Special Paper No.9

www.taml.co.uk April 2022

Currency – Last But Not Least

"The US dollar remains as important as when Bretton Woods collapsed".
Mark Carney at Jackson Hole, 2019

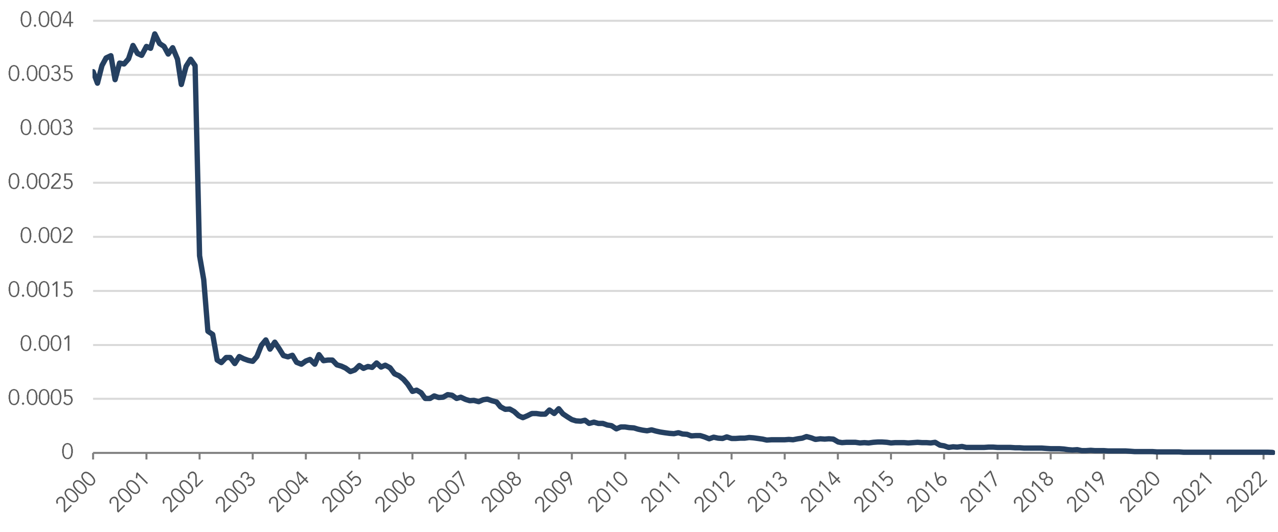
Currency markets can change quickly, but Carney highlights that the US dollar's dominance is one element that has endured for decades.

Currency analysis is often left out of discussions, perhaps as there is no consensus on the complex drivers of currency movements, but it can be immensely important when attempting to preserve capital in real terms – just ask the savers in Argentina, who have experienced first-hand the vicious erosion of their currency against recognised stores of value such as gold (*Figure 1*).

In our multi-asset mandates at Troy, investments are selected through 'bottom-up' analysis of the attractiveness of individual equities and fixed income securities. The approach is different to a 'top-down' attitude, where securities are owned to gain exposure to a particular currency or macro driver. Currency risk is managed carefully and hedged when we feel it is appropriate. We are happy to be unhedged or fully hedged depending on market dynamics at the time. Currency exposure has made a significant positive contribution to the multi-asset mandates since the strategy's inception and is responsible for 10% of historic returns[1], whilst also helping to protect capital during downturns.

Over the last two decades the multi-asset funds have owned fewer sterling-denominated assets and more dollar assets. The transition has been driven by us continuing to find exceptional companies listed in the US and discovering better relative value in the large US inflation-linked bond market. The result has been that the Trojan Fund's unhedged US dollar exposure has risen from 2% in mid-2004 to 59% at the end of March 2022 (with

Figure 1 – Value of the Argentinian peso against one ounce of gold



Past performance is not a guide to future performance

Source: Bloomberg, 5 April 2022.

