

Corporate Hedging Toolbox

Considerations for Corporate Hedging Activity

Second Quarter 2021

Knowing When to Hold 'Em

Welcome to the Q2 Corporate Hedging Toolbox - our practical guide for corporate risk managers. We use a variety of quantitative tools to make sense of financial markets, and offer hedging considerations to address some of the challenges facing corporate treasuries. Contact mike.jones@asb.co.nz to subscribe or go [here](#).

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Summary

- The broad thrust of the views and considerations set out in our [last CHT](#) have played out, and we're holding onto 'em. We see risk that the trend higher in the NZD and wholesale interest rates extends.
- Markets are abuzz with talk about inflation. Our [Special Topic](#) outlines three implications for risk managers.

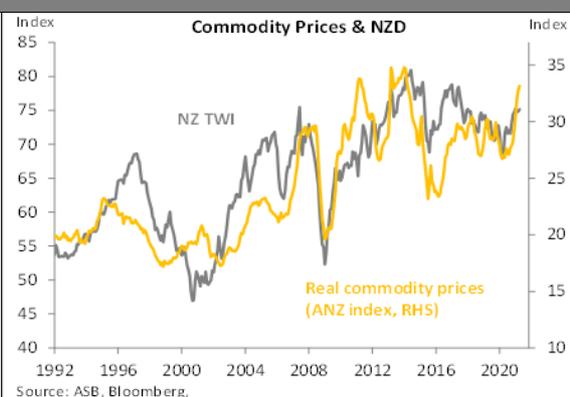
Interest rates

- [Market pricing](#) for RBNZ rate hikes is now similar to our own earlier-than-consensus view. This may limit topside potential in NZ short-dated interest rates. Longer-term interest rates may have more upside though, as global deflation continues.
- We maintain our view from the last CHT that it's appropriate to either maintain interest rate hedging ratios or move them up. The rub for risk managers is that the cost of hedging has risen.
- 'Blend and extend' [strategies](#) may have value.

Foreign exchange

- [FX market conditions](#) and the outlook haven't changed much. Using NZD dips to boost levels of forward cover may make sense for [exporters](#), as part of a strategy to return hedge ratios to at/above policy midpoints.
- For [importers](#), low implied volatility provides opportunities around vanilla put options (see [note](#)). Erring on the side of setting hedges for longer might help limit transaction costs given supply chain delays for some.

Feature chart: NZD undervalued?



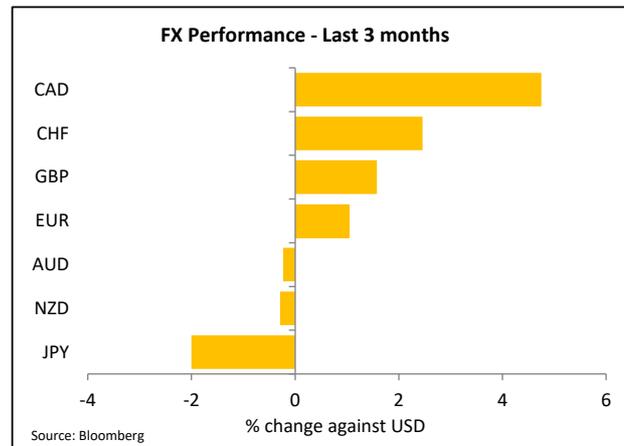
	Last 3 months	Next 3 months
NZ economic pulse	↑	↔ The growth pulse has slowed as expected but booming global growth and a slow border re-opening bode well for 2022.
NZD/USD	↔	↑ Global deflation and early RBNZ rate hikes are big tailwinds. Booming US economic conditions & a steady USD are capping the upside for now.
NZD/AUD	↔	↓ The RBA is at risk of walking back its dovishness, similar to what the RBNZ did in May. The Aussie outlook is also slightly more promising than NZ.
NZ wholesale interest rates	↑	↔ RBNZ rate hike pricing is starting to look rich, but we still think the trend higher has further to run, particularly for long-dated rates

Mike Jones –Senior Economist (649) 301 5661 mike.jones@asb.co.nz

Please refer to the important disclosures at the end of this document.

Foreign Exchange - Market Themes

- Investors have hit ‘pause’ on the USD downtrend, allowing relative fundamentals to shine through more obviously in driving currency performance over the past three months.
- After outperforming for much of 2020, the uptrends in the NZD and AUD currency pairs have stabilised. This reflects other G10 economies ‘catching-up’ to the prior outperformance of the antipodean economies.
- The NZ economic recovery has also hit a few speed bumps recently, dampening NZD sentiment a little.



