COVID-19 AND CURRENCY RISK: ACT OR WAIT?

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FX Risk Advisory Insights:
Executive summary

Currency markets have experienced tremendous amounts of volatility during the COVID-19 period

We are seeing larger daily trading ranges, sharp trend reversals, and the breaching of exchange rate levels either never before seen or not seen in decades

Directionally, the US dollar appreciation has been imbalanced with emerging market currencies and the Australian, New Zealand, and Canadian dollars experiencing the sharpest declines

New paradigm has implications on

Corporate FP&A

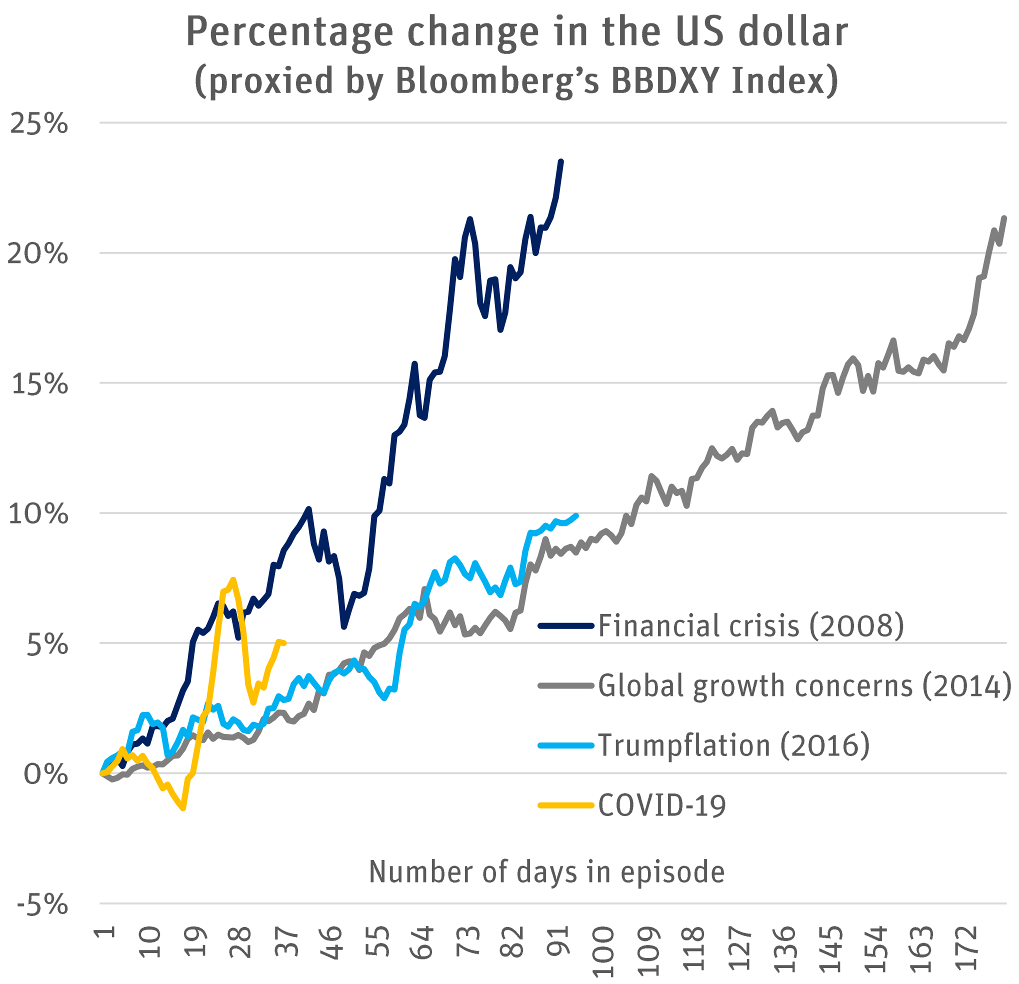
FX execution

Risk model projections

Pricing for currency buyers

FX Risk Advisory Insights:

Data insights suggest the move in the US dollar may have just begun



Source: FX Risk Advisory | Data: Bloomberg

Note: COVID-19 period covers Feb 14, 2020 – Apr 6, 2020.