[1]Troy Asset Management

unhedged sterling exposure of 26%, gold being 12% and no other currency above 3%).

Many investors in Troy's multi-asset funds have sterling-denominated liabilities, and performance in sterling terms is key. The primary non-sterling exposure in the Fund is to cable (GBP/USD). To manage the currency risk, we hedge a significant portion of the dollar exposure back to sterling. At the end of March 2022, this reduced the unhedged dollar exposure of 59% to 28% net (*Figure 2*).

"The cemetery for seers has a huge section set aside for macro-forecasters"

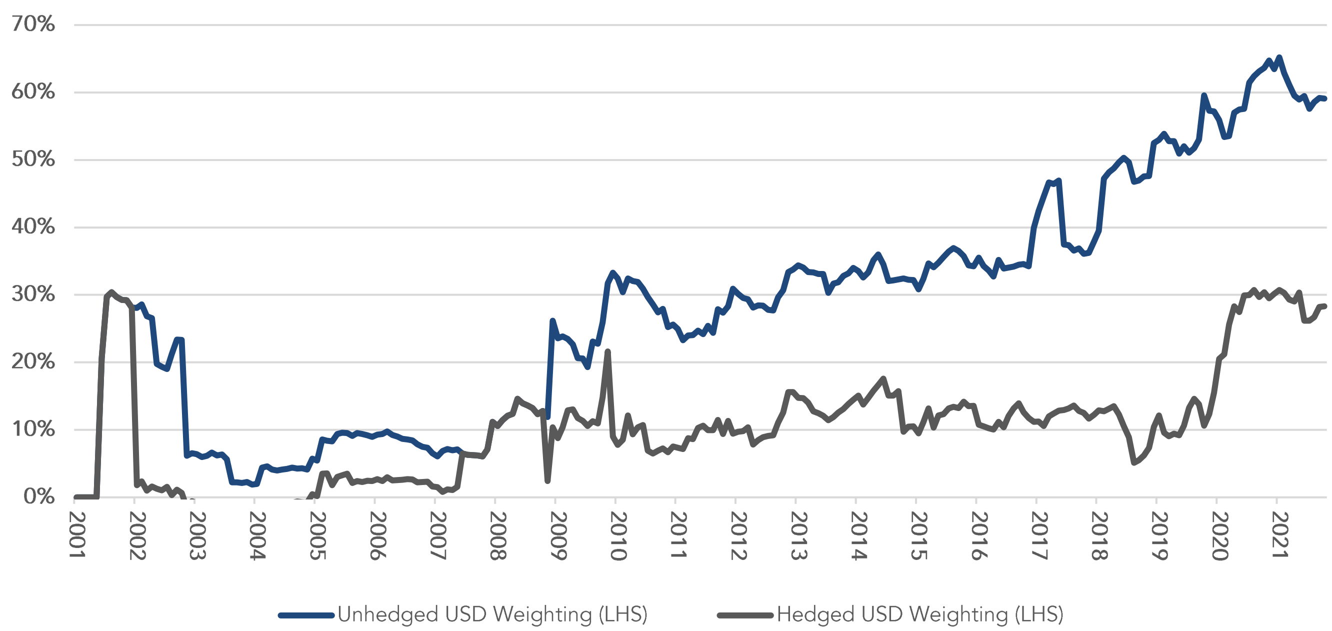
Warren Buffett, 2004

Currencies are very different to equities and bonds, as there are no cash flows to value. There is no 'price' of a currency in isolation, so currencies are quoted relative to one another. Beauty is in the eye of the beholder, and unfortunately the holders tend to be fickle. The task of predicting currency returns, at least in the short term, is best left to others with much shorter time horizons.

In the world of currency analysis, several analysts point to current account deficits as an indicator that a currency will weaken. However, the US has run a current account deficit since the early 1990s yet the dollar has held up well over the period, suggesting current accounts may be less predictive for the US.

