Currency markets explained – the investment case for uncorrelated systematic FX strategies

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With a daily volume of over $6.6 trillion the global FX market is the largest marketplace in the world. However, to many investors FX remains a big unknown area of the market; some would not even recognise it as an asset class in its own right. While almost every investor is running FX risk via their overseas investments without giving it too much thought (many are not hedged), an outright investment into a well-run FX strategy is something only few have considered so far. But investing in FX is not necessarily something that can only be done by a hedge fund "wizard" with an upmarket fee structure. Done the right way, FX investment can be a perpetual exercise of discipline on ever-recurring patterns of story and price.

Investing with the trend and earning interest in a trendless market

There is always a trend in markets, at least somewhere in the world, many would think. To the seasoned FX trader or market participant it might feel that sometimes markets are just ranging endlessly within expected and known boundaries and trending less than 50% of the time.

Luckily, for FX investors there are ways to trade profitably during either of the described market environments. In different parts of the world these differing environments might be current affairs, occurring during the very same period of time. Not too differently from a stock picker, however, provided with a much smaller target selection, the FX investor will have to make a decision where to go with their cash. Typically, market trend and interest rate will be factors that determine these decisions.

It is very possible to participate in positive economic trends via FX positioning. For example, Turkey experienced a number of great years between 2004 and 2012, attracting a lot of foreign direct investment which fuelled a domestic economic boom. Naturally, due to the immense money flow towards Turkey at that time, the Turkish lira (TRY) kept strengthening steadily. In similar fashion the Chilean peso (CLP), driven by Chinese demand for Chilean copper, kept rising between 2004 and 2007. Investors who followed these trends early and stayed with them managed to earn a substantial return from the directional move of TRY and CLP versus the USD, EUR or GBP over a long period of time. This type of positive trend happens every once in a while in FX markets, especially in emerging markets. It will always be about recognising it, getting on it early and in principle staying with it while trading around it whenever it makes sense.

The other classic strategy to implement is the so-called "carry trade", whereby the investor borrows the currency with the lower interest rate in order to invest in the higher yielding currency. The differential in interest earned versus paid out over the holding period of the trade is the investor's profit. In Japan, where zero interest rates have been part of life for much longer than in the UK, this strategy has been so popular that it earned itself a reputation as a "Japanese housewife trade", meaning every "Mrs. Watanabe" has been in the know and on this trade, for example by being short JPY (at zero interest) and long AUD (earning some interest). For a while, in fact for numerous consecutive years, it had become the thing to do. Until the tide turned.

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Know your market – be on your toes

Like in any market, it requires complete market knowledge and experience to run an FX investment strategy successfully over a long period of time. Discretionary traders at pricey hedge funds will usually be offering their services. Additionally, there are a number of systematic traders who are pursuing the same goal, albeit asking for a significantly more modest fee. Typically, systematic traders will be seasoned market professionals who one day decided to put their thoughts and experiences on FX markets into code, thus creating a set of coded rules by which their systematic currency strategies are now run. The formulation of winning trading set-ups and putting them into code is something that, in our view, can be only done successfully by traders who have seen a number of market cycles and know Mr Market’s playbook inside out. “Risk happens fast” and for that reason alone the minimum requirement for any FX investor is to know when not to play.

In principle, the FX market playbook is very repetitive and can be implemented as a rinse and repeat type procedure across numerous currencies at different points in time. There is always one or a number of currencies and countries that will be doing relatively better than others. Those are the ones which as an investor one wants to be invested in. And there are always the ones who are notoriously bad with their budgets or have a terrible history of devaluation or even default (for example Argentina). These are the ones that the savvy investor will not touch. Uptrend cycles in currency markets usually last for about 3-7 years, before some type of market sell-off occurs and the whole exercise starts again.

“Risk-off” mechanics at work

During sell-off periods most investors lose money. FX investors will usually be seen switching towards “safe haven” currencies such as CHF or JPY or even SGD in these moments. However, if the “risk-off” scenario is underpinned by events of broader magnitude such as a global credit event (as seen in 2007/08 and 2020) the playbook gets even simpler: Firstly, one can expect the preferred carry trade funding currencies such as EUR and JPY to rally, as investors close their carry trades. If this procedure is conducted in such an aggressive manner that market participants suspect there are margin call-related market moves occurring, one will quickly be able to observe how suddenly the USD becomes the place to be. In times of crisis, cash is king. The world’s reserve currency will, at that very moment, be experiencing incredibly high demand as investors (mostly leveraged) cash in on their investments in order to fill margin call-related gaps elsewhere or repay previously borrowed funds.

Despite the rise of China over the last three decades, the US is still the largest and strongest economy in the world, and it still has the most powerful military. It is governed by the rule of law, which makes it a great home for domestic and international investors and even more so their money. Therefore, the USD remains the most borrowed currency in the world. Hence, for purely mechanical reasons, the very same dash for cash pattern will play out in FX markets time and time again in a credit related “risk-off” scenario. This scenario could be perfectly observed in GBP/USD as well as EUR/USD in the 2020 crash. The reason for the violent price action was purely credit related, as Covid-19 suddenly threatened to turn from a global health concern into a global credit event.

During a credit-related sell-off, investors raid every single avenue for liquidity one by one, and they start with the most liquid ones. Typically, the chain of events will move from equities to bonds and then on to industrial commodities such as copper (usually reacting late to pressure) and finally on to FX. There is usually a struggle to be the “last man standing” between gold and US T-Bonds, and once that happens we know that we are in the final innings of the sell-off.

As usual, the senior central bank, in this case the Fed, comes to the rescue and provides, as seen in March 2020, limitless USD liquidity to other central banks and to the market, which leads to the buying pressure in USD to slowly abate and the bottom building process in higher yielding currencies to begin. From cash is king to money looking for a new home again. Rinse and repeat.

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Currency overlay as an integral part of the defensive playbook

To discretionary and systematic investors alike, the most difficult part is to hold on to previously earned returns once the tide begins to turn. Some hedge funds will see this as an opportunity to make money with timely short positions. However, we have all been witnessing how badly many macro hedge funds and notorious short-sellers underperformed over the last 10 years by being too early on short positions.

In a systematic trading approach, we believe that it is more prudent and sensible never to try to be short an expensive high yield currency. Instead of timing the market for a potential decline in risky assets, in our view it is more valuable to know when to simply stay on the sidelines.

Furthermore, especially given the mechanical relationships at play explained above, it becomes evident that in a systematic approach to FX investment, there must be a role to be played by the senior currency, the USD. In fact, a recent in-house study confirmed that running a carry strategy with a EUR/USD overlay as protection will create returns over time that are uncorrelated to major asset classes such as equities or fixed income. Moreover, by applying a battle-hardened systematic EUR/USD overlay over a portfolio of currencies, volatility will see a substantial reduction. As a consequence, potential drawdowns will likely be of very limited size only.

"All-weather" FX portfolio?

Achieving steady and uncorrelated returns over time in FX is possible. Broken down to the very basics there are in principle only two things one has to look for in a manager: that they know when to step aside and that they include the senior currency in their strategy as a place to hide should there be need to do so. Respecting and applying these two rules successfully might just be the difference between long-lasting success over time and failure. A well-run FX strategy is unlikely to generate the exorbitant returns that we have seen on occasions in other asset classes but it will not come with sleepless nights either. Over the long run it might just feel close to an "all-weather" portfolio.