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ADORA FX - 2022/23 in Review - When the Greenback earns alpha.

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The last two years were characterised by a magnitude of geopolitical tensions, socioeconomic problems and monetary policy changes that massively impacted global equity, fixed income, and foreign exchange markets alike. While the US reacted fast to the ongoing cost of living crisis by aggressively raising interest rates already in 2022, the European Central Bank had to solve a more complex problem by factoring in a total of 20 economies before acting in an appropriate manner.

In light of potentially better crisis management and growth prospects in comparison to their domestic market, investors naturally turn their head to overseas markets. However, with the benefits of globally uncorrelated investments comes the risk of currency conversion. In detail, the investors return expressed in his home currency is not only dependent on the volatility of his investments, but also on the volatility of the respective currency exchange rate. The resulting effects are non-neglectable. For example, the return of the US 10 Year Treasury Bond Index in 2023, stands at 3.9 % in USD terms, but is subsequently reduced to a merely 0.74% in EUR terms. A reduction of more than 3% simply due to the currency conversion. In 2022 even more significant difference arose: the index lost 7% in USD terms and 7% more in EUR terms.

With a reduction of more than 3% in performance, the prima facie appears to be a static hedge in which all currency exposure is eliminated. However, such a hedge is not only costly for the EUR based investor but can lead to liquidity issues in the portfolio.[1] The investor is then best advised to resort to an overlay solution that dynamically reacts to market movements and allows to participate at foreign currency appreciations, avoiding negative cash flows. Figure 1 serves as our blueprint for hedging the USD long position over the last two years. In fact, we contrast the performance of a EUR investor, when no hedge is performed, when a simple static hedge is followed, and when using our proprietary Advanced Data Operating Risk Agent model, applied to the FX market – short ADORA-FX. The focus of our review is on the last two years, as the magnitude of geopolitical events have changed sound economic forces and the regimes in which the currencies move substantially.

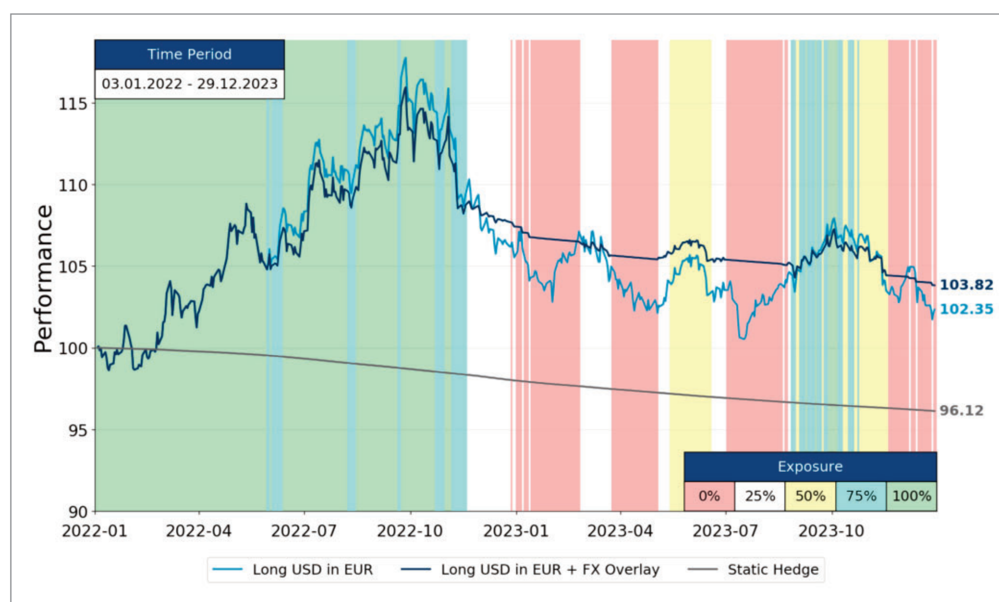
At the beginning of 2022, Russia's invasion in Ukraine sent waves of shocks around the world, resulting in economic disruption and a worldwide energy crisis. The resulting soar in prices forced central banks to raise interest rates in an unprecedented dimension. While the Federal Reserve carried out the most drastic rate hikes since the 80s, the ECB faced a more complex dilemma. Trapped between raising the deposit interest rate and unleashing a European recession their answer was more cautious and delayed.

1) The interested reader is referred to the article "The new Gold Standard? Machine Learning based Currency Overlay" for further information on FX hedging possibilities and the remedies for avoiding a costly static hedge.

