What makes currencies move?

Learn how the currency market affect your investment returns

The Federal Reserve has started hiking interest rates since late 2015. Should we expect the US dollar to continue strengthening throughout the rate hiking cycle?

Exchange rates are relative and determined by various factors like interest rates. Generally speaking, higher interest rates would cause the exchange rate to rise. However, the impact of higher interest rates would be mitigated if there are other factors that drive the currency down.

One of the important factors is market expectation. The market tends to price in expectations way ahead of the reality. If a rate hike is widely anticipated before it happens, its actual impact on the currency will likely be much weaker than a surprise rate hike. As for the US dollar, we think the market has priced in a relatively mild Fed rate cycle in 2018 and 2019. However, if the pace of policy tightening were to accelerate faster than market expectations, the dollar could strengthen further.

Besides interest rates, what are the other economic factors that make currencies move?

Positive economic data releases or an unexpected political event could cause a currency to jump or slip in the short term. But it is very difficult to forecast short-term currency movements. In the medium or long term, there are several main factors that influence the demand and supply of currencies and thus their exchange rates.

These factors include the relative purchasing power of a currency, inflation level in the economy, strength of the economy as well as a country's trading relationship with the rest of the world. In general, a stronger economy implies a stronger currency. Countries that export more than they import (i.e. having a trade surplus) will typically have stronger currencies, boosted by the demand for their goods. Meanwhile, government intervention in the foreign exchange market could also lead to a change in the relative value of a currency.

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Would exchange rates fluctuation affect my investment returns even if I am not directly exposed to the currency market?

If you invest in overseas stock or bond markets, any gains or losses will be offset or enlarged by the change in currency values. Assume you put HKD10,000 in European assets, the price of the asset itself doesn't move after 12 months but the euro climbs by 10% against the HKD. When your investment is converted back into the HKD, you will see an investment gain of 10%. Similarly, if the euro falls by 10% without the asset price moving, you have lost 10%.

In many circumstances, the reality could be more complicated than the above assumption. Stock markets that are more "export-oriented" (i.e. with constituents that make a large portion of profits from sales abroad) will usually benefit from a depreciation in currency which makes their goods more competitive overseas. Therefore, it is very common to see export-oriented markets such as the Japanese and German stock markets to move in opposite direction with their currencies. In such situation, as an overseas investor, while the stocks you own benefit from the currency depreciation, the gains are mitigated by the fall in the currency value.

Emerging market bonds: "hard currency" versus "local currency"

Many investors would have come across two types of emerging market bonds. The first one is denominated in "***hard currencies***" which are basically currencies of developed countries, most commonly the US dollar. If a USD-based investor purchase USD-denominated emerging market bonds, he/she is not affected by currency risk arising from exchange rate fluctuations.

Meanwhile, bonds that are denominated in ***local*** currencies are the second type of emerging market debts. In this case, investors buy the bonds in terms of the local currency, e.g. the Indonesian rupiah. The implication is that in addition to the price movement of the underlying bond, the value of the investment is also affected by the rise and fall of the rupiah against the US dollar.

We highlight some of the key differences between local currency and hard currency emerging market bonds in the table below:

	Local currency emerging market bonds	Hard currency emerging market bonds
Universe	Smaller in terms of country selection	Bigger in terms of country selection
Issuers	Sovereign	Sovereign, quasi-sovereign, corporate
Denomination	Local currency	Hard currencies (e.g. the US dollar, the euro)
Credit ratings	Local currency ratings are typically higher. This is more a result of all-rounded stronger characteristics of countries who issue local currency: to make their local currency debt available to foreign investors, they need to have strong underlying fundamentals and more sophisticated credit markets	
Yield	Usually higher yields – a function of the additional currency risk	Usually lower yields
Sources of investment returns	▸ Coupon payments and reinvestment income ▸ Capital gains/losses from bond price movement ▸ Local currency appreciation/depreciation	▸ Coupon payments and reinvestment income ▸ Capital gains/losses from bond price movement
Volatility	Higher volatility – a function of the additional currency risk	Lower volatility

Investors who are looking to allocate a portion of their portfolio to emerging market bonds must make a choice between hard currency and local currency bonds. Meanwhile, many emerging market bond funds allocate investments between these two types of bonds. You are advised to study carefully any potential bond fund investment to make sure you understand the currency denominations of the bonds in its portfolio to confirm that the fund fits your risk appetite and investment objective.

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