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Currency hedge strategies in today's market

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Key market themes

- **From decoupling to recoupling to decoupling (albeit a different type)**
 - **Euro zone challenges off the radar**
 - **TOTO (Talk of tapering off) dominating headlines and sentiment**
 - **Rising US yields putting pressure on Emerging Market (EM) assets and currencies**
 - **A new paradigm of broad-based USD strength**
-

2013

The last phase of the global unwind of carry trades

**I will gladly pay you Tuesday for
a billion hamburgers today.**



Carry trades

Not just reserved for the investment community

- **A carry trade is any transaction in which an individual or institution has access to low-cost funding, and utilizes this funding to allocate capital to higher-yielding assets or projects.**
- **Examples**
 - Individual receives a 0% for 12 months offer in the mail from a credit card company, draws on this line and buys Koo Koo Roo stock in April of 1998 following the announcement that Lee Iacocca was named acting chairman of the revolutionary fast-food chain.
 - US-based investor buys government bonds from Turkey, India, Brazil, South Africa, Iceland.
 - Hedge fund has direct access to wholesale currency markets and will buy a high yielding currency and fund it with a low yielding currency via FX forwards (i.e. cross rates AUDJPY, CHFBRL, USDTRY).
 - US multinational corporation taps into deep and liquid US debt markets for funding expansion into Australia and does not swap funding into local currency debt.
 - Brazilian Development Bank (BNDES) offers subsidized loans for infrastructure projects.
 - Korean entity establishes USD-funding for domestic operations.
- **Success in a carry trade strategy implies there is such thing as a free lunch.**

Carry trade unwind

Risk in the carry strategy comes from two sources: the asset and the liability

- **Phase I
(2007-2008)**

Global financial crisis which originated in the US due to housing market crash and overexposure to high-risk mortgages and financial engineering.

- **Phase 2
(2009-2012)**

While risk assets recovered, carry trades funded by the Japanese yen and the Swiss franc were flushed out from excessive appreciation in these currencies due to their safe-haven status.

- **Phase 3
(2013)**

USD strength, accompanied by a rise in US treasury yields, is causing global investors to re-evaluate and re-price risks taken, especially across EM (asset side concerns). In addition, multinational corporations are being challenged by rises in the relative cost of USD-funding.

