Managing sterling in a period of euro instability

Steve Englander, Gregory Edwards and Chris Leuschke of Citibank/SSMB look at the different FX strategies available to companies looking to hedge their bets.

A key theme in exchange markets in recent years is that most currencies have been correlated with the euro in its ups (and mainly) downs against the dollar. Buyers of sterling (or the Swedish krone or Australian dollar, for that matter) have largely been buying a long euro position against the dollar because movements in the euro have accounted for the largest share of the currency's move. Sterling is a particularly strong manifestation of this caught-in-the-middle phenomenon. Historically, most of the movement in eurosterling can be explained by movements in eurodollar, with rate differentials between sterling and euro explaining a relatively small share in sterling's movements. While there has been significant volatility in both cable and €/£, the average of the two has been stable, (see *Figure 1*). Therefore, UK-based firms with exposures in dollars and euros with ratios of roughly 50:50 already enjoy significant natural hedges.

These correlations matter because UK-based companies with dollar or euro exposure implicitly have significant exposure to the euro's movements against the dollar. Therefore, while we expect sterling to rebound against the dollar from its recent weakness, this rebound is contingent on the euro at least remaining stable in coming months. More precisely, as of mid-April we expect €/$ to move back to 0.90 over the next three months and cable to rise to 1.49 (€/£ falls to 0.61).

While the euro area retains its cyclical growth advantage over the US we now no longer expect this to translate into a sharp euro rebound. US equity markets are beginning to show some signs of firming and initial indications of a renewed appetite for risk among investors are emerging. Merger and acquisition activity, which had been very limited in late 2000 and early 2001, is also showing some tentative signs of revival. In addition, the European Central Bank (ECB), both in its policy and delivery of its policy message, has contributed to renewed downward pressures on the euro.

Experience has taught us that an already competitive euro subsequently can become an even more competitive euro. Beyond the next few months we expect the impact of the Federal Reserve's monetary easing and the expected easing of fiscal policy to revive US asset markets and reinvigorate the flow of capital into the US. We expect US GDP to grow $4\frac{1}{2}$% in the first half of 2002 – while such a pace will not persist, we expect echoes of the boom days of 1999/2000 to re-emerge at least temporarily.

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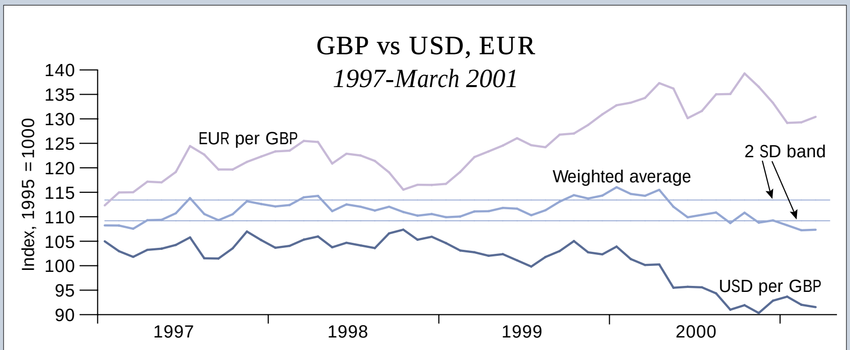
Where does this leave sterling?

Near-term we expect sterling to remain firm. The UK will grow 2.7% in 2001, the fastest pace among G7 economies, even after subtracting effects of foot and mouth disease. The Monetary Policy Committee has also had a deft touch in lowering interest rates and maintaining confidence. However, on a 12-month outlook, our expectation of euro weakness against the dollar will drag cable down with it – to levels below 1.40. By March 2002 the cycle in €/£ will begin to move in favour of the euro. Fiscal policy will no longer be a sterling plus, while the weak euro (in trade-weighted terms) means that exports will rise sharply. Hence, despite euro weakness versus the dollar €/£ will not reach the lows previously associated with very weak €/$ levels.

What about FX exposures?

For a treasury that has to cover foreign exchange (FX) exposures, the most conservative mandate is to cover all exposures at the time they are recognised and match them to the cashflow or

FIGURE 1



Source: Citibank/SSSB

translation date (mainly through spot or forwards). A more aggressive objective is to add value to the hedging process and to advise how best to maximise the value of future cashflows. As a global FX organisation, we are seeing an increasing number of corporate treasuries examining the way they regard hedging and looking to add value through strategic FX structuring.