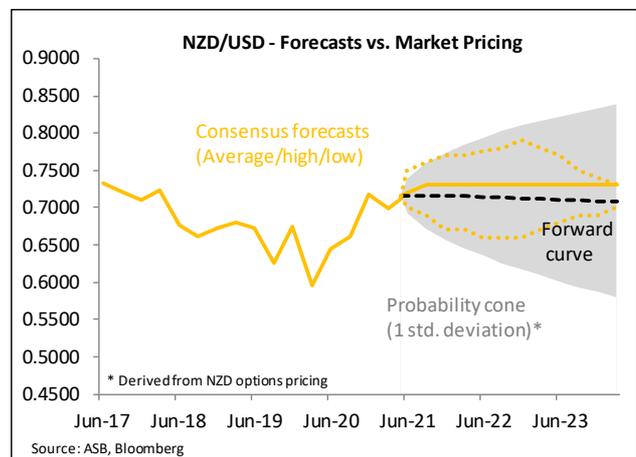
FX Hedging Considerations – What should you be thinking about?

Spot Position

NZD spot rates have been remarkably stable this year. Other than a quick round trip below 0.7000 in late March, it’s been a sideways 0.7100-0.7400 grind for the NZD/USD.

Market pricing has this sideways trend basically continuing. There is no obvious skew up or down in either analyst forecasts or implied pricing from FX option markets (chart opposite).

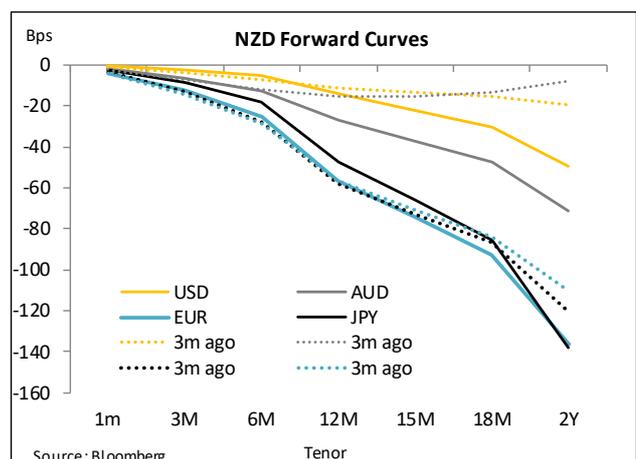
We continue to hold a constructive NZD bias, which was validated by the brevity of the sub-0.7000 dip in March. We think dips will remain short-lived given positive NZD fundamentals (see *valuations* section). That is, we stand by the view expressed in the Special Topic of the last CHT. The risks are tilted more toward a topside break out of the NZD/USD range, rather than a break to the downside. If anything, our conviction around this view has strengthened since the last CHT.



Hedging Instrument - Forwards¹

NZD forward points have mostly fallen since our last CHT (chart opposite). This entirely reflects the fact that NZ wholesale interest rates have risen by more than the rest of the world over the past three months.

Despite this, our point from the previous CHT remains. Forward points for many NZD currency pairs are barely different from zero, historically speaking. This means all-in hedged rates are pretty close to spot rates. The implication is that forward points are not a material consideration for corporate hedging activity for the moment. Nearly all of the variation in all-in hedged rates (spot rate + forward points) will be coming from the spot



¹ See Appendix for the ‘what’ and ‘when’ of the hedging instruments discussed in this section.

rate.

So, in summary, NZD spot rates remain largely range-bound (NZD/JPY excluded) and forward points are not a material consideration. In other words, there's been little in the way of, at least market-related, triggers to change hedging strategies. Keep doing what you're doing.

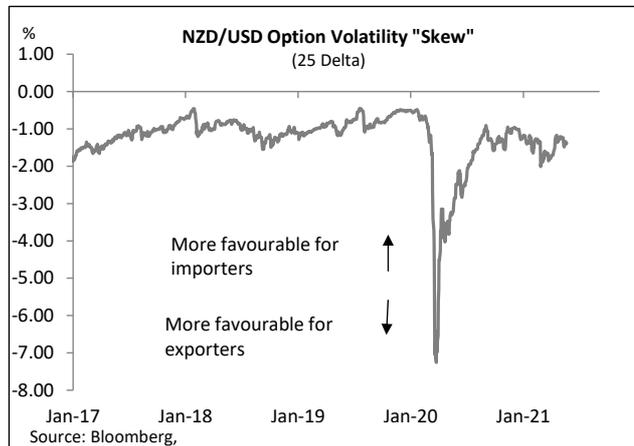
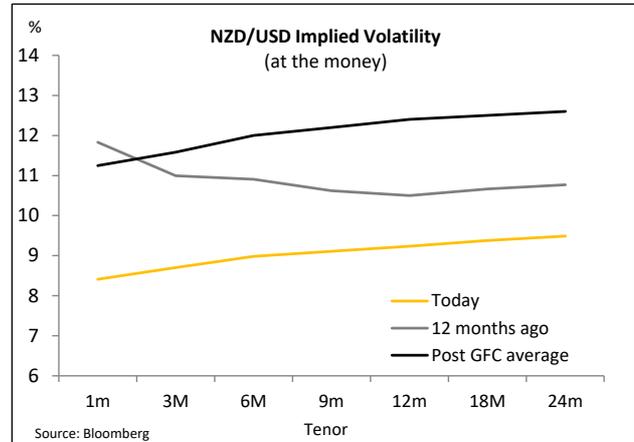
Hedging Instrument - Options

Last month we released a short [CHT Insight](#) flagging the big fall in NZD/USD implied volatility ("vols"), and what it meant for corporate risk management. Since then, vols have ground a little lower still.