The strong USD paradigm

Winners and losers

- **Winners**

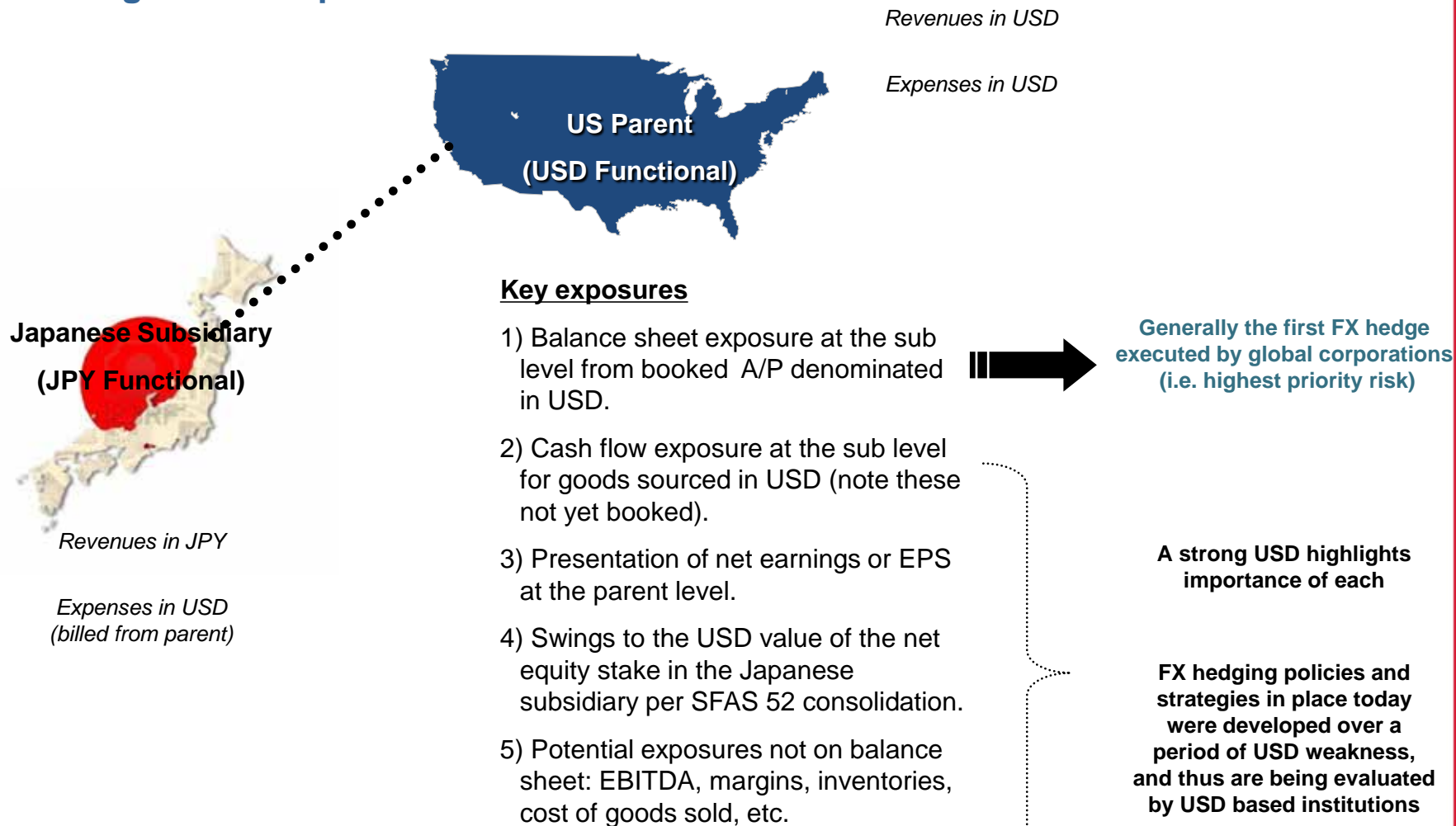
- US firms benefit from a strong USD when sourcing product overseas, making capital injections into other countries, engaging in M&A activity overseas, servicing debt or liabilities established in foreign currencies.
- In other words, the world is on sale from a USD perspective.

- **Losers**

- US firms at a disadvantage from a strong USD when holding non-USD assets and cash balances, translating foreign currency balance sheets, financing overseas operations with USD debt.
- Depending on functional currency choice and accounting designation, the bad news will travel slowly.

The strong USD paradigm

Defining risks and priorities



The strong USD paradigm

Brings to the surface new FX problems

- **Consistent with SFAS 52, Statement 133 allows for net investment hedging, the process by which US corporations protect the foreign currency risk in the net equity stake in foreign subsidiaries.**
- **For companies with local currency functional subsidiaries, translation gains and losses flow into the equity component of the balance sheet and thus have no income statement impact.**
 - Protecting margins, earnings, balance sheet items generally takes priority for most hedgers.
- **A few reasons a company would enter hedges of net investment or equity exposure (Note: an equity hedge would fall outside cash flow and fair value hedging mandates).**
 - Banks and insurance companies must maintain specific capital ratios in order to do business overseas at the subsidiary level (issue loans, write policies, etc.).
 - Creditors generally have imposed thresholds or covenants which require preservation of equity or capital balances; Rating agencies also keep a watchful eye on such metrics.
 - Companies that are planning to sell a foreign subsidiary, pay out dividends.
 - A change to the business, economic, or competitive landscape would cause a corporation to take an impairment charge to foreign assets.
 - **Impairments flow through current income.**
 - **Recent examples of impairments caused by foreign exchange: Financial crisis of 2008, Venezuela 2010 and 2013**

