USAA Real Estate

The rising cost of currency hedging

When investing in U.S. real estate, foreign investors must decide if they should hedge currency risk. In fact, a 2016 survey by INREV (European Association for Investors in Non-Listed Real Estate Vehicles) found approximately 71 percent of survey participants hedge their currency risk from cross-border investments.[1] More recently, however, an increasingly volatile currency environment, combined with historically low interest rates in many countries around the globe (relative to the United States), has caused hedging costs to rise to abnormally high levels. Consequently, both foreign and domestic investors are questioning the impact hedging costs could have on the U.S. real estate markets.

This research paper will address the following questions:

1. Why are hedging costs so high today?
2. What does history tell us about the current hedging conditions?
3. What is the near-term outlook for hedging costs?
4. Should foreign investors hedge at all?
5. How has the U.S.-dollar trajectory impacted hedging decisions?
6. What are the U.S. commercial real estate implications, given these rising costs?

1 – Currency hedging costs are on the rise

For foreign real estate investors looking to hedge U.S.-dollar assets, the cost of currency hedging has increased tremendously. Hedging costs are now upward of 200 basis points to 300 basis points for some cross-border investors. Such a substantial increase raises the question: Why have costs risen so high? Three main elements drive hedging costs, as described in the following:

Short-term rate differential: The cost of hedging currency exposure is related to the interest-rate differential between the United States and the other currency's country or region, known as the cost of carry. As highlighted in the following chart, the spread between U.S. one-month government bond rates versus other countries' rates has widened in recent years, causing hedging costs to increase.

Transaction costs: These costs vary based on the type of hedge and frequency of implementing the hedge. For example, rolling over hedging contracts more often provides a better hedge (i.e., less basis risk), but this approach also incurs higher trading costs.

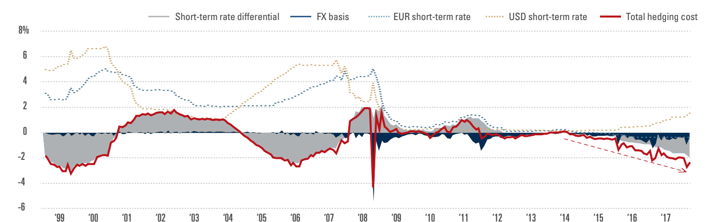
Cross-currency basis: In general, the cross-currency basis is a measure of dollar shortage in the market. For example, to hedge risk, a European investor enters into a one-year EUR/USD currency swap with a market counterparty, agreeing to swap a certain number of euros for U.S. dollars at today's spot rate in one year's time. In theory, the European investors will need to pay back U.S. Libor as interest in exchange for Euribor from its counterpart. However, in practice, whenever there is a higher demand for the dollar, the counterparty lending the dollar will ask for an additional price premium, which is referred to as the cross-currency basis.[2, 3]

Using USD/EUR as an example, the differential between the dollar and the euro reflects the diverging Federal Reserve and European Central Bank (ECB) monetary policies. Also, the cross-currency basis has remained negative due to strong net demand for dollars globally. In effect, accelerating short-term interest rates in America and a healthy market for the dollar have increased hedging costs of U.S. assets for foreign investors.

2 – Hedging from a historical perspective

Hedging costs are expensive today, but similar conditions have also occurred in recent history. As noted in the chart below, hedging costs soared in 1999–2000 and 2005–2006, as the Federal Reserve raised short-term rates faster than most other central banks. It is worth noting that interest rates, as well as commercial real estate cap rates, were significantly higher during the two previously noted periods than they are today. **Consequently, a 200-basis-point to 300-basis-point hedging cost would have been more manageable when core real estate cap rates were around 7.5 percent to 9.5 percent and 5.0 percent to 7.0 percent, as was the case in 1999–2000 and 2005–2006, respectively.** As of first quarter 2018, however, cap rates were near historic lows, around 4.8 percent, suggesting there is little room to absorb high hedging expenses. Therefore, U.S. real estate may not be as attractive to some foreign buyers, given the drag on returns.

Decomposing Currency Hedging Costs (USD to EUR)[4]



Source: Bloomberg, as of Dec. 31, 2017. USD and EUR short-term rates are represented by 1-month USD Libor and 1-month Euribor, respectively

3 – Hedging costs outlook

If the historic USD/EUR currency relationship is any indication, these cycles tend to be short-lived; however, the situation may be different this time. In fact, conditions may worsen before they improve, given the divergence in monetary policy of the United States compared with almost the entire developed world. Hedging costs are indeed a direct function of the difference between U.S. interest rates and the interest rates of foreign central banks, such as the ECB. The total hedging expense, however, is also impacted by interest-rate expectations. For example, the Federal Reserve forecast currently suggests up to four rate hikes in 2018 and potentially another three increases in 2019. If market participants expect U.S. interest rates to accelerate at a faster pace, while the ECB's monetary policy outlook remains flat, then hedging costs will rise accordingly between the U.S. dollar and the euro. Ultimately, hedging costs are a reflection of market expectations and diverging interest-rate policy between two currency regimes.

4 – To hedge or not to hedge

Should foreign investors reconsider hedging U.S. real estate? The answer depends primarily on the investor's risk tolerance. The previously mentioned INREV study suggests 29 percent of participants do not hedge currency risk from cross-border real estate. While it is difficult to know all the factors impacting this decision, the following highlights several points worth considering:

Portfolio strategy: Investors should evaluate their exposure to U.S. real estate relative to their broader multi-asset portfolio. Opportunities further along the risk/return spectrum could be more attractive if they can absorb the drag caused by hedging costs and still deliver a solid return.