The broad conclusions of the *Insight* piece remain intact. Low vols cheapen the pricing of many FX option structures, boosting their relative appeal for corporates. 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. As discussed in the piece, we think the bias towards lower vols will continue. Market sentiment will remain underpinned by central bank stimulus and an increasingly turbo-charged global recovery.

The pricing of **collar structures** has not been affected to the same degree. FX collars involve the simultaneous buying and selling of options, which neutralises most of the impact of lower vols.

The chart opposite shows that the FX volatility 'skew' for NZD/USD – the key market-determined pricing component of collar structures – hasn't changed much lately. Relative to historical averages, the skew continues to favour sellers of NZ dollars (e.g. importers). This means the pricing of collar structures for importers remains more attractive than usual (although not necessarily attractive in an outright sense, as discussed in the *Strategies* section).



Hedge Tenor

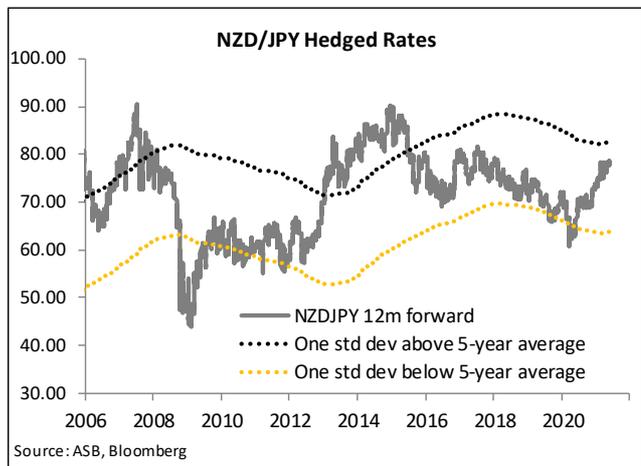
With spot rates range-bound, there are no 'calls to action' offered up by our hedge duration model (see overleaf for explainer).

The model tracks the deviations of all-in hedged rates from 5-year averages as one way of ascertaining when currency pairs might be around cyclical extremes – a possible trigger for risk managers to re-examine hedging duration.

Of the six NZD pairs we monitor (table opposite), the one to keep an eye on in this regard is NZD/JPY. It's been creeping steadily higher as a key beneficiary of the 'reflation trade', and is now approaching the topside trigger around 82.50. A break through this level could be a catalyst for exporters to think about winding back the duration of NZD/JPY hedges, and for importers to increase hedge duration in this pair.

Hedging Duration Model			
	+1 st dev trigger	-1 st dev trigger	High/low trigger hit?
NZD/USD	0.7524	0.6166	●
NZD/JPY	82.50	63.80	●
NZD/AUD	0.9975	0.8730	●
NZD/EUR	0.6475	0.5270	●
NZD/GBP	0.5847	0.4550	●
NZD/CAD	0.9750	0.8120	●

Note that none of the ‘triggers’ in the table should be treated as gospel. The idea is to provide a simple quantitative (and hence objective) ‘heads-up’ that the cycle (up or down) might be close to peaking. Conversation starters, if you will.



Hedge Duration Explainer – How far out should you hedge?

Decisions around FX hedge tenor should be driven primarily by business requirements – things like the timing of exposures, treasury policies, and commercial requirements for certainty or flexibility. The influence of market factors on tenor decisions should be a secondary, but nevertheless important, consideration. It’s these market factors that we discuss above.

For an exporter, an opportune time to be thinking about increasing FX hedge duration (i.e. increasing the average tenor of the hedge book) is when available hedge rates are close to cyclical lows. Conversely, exporters should think about winding back their average hedge duration when hedged rates are cyclically high. Of course, for importers, the reverse of all this applies.

By gradually increasing/reducing hedge duration when the currency moves into historically high/low areas, corporates may be able to add incremental value to their hedging strategies relative to typical benchmarks. One way to get an objective steer on where the NZD might be in the cycle is via models that track all-in hedge rates relative to some sort of average. This is the essence of our hedge duration model. It tracks 1-year forward hedged rates against a 5-year moving average. It generates a cyclically high/low “signal” – a possible trigger to rethink hedging duration – when hedged rates move more than one standard deviation away from this average.

CHT Special Topic – What are the implications of the inflation comeback?

For the first time in a decade, markets are abuzz with talk of inflation.