The strong USD paradigm

Adapt hedging strategy to the changing market conditions

- **Key considerations related to hedging strategy for a US multinational**
 - Increase hedge ratios and tenors as USD becomes more expensive
 - Are forwards more attractive than options?
 - Influence product pricing - effective hedging strategy can influence pricing strategy and help protect market share and competitive positioning
 - Hedge net investment? Any adverse impact on financial covenants from strengthening USD (eg: CTA and its impact on equity based covenants)?
 - Lower cost of hedging balance sheet exposure especially in emerging markets
- **But remember, hedging only delays the impact of foreign exchange movements**

The strong USD paradigm

Impairments – Where accounting meets economics

- A handful of S&P firms took FX-related impairment charges as a result of the financial crisis of 2008 (Data: Bloomberg)

Sector	Year	EBITDA (in \$ millions)	Impairment Amount (in \$ millions)	Impairment Amount (as % EBITDA)	Reason Cited
Utilities	2008	4,400	680	15.5%	Volatility in Latin America caused by "regulatory and economic difficulties, political instability and currency devaluations being experienced in many of these countries."
Consumer Staples	2008	850	13	1.5%	Impairment is due to a decline in recent operating activities, restructuring activities, loss from foreign exchange transactions in Europe, Middle East & Africa regions.
Materials	2008	850	46	5.4%	Impairment due to decision to close an impaired plant in the UK and manufacturing facilities sold in Mexico & Argentina.
Consumer Discretionary	2008	1,500	8,350	556.7%	Impairment driven by soft business trends, specifically the recessions in the US & UK
Consumer Staples	2008	6,000	44	0.7%	Impairment of the intangible assets in the Netherlands, France & Puerto Rico.
Consumer Discretionary	2009	3,000	401	13.4%	Non-cash impairment resulting from deteriorating global consumer markets, particularly in the UK
Information Technology	2008	(700)	10	-1.4%	Impairment due to a depreciation in the Japanese Yen to US Dollar exchange rate and the effect this had on firms investment overseas, which is denominated in Yen.