The result was a massive USD appreciation not only against the EUR but also other major currencies. Investors that left their USD exposure unhedged could record an almost 18% FX alpha at the end of the third quarter when the USD/EUR peaked.

As it is evident from Figure 1, our ADORA-FX model enabled the investor almost fully participate at this strong appreciation. While the reaction of the ECB was delayed, it strengthened the EUR against the USD, when interest rates were finally raised in Europe. The trend reversed and the investor was best advised to hedge their currency exposure to not fully lose their FX alpha. The ADORA-FX model was again able to identify this difficult trend change and subsequently reduced the USD exposure down to merely 25%, allowing the investor to lock in a 7.5% return at the end of 2022. Furthermore, in comparison to the static hedge, an investor was able to add nearly 9% alpha return by utilizing the ADORA – FX overlay strategy.

FIGURE 1
Simulated performance of Advanced Data Operation Risk Agent (ADORA-FX)



Source: La Française Systematic Asset Management GmbH, Bloomberg, Own calculations; Simulated back calculation: 01/2022-12/2023. For illustration purposes only. Past and simulated performance is not a reliable indicator of future performance.

	Return	Return p.a.	Volatility p.a.
Long USD in EUR	2.3%	1.2%	8.9%
Long USD in EUR + FX Overlay	3.8%	1.9%	6.9%
Static Hedge	-3.9%	-1.9%	0.0%

Moving on to 2023, interest rate hikes were mostly priced into the market and the outlook for USD turned more neutral. Nevertheless, the unsolved energy crisis, recession, geopolitical and inflation risks, left room for USD appreciations, as the currency is widely regarded as a safe heaven. In fact, as it is evident from Figure 1, the year 2023 was also characterised by times of USD appreciations, which can be an important source of alpha return. However, without a clear direction it seems best to either hedge the foreign exchange exposure and accept an about 2% cash drag due to the interest rate differential, or to stay unhedged and accept an increased portfolio volatility due to the

currency risk. Nevertheless, behavioural theory tells us that such passive stance in decisions taking – the regret aversion – leads to a long-term underperformance. For the EUR/USD it meant missing out on the USD appreciation in 2022 with the passive hedge or equivalently having to suffer through the depreciation at the end of 2022 with the unhedged position.

In 2023 and being faced with a sideways market, a situation in which risk management solutions are prone to produce false signals by entering/exiting the at unfavourable times, our ADORA-FX model performed well. Here, the interplay between the momentum and the machine learning component highlights the strength of our overlay system. The behavioural component was influenced by the already mentioned sharp downtrend that the USD exhibited since October 2022. Exposure to the USD was subsequently hedged from November 2022 until the end of August 2023. On the other hand, the machine learning model aimed to capitalize on periods of USD appreciation, evident from the magnitude of macroeconomic, fundamental, sentiment and price data that the model analyses at each point in time. In fact, in the second quarter the Eurozone entered a technical recession. Global growth continued to slow with sticky inflation still putting pressure on world economies. The distinction between core and headline inflation became evident, with headline inflation falling due to a reduction in energy prices, but core inflation staying strong, as it is mostly impacted by wages and shelter costs. Again, the FED showed a more restrictive stance than the ECB, resulting in a stronger USD. The ML component was able to exploit these developments increasing the USD exposure to 50% in Q2 2023. This behaviour also materialized in the later stages of 2023, when both the ML and the momentum component picked up on the positive USD trend, subsequently increasing the USD exposure to 100% until the beginning of October 2023, before reducing it again to shield the investor from the year end depreciation of the greenback.

Overall, over the recent two-year period, the ADORA-FX model was able to produce a +7.7% higher return as compared to the static hedge (+3.8% vs. -3.9% resp.) and even outperform the unhedged foreign exchange exposure. With the still ongoing crisis around the globe, we remain confident that our ADORA-FX overlay model is able to capitalize on strong USD appreciations, reduce the hedging costs and at the same time navigate difficult foreign exchange sideways markets.

Main risks:
currency risk, capital loss risk. The investor is notified that his capital is not guaranteed and therefore might not be returned.
Model risk:
The model may not always behave as expected. Therefore, the model cannot guarantee to reduce losses in value.
Risk associated with derivatives:
The model uses derivatives. These are financial instruments whose value depends on the underlying asset. Minor fluctuations in the price of the underlying asset can lead to significant changes in the price of the derivative.

Do you have any further questions? – We are pleased to help you.

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