Hedge Demand Soars as Funds Seek to Tame Volatility: Currencies
2013-08-30 08:29:54.567 GMT

(For a Currencies column daily alert: SALT FXCOL.)

By Cecile Gutscher
Aug. 30 (Bloomberg) -- Investors are piling into funds hedging against currency risk at a record pace on speculation that the Federal Reserve dialing back four years of stimulus will exacerbate foreign-exchange swings.

Money invested in North American-based exchange-traded funds with currency hedges more than tripled this year, while those offering no protection grew 6 percent, data compiled by Bloomberg show. Franklin Templeton Investments hedged against swings between the U.S. and Canadian dollars in its flagship fund this week, while Vanguard Group Inc. started a fund in May that guards against currency risk of emerging-market bonds.

"I'm trying to prepare for the possibility of more volatility at a time when there's a meaningful conversation about when the Fed will reduce its quantitative-easing program," Jonathan Lemco, a senior sovereign-debt analyst at Vanguard, said in a phone interview yesterday from Valley Forge, Pennsylvania. The firm is the world's biggest mutual-fund manager, overseeing $473 billion in assets.

The prospect of the Fed reducing as soon as September the $85 billion it spends every month buying bonds helped push JPMorgan Chase & Co.'s Global FX Volatility Index to a seven-week high on Aug. 28. Currency gyrations threaten the returns of funds seeking to profit from carry trades, which depend on stable exchange rates between countries.

Forward Contracts

Currency-hedged ETFs attracted $22 billion in net flows this year, bringing their total assets under management to $32.5 billion, according to data compiled by Bloomberg on more than 100 funds.

Investors use hedges to mitigate the effect of currency swings on items such as interest and dividends. Typical agreements include forward contracts, which lock in foreign-exchange rates at some point in the future, and options, which give investors the right to make certain trades at later date.

Franklin Templeton used forwards to add protections to its $70 billion Templeton Global Bond Fund, the San Mateo, California-based firm said in an Aug. 28 statement. The fund, which is managed by Michael Hasenstab, lost $611 million in June after attracting more than $5.6 billion in the first five months of the year, according to data provider Morningstar Inc.

‘Prolonged Conflict’

JPMorgan’s volatility index headed for a third straight week of increases as the Obama administration weighed military action against the Syrian government for what officials said was a chemical-weapons attack. The gauge rose to as high as 10.5 percent this week, the highest level since July 16.

“With Fed tapering, geopolitical risk and potential issues in Syria and concern about whether this will be a prolonged conflict, we’re in for another bout of volatility,” Mirko Mikelic, a senior money manager at Fifth Third Asset Management in Grand Rapids, Michigan, said in an Aug. 28 phone interview.

Mikelic said he favors the U.S. dollar over its Australian and Canadian counterparts. The Aussie fell 1.1 percent this week to 89.29 U.S. cents at 9:28 a.m. in London, while the loonie weakened 0.3 percent to C$1.0531.

Price swings are squeezing potential profits for carry traders borrowing in nations with low interest rates and using proceeds to buy in higher-yielding countries. Deutsche Bank AG’s G-10 FX Carry Basket fell this week to 109.98, the lowest level since June 2012, from a five-year high of 125.44 in April.

Dollar Strength

The prospect of the Fed reducing its bond purchases and rising tensions in the Middle East are also boosting the haven appeal of U.S. assets, including the dollar.

America’s currency has gained 1.5 percent in the past three weeks, the biggest advance in more than a month, according to the Bloomberg U.S. Dollar Index, which tracks the greenback against 10 major peers. The gauge reached 1,034.23 today, the highest level since Aug. 2.

The dollar is the second best-performer this year among 10 major currencies tracked by Bloomberg Correlation-Weighted Indexes. The U.S. currency strengthened 5.7 percent against the basket of peers including the British pound and Japanese yen, compared with the 17-nation euro’s 6.1 percent increase.

“The dollar should be going into a period of some volatility and probably bigger volatility than we’ve seen in the last four to six weeks,” Jens Nordvig, the managing director of currency research at Nomura Holdings Inc., said by phone from New York yesterday. “The key events are Fed-related” and “whether we’re going to get the tapering or not in September.”

Fed Minutes

Minutes of the Federal Open Market Committee meeting published Aug. 21 show that most members were “broadly comfortable” with a plan to trim stimulus in 2013, while 65 percent of economists surveyed by Bloomberg Aug. 9-13 anticipated a pullback in September.

The prospect of an imminent attack on Syria faded yesterday as questions about U.S. intelligence arose and the U.K. House of Commons rejected Prime Minister David Cameron’s motion for military action in principle. Syrian President Bashar al-Assad’s government has denied using chemical weapons.

“There’s a lot of reasons to think we’ll have a volatile September and October,” Greg Anderson, the head of global foreign-exchange strategy at Bank of Montreal, said in a phone interview yesterday from Toronto. “Fed taper and a still-troubling geopolitical situation in the Middle East are all likely contributors to rising volatility.”

For Related News and Information:
Loonie Reprieve Seen in Canadians Spending Like 2010: Currencies
NSN MRA2WH6TTDSM <GO>
Bank Revenues Surge on Trading Over What Fed Will Do: Currencies
NSN MQRG330YHQ0Y <GO>
Dollar Seen Too Weak in Lowest Index Since June: Market Reversal
NSN MR850T6TTDS3 <GO>
Currency reversal calls: NI MARKETREV <GO>
FX options probability calculator: FXFM <GO>
Canadian dollar volatility: CANA 9 <GO>

--With assistance from Ari Altstedter in New York, Sara Prager and Radhika Bhisey in Princeton and Charles Stein in Boston.
Editors: Paul Armstrong, Robert Burgess

To contact the reporter on this story:
Cecile Gutscher in Toronto at +1-416-203-5717 or
cgutscher@bloomberg.net

To contact the editor responsible for this story:
Dave Liedtka at +1-212-617-8988 or
dliedtka@bloomberg.net