Insights

- So far, the move in the USD in aggregate has **not** been particularly large. In fact, at 7% or so for the USD versus a basket of currencies, it would be classified as being less than a one standard deviation move. This is especially small in the context of moves we have seen in equity, oil, and credit markets.
- That said, the USD has **appreciated considerably** versus **some emerging market currencies** (i.e. MXN, BRL, ZAR, COP, RUB), well into the double-digit range.
- The **speed** at which the USD has risen, however, parallels that of the Financial Crisis of 2008, so far.
- Financial distress episodes in **2008 and 2014** translated into **USD moves of over 20%**, suggesting the start of a broader move.

Implications on FP&A

- If your firm is buying foreign currency, layer into spot or hedges now to capture savings to FP&A projections. Savings are greatest for a number of EM currencies, and for GBP, AUD, and NZD.

- If your firm or fund has assets and cash flows denominated in foreign currencies, it is still early and a good time to proceed with hedging. The ship has by no means sailed.

FX Risk Advisory Insights:

COVID-19 volatility has increased daily trading ranges for various currencies

Insights

COVID-19 has sharply increased intra-day trading ranges in FX markets.

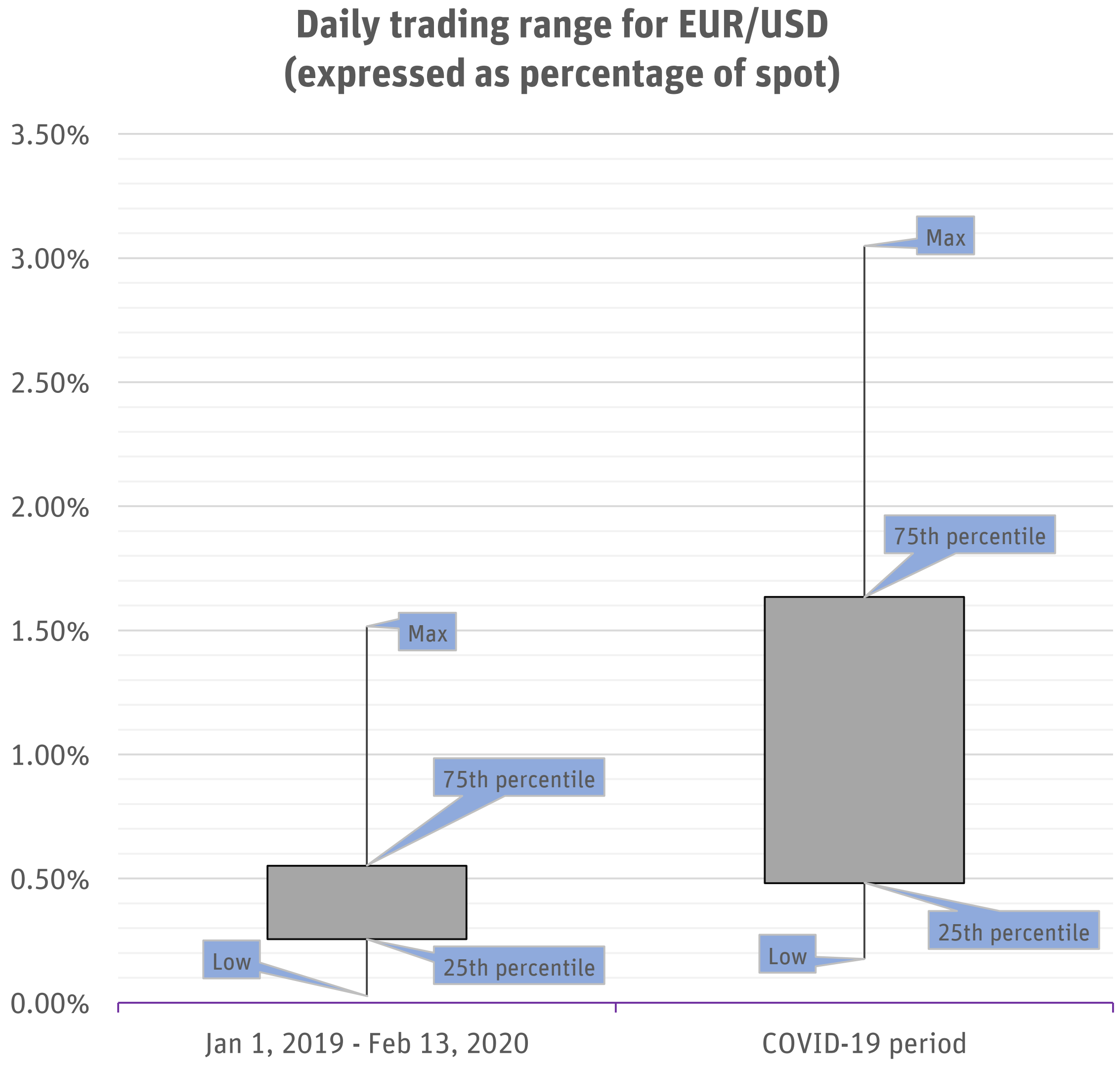
For the EUR/USD exchange rate for instance:

