U.S. DOLLAR VOLATILITY:

IS RECENT WEAKNESS TEMPORARY OR A NEW TREND?

The U.S. dollar has recently been experiencing increased volatility. Economists often can't determine if there is a shift in currency trends until after it has occurred. How does one manage the impact of the changing value of the dollar and other currencies?

From 2014 through 2016, the U.S. dollar strengthened substantially against most currencies due to the divergence in monetary policies between the U.S. Federal Reserve and other Central Banks.

Historical Context

During the global financial crisis that began in 2008, the Fed implemented a Quantitative Easing (QE) or asset-purchasing program in the hopes of spurring economic growth. This type of program, which was seen as unconventional at the time, was also used by other Central Banks including the Bank of Japan (BoJ) and European Central Bank (ECB).

The Fed started tapering back its asset purchases in January 2014 and officially ended the program in October 2014. Since then, U.S. Central Bank officials have been assessing the economic recovery in the United States and raising interest rates accordingly.

The first interest rate hike, originally expected during the first half of 2015, finally occurred later that year in December. After another volatile year in 2016 with the approaching U.S. election, the second rate hike was delayed until December 2016. In 2017, the Fed has so far delivered two more rate increases.

Directional Trends

Since the Fed started tapering back its asset purchases in 2014, the U.S. dollar's change in value was relatively one-directional, significantly strengthening for about a year, as Central Banks such as the ECB and BoJ were still continuing — or even increasing — their asset purchases. The Bloomberg U.S. dollar index (a gauge of the U.S. dollar against 10 major currencies) reached a high on December 28, 2016, a nearly 30% rise during the three-year time period.

Unexpected Weakening

When the U.S. Fed began their tightening cycle, many Central Banks were still increasing monetary stimulus. Some even introduced negative interest rates. Now that the Fed is finally on an increasing interest rate path, one would think the dollar would be stronger than ever. The U.S. dollar has instead weakened during 2017, which can be attributed somewhat to uncertainties in the new administration. In addition, now that other Central Banks are beginning to follow the U.S. Fed and tighten their policies, there is a new state of volatility and uncertainty.

Looking at the U.S. dollar in hindsight, the one-directional trend beginning in 2014 may appear to have been easy to predict. Watching the moves day-to-day, though, the question remains: "Is this a new trend or a temporary market reaction?" Forecasters predicted dollar strength after the QE tapering began, but the constant debate was, "How far could it go?" Most economists didn't foresee such a drastic move.

Managing Changes in Value When New Trends Are Hard to Detect

With such uncertainty in the currency markets, it may not be wise to speculate. A disciplined hedging program can help mitigate the risk of a drastic change in currency value. A dollar-cost averaging approach involves layering a series of hedges over time to form a blended exchange rate.

By hedging most short-term exposures and a smaller percentage of future exposures, one can reduce short-term volatility while allowing some participation in a favorable currency movement in the future.

Evaluating Layered Hedging

The Euro and Canadian dollar are two examples where forecasters had a hard time determining when the trend would end. A look-back analysis shows that a company that utilized a "layered hedging" or dollar-cost averaging approach would have reduced volatility during the times the Euro and Canadian dollar were significantly weakening. Time periods to note are the end of 2014 and 2015 for the Euro and 2015 to the beginning of 2016 for the Canadian dollar.

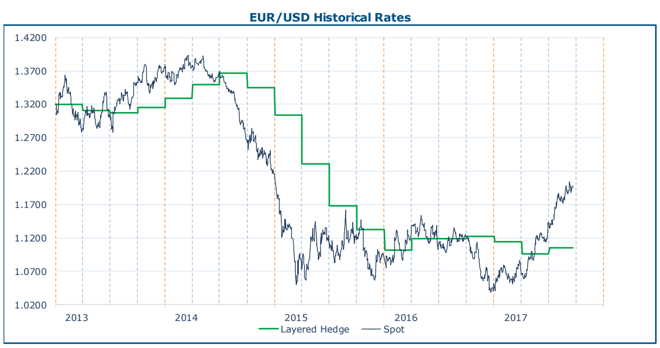
Preparing for Unexpected Market Shocks

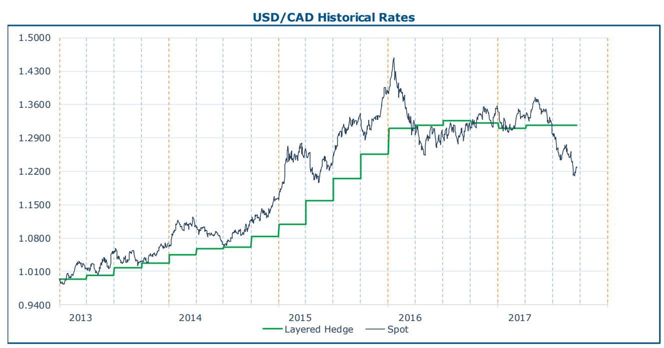
Who could have predicted the Euro-Swiss franc peg removal, the Chinese yuan devaluation and Brexit? After these market shocks, companies that were negatively affected looked for ways to regain some of their losses. There are strategies that can be considered after such an event, but a better approach is to prepare for the volatility before it occurs. Again, a disciplined hedging policy helps to ease the negative impact of a large market movement.

Developing a Risk Management Plan

What is the best way to develop a risk management plan for your business? What resources are available for assistance with the financial and market variables that will impact a risk management plan? What is the best way to identify the appropriate hedging instruments to use? What are the outcomes of an effectively implemented risk management plan?

PNC, through its Capital Markets group and its Foreign Exchange advisory team, is committed to providing insight into these and other questions and to helping you make smart, well-informed decisions. We can assist you as you grow your business globally and help you develop a customized currency risk management plan to meet the goals of your organization.





Source : Bloomberg

In these graphs, the green lines show the effective blended rates that would have been achieved with a layered hedging approach compared to the blue lines, which show the spot rate.

READY TO HELP

PNC provides the resources and support to help companies develop a customized hedge policy in order to manage international exposures. For more information, please contact your Foreign Exchange Advisor at 800-723-9106.

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