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The impact of 'Black Swan Events'

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To start with a definition, a Black Swan Event can be characterized by the disproportionate role of high-impact, hard to predict, and rare events that are beyond the realm of normal expectations.

Examining this in the context of our unpredictable financial markets, these events can broadly be translated into the natural disasters and geo-political tensions that occasionally (although seemingly more frequently) rock the market. The horrific earthquake and subsequent tsunami in Japan is an obvious recent example.

The spike in short term volatility that is typical of a Black Swan, brings with it a sobering reminder of the potential losses that an unprepared corporate treasurer may face. On the face of it, such events should send a shiver down the spine of any treasurer, but for the more sophisticated, there are a number of tools available which enable them to successfully navigate the choppy markets, and actually use the increased volatility to their favour. Effective risk mitigating tools, such as market orders and a live rate watch service, prove to be extremely popular during times of duress, given the significant intra-day swings in exchange rates that often occur. Not only do they allow treasurers to take advantage of any unforeseen rate movements, but they also allow them to benefit from large overnight moves in the rates.

Using Japan as a recent example, many UK companies were affected by delayed (or even cancelled) contracts after the heavily industrialised North East region was crippled by the tsunami. As a result we witnessed a greater demand for the flexibility that products such as Vanilla Options bring.

In contrast to the spike in short term volatility, it is common to see longer term FX option volatility remaining largely unchanged, allowing companies to take advantage of the fact that long term optionality has been as cheap as it has been for many a year. Unlike a standard forward contract where there is an obligation to buy the currency on maturity, a Vanilla Option gives the buyer the choice as to whether they want to convert into the foreign currency or not. Therefore if the delivery of goods is cancelled by suppliers, a prepared treasury wouldn't be obliged to take delivery of the unwanted currency and therefore avoid the associated currency risk.

As an added benefit, not only do option based products protect against adverse exchange rate movements, but many solutions also allow participation in favourable rate movements – ideal for treasuries who also focus on increasing profit margins through their treasury activities. In fact, many of our clients who bought Yen are now reaping the rewards from opting for option based protection in the 120's (hedged in the aftermath of the tsunami) as the spot rate is now in the 130's.

Another notable consequence of the loss in Japanese output has been that some UK companies have looked to source replacement goods from elsewhere in the world. As a result we've witnessed increased demand for alternative currencies such as the Brazil Real. As the Real is a non-deliverable currency, the demand for NDFs has heightened. This is an added challenge for treasurers looking to manage currency risk on deliverable goods. An NDF is a product that allows a company to hedge the risk of currency volatility even in a currency that can't be physically delivered.

Black Swan Events can also be characterised by the deep impacts they carry through the interest rate and inflation markets. For example, as the markets slowly digested the economic implications of the earthquake, interest rate expectations across most major currencies tended to fall. These markets were predicting that such an event was likely to reduce global demand and therefore cause a slowdown in the economic recovery – thus making central banks less likely to hike rates in the future, even though inflation fears persisted.

With the expectation that rates may remain lower for a longer period priced into the swap curve –corporates with long-term borrowings were able to take advantage of this opportunity to fix their funding rates at the low levels suddenly achievable. Furthermore, for those corporates who already had hedges in place (many of which were done at higher rates), by proactively analysing their hedge profile, we were able to restructure and extend their existing hedges to achieve an overall lower blended cost of funds.

However, in drawing inspiration from a notable British physicist, the quote "for every action there is an equal and opposite reaction" comes to mind. So, whilst the prospect of an extended period of lower interest rates is great for borrowers, for those companies who hold surplus cash on their balance sheet, the sudden change in interest rate expectations simply provided further evidence that the era of poor cash returns on their deposits was not ending any time soon.

Of late we have received a lot of queries about deposit products that allow companies to benefit from an enhanced yield (important) but with no risk on the principle (equally important). A popular choice following the earthquake were deposits linked to the strength of the USD (which is often considered a natural benefactor in many Black Swan Events). These enabled clients to earn a return on their cash beyond what was achievable through a vanilla fix term deposit. In the case of a 6-month GBP deposit placed after the tsunami, the earning range was between 1 – 4%, potentially outperforming LIBOR by over 2.8%.

So what lessons can we draw from all this in conclusion? Well, we know that Black Swans are characterised by wildly unexpected events that are never predicted and seldom positive. But for corporate treasurers this can offer advantages and opportunities, as well as challenges and concern. Having innovative products and knowledgeable market experts at hand is fundamental to building an assertive strategy. With increasingly volatile markets, treasurers need clear information and timely advice from specialist banks to combat the next outlier and protect profitability. The prepared corporate treasurer will sleep a little easier by protecting against uncertainty and mitigating risk, as the next Black Swan will surely not be long in coming.

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To speak to one of the team, and see how you can prepare yourself for the next Black Swan, please contact 0800 055 6339 or visit www.investectreasury.com

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