A perfect storm of global supply shortages, rebounding economic growth, and massive COVID stimulus programmes is putting a rocket under cost pressures. Commodity prices have bounced strongly. Wage inflation is also turning the corner. There is still a lot of uncertainty about how much all of this is likely to be transitory vs. sustained. But we know many firms are looking to recoup higher costs by raising prices this year. In NZ, surveyed pricing intentions are at the highest level since records began.

So what does the return of inflation mean for markets, and for corporates thinking about financial risk management?

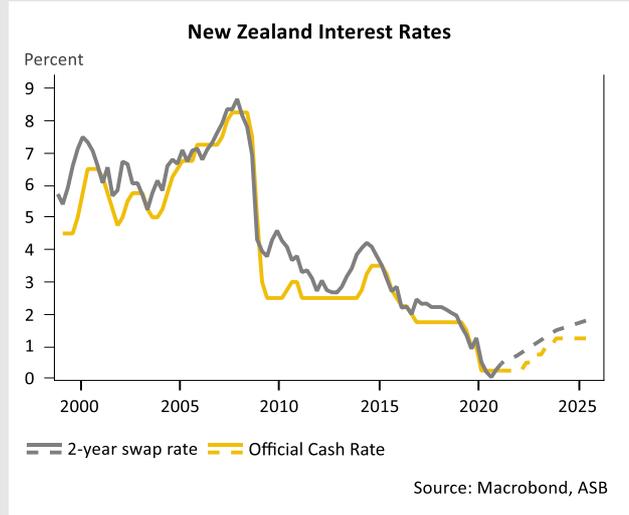
The first point is that higher inflation is already priced to some degree. “Breakeven” inflation rates – a sort of market-implied inflation expectation – have soared. For example, US 10-year breakevens recently skirted 8-year highs around 2.55%. That is a full 150bps higher than this time last year. The slow trend higher in wholesale interest rates of the past 6 months also reflects an implied expectation of higher inflation this year and next.

But should inflation pressures continue to build, we see three high-level implications for financial markets and those exposed to them:

(1) **Higher wholesale interest rates.** Central banks may have to capitulate on the idea that the global inflation spike is entirely temporary, reducing stimulatory policies earlier than currently planned. We think the chances of this risk crystallising are relatively high, albeit it's partially priced already. Indeed, we saw the first signs of such from the RBNZ in May. Central banks are understandably cautious, but markets can continue to speculate about early stimulus withdrawal, which would keep the uptrend in wholesale rates going. The chart below shows that, in past NZ interest rate cycles, wholesale yields have often risen a fair way prior to any shift in the OCR itself.

(2) **Volatility.** We're starting to see this already. The great inflation debate – will this year's inflation spike be sustained or temporary? – is far from resolved. And so any time a run of economic data or central bank rhetoric threatens one side of the debate there can be big movements in markets – equities, yields, and currencies. Witness the 1½% round trip in the NZD/USD following April's huge US inflation print.

(3) **The currency market reaction** to higher global inflation is difficult to discern. That's because exchange rates are a relative price, so the *relative* pace of inflation across countries is what matters. For example, the large US inflation surprise noted above briefly caused the USD to appreciate and the NZD/USD to fall a cent.

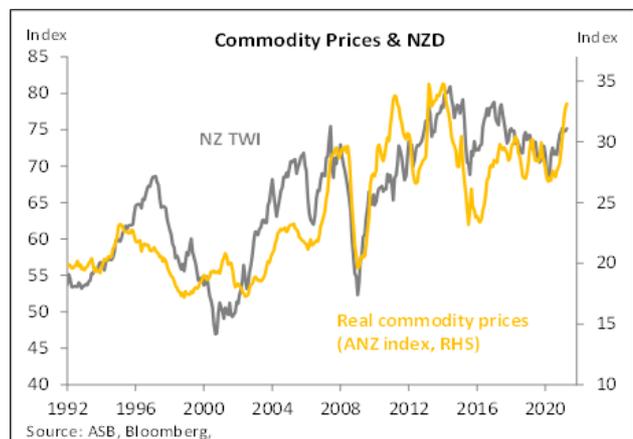


Our take on the reaction to ongoing *global* inflation surprises is that the environment would probably be NZD/USD positive. The 'growth-sensitive' NZD would draw support from further uplift in global commodity prices. And NZ's solid economic platform relative to other countries would see investors further speculate on the RBNZ being one of the first central banks in the world to lift policy interest rates, bolstering interest rate differentials in favour of the NZD.

Exporter Strategies

Our ideas around exporter hedging strategies haven't changed much since our last *CHT* in February. That's because market conditions and the outlook haven't changed much. We see the key of these factors as being:

- A NZD that is largely middling in terms of its position in the cycle. Short-term and long-term [valuation](#) modelling do not have the currency as "expensive", despite the recent appreciation.
- Supportive medium-term fundamentals, notably commodity prices. Indeed, the NZ TWI looks a little *undervalued* relative to commodity prices (chart opposite). No one knows exactly where the NZD will end up, but these supports, in the least, should keep the currency supported on dips, like the brief episode we saw in March.
- Market pricing from an exporters' perspective that is *relatively* unfavourable for forwards and collars (forward points and risk reversals at high levels), and *relatively* favourable for purchased options (very low implied volatility).