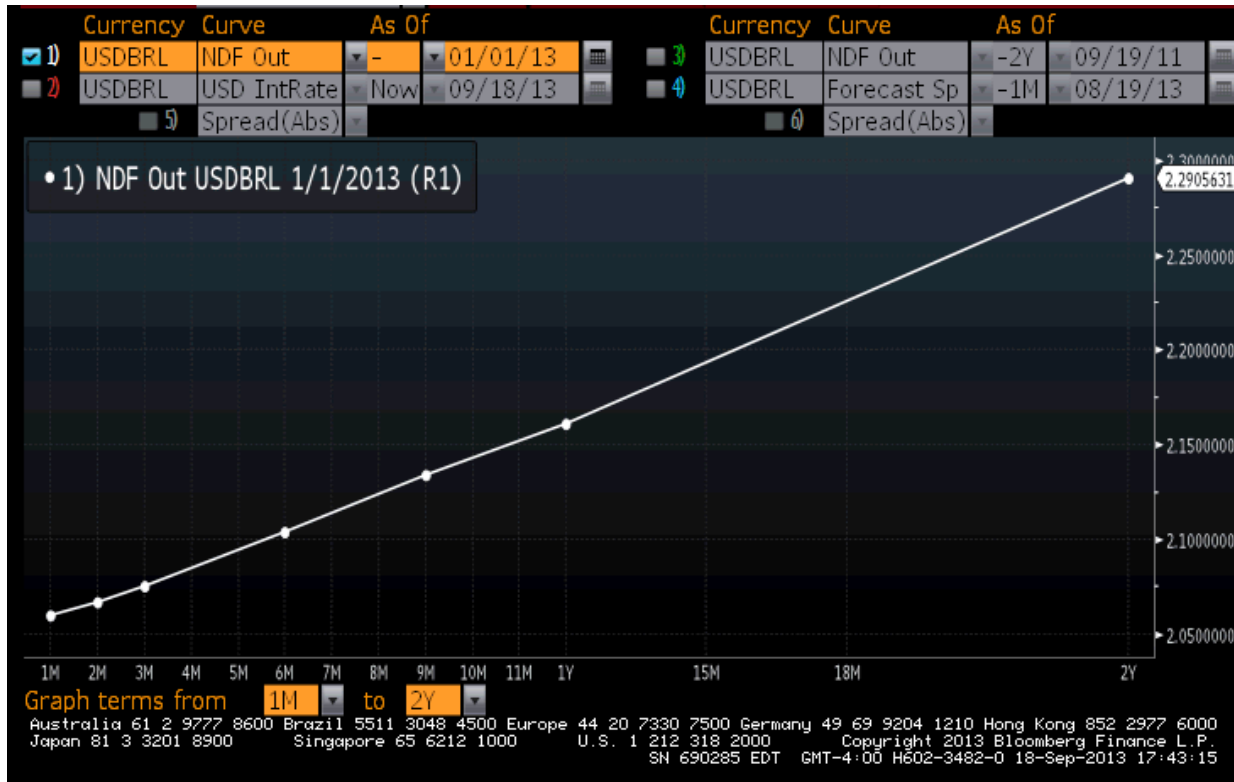
Setting FX budget rates

Respect the forward curves

- **There are a number of approaches for setting FX budget rates:**
 - Current spot
 - Current forward
 - Consensus forecasts
 - Historical averages
 - Cost of capital
 - Spot adjusted by 'cushion'
 - Portfolio averages
- **There is no conclusive evidence that suggests that one method is superior to another.**
- **However, the most conservative approaches involve setting budget rates at rates that are attainable in FX hedging markets (i.e. using forward curves).**

Setting FX budget rates

Example



With regard to the relationship between FX spot and forward rates, international finance theory suggests there should be interest rate parity across borders, net of FX impact

This is known as Uncovered Interest Rate Parity (UIP), a condition that states that the difference in interest rates between two countries today should be equal to the future change in the exchange rate between these two countries

USDBRL forward curve as of 1-January-2013 was pricing in a 6% depreciation in BRL per annum

Theory aside, however, it is not possible to lock in a rate of 2.0500 on 1-Jan-2013 for a multi-year period (i.e. setting a budget rate equal to the spot rate is immediately underwater by 6% per annum)

Cost of hedging EM currencies is high

But recent evidence suggests it is justified



Annual cost of hedging cash flows denominated in Indonesian rupiah (IDR) back to USD via non-deliverable forwards (NDF's) ranged between 2-3% at the beginning of 2013 but recently peaked at closed to 30%

This is illustrated in the chart and expressed as a % per annum

Is the cost justified?

IDR has depreciated 15% over the last 12-months

2014 FX hedging

Take a portfolio approach



US institutions face the following risk-reward proposition as we approach 2014 hedging:

Lock in relative strength in MXN, EUR, RMB

Cut losses in TRY, BRL, AUD, JPY, ZAR whilst retaining the opportunity for upside potential

But be careful relying too much on diversification implied by value-at-risk (VaR) calculations, in times of deep financial stress, diversification disappears

2014 FX hedging

Carry earned for selling USD helps offset carry incurred for buying USD (versus EM)