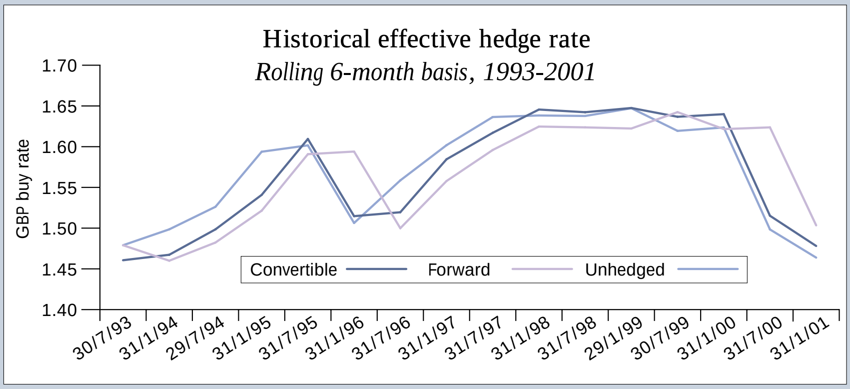
We will look at two examples that require no premium payment at inception and where we take the viewpoint of a GBP buyer who faces a cable spot rate of 1.4300 and a six-month outright rate of 1.4258.

Convertible forward

Firstly a convertible forward – this is a strategy that enables a worst case forward rate to be locked in that is slightly worse than the available market rate, while allowing the potential for substantial improvement if the currency behaves favourably. Using the above assumptions, a firm can lock in a worst-case rate of 1.4300 (that is, the current spot rate), while allowing the company to participate in any currency depreciation down to 1.3600. The company 'gives up' 42 points (1.4300-1.4258) from the forward price to potentially gain over 650 points, an attractive risk versus return ratio of up to 1:15. If sterling is above 1.4300 at expiry in six months' time, the company is protected and exercises its option to buy sterling at 1.4300. If at expiry the spot market is between 1.4300 and 1.3600, and 1.3600 has not traded in the spot market, the company will purchase sterling from the market (and potentially gain over 650pts). If, however, spot trades at 1.3600 at any time before expiry, the company is locked into a forward to buy sterling at 1.4300.

This product is often used when the budget rate is above (in this example) current market rates. This enables the company to lock in its benchmark as the worst-case rate, while having the chance to gain substantially. So, if the Treasury shares our view that cable will rise and then fall, this product is ideal, because it has an acceptable worst-case with a substantial upside if sterling weaken, as long as it does not fall to 1.3600. (The last time sterling traded below 1.36 was in 1986). For comparison purposes, a six-month sterling call option with a strike of 1.4300, would require a premium payment equivalent to 350 points,

FIGURE 2



equating to a break-even rate of 1.3908 (1.4258-0.0350).

Analysis done on comparing the convertible with an at-the-money forward and remaining unhedged, revealed the convertible forward to be very effective and marginally better on average over this period than the two alternatives. This back-testing (see *Figure 2*) was done on the period between 1993 and 2001 on a rolling six-month basis assuming a given set of market condition. The convertible is appealing to many treasuries due to its ability to achieve certain cover with a known worst case, while allowing the chance to participate with no up front premium payment required. Note, however, if a different period and different assumptions were used the results may well be different.

Seagull structure

A 'seagull' structure is another attractive option that can be tailored to any set of company circumstances and underlying currency market expectatations. We will use an example that corresponds to the currency views expressed above. Our specific example allows a firm 100% participation down to a best-case rate of 1.3700. The firm has the right to buy sterling at 1.4400 in six months' time if spot is between 1.4400 and 1.4900. If spot is higher than 1.4900 at expiry, the company will receive 500 points 'compensation' and buys sterling at the prevailing market rate.

At expiry, the firm faces the following possibilities, if the spot market is:

- above 1.4400 and below 1.4900 – the company deals at 1.4400;
- above 1.4900 – it deals in market and receives 500 points compensation;
- below 1.4400 and above 1.3700 – the firm will deal in the market; and
- below 1.3700 – the company will deal at 1.3700.

This product represents a view that sterling will weaken against the dollar in the longer term, and that any move higher would not be significantly higher than 1.4900.

Other options are available to the company, including hedging strategies that reflect the individual firm's exposures to exchange rates or business cycles. Most firms find they can use such strategies to improve their hedging, whether or not they wish to embed a particular market view in the strategy. Such FX hedging strategies can often be used to reduce the overall risk to a firm's cashflow that results from macroeconomic or market fluctuations. Over time, such strategies are likely to become more and more popular. ■

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