The net of these factors means that, in our view, exporters should still be thinking about:

- Using dips in the NZD/USD as opportunities to add to cover levels, as part of a strategy to return hedge ratios back above treasury policy midpoints.
- Despite the relatively unfavourable pricing relative to options, adding forward cover on dips appears more compelling than using options given the solid fundamental backdrop described above. A higher share of options would be more appropriate when the NZD is around cycle-highs, and there is a greater chance of breaking even on option premium spend via a big fall in the currency.
- Collars may hold some appeal around the top-end of the NZD/USD's recent range. For example, if the spot rate got back up to 0.7350, a three month zero-cost exporter collar that protected 0.7600 on the topside would allow participation back down to the bottom of the range around 0.7080 (all levels are indicative only).

Importer Strategies

The FX market backdrop generally remains favourable for buyers of foreign currency like importers. All-in hedged (via forwards) rates for most NZD currency pairs have been gradually trending higher in recent months (NZD/GBP and NZD/EUR excluded). Moreover, the outlook is for broadly more of the same, with most forecasters expecting the NZD to hold up or appreciate further.

This naturally reduces the urgency to hedge amongst importers, as does the fact that many would have achieved budgeted NZD rates already given the steady currency appreciation over the past year. Nothing is certain in the world of foreign exchange though, and we still don't think hedging strategies should be based on currency forecasts. So, for importers, strategies we've been thinking about include:

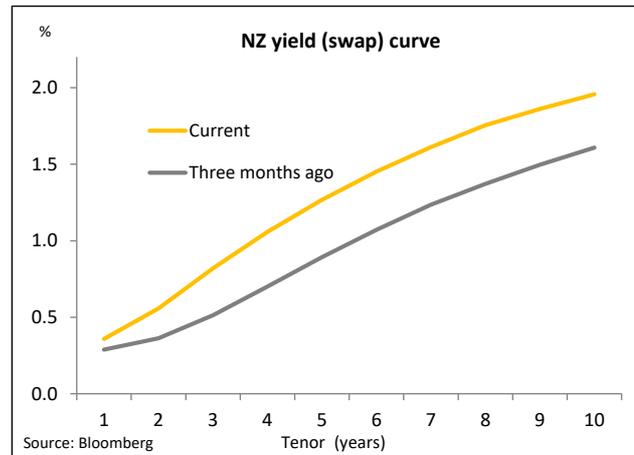
- **As we discussed in our recent [CHT Insight](#), there are opportunities around vanilla put options.** FX vols have fallen to low levels, cheapening the pricing of options. For those wanting the opportunity to participate in a potentially higher NZD/USD in future, the purchase of an option allows the holder to effectively buy time, while retaining the insurance policy of a "worst case" rate.

By contrast, we don't think FX collars are particularly compelling for importers, even with the favourable shift in the option volatility skew noted earlier. As an example, a vanilla 6 month purchased NZD put option protecting a NZD1m exposure at a worst case of 0.6950 would cost around NZD15k (rates are all indicative and based off market mids). This offers unlimited upside. Turning this into a zero-cost collar would involve introducing a cap around 0.7520. In other words, the transactor under the collar scenario would be giving up more downside than they are obtaining upside potential (based on a spot rate of 0.7260). Not good risk/reward there.

- **Erring of the side of caution when it comes to setting the duration of forward hedges.** We understand that supply chain disruptions are still playing havoc with the delivery times of many imported goods. These delays mean that any FX hedges on ordered imports are having to be rolled, often several times, before delivery takes place. So it might make sense to err on the side of setting hedges for a slightly longer duration than usual. This will help avoid the transaction costs of repeatedly rolling forward hedges.

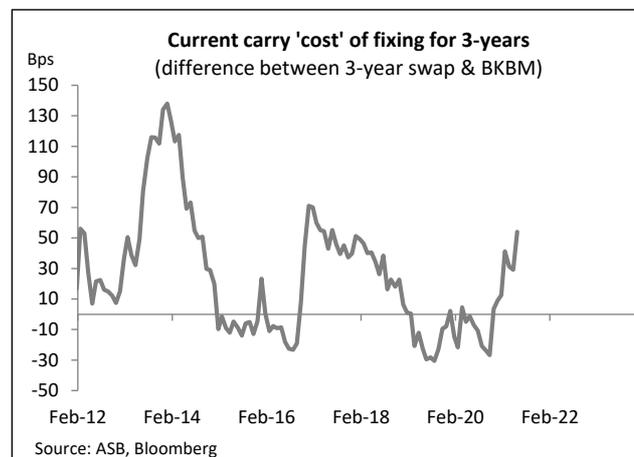
Interest Rates – Market Themes

- More of the same. Global wholesale interest rates have continued to head higher since the last CHT.
- Economic reopening, impressive vaccination progress (notably in the US and UK), and the rapid return of inflation pressures (see [Special Topic](#)) have seen markets continue to bring forward the expected timing of central bank stimulus withdrawal. See [RBNZ pricing](#).
- The NZ swap curve is up 10bps (1-year) to 70bps (6-year) since the last CHT. The outsized lift in the belly of the curve (5, 6 year tenor) reflects a re-jigging in the market’s OCR expectation following the surprisingly forthright May RBNZ [announcement](#).