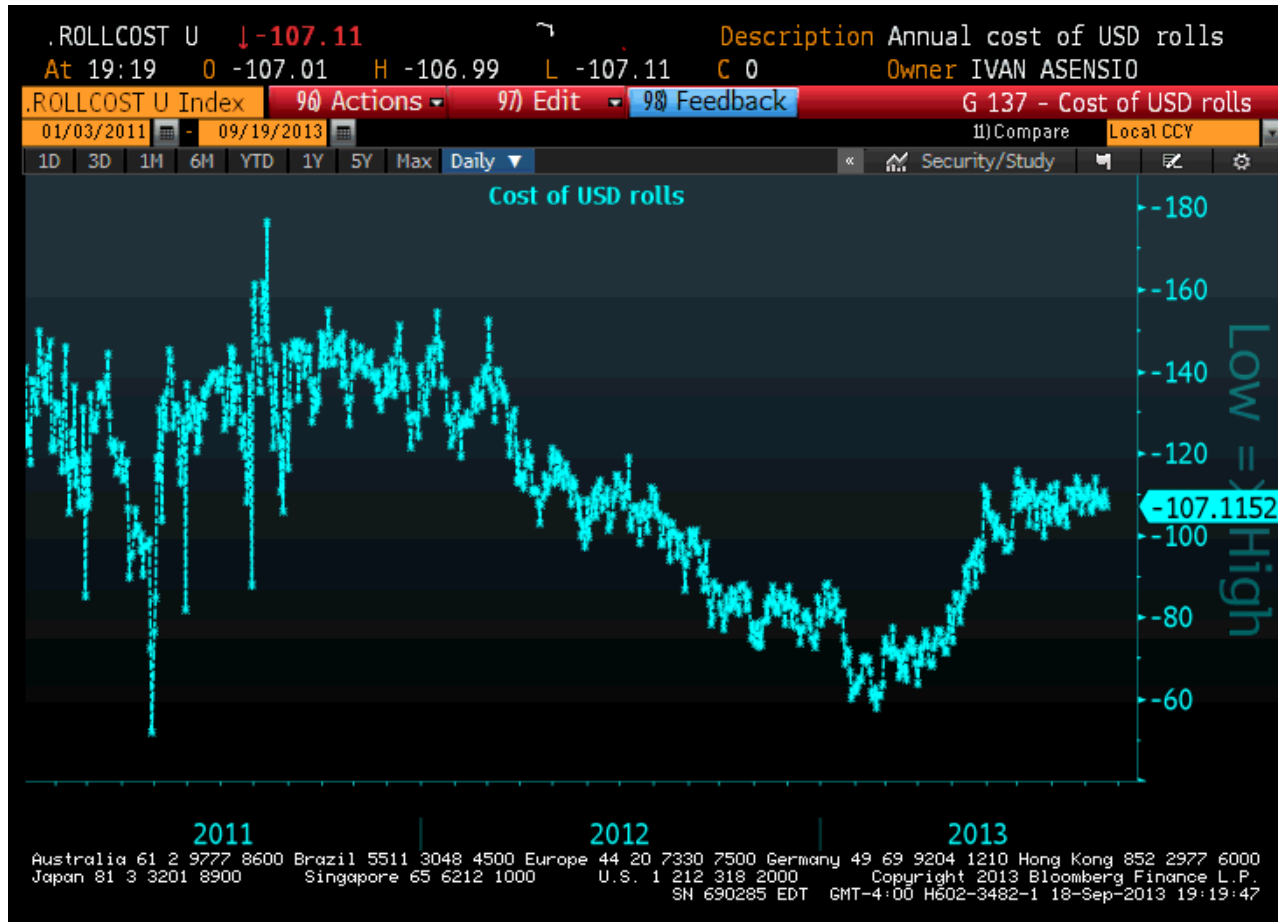


Chart shows cost of rolling FX forwards to hedge a non-USD portfolio back to USD, expressed in basis points per annum

Hypothetical portfolio
 50% EUR, 20% JPY, 10% KRW, 10% BRL, 10% AUD

2014 FX hedging

Despite the uncertainty in markets today, FX option prices in some key pairs offer attractive value