Purchasing power parity (PPP), the idea that things should cost a similar amount in different countries, also appears to have little predictive power. For example, *The Economist's* Big Mac Index is a light-hearted PPP tool that compares the cost of the McDonald's classic in countries around the world. The Swiss franc is a currency that has consistently appeared 'overvalued' on PPP metrics for decades, yet it has strengthened against most other currencies, including sterling over the same time frame. *The Economist's* tool also suggests that, as of early April 2022, the Russian rouble and Turkish lira are the most undervalued currencies relative to the dollar. (It is safe to assume that we will not be swapping our dollars for lira).

Figure 2 – Trojan Fund unhedged and hedged US dollar exposure



Source: Troy Asset Management, 31 March 2022.

Past performance is not a guide to future performance

The safe haven

Much easier to predict is the dollar's strength at times of market stress. During crises investors want to hold a low-risk currency they can trust. Many investors also follow carry-trade strategies, where money is borrowed in a low interest rate currency such as the US dollar and invested in a higher interest rate currency. These carry trades are typically unwound during market downturns, resulting in significant forced dollar purchases as cash 'returns home'. In response to this combination of forced buying as well as 'safe haven' flows, the dollar typically appreciates against most other currencies, including sterling, offering a valuable offset (*Figure 3*).

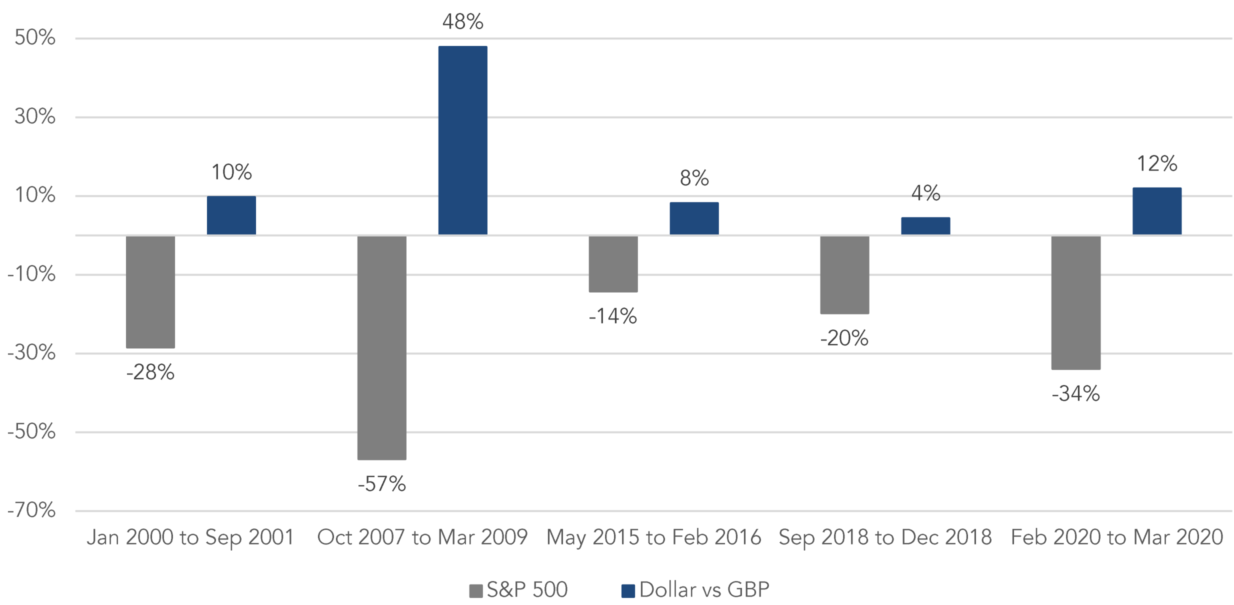
The dollar is therefore both a risk to be managed, and a tool for managing risk. The 'safe haven' status of the dollar is increasingly useful today, given rising correlations between equities and bonds. The multi-asset funds' dollar exposure, although reduced through currency hedging, has helped during periods of drawdown. As an example, during the market sell-off at the start of the Covid pandemic, the Trojan Fund's return would have been -1.8% lower had the dollar exposure been fully hedged[2]. Similar benefits are visible during the recent Ukraine crisis where the Trojan Fund's return would have been -0.9% lower with no dollar exposure, or Brexit[3] where returns would have been -1.1% lower.

