CHAPMAN CRAIG

Currency Fluctuations – April 2022

Currency fluctuation is an ever-present factor that investors should take into account.

We have come a long way since pre-Bretton Woods, but there remain serious challenges for investors and portfolio managers in dealing with currency fluctuations.

Currency exchange rates fluctuate constantly, impacted by many economic and sentiment factors. These can be exacerbated by a country's poor economic policies, its exposure to increasing commodity prices and reversing capital flows from foreign investors.

Nearly all Central Banks have been or are about to start raising interest rates significantly, with the view to moderating inflation by tightening financial conditions. Historically, tightening financial conditions has impacted some economies, particularly emerging economies, more than others, including by triggering significant foreign exchange rate volatility.

Our comments will focus on the role currency selection and the associated risks may play in your own personal investment decisions.

Economics

There are many economic factors that lead to the strength or weakness of one currency versus another. A nation's trade, current and capital accounts, and its government's fiscal and monetary policies, including the local-currency yield curve, are important factors.

For example, a country experiencing a decline in its currency may see increased exports of locally produced goods or services. A country can support its currency by raising local interest rates.

During periods of calm, investors often move funds from low interest rate countries to higher interest rate countries. However, during periods of heightened uncertainty, investors unwind carry-trades or seek safety in securities in currencies perceived as safe, such as US dollars, Swiss Francs or the Japanese Yen.

Of course, economic analysis is unfortunately never that simple -- multiple factors, both internal and external, simultaneously impact a country's currency movements, with some tending to have short-term impacts and some are felt longer term.

Minimize Currency Effects

While foreign exchange risks are only some of the many risks to which your investment portfolio is exposed, there are ways that professional managers mitigate or avoid these risks. They may manage foreign exchange exposure to match clients' liabilities, or they may hedge certain exposures, or they may diversify appropriately.

Professional advisors and economists also use various models or theories to help forecast currency movements, e.g., the *purchasing-power parity* theory. These models incorporate many factors mentioned above and include interest rate differentials, relative economic strength and inflation expectations.

Your Investment Objectives

If you need regular income from your investment accounts, then the currency mix chosen for your investments should match up well with the currency or currencies in which your expenses are based. For example, if you are retired in the United States, then you would be more comfortable with a significant portion of your portfolio producing a USD income.

However, your specific objectives might be best met by a good, internationally-oriented, discretionary investment manager. Your currencies exposure would be directly related to your specific asset allocation.

A good portfolio manager will include currency-related risks when assessing investment opportunities. For example, currencies are a relevant factor in determining a company's cost structure and competitive position.

Currency implications are unlikely to drive investment decisions or portfolio construction, but we suggest that these issues be included in discussions with your financial advisor when evaluating returns or matching your portfolio parts with your long-term financial objectives.

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