- The daily trading range (difference between the high and low for a given day) was larger than 0.50% for 1 in 4 days in 2019.
- For the COVID-19 period, which started around Valentine's Day, the daily trading range was larger than 1.50% for 1 in 4 days (3X increase)

Implications on FX execution

- Do not try to pick tops or bottoms in FX rates, or wait for a specific market price. Today's volatility and erratic price action mean the market can quickly move against you. We suggest determining your needs, and instead transacting as needed in layers to smooth out adverse impacts through averaging.

- FX rates may rapidly distance themselves from your budget rates, more so than before. If such a move works in your favor, look to lock in gains sooner rather than later. If the move is unfavorable, do not wait for the market to come back.



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FX Risk Advisory Insights:

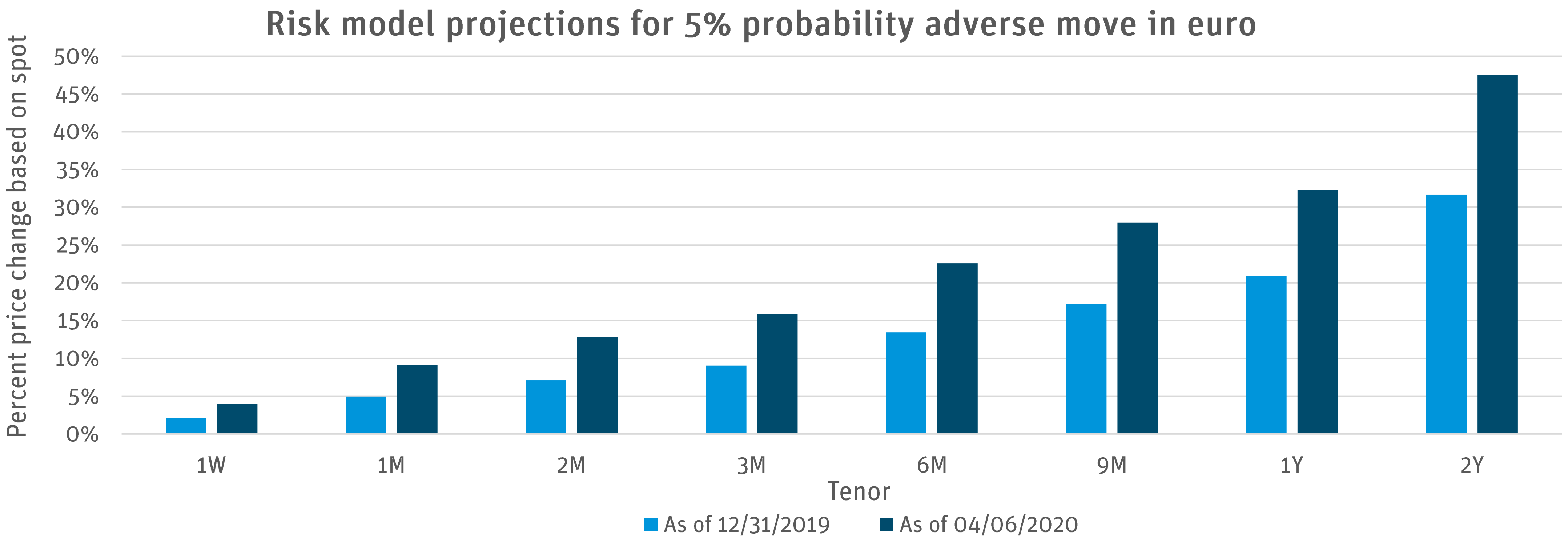
COVID-19 has brought about higher actual and ‘expected’ volatility

Insights

Pre-COVID-19, currencies had traded for years in a low volatility environment. Low actual volatility made its way into projections of future volatility either directly through risk model inputs, or indirectly through the pricing of options by market-makers.

