



Why Currency Risk Shouldn't be Overlooked

Description

At the present time, there are a number of risks facing investors across the globe. For example, there remains a relatively high degree of political risk in the US, while President Trump's spending plans have not yet been able to have their expected impact. Similarly, in Europe the challenges associated with Brexit could weigh on investor confidence.

These are just a few of the risks facing investors which could hurt share prices in the medium term. However, one risk which is a constant for investors is currency risk. It could be about to increase, which makes it even more important for investors to focus on it.

Changing outlook

Currency risk may be about to increase because of the changing outlooks for different regions in the world. This could cause above-average volatility for foreign exchange markets, and may lead to positive or negative translation adjustments for companies operating in multiple regions of the world.

For example, in the US the economy is undergoing a gradual rise in interest rates. This is largely because confidence has now returned, economic growth is relatively robust and employment levels are generally high. Although inflation may not be high as yet, Trump's spending plans suggest the price level could increase over the medium term. Therefore, the Federal Reserve has already started to raise interest rates in anticipation of potentially higher inflation, as well as to reflect the improving outlook for the economy.

In contrast, the Eurozone is continuing to adopt an ultra-loose monetary policy. It is engaged in quantitative easing, as well as having an ultra-low interest rate. This is due to the disappointing economic growth rate which the region has experienced in recent years, with the ECB seeking to stimulate GDP growth in the area. Japan has also engaged in sustained QE programmes, which may continue over the medium term. Meanwhile, the UK may be on the cusp of increasing interest rates, with its policymakers narrowly deciding to maintain rates at historic lows.

Changing currencies

The fact that different parts of the globe now have differing attitudes towards monetary policy means that there could be significant changes in the valuations of major currencies. For example, the dollar may strengthen versus a basket of other currencies, since interest rate rises have historically led to an appreciation of a domestic currency. For investors owning stocks which report in dollars but operate mostly outside the US, this may lead to a negative currency translation.

Similarly, investors in stocks with exposure to the US but which report in other currencies may see a boost to their investment performance. That's because those companies reporting in euros, yen or even pounds may become more competitive versus rivals, which could allow higher profit margins or greater sales.

Takeaway

While currency risk has been an ever-present threat for investors, different monetary policies across the globe could bring it back into focus in the near term. Investors may therefore wish to own a mix of companies which report in different currencies, and that operate in a range of economies across the globe. That way, an investor may be able to reduce the threat from currency risk in future.

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