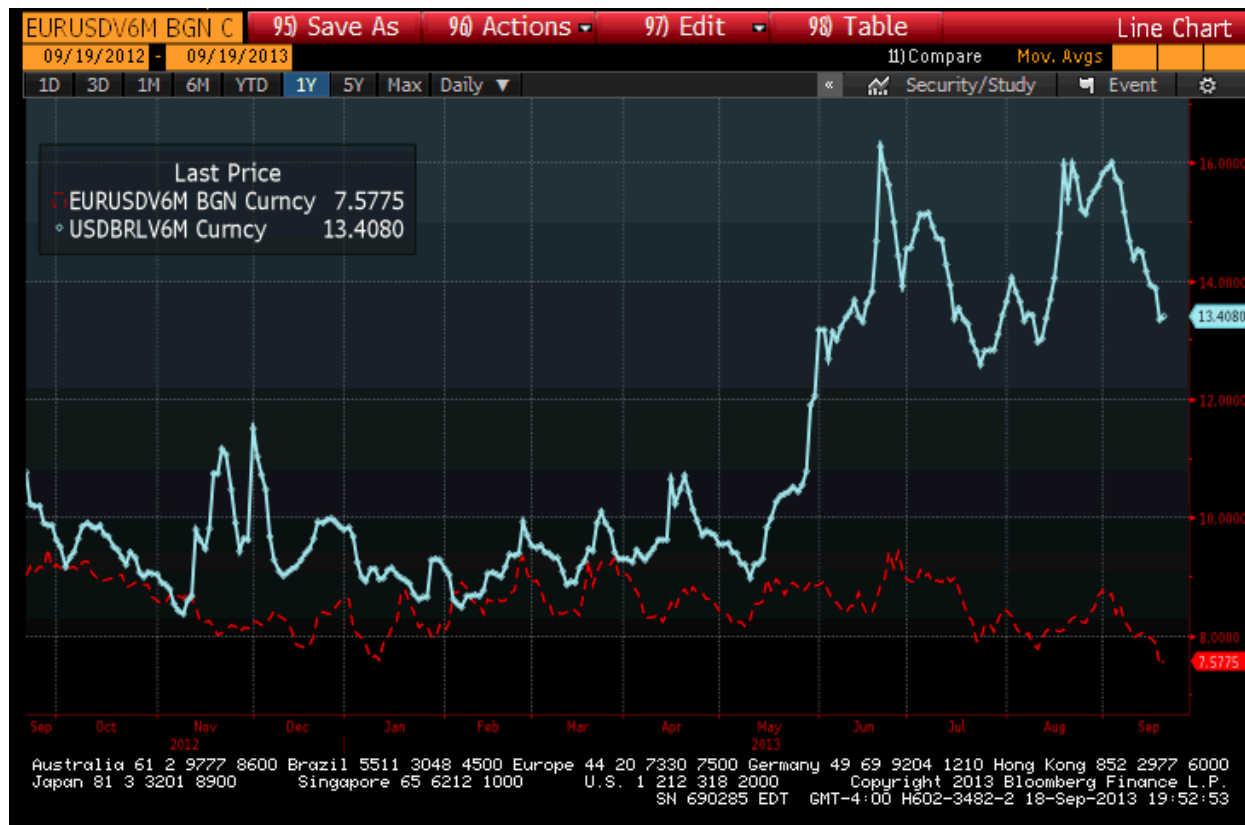


Chart illustrates divergence in FX option prices between G10 currencies and EM currencies, versus the USD

Note
For US corporates in general, the Eurozone still represents a bulk of the FX exposure

2014 FX hedging

Cross-currency basis spreads still reflect pricing anomalies that may be exploited



During turbulent market times, the hunt for USD's and/or oversupply of local market liquidity contribute to deviations to the equilibrium between FX spot, interest rates, and FX forward rates, a situation that manifests itself in the movement of the cross-currency basis

Pre-2008-crisis, the cross-currency basis was minimal and fairly stable, that is not the case today, however



Strategies designed to exploit anomaly include:

USD debt may be swapped into foreign currencies to achieve lower cost of funding versus overseas borrowing (also achieves asset-liability matches overseas)

Yield enhancement strategies (over similar duration treasuries) involving FX-hedged foreign paper

Concluding comments

**I will gladly pay you Tuesday for
a billion hamburgers today.**



**...but I will
lock in my
worst case
price today.**

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