Implications on risk model projections

Pre-COVID-19, a standard risk model would assign a 5% probability to experiencing an adverse move of 9% over a 3-month period, and 21% over a 1-year period (from €1.1213 starting point). Today, the same model, whose inputs have been adjusted to reflect new realities, would project adverse moves more than 1.5X larger.



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FX Risk Advisory Insights:

COVID-19 induced Fed rate cuts have resulted in improved forward pricing for buying currency

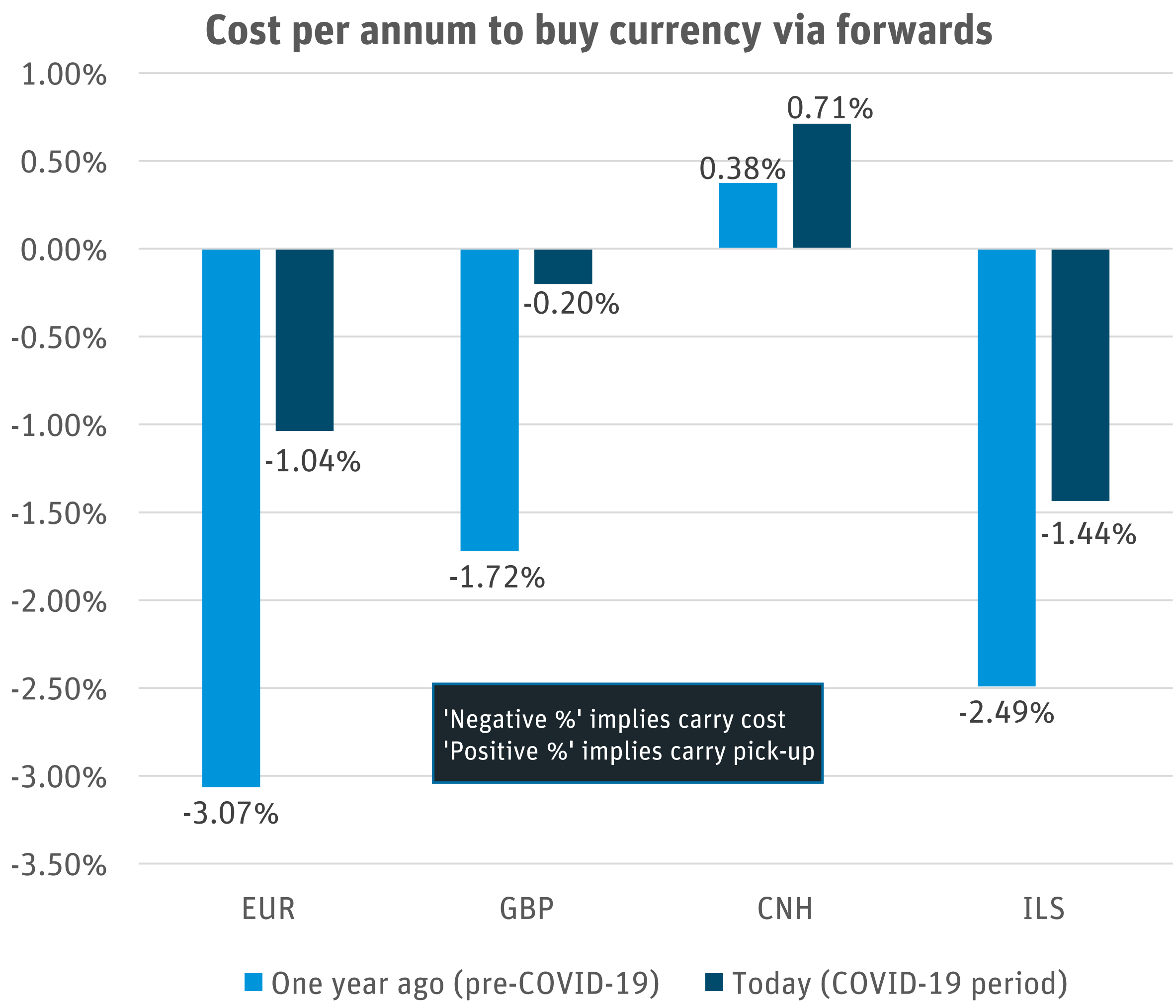
Insights

The fall in US interest rates, which has outpaced the fall in interest rates in other countries, has translated into improved prices for buying currency via forward contracts. Not all currency pairs have been impacted, but some notable examples are: EUR, GBP, CNH, and ILS.