Interest Rates – Hedging Considerations & Strategies

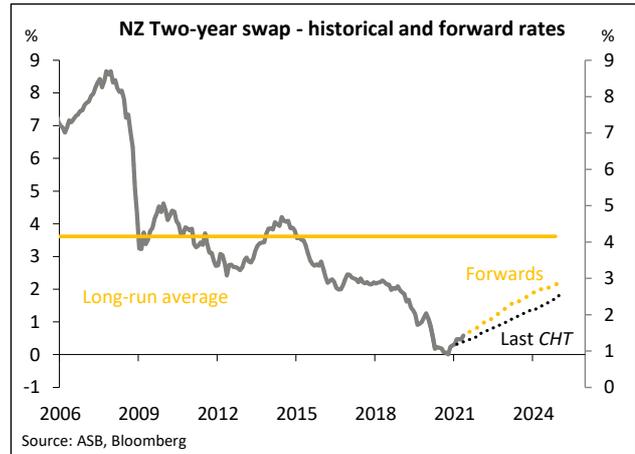
- In the last [CHT](#), we saw “value in the curve for corporates looking to add pay-fixed cover at shorter-term (1-3 year) horizons. Forward pricing further along the curve looks a little rich.” **This view has roughly played out.** Short-term swap yields have continued to trend higher since our last update, while longer-dated yields have tracked broadly sideways.
- **So, what now?** Below we lay out all the usual considerations and caveats for risk managers. In short, we think the big moves seen since the last CHT now leave short-rates roughly “fairly” priced, while long-term rates can probably rise further from here as ‘reflation’ continues. It’s essentially a rotation of the view from our last CHT.
- Broadly, there are two main considerations in deciding whether to lift levels of interest rate hedge cover:
 - **An individual firm’s desire for certainty** over interest expense. This is based on a certain risk tolerance, mandated in a treasury policy or specified by the Board. It’s often static over time. For example, cash flow at risk must be kept below “\$x” at all times, or the level of fixed interest rate cover must not drop below “y%” of forecast debt over a three year horizon.
 - **Market conditions** and the economic cycle. This is the more dynamic part of the decision matrix. That is, a corporate might look to flex fixed interest cover percentages over time as the outlook for interest rates and hence the cost of hedging (or not hedging) changes.
- **The risk profile has clearly tilted towards higher interest rates.** The global economy is strengthening, the NZ economy continues to outperform, and policy-makers are suddenly talking about how and when to wind up the ‘emergency’ monetary stimulus deployed during COVID.
- **The rub for risk managers is that market pricing has responded,** and it now costs more to hedge. For example the chart shows the ‘carry’ cost of entering a three-year pay-fixed interest rate swap. The pay-fixed (mid) rate of around 0.85% is still extremely low



relative to history, but the spread to the 90-day (BKBM) rate – the quarterly fixing “cost” – is currently the highest in four years around 55bps. Interest rate [forward rates](#) have also moved up, increasing the cost of longer-dated or forward-start interest rate hedges.

- **This extra cost, and the fact that market pricing for RBNZ rate hikes is starting to look quite punchy, are factors that might encourage corporates to stay floating** or to think twice about lifting levels of fixed-rate hedge cover. A lot has to go right for the RBNZ to start lifting rates in April/May, as is currently priced.

But fine-tuning forecasts for policy rates is difficult at the best of times, and especially so now. This publication is more about managing risk. And the risk is that the trend for higher wholesale interest rates continues. Global economic activity and inflation have consistently beat analyst expectations for an entire year now and there’s a good chance this momentum continues. Forward pricing for the next five years still only implies wholesale rates returning to the (still low) levels of 2018 (chart opposite).

