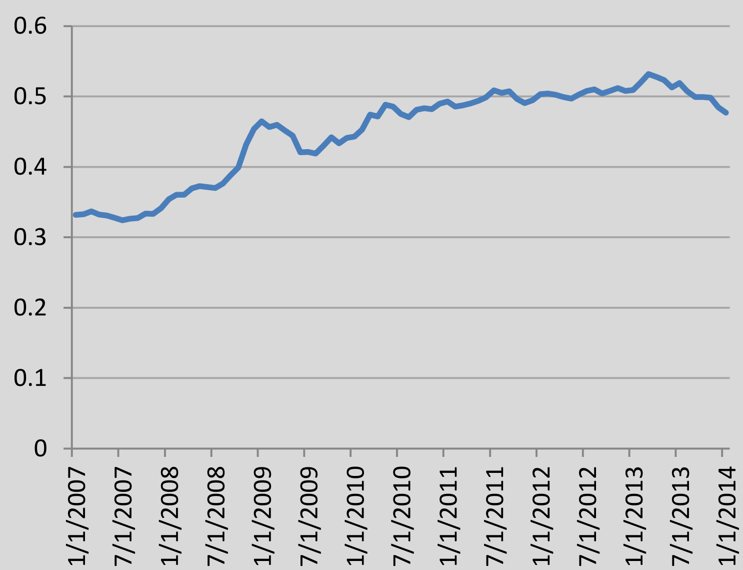
I believe this last fact in particular augurs well for the future strength of the SGD. Years ago when I first started investing in currencies, I was confronted with what I coined the "Swiss Franc Conundrum." Using a battery of fundamental tools, it appeared that the franc had remained at an exceptionally elevated price level for many years. It did move within a band over time. But that band was limited to "extremely overvalued" through "absurdly overvalued!" After a great deal of consideration and research, I determined that the market had granted an extreme premium to the franc based upon a combination of its world-class and theretofore secretive banking sector and its persistent 10%+ current account surpluses.

In light of Switzerland's cooperation with the US Treasury in order to track illicit deposits, some of the bloom has come off the Swiss banking rose. Singapore, which still maintains banking secrecy, has already benefited, and most certainly will continue to benefit, from this. As deposits from across the world continue to flood the coffers of Singaporean banks, and its current accounts continue to remain at stratospheric levels, I anticipate that at some point, investors will begin to grant the SGD a premium similar to that enjoyed by the Swiss franc and demand for the SGD will increase substantially.

I should note that like my currency ideas from last October, one of the advantages of this investment idea is that both the SGD and the GBP have a tendency to move in the same direction as one another, reducing the anticipated volatility of the position regardless of the market environment. Both the SGD and the GBP have tended to appreciate during times of equity market gains and decline during periods of general market dislocation. However, owing in large part to its much sounder fundamentals, the SGD has tended to depreciate significantly less than the GBP during times of declining equity prices.

With the pair declining 10% over the last year, this also appears to be a relatively attractive entry point for the SGD/GBP. I believe that this is a "dead cat bounce" for the GBP (which, of course, could last for months or longer), and anticipate that the upward appreciation of the pair, which began in the middle of 2007, should continue (see Figure 2).

Figure 2. SGD/GBP



(Source: www.oanda.com)

What could go wrong with this investment idea? The SGD is not a true freely floating currency. The Monetary Authority of Singapore (MAS) actually maintains an undisclosed crawling target band for its currency as a tool to manage inflation. While I generally find central bank intervention odious as a matter of principle, this is certainly one of the least deleterious forms of monetary activism. Should deflation become an issue, the MAS could attempt to weaken the SGD. However, I must say that if/when investors begin to appreciate the upside of the SGD, the MAS might not be able to stem market forces, and the currency may appreciate nonetheless.

About the only troubling fact fundamentally about the MAS is its proclivity to print money. According to the MAS, M3 money supply is up 9.4% year-over-year. All other things being equal, this level of currency dilution would be expected to cause SGD depreciation. On balance, however, the other significantly positive fundamental factors should more than offset this peccadillo on the part of the MAS. The prospects for future appreciation in the SGD/GBP thus seem quite attractive.