Risk-on or Risk-off, what is driving currency performance?

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This blog is the fourth instalment of our blog series on Defensive Assets: '**Offence wins games but defence wins championships**'.

Last week, we focused on fixed income and highlighted how higher duration, higher yielding government bonds could deliver strong negative correlation in downturns and strong long term expected returns. This instalment will examine currencies and illustrate how their behaviour in crisis is mostly driven by their risk-on and risk-off tendencies. We will continue to use our framework as a guide to assess the defensiveness of this asset class and in particular look at how they are positioned versus their fundamentals.

Risk-on and risk-off currencies

In Figure 1, we focus on the performance of the money market investments in G101 currencies from the point of view of a Euro (EUR) investor. This figure illustrates perfectly currencies reaction to periods of stress. In a nutshell, currencies are either risk-on, meaning that they tend to perform well when the market sentiment is positive, or risk-off, meaning that they tend to perform well when the market sentiment is negative.

- Risk-on currencies do poorly in periods of stress and in particular when equity depreciates. In the graph below Australian Dollars (AUD) and Canadian Dollars (CAD) exhibit this behaviour perfectly with negative performance across the board during equity drawdowns.
- On the other hand, risk-off currencies perform strongly during those same equity downturns. The US Dollar (USD), the Japanese Yen (JPY) and the Swiss Franc (CHF) show strong annualised performance across those periods. This behaviour is driven quite strongly by investor behaviour and the tendency for money to flow to safe haven economies and safe haven currencies in periods of trouble.

Outside of those periods of stress, the risk-on/risk-off behaviour is less prevalent, and the performance of the currencies is driven more strongly by local factors such as central bank interest rate, economic performance or inflation expectations.

This phenomenon can also be observed through correlations. In figure 2, we look at the correlation between risk-on currencies (AUD and CAD), between risk-off currencies (JPY and CHF) and across risk-on and risk-off currencies. The histogram clearly illustrates the behaviour described above in periods of equity drawdowns.

- The correlation between risk-off currencies increases significantly during equity drawdowns signifying that in crisis, the market regime drives the performance more directly than local or geographical drivers.
- The same behaviour is observed on risk-on currencies where correlation also increases in drawdowns.
- Maybe the most illustrative point, the correlation between risk-on and risk-off currencies turn negative in those drawdowns, highlighting quite clear how currencies divide into two groups under stress.

WisdomTree Currency Framework

Overall, there is no real asymmetry to be found in this asset class as currencies behave very strongly according to their risk feature in and out of risk periods. However, outside of periods where investors' fear is high, currencies are driven more by their fundamentals and it is therefore possible to assess how cheap or expensive they are and therefore their potential on the upside.

In our Outlook 2020, we introduced a framework to highlights the strengths and weaknesses of currencies in risk-on periods. Figure 3 shows the results of that framework (all details can be found the Outlook 2020). Looking at EURUSD pair, we observe a negative overall score which indicates a possible strengthening of the USD versus the EUR, driven mainly by the momentum and strong difference in local short-term rates. It is interesting to note that among risk off currencies, only US Dollars display strong fundamentals versus the euro. This may make the USD dollars a stronger all-weather approach with risk off potential if the economic conditions worsen and positive fundamentals if they do not. JPY and CHF, on the other hand, present weak fundamentals following relatively strong recent performance.

Figure 3: WisdomTree FX scoring system based on 6 indicators

Source: WisdomTree, Bloomberg. As of 31st December 2019. All definitions in this Table can be found in the WisdomTree Outlook 2020.

Historical performance is not an indication of future performance and any investments may go down in value.

Currencies are among the most liquid assets in the world. When it comes to implementation, investors are spoilt for choices from direct currency holdings to money market funds or short-term treasury exchange traded funds (ETFs). For more tactical implementation, delta one and leveraged exchange traded products (ETPs) are also available on most currency pairs. However, currency exposure can also be gained as an overlay to other asset classes. Next week we will focus on assessing those combinations, looking at the effect of the characteristics on fixed income or equity portfolio by bringing in a currency layer to our investments.

1.G10 Currencies are ten of the most heavily traded currencies in the world. United States dollar (USD), Euro (EUR), Pound sterling (GBP), Japanese yen (JPY), Australian dollar (AUD), New Zealand dollar (NZD), Canadian dollar (CAD), Swiss franc (CHF), Norwegian krone (NOK), Swedish krona (SEK).

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