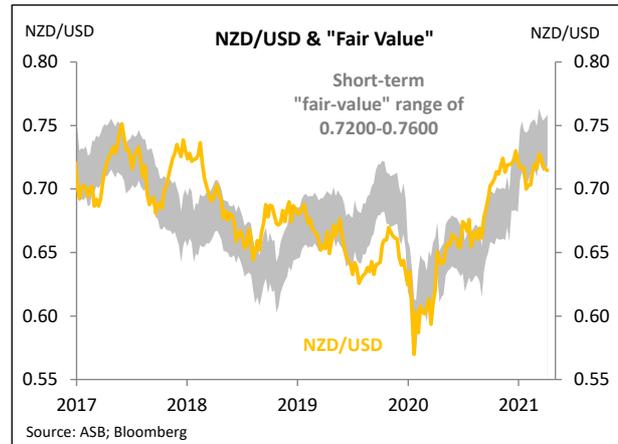


- **This risk appears more pronounced at the long end of the interest rate curve.** Short-end rates – one to two year swap yields – will be capped to some extent by RBNZ machinations. The longer end of the yield curve tends to be driven more by movements in global yields – Australian and US yields in particular. And we see these as biased higher given the turbo-charged global recovery, heightened inflationary pressures and the eventual stimulus wind-back from the RBA and Federal Reserve.
- **Overall, we maintain the view we outlined in the last CHT that it’s “appropriate to maintain hedge ratios at current levels or start to move them up** when opportunities present themselves”. The previously popular, and indeed highly successful, strategy of letting fixed interest rate hedging ratios erode towards the lower end of policy bands now carries more risk. We’d still be wary of going to policy maximums though.
- **To our minds, blend and extend (B&E) strategies have value given the risk profile described above.** This involves extending the duration of existing (shorter-dated) cover at market rates. In doing so, the borrower increases longer-dated hedge ratios, without lifting the shorter dates and incurring the extra carry cost noted above. A B&E strategy also helps a corporate to ‘average down’ the overall rate on the hedge book by participating in current low rates.

Valuations Chart Pack – Foreign Exchange

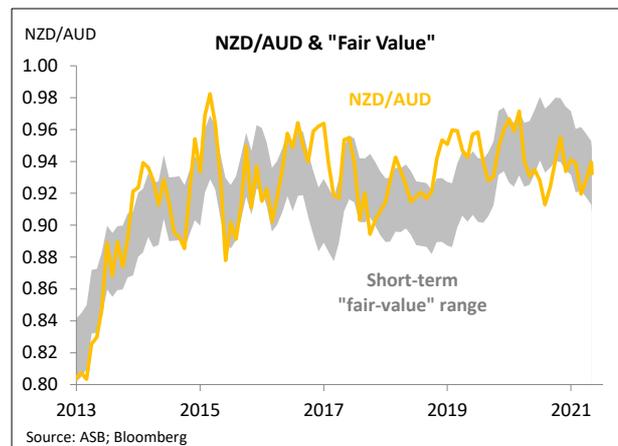
NZD/USD short-term fair-value range **0.7200-0.7600**

- Our short-term valuation model provides an objective estimate of fundamental NZD/USD “fair-value” based on its fundamental drivers: commodity prices, risk appetite, and NZ-US interest rate differentials.
- FV is a full 4 cents higher than our last update. Higher commodity prices and risk appetite have done most of the heavy lifting here, and both are linked to the fact the global recovery continues to beat expectations. By contrast, interest rate differentials are only a little higher, thanks to the RBNZ’s less dovish stance.
- We see the relatively low position of the NZD/USD spot rate against FV as a fair reflection of the risk profile . That is, it’s marginally “undervalued”, short-term.



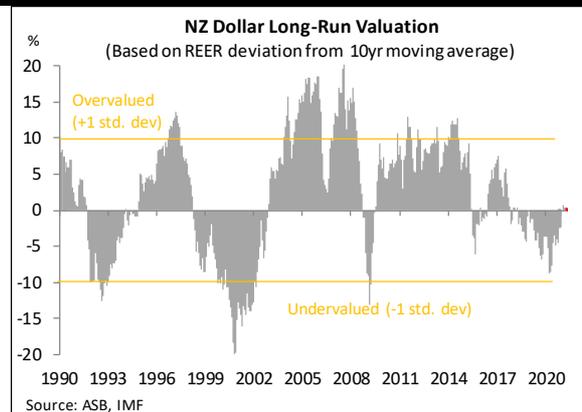
NZD/AUD short-term fair-value range **0.9150-0.9550**

- Our new NZD/AUD short-term valuation model is based on NZ-AU interest rate spreads, relative commodity prices, and relative equity market performance.
- NZD/AUD FV has been pretty stable over the past few months, matching the stability of the spot rate. Interest rate differentials remain the key upward force under NZD/AUD FV with the other two factors tending to pull it down.
- NZD/AUD is bang in the middle of our FV range and is thus broadly “fair”. We still see some risk the cross heads back down toward the bottom end of FV if the RBA becomes less dovish over the coming quarter.



