Managing currency market volatility

LEE McDARBY DISCUSSES THE IMPORTANCE OF PROACTIVE FX HEDGING, AND OFFERS GUIDANCE TO THOSE NEW TO CURRENCY VOLATILITY ON HOW THEY CAN MANAGE DAILY CURRENCY FLUCTUATIONS AND ENHANCE FX PLANNING RELIABILITY

SHUTTERSTOCK

From being jilted by the Swiss National Bank in January to coping with a potential split with Greece for a large part of the year, not to mention quantitative easing (QE), 2015 was a turbulent 12 months for the euro – as outlined in the graph on page 33.

Despite starting last year on the front foot – on 3 January £1 stood at €1.27 – the single currency soon began to wobble. By March, the pound had reached a more than seven-year high against the euro – hitting €1.40 for the first time since December 2007 – following the introduction of the European Central Bank's (ECB's) economic stimulus programme, a bond-buying scheme designed to revitalise the flagging eurozone economy.

Even the UK general election in May couldn't provide much respite for the single currency. With opinion polls predicting the outcome would be 'too close to call', the possibility of a second hung parliament in a row saw the euro begin to gain traction in the run-up to the vote. However, these attempts to gauge the public's intentions were proved to have underestimated the Conservative vote, which bore resemblance to their surprise majority victory in the 1992 election. Consequently, the pound made its biggest one-day gain against the euro for two years and continued its ascent for several weeks, as markets gave the thumbs-up to the prospect of a stable, Tory-led government continuing the austerity economics of the past five years.

Fast forward another two months and fallout from the ongoing Greek debt crisis, coupled with Bank of England rhetoric around a possible interest-rate hike in the new year, had pushed £/€ levels to an annual high of €1.43 by 16 July.

For UK businesses exporting stock to the eurozone, sustained euro weakness had a detrimental impact on their bottom line. For example, at the early January rate, €300,000 worth of stock would have generated £236,220, whereas at the March rate it would have been worth just £214,285. That's a difference of almost £22,000 in just a matter of weeks, simply due to fluctuating exchange rates.

So just how perilous was this period for the euro? Let's take a look at the average yearly £/€ rates since the 2008 global financial crisis. In 2015, the average rate for the pair settled at 1.37, compared with a previous annual high of just 1.25 since 2008; while in 2009, the average rate was as low as 1.12. This paints a picture of a currency that struggled considerably last year under significant downward pressure from various political and economic events.

What could 2016 hold?

The new year has signalled a shift in momentum, as speculation surrounding the likelihood (or unlikelihood) of a UK interest-rate hike, and the outcome of Britain's in/out EU referendum, began to weigh on the pound. By 20 January, the pound had weakened to €1.29, dipping below €1.30 for the first time in just over 12 months.

Looking ahead, potential UK interest-rate and EU referendum speculation could continue to play a large part in determining the euro's performance against the pound in the coming months. As will updates from ECB president Mario Draghi on the effectiveness of its extended QE programme.

Just a few months ago, Bank of England governor Mark Carney was warning City investors not to bet against an interest-rate rise. More recently, dovish rhetoric around the subject has revealed a change of stance from the central bank, influenced by news of collapsing oil prices, lingering low inflation, slowing UK growth and a 'weaker' global economy – propping up the euro, as expectations of a hike are pushed back to mid-2017.

The EU referendum will take place on 23 June, and mounting uncertainty surrounding the outcome of the vote in the lead-up to polling day should continue to benefit the euro; as was the case with the 2014 Scottish referendum, when the pound dropped to £1:€1.24 prior to the vote, before recovering as Scotland voted 'No'.

Having announced in December that eurozone QE would be extended by six months until March 2017, attention will now focus on the ECB's appetite to expand its landmark programme. Any move to increase the amount of money injected into the eurozone economy each month will be seen as a sign that it isn't working as planned, which is likely to depress the euro.

The single currency's performance since January last year has provided plenty of food for thought for any UK-based business that trades on an international scale. From sustained euro weakness during 2015 benefiting imports from the eurozone to a resurgence in the currency's fortunes in the early part of 2016, that has improved the landscape for exporters of goods and services to the continent. The question is 'how can a business manage exposure to currency risk?'

Hedging currency risk

Because we are now much more connected, increasing numbers of companies conduct some sort of trade abroad. Your firm might import raw materials from overseas, or export goods or services to other countries. Or perhaps it pays claims or dividends across international borders. The ensuing reliance on making international payments inevitably generates costs (as well as risks).

A major concern for any business conducting transactions in different currencies is market volatility, which can produce unexpected changes in currency exchange rates. The fluid nature of the FX market – demonstrated by the euro's performance in recent months – is dictated by its sensitivity to various external factors – from the release of positive or negative economic data to a political announcement. The resulting fluctuations in exchange rates can happen rapidly, making its performance difficult to predict. If not managed effectively, this could impact a company's profitability and the value of its assets and liabilities.

Therefore, currency hedging is used by organisations to reduce such risks when conducting business internationally. However, a lot of corporate FX hedging programmes are reactive rather than proactive. The typical process at many companies involves the execution of FX transactions by individual business units on an ad-hoc basis, with contracts executed for specific payment or collections. This decentralised process often leads to higher costs and increased risks.

By clarifying what the organisation is trying to achieve and understanding its true risks, across all of its currency pairs, it will be well placed to establish or revamp a currency hedging programme.

Businesses should speak to an FX expert that can help their business to develop, and implement, FX hedging strategies in line with their ongoing trading activities. Using a currency specialist can provide a personal, tailored service that may not always be offered by a bank.

It is important for a client to be understood and for an FX company to monitor the currency markets on their behalf, providing specialist guidance aimed at facilitating informed decisions around the optimum timing of international transfers. Using dedicated experts can also help a business to understand which FX products best suit its requirements.

Using the up-to-the-minute insight that FX specialists can provide informs companies of the driving forces affecting the currency markets. This can ensure clients are provided with crucial information in a timely fashion. Armed with this knowledge, businesses should be well equipped to make more-informed decisions regarding their hedging strategies and, ultimately, mitigate losses that may be incurred by exposure to FX market volatility.

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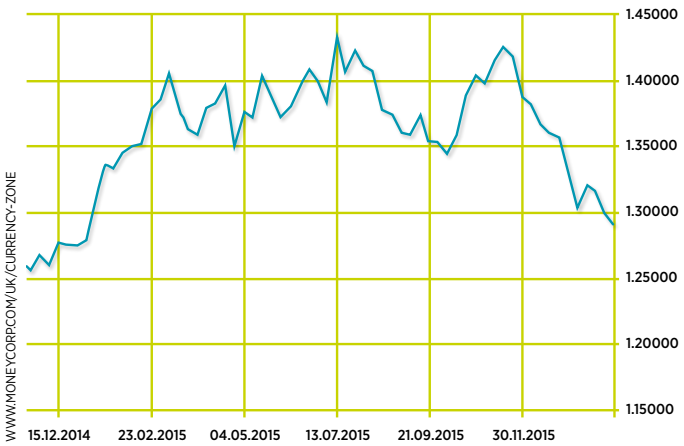
£ VERSUS € 2015



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