Investment horizon: A longer investment horizon provides flexibility. For example, a foreign investor may opt not to hedge if they do not immediately require the cash flow from real estate and can wait years, if necessary, until currency conditions are favorable to repatriate the capital to their home country. Conversely, hedging is likely essential if the cash flow is required to meet near-term liabilities.

U.S.-dollar outlook: An investor's outlook regarding the dollar can impact their decision to hedge currency risk. For instance, an investor may opt not to hedge if they believe the dollar will continue to strengthen, relative to their home currency, during the period in which they hold their U.S. assets. In effect, not hedging is equivalent to taking a bullish position on the dollar.

Home-currency volatility: A decision to hedge U.S. real estate can depend on the stability of an investor's home currency, as well. Currencies within developed countries tend to be more stable, while those of emerging markets tend to be more volatile. Consequently, market participants with a more volatile home currency are more likely to hedge investment risk.

Mark-to-market implications: Mark-to-market is an accounting practice which requires investors to periodically record the value of an asset, reflecting its current market levels. While some countries may not adhere to this accounting practice, investors affected by this requirement may experience mark-to-market losses if they do not hedge currency risk, which could undoubtedly impact overall investment performance.

Ultimately, the decision to hedge currency risk associated with U.S. real estate is unique to each investor. Opting not to hedge, however, potentially exposes the investor to volatility in the currency market. The question as to whether an investor should hedge currency risk does not have to be a binary decision either, as partial hedging may be suitable in some cases. In the end, an investor's appetite for risk will ultimately govern the decision whether to hedge currency risk from U.S. real estate.

5 – Making sense of the U.S. dollar

While the dollar has recovered through much of 2018, market participants remain split on its long-term trajectory. The following highlights several critical factors that could influence the dollar outlook going forward:

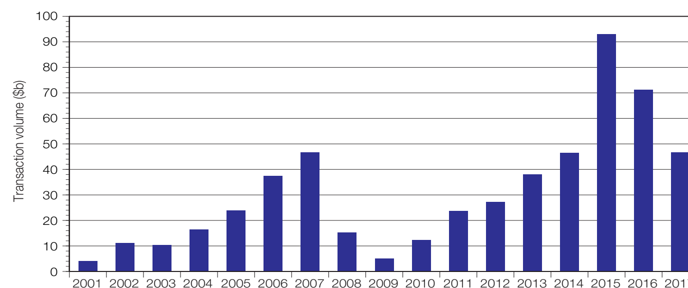
1. The global economy is improving, which has the effect of normalizing an overpriced dollar.
2. The Trump administration appears to prefer a weaker dollar policy as a catalyst for stronger domestic exports.
3. The historically low interest-rate environment and the unwinding of quantitative easing have distorted traditional currency-market assumptions.

Given today's increased market uncertainty, hedging currency risk could be the prudent approach when considering U.S. real estate markets, unless foreign investors have a conviction regarding the direction of the dollar.

6 – Implications for U.S. real estate markets

Cross-border capital flows have played a critical role in the U.S. commercial real estate market during the current cycle. According to RCA, direct foreign capital acquisitions of U.S. real estate peaked in 2015 at just over $90 billion, nearly double the previous all-time high in 2007. Direct international purchases have since gradually receded from those recent highs, yet still accounted for more than 10 percent of all transactions in 2017. **In the near term, however, U.S. investments may not be as attractive for foreign capital due to the drag on returns created by currency hedging costs.** Value-add and opportunistic investment may be more appealing to foreign investors, given the potential for higher yields that can absorb the hedging drag and still deliver solid returns. Furthermore, core prices could soften, given that foreign capital sources have historically gravitated toward these assets.

Health of U.S. Real Estate Markets



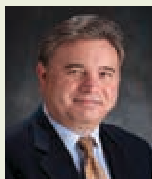
Source: Real Capital Analytics

Conclusion

In the end, commercial real estate is just one of several dollar-denominated assets that foreign investors will need to decide if or how to hedge, as the same issue is applicable across all major asset classes today. Foreign investors face similar conditions regarding U.S. Treasury bonds, corporate bonds, high-yield junk bonds, and the stock market. There are variations in the fundamentals that drive returns in each asset class, but the effect on returns caused by fluctuations in the dollar is generally the same.

Investors should ask themselves: Is U.S. commercial real estate still an attractive opportunity for foreign capital on a relative basis, given the current hedging costs? Some may choose to hedge (in whole or part), others may opt not to hedge at all, while some may find it impractical to invest in U.S. real estate right now. **It is difficult to quantify the impact these conditions will have on the commercial real estate market, but we believe it could cause a decline in cross-border capital flows, softening in core prices, and a reduction in transaction volume.** Ultimately, the cost of mitigating currency risk may prove too expensive for some foreign investors who are considering investing in U.S. commercial real estate today.

[1] *Snapshot Research: The Impact of Currency on the Performance of European Non-listed Real Estate Funds,* February 2017, INREV, www.inrev.org. [2] Ram, Kondo, *Why Cross-Currency Basis Swaps Are Year-End Focus: Quick Take Q&A,* 15 December 2017, Bloomberg, www.bloomberg.com. [3] Chang, *Cross Currency Basis – What is It? And What are the Implications?* 29 December 2017, Bond Vigilantes, www.bondvigilantes.com. [4] *The FX Dilemma: An Introduction to Hedging Currency Risk in Portfolios,* January 2018, PIMCO, www.pimco.co.uk.



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