Forward contract prices are a function of interest rate differentials (inclusive of cross-currency basis) between two countries. Thus, to the extent US interest rates have fallen, this has narrowed the rate differential between the US and eurozone countries, UK, and Israel, leading to lower costs to buy today for future exchange.

Implications on pricing for currency buyers

A way to take advantage of the dual-savings (weaker spot levels and lower hedging costs) is to refresh OpEx projections, incorporating post-COVID-19 business realities and hedge 50-90% of such projections based on the certainty of the cash flow forecasts. As the USD has not yet found a ceiling, executing the strategy in 2-3 layers may make sense.



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FX Risk Advisory Insights:

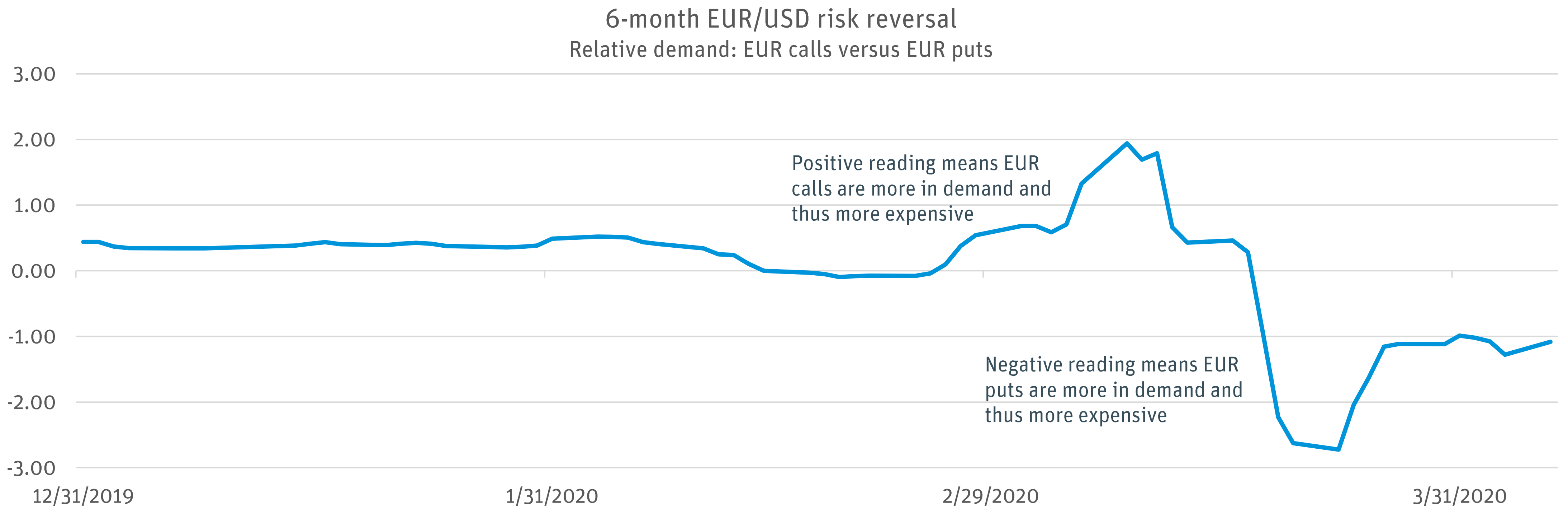
COVID-19 induced option demand has resulted in improved collar pricing for buying currency

Insights

Prior to the COVID-19 period, EUR calls, which protect against a rise in the currency, were more expensive than EUR puts, which protect against a fall, for the same level of protection. This has reversed. Today EUR puts are in greater demand and more expensive signaling market positioning and sentiment.

Implications on pricing for currency buyers

A collar is a hedging strategy that offers a best case and a worst case rate for buying currency. Structurally, a collar can be made zero cost through the simultaneous purchase of a EUR call financed by the sale of the EUR put. Due to the excess demand of calls versus puts, the hedger receives greater upside potential versus downside risk.



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Silicon Valley Bank