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Hedge EM Risk with Short EURUSD

The Eurozone is buffeted by triple event risk:

- Hard Brexit is increasing in likelihood
- A U.S.-China trade deal remains uncertain
- U.S. tariffs on European autos are under serious consideration

The odds seem good that the Eurozone will be hit by at least one of these shocks. With a still-impaired banking system and an impotent central bank, any shock to the Eurozone economy is at risk of quickly morphing into debt-deflation.

The ECB is really scuffling. The consideration of "tiered deposits" reveals that they question whether negative rates are doing more harm than good (they aren't!). The proposal – reducing the penalty to banks for sitting on reserves – would be counterproductive.

Some headlines from the ECB's Klaus Knot this morning sum up the ECB zeitgeist:

> ECB'S KNOT: REASONS WHY INFLATION NOT RISING AS EXPECTED MOSTLY BEYOND ECB'S CONTROL
>
> ECB'S KNOT: CRISIS HAS SHOWN WE UNDERSTAND EVEN LESS ABOUT HOW INFLATION WORKS THAN WE THOUGHT

If the Dutch no longer understand money, Europe is well and truly screwed.

EURUSD is an attractive short and an excellent hedge to Dollar-funded EM local-currency risk. The trade picks up 300bps of carry to boot.

Any currency short has two ways it can go wrong: the currency can strengthen or the counterpart currency can weaken (by more).

We can discount the risk of isolated strength in the Euro, which would probably require a dramatic easing of fiscal policy. Perhaps the event risks pass quietly and the EZ economy exceeds depressed expectations - you might get some moderate Euro strength, but that's probably a decent environment for EM risk.

The big risk to a short EURUSD position is something dramatic on the Dollar side. But unless it results from some unforeseen, broadly risk-bearish shock to the U.S. economy, any significant weakening of the Dollar should be rocket-fuel for EM local-currency risk.

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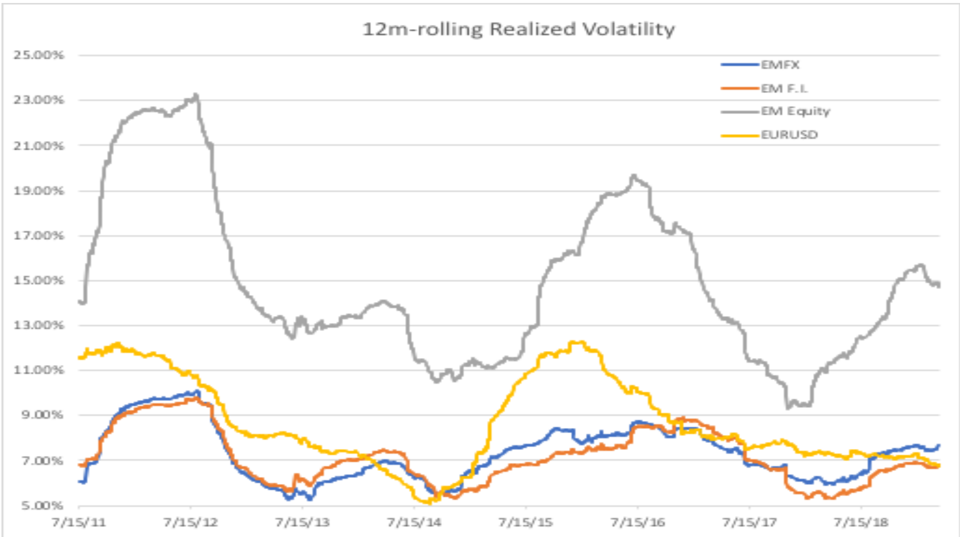
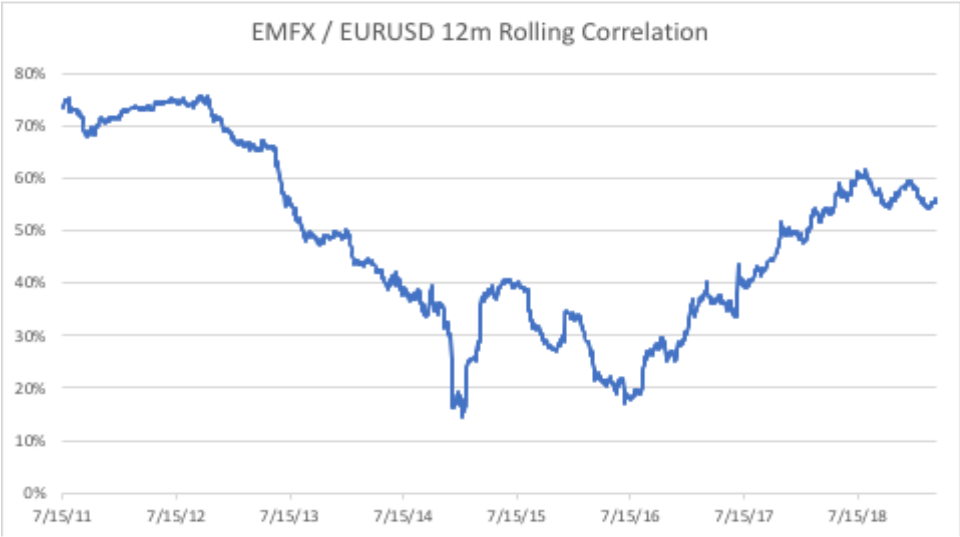
The short-EURUSD hedge is more compelling in a portfolio of EM local FX or Fixed Income than EM equities. The following analysis is based on:

- EMFX: JP Morgan EM Currency Index Live Spot (FXJPEMCS Index)
- EM F.I.: Markit iBoxx Global EM Local Currency Bond Index (GEMXEMB1 Index)
- EM Equity: MSCI EM Net Total Return USD Index (M1EF Index)

Here are the volatility profiles. EM local FX volatility has been fairly restrained in recent years:



A EURUSD overlay to an EMFX portfolio adds a higher-vol asset, but your adding a short in an asset which has been reliably-correlated:



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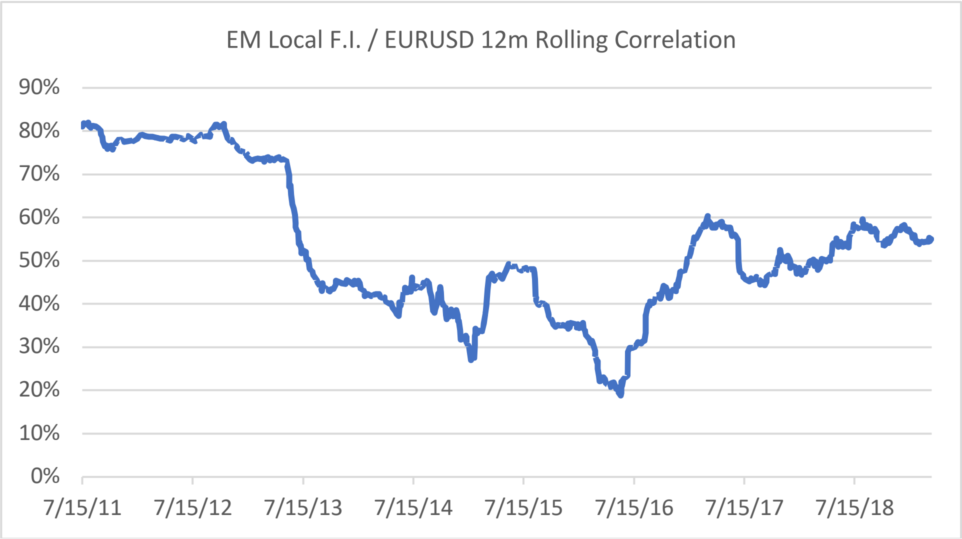
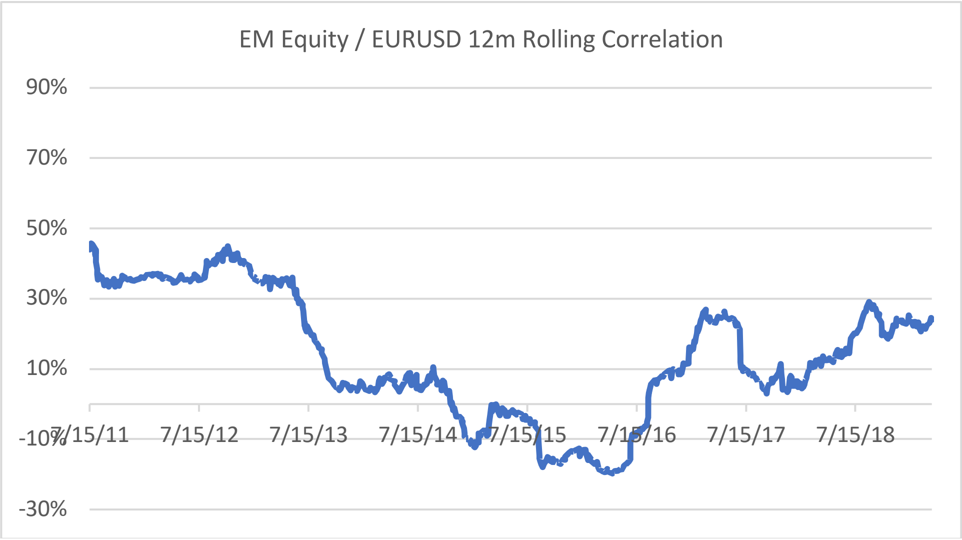
Same goes for EM local Fixed Income:



The correlation to EM equities is less compelling:



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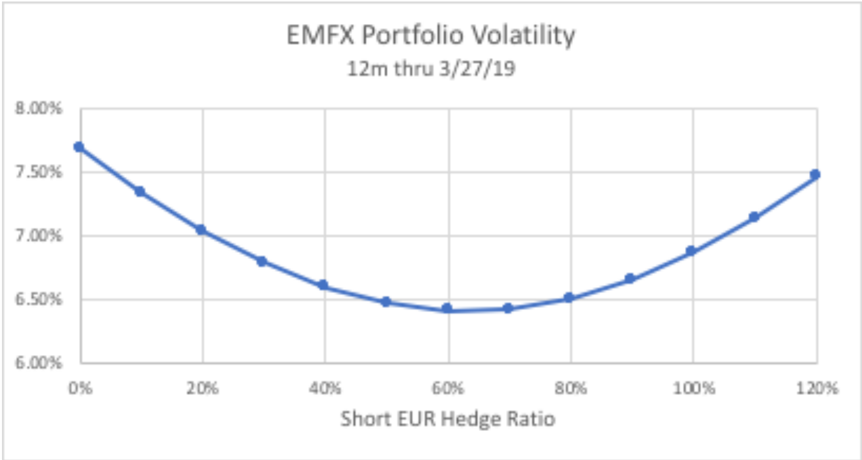
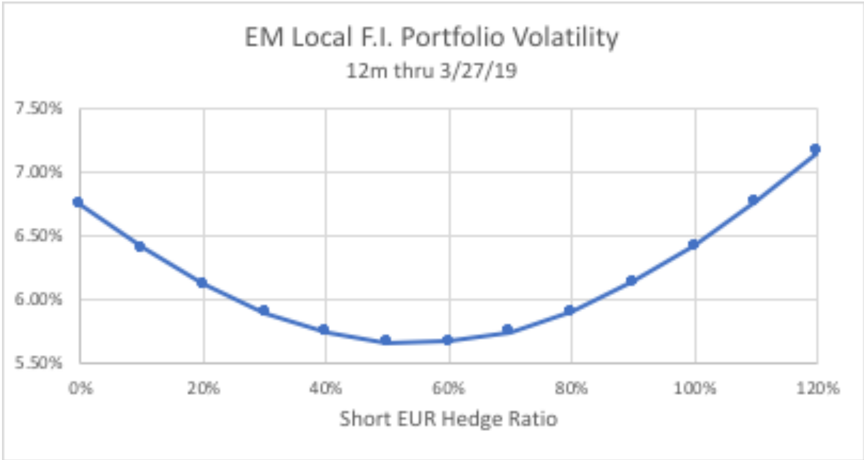
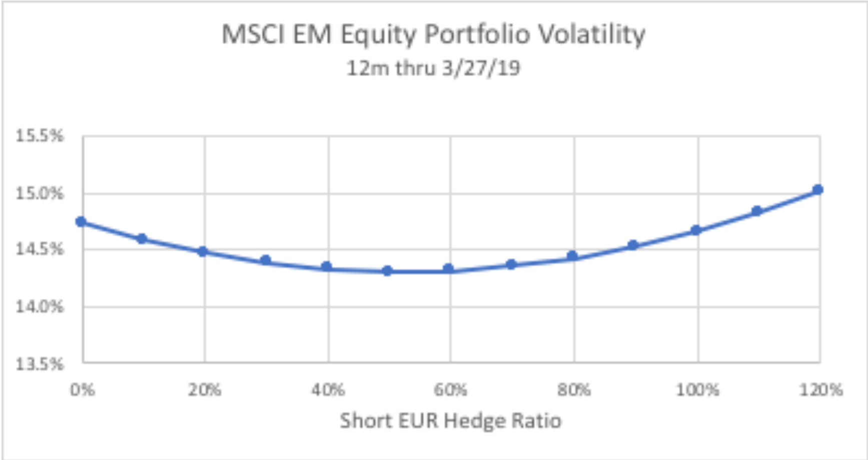
Here's how adding a short-EURUSD hedge (in 10% increments) to each portfolio would have affected realized volatility over the past 12 months:







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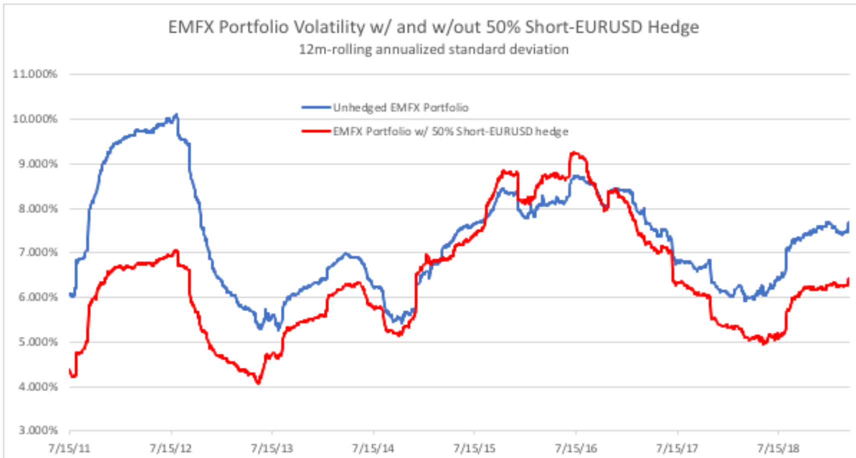
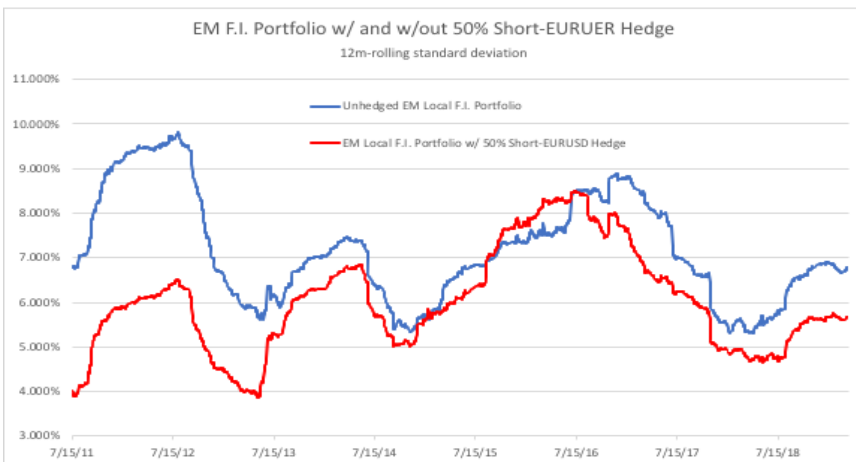
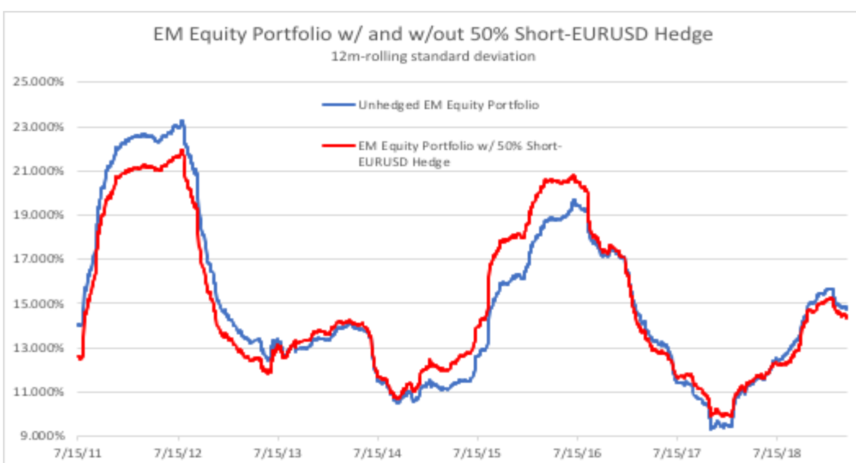
Here’s how adding a 50% short-EURUSD hedge to each asset class would have affected realized volatility over time:







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While past performance is not indicative of future results, we can be fairly confident that adding a EURUSD short to an EMFX or EM Local Fixed Income portfolio will reduce portfolio volatility - and we can be certain it adds carry (~300bps annualized or a 100% hedge).

The risk to the trade would be a negative bolt-from-the-blue to the U.S. economy that hammers both the Dollar and risk-assets. In this case a short-EURUSD position could add pain to local EM exposures. Given the lack of apparent catalysts for such an event, I'd characterize this as a black swan.

A reliable hedge can be used to either reduce prospective risk or increase prospective returns. An EM investor who's bullish on Fed reflation and comfortable with their current level of portfolio risk can add the vol-reducing short-EURUSD hedge and then lever the whole book back to current risk levels, thereby increasing expected returns.

Given extant uncertainties and a bearish-tactical view on EURUSD, my preference would be simply to add some short-EURUSD exposure to an EMFX or EMFI book to reduce overall risk while enjoying the increase in carry.

While the trade is not as compelling in terms of volatility reduction for an EM equity investor, it's still an advisable overlay given Europe's potential to serve as an epicenter of any global risk-off event.

Note: All charts are sourced to Bloomberg, with calculations by Macrolens.