PROFITING FROM CURRENCY WARS

AVIVA INVESTORS
March 2016

Key points

Currency exposures play a significant role in helping us to generate returns and manage risk within the Virtus Multi-Strategy Target Return Fund.

The Fund has positions aiming to profit from the US dollar appreciating against the renminbi, the Australian dollar, and the Saudi Arabian riyal, while another position aims to make money from the US currency depreciating against the Indian rupee.

Currency markets will offer opportunities to help provide the performance clients desire for some time yet.

Peter Fitzgerald*
Global Head of Multi-Assets, London

Peter manages the Virtus Multi-Strategy Target Return Fund, as well as a number of risk-targeted, unit-linked and pension portfolios. He heads Aviva Investors' multi-asset team which is responsible for over $123 billion[1] of multi-asset and multi-strategy portfolios.

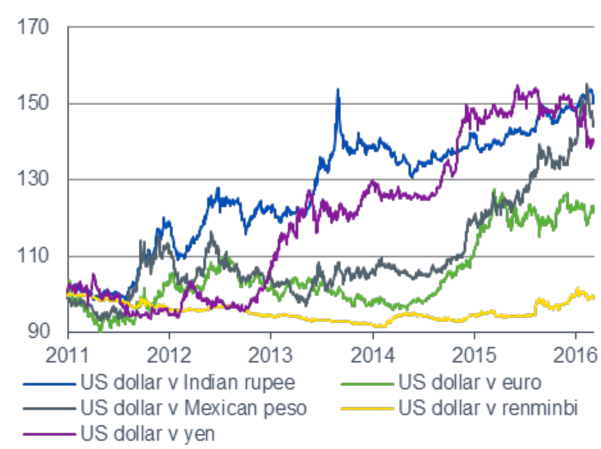
*Investment professionals listed are members of AIA's participating affiliate, Aviva Investors Global Services ("AIGSL").

Currencies can provide a rich source of investment ideas for portfolio managers who are able to profit from them in a world of experimental monetary policy and beggar-thy-neighbor attitudes to currency depreciation, says Peter Fitzgerald.

The outlook for the Chinese economy is likely to be among the key drivers of financial market sentiment this year, like last. Add into the mix the risk of more "Quantitative Easing" (QE) in Europe and Japan, US rate hikes, and the UK exiting the EU and it looks like being another roller-coaster year for currency markets in particular. As such, currencies should continue to offer potential profits for those able to call markets and central-bank policy correctly.

We expect the US currency will continue to strengthen this year, as it did in 2015, albeit less rapidly. A soft patch of US economic data at the start of 2016 led investors to scale back expectations of the extent to which domestic interest rates would rise. However, we have seen more encouraging signs in recent weeks. The labor market – which added more than two million jobs in 2015 for the fifth year in a row – is showing little sign of slowing down. That means rates may rise faster than the market expects. By contrast, central banks in the eurozone, Japan, and China look set to ease policy even more as they try to boost economic growth, partly by making exporters' goods more competitive via weaker exchange rates. For instance, the Fund holds a position against the Japanese yen to express this view. However, the effectiveness of these policies on weakening the exchange rate may face some limit. Both the yen and euro actually rose after recent policy action by the Bank of Japan and European Central Bank left investors underwhelmed.

Currency volatility set to last as dollar rallies



Source: Bloomberg, exchange-rate data between 1/1/2011 and 3/4/2016

Currency exposure in the multi-strategy portfolio

The Fund combines a wide range of investment strategies, some of which perform well when markets rise and others when they fall, in seeking to meet their objective. With portfolio managers free to invest where they want, portfolios can profit from an almost limitless pool of investment ideas in an effort to diversify risk whatever the investment climate.

Currency exposures typically play a significant role in helping us to both generate returns and manage risk within the portfolio.

[1] Source: Aviva Investors, data as of December 31, 2015

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Currency positions

The portfolio currently has positions aiming to profit from the US dollar appreciating against various currencies such as the renminbi, the Australian dollar, and the Saudi Arabian riyal while other position aims to make money from the US currency depreciating against the Indian rupee.

Chinese policymakers spooked markets in August 2015 by devaluing the renminbi against the dollar after the domestic economy began to slow surprisingly quickly. The Chinese authorities subsequently spent most of the $754 billion drawn from reserves in 2015 to support their currency and try to stem capital flight. This pace of reserves depletion will not last. And with the domestic central bank in easing mode to attempt to stimulate growth, the renminbi is likely to depreciate in 2016 both on a trade-weighted basis and against the dollar. Along a similar theme of continued weakness in the Chinese economy, we expect the Australian dollar to depreciate against the US dollar.

The market is pricing in a low probability that the Saudi Arabian riyal peg to the US dollar may break. With oil prices likely to be relatively low for some time and the Saudi government seeking to use reserves prudently, to fund social spending and support the currency, we believe that recent capital outflows from the kingdom make the riyal susceptible to a significant drop.

The portfolio is simultaneously looking for the Indian rupee to appreciate after it was dragged down in sympathy with other emerging nations' currencies in 2015. Unlike many developing economies, India is a net importer of oil, is embarking on business reforms and is easing monetary policy. Furthermore, only 4.5 percent of Indian exports go to China, meaning the economy is largely immune from the direct effects of a weaker Chinese economy. [2] We expect the rupee to be one of the strongest performing emerging currencies in 2016. By contrast, the currencies of those countries that are more exposed to China – such as South Korea, Malaysia, and Thailand – look far more vulnerable.

Conclusion

The sharp moves seen in currencies over the last twelve months around prospects for the global economy and monetary policy highlights how sensitive markets can be to the authorities' plans. And, the potential for shocks around leading central banks' policy intentions remains high as they grapple with experimental policy and negative interest rates. Currency markets will offer opportunities to help provide the performance clients desire for some time yet.

[2] Source: Aviva Investors, February 29, 2016

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