Managing Currency Volatility

The turmoil we are witnessing in global markets, can be viewed as the response to concerns over a global economic slowdown triggered by the slowing GDP growth in China, softness in U.S. GDP, and its resulting impact on the U.S. Federal Reserve's (Fed) rate policy. Although the situation in China may well have served as a trigger over the past few months, it is important to dig deeper to develop a strategic view on matters. The start of Fed tightening has been uneventful other than a speculative run-up in the U.S. dollar. However, since the start of the year, global markets have been anything but uneventful, as risk markets have sold off, bond yields have fallen, and volatility has jumped – and now currency volatility is rising. As a result, many investors have grown pessimistic about the global outlook, and are skeptical that the Fed will hike more than once or twice this year. The ability to look past recent market volatility is once again proving to be difficult.

We believe the real cause of recent turbulence is related to the Fed's decision to bring quantitative easing to a complete end, thereby signaling to the market a significant shift in its pricing of various asset classes be that in stocks, bonds or currencies. Remember, the central bank's asset purchases lifted the prices of government bonds and other assets to levels considered above their value by most investors. Those investors were forced to move their funds into other markets, thereby lifting the prices of assets in general. The resulting positive wealth effect then boosted many asset classes in the U.S. and, to a degree, the U.S. economy. The un-responsiveness of Fed intervention through interest rates precipitated this asset-buying approach that has violated asset price equilibriums globally for years. That is the elephant in the room!

Amidst this turbulence, it becomes challenging to articulate our asset mix decisions, be it asset classes or currencies. We have to clearly differentiate between strategic (long-term, based upon philosophy and proof), tactical (short-term, based upon near-term macro fundamentals) or speculative (reactive, with panic as the basis) approaches to decision-making.

As a investment global manager, the ability to manage currency risk has become a relevant and crucial topic. The USD/CAD relationship has by de-facto become the pall bearer of macro decisions, exasperated by many a concentrated USD proxy, marauding as a global portfolio. We would like to reiterate that a well-diversified global portfolio has only half its assets in USD-denominated assets. The rest of the portfolio is exposed to multiple currencies, including the British pound, Swiss franc, Euro, Australian dollar, and the Canadian dollar. Furthermore, the companies held in our portfolios are truly global in nature and encompass multiple revenue streams coming from multiple countries across the globe. If one digs deeper, the diversification of cash flow sustenance for paying dividends is even more pronounced, encompassing all the 11 economic sectors across the globe. This is an important metric to understand as we look at a global portfolio through a red-colored USD lens.

The decision to move from USD to CAD or vice versa is tactical at the very best and speculative in most cases. In terms of asset allocation, the primary purpose of a global divided strategy is to diversify away from the concentrated and often volatile dividend source coming from our respective domicile allocations. A global dividend strategy should be used to reach the overriding goal of meeting liabilities over the long-term and into retirement. So, a frequent or tactical USD/CAD decision becomes regressive with respect to a diversified global divided strategy, and we should not confuse near-term foreign exchange impacts on the global portfolio, with this long-term goal.

We just need to look at the diversity of revenue streams for the so-called U.S. companies held in the portfolio. Even as the USD falls with respect to other currencies, these very companies listed below should significantly benefit from the translation gains accrued from a falling dollar.

Total Revenue Segmentation - Percent

U.S. dollar - denominated stocks	U.S.	Europe	Asia Pacific	Latin America	Canada	Total
McDonalds	32	40	23	5		100
Disney	75	14	8	3		100
Proctor and Gamble	27	40	23	10		100
Johnson & Johnson	51	22	18	9		100
Anheuser Busch	34	10	11	45		100
Apple	39	23	27	11		100
Dow Chemicals	33	32	31	4		100
Pfizer	59	22	16	3		100
Merck	28	47	19	6		100
Gilead Sciences	57	36	4	3		100
Illionois Tool Works	43	30	17	3	7	100
Exxon	38	27	25	1	9	100
Broadcom	11	32	57	0		100

The benefits of owning global 'Gorillas' vs. local-centric companies is evident from the sensitivities of names to a falling dollar, and, relatively speaking, we are much less exposed to the USD than a localized peer group.

In summary, the onus is on the portfolio management team to articulate the differences between passive responses – that more often than not leads to unknown market risk exposures through ETFs – vs. the value-add that is brought through active management. Generalizing asset classes-risk or grouping all Global and U.S. managers together is a symptom of passive indulgence. As portfolio managers we have a high conviction in our strategic views on currencies, while at the same time stay adaptive to near-term macro changes. The Global Systematic Team at Guardian Capital LP, will make adjustments if necessary, to help you avoid making tactical decisions. If that is not active management, we are not sure what is.

We continue to provide growth in dividends, a payout that is reasonable, and sustainability of cash flow that allows you to see past recent market volatility.

Sri Iyer
Managing Director, Head of Systematic Strategies

For more information on the Global Systematic Team, explore the world of Guardian Capital - guardiancapital.com