

Back to the 1980s: Re-emerging Opportunities in the Currency Markets

In this webinar, Chief Investment Officer Thomas Stolper of Embankment Currency Research Thomas Stolper share his expert insights on changes within central banks to fight inflation.

The summary notes covered the following key topics:

- Changes within central banks to fight inflation
- Central banks striving for a stronger currency
- Return of carry trading
- Major “tradable” FX trends

Reminiscent of the 80's & 90's

After uneventful years in the foreign exchange market, the recent developments in this sector remind Thomas of the extreme market swings about four decades ago, amid the Plaza Accord and the Louvre Accord in 1985 and 1987, respectively, with a lot of interesting parallels. Among the issues, the most striking comparison is the major spike in inflation, the biggest shock since the 1980s.

Thomas highlighted:

“What is important to understand is that, when inflation goes up, it becomes a massive policy issue and policymakers in governments - in particular, central banks – are under enormous pressure. Measuring how populations respond to inflation is not easy.”

As the discussion proceeded to explain certain directions that central banks can choose when dealing with rising inflation, he re-introduced the “Sacrifice Ratio”, an economic concept last used in the 1980s that relationship between the rise in unemployment and decline in inflation is assessed. To policymakers, it asks the question of how much unemployment level can they accept in order to bring down inflation to a certain level.

Current Dilemma Among Central Banks

In the present-day inflation scenario, he believes that central banks struggle and apply different strategies to avoid the blame:

- Wait and hope that the problem would go away (ECB)
- Act early to avoid the worst (FED)
- Strengthen currency to lower import prices (SNB)

He said:

“When there’s less monetary policy sync, the larger the foreign exchange markets move,”

Since late 2021, G10 interest rate changes have become less coordinated when central banks grapple with the surge in prices. Currencies appreciated when central banks hiked rates last year, a clear example of how currencies respond to movement in interest rates.

He went on to illustrate behavior changes in the G10 central bank rates in the 1980-1990s during crises, comparing periods when they are in synchronization and when they are not, and how these impacted foreign exchange returns.

Outlook for FX Investors

From his analysis, he indicated that an international portfolio in multiple countries benefits from maintaining exposure to assets denominated in an undervalued currency when the currency re-appreciates, although exposure to an overvalued currency must be hedged. Thomas believes,

- There will be some parity between the euro and US dollar by end of 2022, emphasizing that much can still happen in the markets despite the current high volatility.
- While the Japanese yen is extremely undervalued, it has a history of recovering quickly and Japan is not under any major inflation threat.
- The Chinese renminbi is unlikely to become a reserve currency until external investments are allowed into the country.
- Commodity currencies, such as the New Zealand dollar, Canadian dollar and Australian dollar are promising candidates for value appreciation.
- The Japanese yen, the Swiss francs and the Canadian dollar are likely to strengthen against the US dollar. On the other hand, the euro, the sterling, the Russian ruble, the Chinese renminbi and the Turkish lira could weaken.

He concluded that the success of currency investors depends on market conditions. They need to be critical and agile in an environment of big risk premiums, momentum, and sharp reversals.

The webinar was held on May 25, 2022 in collaboration with The Family Office Co. Bsc (c) and was moderated by Naji Nehme, Chief Investment Officer at Petiole Asset Management.

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