Some level of dollar exposure is therefore useful. However, the approach to selecting the level of dollar risk to be hedged has evolved over time. Our focus is on having enough exposure to allow for the positive offsetting effects to be felt by the fund, without taking excessive risk.

Dollar dominance to persist?

In 1900, sterling dominated global finance and made up 64% of global foreign currency reserves, with most of the rest being French francs and German marks. Keynes described in 1930 how the Bank of England serves as "conductor of the international orchestra". The dollar steadily grew in importance under the

Figure 3 – S&P 500 performance vs USD/GBP during market drawdowns



Source: Bloomberg, 31 March 2022.

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[2] Covid period: 19 Feb 2020 to 31 Mar 2020, source: Troy
[3] Ukraine period: 16 Feb 2022 to 31 Mar 2022, Brexit period: 31 Dec 2015 to 30 Jun 2016, Source: Troy

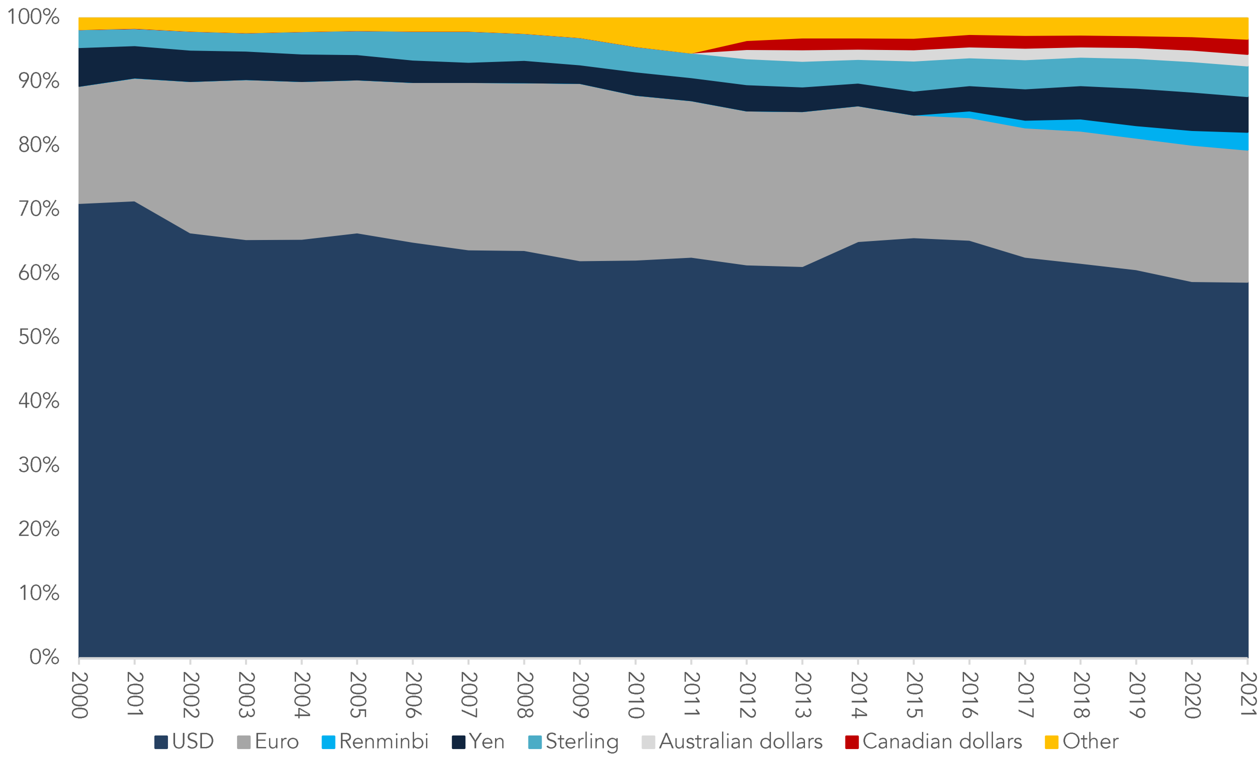
Bretton Woods System, where the dollar was pegged to gold and other currencies to the dollar. Growth in dollar use attracted the ire of many, with French Minister of Finance, Giscard d'Estaing, referring to its "*privilège exorbitant*" in the 1960s. The US Treasury Secretary's 1971 comments to G10 ministers that "The dollar is our currency, but it is your problem" is unlikely to have helped sentiment in Paris. Today's world is very different to 1900, with sterling only representing 5% of foreign currency reserves and the dollar occupying a similar level of dominance today as sterling did over 120 years ago.

