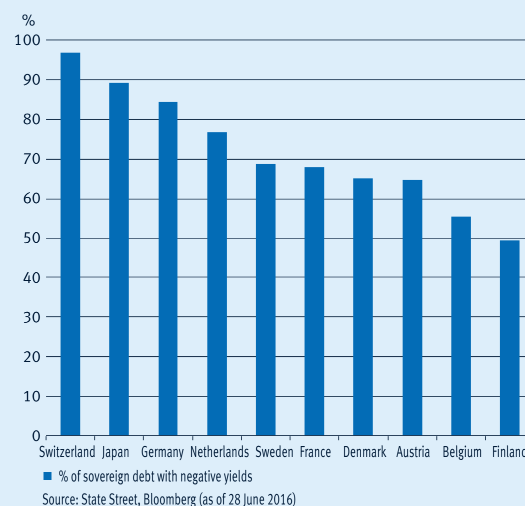
Currency

Negative rates: do they drive currencies lower?

Negative rates were expected to be a central part of the easy-money policy armoury, but currency implications have surprised the market.

Ken Dickson
Investment Director, Currency

Chart 1
Going underground



Source: State Street, Bloomberg (as of 28 June 2016)

Negative rates as a driver of currencies

The relationship between negative rates and currencies is not well understood, as this phenomenon has a rather limited history. Ahead of recent central bank policy decisions, investors expected that negative rates would be a means of directly attacking currencies – an extension to the easy-money policy armoury that included quantitative easing (QE), forward guidance and zero interest rate policy (ZIRP). One important issue to highlight is that the mandate of some central banks means they are unable to hold assets earning negative rates. This might indeed be a significant factor in the euro's relative weakness in 2014, for example. However, our analysis suggests that currencies react more to QE and to interest rate differentials rather than to whether one country's interest rate is positive or negative.

Extraordinarily low global interest rates

Nominal and real bond yields across the world are still falling, with Australian, German and Swiss yields recently breaking new lows. At face value this is surprising, given historically high public sector debt-to-GDP ratios. However, other factors such as low inflation, QE, regulatory-driven buying and global savings and investment imbalances have proven more important. As negative government bond yields have become more common (see Chart 1), interest rate curves have flattened and interest rate differentials between currencies have moved lower. This has meant that foreign exchange carry portfolios have continued to underperform. Moreover, when so many countries operate a negative interest rate policy, investors understandably suspect an element of desperation in economic policy. This has often led to an increase in risk aversion in trading, irrespective of the available carry.

Different monetary policy tools

In many cases a conventional monetary approach of rate cuts was followed by ZIRP and then QE before a move to negative rates was tried. However, this path has not been followed by everyone. The Bank of Japan (BoJ) adopted a QE policy as far back as 2001, although more relevant is the re-start date for more aggressive QE in December 2012. The ECB had negative rates before QE, the Riksbank announced QE and negative rates at the same time, and the Swiss National Bank has never had QE. While the journey through the monetary policy maze differs across countries, there is a clear tendency for fixed income markets to pre-empt policy as negative bond yields became the norm ahead of any official announcement.

Mixed currency reactions to negative rates

Different announcements have different effects. The euro fell substantially on a trade-weighted index when interest rates turned negative. Yet since QE was announced the euro has become more stable. In contrast, Swedish policymakers tried QE first and then had a number of iterations of negative rates and QE packages. The Swedish krona fell in anticipation of these moves, but then the policy announcements merely created additional volatility with no directional impact.

Safe-haven currencies are more interesting. The Swiss franc (CHF) had a currency floor in place alongside negative short-dated yields for a few years before the EUR-CHF floor was breached in January last year – just after official rates also went negative. The Swiss franc remains 10% stronger versus the euro than in January 2015. Elsewhere, the yen weakened against the US dollar after BoJ QE programmes were announced in December 2012, April 2013 and October 2014 – culminating in a currency depreciation totalling almost 50%. However, since the announcement of negative rates in February this year, the yen has actually moved about 12% higher. So it appears that negative rates are currently having the opposite effect to policymaker and market expectations; as global carry returns are reduced and investors become more risk averse, this pulls safe-haven currencies higher, not lower.

Our currency views

At the end of last year we suggested that range trading would become increasingly prevalent as carry returns fell and currency volatility increased. In developed markets, negative rates have hurt investor confidence and, in combination with a more cautious outlook from the Fed, have undermined the case for monetary policy divergence within a gradual global recovery. This has hurt the performance of the US dollar in the major markets, but the risk-averse regime has also led to the underperformance of some emerging market currencies. Our longer-term preference for the US dollar reflects safe-haven flows post the UK's vote on the EU, as well as higher US interest rates, so weaker Asian and commodity currencies are the best way to play these themes. Our favoured approach is to be short the Korean and Taiwanese currencies.