Not All Currencies Are Made Equal, So Don't Treat Them as Such

Selective currency hedging may boost yields and add stability.

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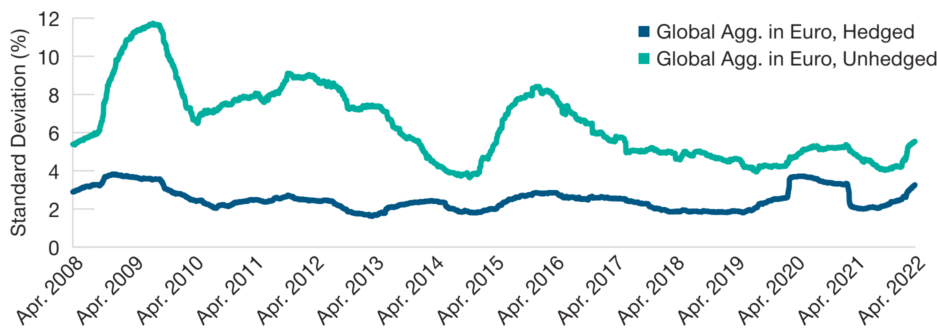
Investors in global fixed income markets typically hedge their currency exposure to reduce volatility. In some cases, however, selected unhedged currency exposures can bring additional yield and even help to anchor a portfolio during volatile periods. This suggests that investors may benefit from adopting a more nuanced approach to currency hedging than is typically practiced.

In this paper, the third in a series of articles on the search for yield, we focus on how a selective approach to hedging overseas bond exposure may help to boost yields while also reducing portfolio volatility.

As we noted in an earlier blog post, home-country government bonds are often seen as the least risky building block for multi-asset portfolios. As the yields on many government bonds have increased sharply in recent months, investors looking for income are again finding a place for such assets

Hedging Overseas Bond Exposure Typically Reduces Volatility

(Fig. 1) Comparing hedged and unhedged allocations to the Global Agg.



As of April 22, 2022.
Past performance is not a reliable indicator of future performance.
Rolling 1-year annualized volatility, based on daily observations.
Source: Bloomberg Finance L.P. Analysis by T. Rowe Price. Global Aggregate: Bloomberg Global Aggregate Index hedged to euro and Bloomberg Global Aggregate Index in EUR, unhedged to euro.

In Volatile Times, Hedging Can Be Less Effective

(Fig. 2) Unhedged currencies can outperform during turbulent periods

	Global Agg. in Euro, Hedged	Global Agg. in Euro, Unhedged
Q3 2008–Q1 2009	5.5%	17.3%
Q1 2020	0.9%	1.9%
Q1 2022	-5.3%	-4.1%

As of March 31, 2022.
Past performance is not a reliable indicator of future performance.
Source: Bloomberg Finance L.P. Analysis by T. Rowe Price. The table shows the performance of the Bloomberg Global Aggregate Index for a euro investor on a hedged and an unhedged basis.

> Investing in overseas sovereign bond markets can...improve diversification....

in their portfolios. However, heavy exposure to home‑country bonds brings risks, particularly if the sovereign creditworthiness of the home country comes under scrutiny—as has happened numerous times this century, including some large developed eurozone countries. Investing in overseas sovereign bond markets can, therefore, improve diversification and boost the "shock absorption" qualities in a portfolio.

Holding overseas bonds on an unhedged basis can add significantly to the volatility of fixed income exposures, however. This can be seen by observing the one‑year rolling volatility of the Bloomberg Global Aggregate Index for a euro investor, on both a hedged and unhedged basis, over the last 15 years (Figure 1).

The more volatile nature of an unhedged holding of even such high‑quality bonds can be clearly seen, with particular spikes in periods of turbulence such as the global financial crisis and the eurozone crisis. Over the entire period, the average one‑year rolling volatility was 2.5% p.a. for a hedged investor but well over double that, at 6.4% p.a., for an unhedged investor.

This appears to suggest that the decision to hedge such fixed income exposure is a straightforward one. Yet, while foreign currency exposure generally adds to a portfolio's expected volatility, selected *unhedged* exposures to overseas assets can, in some instances, act as an additional anchor for portfolios in periods of turbulence. During three of the most volatile episodes in markets over the past 15 years, for example, eurozone investors who allocated to the Bloomberg Global Aggregate Index would have generated stronger returns if they left their currency exposure unhedged (Figure 2).

> ...*unhedged* exposures to overseas assets can...act as an additional anchor....

What drove this pattern of returns? Well, not all currencies are created equal. Some, such as the U.S. dollar, are often seen as a bolthole in times of market stress (this has again been very evident during the events of recent months). When investors are very fearful about the return outlook for a wide range of markets, U.S. assets are frequently viewed as the safest place to be. This drives up demand for U.S. dollars from investors worldwide. Other currencies, including the Japanese yen and Swiss franc, have played a similar role historically, although in some cases their efficacy can vary from crisis to crisis (Figure 3).

An additional benefit for euro investors investing for income is that yields on overseas government bonds may be higher on an unhedged basis, especially as the European Central Bank moves more slowly to unwind easy monetary policy than other key central banks such as the U.S. Federal Reserve, the Bank of England, and the Bank of Canada.

Major Currencies Can Serve as a Bolthole During Periods of Stress

(Fig. 3) The U.S. dollar has been the leading “safe-haven” currency

	EUR	JPY	USD	CHF
Q2 2008–Q3 2009	-4.4%	18.2%	16.4%	3.5%
Q1 2020	0.7%	3.0%	3.5%	2.6%
Q1 2022	-0.5%	-4.4%	2.1%	1.2%

As of March 31, 2022.
Past performance is not a reliable indicator of future performance.
Sources: Bloomberg Finance L.P. Shows the performance of Deutsche Bank Trade Weighted Index for each respective currency. Analysis by T. Rowe Price.

We believe that fixed income investors should review their hedging approach to major overseas currencies within their allocations on a case-by-case basis. This will allow them to judge where potential diversification benefits from “safe havens” will offset the additional portfolio volatility such exposures bring.

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