A frequently cited argument against the dollar's continued supremacy is the risk that it loses its status as the world's reserve currency. The argument is receiving particular attention lately because the dollar has become a weapon in sanctioning Russia. The West's ability to remove Russia's access to the majority of Russia's own $469bn of foreign currency reserves has surprised many experts.

The scale of dollar hegemony today should not be understated. Although foreign currency reserves only represent one element of the dollar's dominance, the dollar also reigns in commercial trade contracts. In Asian emerging markets roughly ¾ of exports are denominated in dollars and in South America the number is closer to 100%. Similarly, four out of every five cross-border interbank SWIFT transactions have a dollar leg. The greenback is even dominant in pricing commodities, with everything from oil to copper quoted in dollars. The world is reliant on the dollar and that incumbency is difficult to change.

Several commentators point to China's renminbi as a threat to dollar dominance, due to the ever-increasing size of China's economy and influence. This argument fails to recognise the characteristics that make the dollar

Figure 4 – Global foreign exchange reserves by currency



Source: IMF, 31 December 2021

attractive. The size of the US economy is only one element; reserve currencies are typically freely floating, issued by countries with open economies, broadly accepted political systems and predictable legal frameworks[4]. The renminbi offers none of these.

Where some central banks have sought to diversify their foreign currency reserves away from the dollar, the renminbi has not found favour. Instead, some have moved small amounts to the Australian and Canadian dollar. In 2021 the renminbi made up no more than 3% of global foreign currency reserves, compared to 59% for the US dollar (*Figure 4*). The renminbi therefore appears unlikely to gain significant traction as a reserve currency without large changes to the political, legal and financial system in China.

Our view

Currency exposure can be a significant driver of volatility in returns, particularly in a world of increasingly unorthodox monetary and fiscal policies. Some currencies have also posed a headwind over sustained periods.

The dollar is likely to remain the dominant global currency for the foreseeable future, with few realistic alternatives. Its 'safe haven' status also offers valuable diversification to investors at times when few other assets offer positive returns. The notable exception is gold, which is also held in Troy's multi-asset funds.

Our multi-asset strategy at Troy has dollar exposure which is driven by a bottom-up view on individual assets. The resulting currency risks are then carefully managed as appropriate. Other currencies, such as the euro and Swiss franc, represent a very small part of the portfolio today. It is likely that we will maintain a positive net dollar weighting, giving exposure to its useful diversifying properties during times of market stress. The dollar has proven itself within the portfolio over the last two decades and continues to aid in our endeavour to protect the precious capital of our investors.

Marc de Vos — April 2022

[4] A floating currency is where the exchange rate is allowed to fluctuate in response to market events without influence from central banks.

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