Big Currency Depreciations: What Happens Next?

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-John Mullin

Emerging market currencies have taken a beating this quarter, led by declines in the Brazilian real, Mexican peso, Russian ruble, South African rand, and Turkish lira. According to the financial press, these declines reflect the impact of higher U.S. interest rates, a stronger U.S. dollar, and global trade tensions.

This note attempts to add a bit of perspective to these recent currency declines. In addition, the note provides some historical information about the performances of country equity markets following similarly substantial currency declines.

Big Currency Depreciations in Q2 2018

	Nominal Exchange Rate*		
	March 31, 2018	June 19, 2018	FX Depreciation
Brazilian Real	3.3	3.7	11.6%
Mexican Peso	18.2	20.5	11.4%
Russian Ruble	57.3	63.8	10.2%
South African Rand	11.8	13.8	13.9%
Turkish Lira	3,954,945	4,738,851	16.5%

** Currency units per USD. Source: Bloomberg.*

Recent Currency Declines in Perspective

Recent EM currency declines can be seen in perspective by viewing the past twenty years of the MSCI EM Currency Index (see chart below). This index tracks the returns to a portfolio of un-hedged emerging market money market investments. As such, the index reflects currency fluctuations as well as money market interest payments.

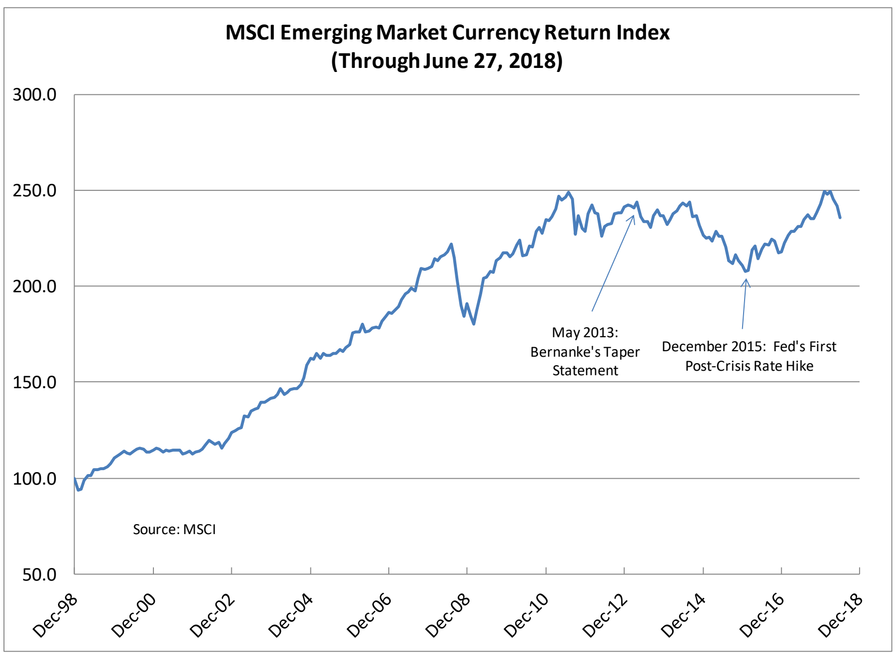
From the perspective of the past twenty years, the index's recent decline (of roughly 5%) leaves it not far from its historic high. The index first neared this high in August 2011. After that, the index had two major swings:

1. The index declined roughly 12% between May 2013 and January 2016. This period began with Bernanke's May 2013 statement signaling the Fed's intention to taper its program of quantitative easing.

2. The index increased by roughly 20% between January 2016 and March 2018. This period began shortly after the Fed's first post-crisis rate hike (when the federal fund's target ceiling increased to 0.5% in December 2015). During the period, the Fed hiked the fund's rate ceiling five more times—in December 2016, March 2017, June 2017, December 2017, and March 2018.

What stands out here is that EM currencies performed poorly when tighter monetary policy was anticipated, but performed strongly during a two-year span when monetary policy was actually being tightened. Viewed from this perspective, it is somewhat puzzling to read commentaries that attribute recent EMs currency declines to tight Fed policy. After all, the markets have been digesting anticipated and actual rate hikes for at least five years now.

Of course, it is not an easy matter to identify the source of currency movements in a particular month or quarter. That being said, however, it would appear that increased global trade tensions are a more likely culprit behind recent EM currency weakness.



<u>Country Equity Returns Following Big Depreciations</u>

We now turn to the question: What happens next? What sort of USD returns do country equity markets produce in periods following big exchange rate depreciations?

For this exercise, we define a "big depreciation" as one in which a country's real effective exchange rate depreciates by at least 10% over a three-month period. At the end of each month during 1989-2017, we identify all of the MSCI ACWI countries (both emerging and developed) that had big depreciation over the previous quarter. We then group these countries' equity markets into an equally weighted portfolio and compare the subsequent USD return performance of this "depreciated currency portfolio" to MSCI ACWI.[1] The subsequent return performances are calculated for over-lapping 3-month and 12-month holding periods. We also examine the return performance of a "blended" portfolio composed of 10% of the "depreciated currency portfolio" and 90% MSCI ACWI.

Our main statistical findings are:

1. The "depreciated currency portfolio" generated an average return that was more than double the return to MSCI ACWI
2. The volatility of the "depreciated currency portfolio" was almost three times that of MSCI ACWI
3. The beta of the "depreciated currency portfolio" was 1.4.
4. The beta-adjusted return—or alpha—of the "depreciated currency portfolio" was substantially positive
5. Blending the "depreciated currency portfolio" with MSCI ACWI produces a portfolio with a higher risk-adjusted return than MSCI ACWI.

Return Statistics -- 3-Month Holding Periods

	Portfolio of Countries w/ Depreciated Currencies (A)	MSCI ACWI (B)	Blend: 10% (A), 90% (B)
Average	6.9%	2.8%	3.2%
Standard Deviation	24.3%	8.6%	9.2%
Beta vis-à-vis ACWI	1.4	1.0	1.0
Alpha	3.0%	0.0%	0.3%

Source: Heckman Global Advisors

Return Statistics -- 12-Month Holding Periods

	Portfolio of Countries w/ Depreciated Currencies (A)	MSCI ACWI (B)	Blend: 10% (A), 90% (B)
Average	24.5%	10.1%	11.6%
Standard Deviation	45.7%	17.9%	19.1%
Beta vis-à-vis ACWI	1.4	1.0	1.0
Alpha	9.9%	0.0%	1.0%

Source: Heckman Global Advisors

[1] To ensure an "apples-to-apples" comparison, we restrict our return analysis to periods when the "depreciated currency portfolio" has at least one member.

Conclusions

- Recent EM currency weakness is more likely the result of increased global trade tensions rather than apprehension about further Fed policy tightening
- On average, country equity markets outperform following big currency depreciations
- However, these markets also have high beta risk
- As a consequence, we would expect these markets to outperform should global trade tensions subside; otherwise, they may be vulnerable to further declines

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