CHT – Quick Insight

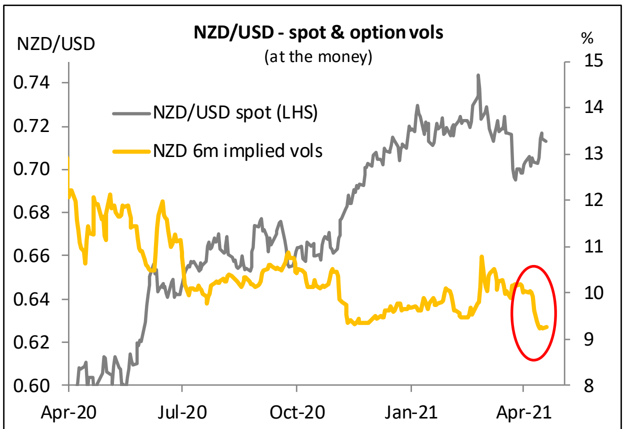
Considerations for Corporate Hedging Activity April 2021

What are the implications of falling FX volatility?

- NZD/USD implied volatility slumps to 14-month lows
- Helpful for corporates that use options to hedge
- Risks still biased toward NZD/USD uptrend continuing

NZD vols slump

Understandably, spot rates tend to occupy most of the focus when it comes to FX markets. It's been a choppy, but ultimately sideways, run on this front lately. The NZD/USD has been bouncing around inside a 0.6950-0.7200 range for the better part of a month.



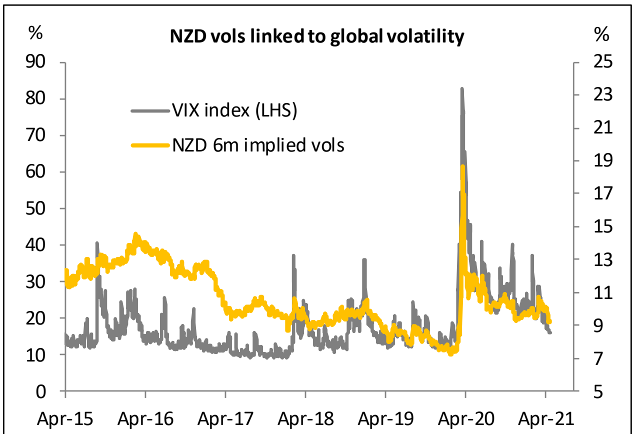
Source: Bloomberg

Given this relative calm, it's been easy to miss the sharp decline in FX implied volatility ("vols"). As the chart shows, NZD vols have slipped to the lowest level since last March. This is true right across the vols curve.

The driver has been both the narrow ranges in spot markets, and the generalised reduction in volatility globally. Perhaps the most closely-followed indicator of such – the VIX index (implied volatility of the S&P500) – is also plumbing 14-month lows. Improving sentiment towards the global economy, and the attendant reduction in COVID-related economic risks, has emboldened risk appetite everywhere. Global equities are hitting record highs, commodity prices are rising, and volatility has declined. The fall in implied, or forward-looking, option volatility is essentially options traders banking on the low volatility environment continuing.

So what?

The fall in vols is helpful for corporates that use options to hedge part of their FX exposures. **Vols are the key market-determined input in FX option pricing** (the other inputs are usually specified by the buyer). So the fall in vols has effectively reduced the premium payable for adding optionality into a hedging strategy.



Source: Bloomberg

Another way to think about it is that the fall in vols lowers the hurdle or 'breakeven' required to make the purchase of an option worthwhile. For example, for an exporter looking to purchase a NZD1m vanilla call option, the breakeven spot level the NZD/USD would have to fall to so as to breakeven on the premium outlay is around ½ cent higher than a month ago (indicatively).

This fall in the relative cost of options as a hedging instrument may increase their appeal for those corporates that would like the additional flexiblity that using options brings. Note that the fall in vols, while cheapening the pricing of

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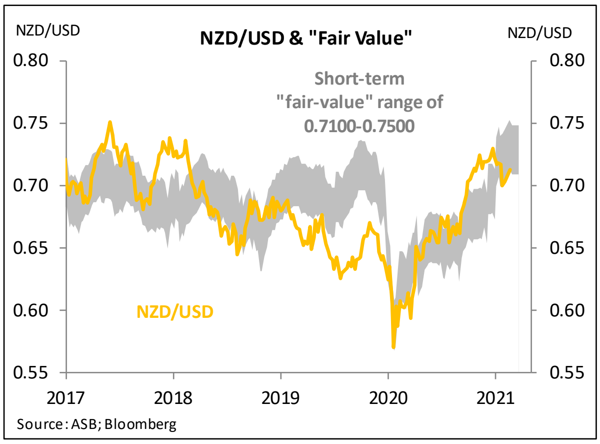
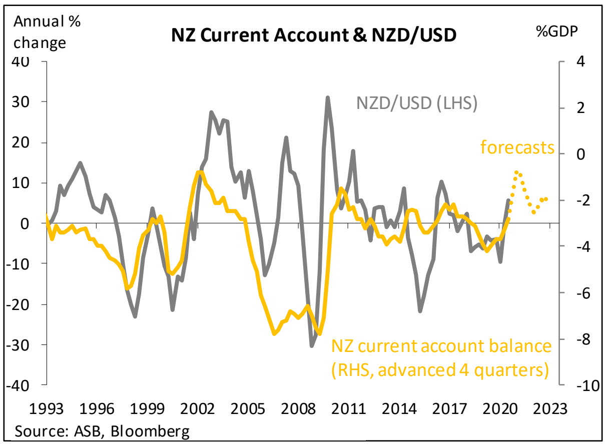
vanilla purchased options and some other structures (e.g. participating forwards), doesn't really impact collar pricing. The latter involves the simultaneous buying and selling of options, which neutralises most of the impact of lower vols.

In our view, the above may be particularly relevant for those that would like to 'buy time' to potentially transact at a higher NZD/USD but still want to lock-in the insurance policy of a "worst case" rate, in case the NZD/USD does slip back into the 0.6000s again. Our FX view, expressed in both our last [Corporate Hedging Toolbox](), and regularly in our weekly reports, is that NZD fundamentals remain supportive, biasing the risks towards the uptrend in the NZD/USD continuing (charts below).





How long will it last?

So, will the conditions described above stick around?

We're not necessarily in the business of forecasting volatility. But we are believers in the global economic recovery. So, to the extent recovering global growth and normalising risk sentiment have been drivers of the slow decline in global asset market volatility, we wouldn't expect vols to start *trending* higher again as long as market participants expect these trends to remain in tact. This suggests corporates have time to assess the above. There is clearly the potential for the odd spike or two in volatility this year though. The post-COVID economic and financial market recovery remains a bumpy and uncertain one.