Ideas @ Edelweiss Multi Strategy Funds – Currency Value Investing

Value investing in equities has a long tradition starting from the days of Graham and Dodd. But what about value investing in currencies – an asset class often viewed as being purely speculative? The theory of Purchasing Power Parity (PPP) is the foundation of foreign exchange value investing. According to PPP, in the long run, a unit of currency should buy the same quantity of goods in all countries. This means that the real exchange rate between two countries must be constant in the long run.

However, as Balassa & Samuelson correctly identified, only prices of internationally tradable goods like electronics will adjust over a period of time due to global competition. The price of non-traded goods like real estate will be subject to the local forces of demand and supply. As a result countries with a larger productivity ratio between traded and non-traded sectors will experience real currency appreciation.

$$FX_{real} = FX_{spot}\left(\frac{PriceLevel_{foreign}}{PriceLevel_{domestic}}\right)$$
$$= \left(\frac{Prod_{domestic}^{TradedSector}}{Prod_{domestic}^{Non-TradedSector}}\right) \times \left(\frac{Prod_{foreign}^{Non-TradedSector}}{Prod_{foreign}^{TradedSector}}\right)$$

Adjusting for frictions like duties and taxes, value oriented investors should look to park their money in countries that have low inflation and higher productivity in internationally traded goods and commodities.