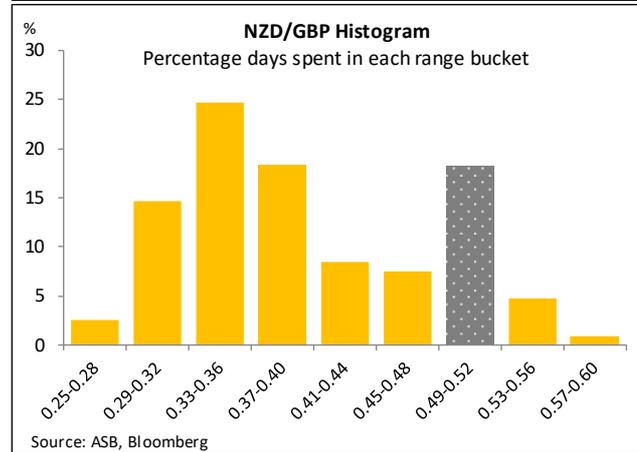
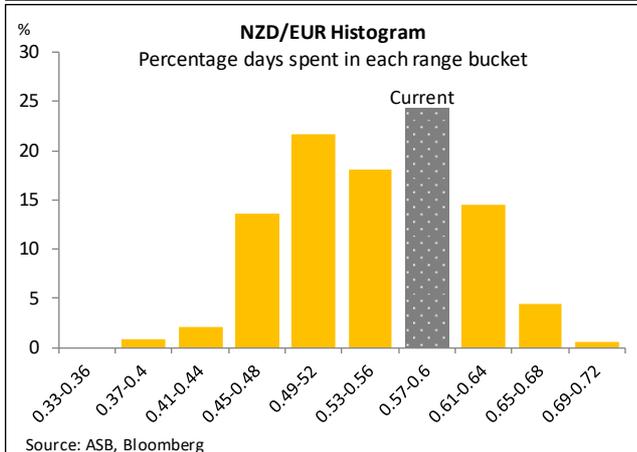
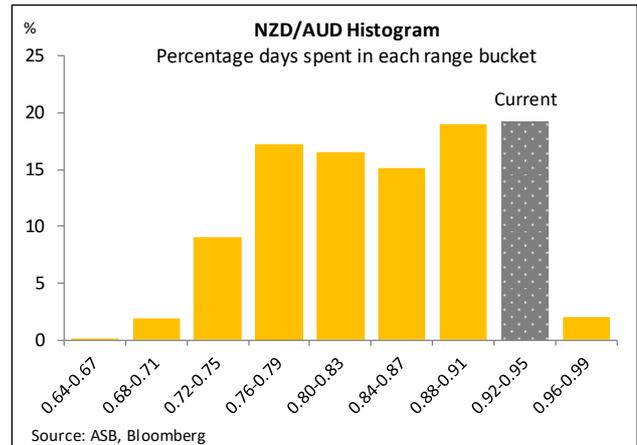
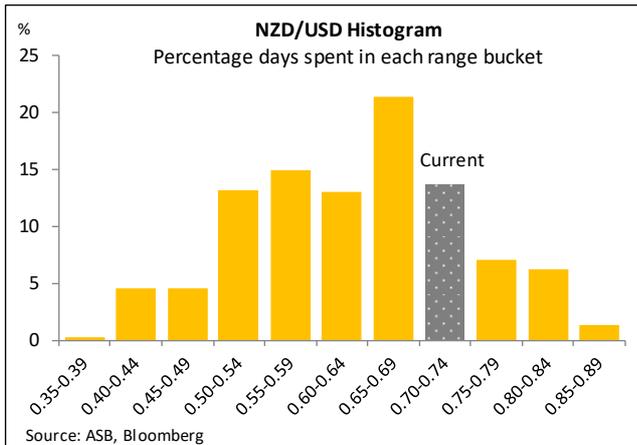
NZD/USD long-run equilibrium **0.6900**

- Our real effective exchange rate model estimates the trade-weighted NZ dollar (TWI) is about as close to “fair” as it gets (that is, neither overvalued or undervalued). The past year’s appreciation has eradicated the prior ‘undervalued’ status.
- Amongst the NZD crosses, the relative outperformance of the NZD/USD has left that pair around 5% *overvalued*. The OECD estimates a long-run PPP equilibrium of around 0.6900.
- None of these valuations are sufficiently stretched to



have any implications for the NZD at this point in the cycle.

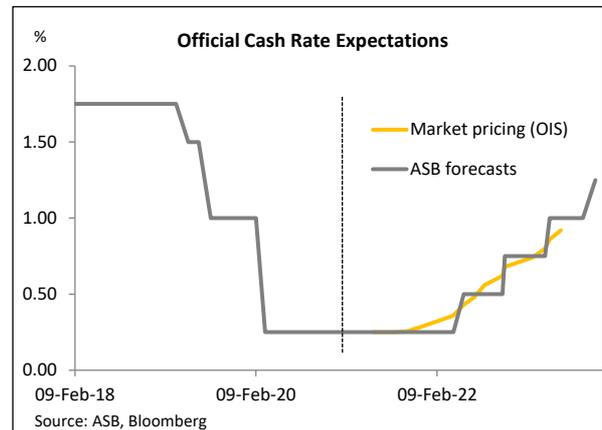
NZD Position in the Cycle – Histograms



Valuations – Fixed Interest

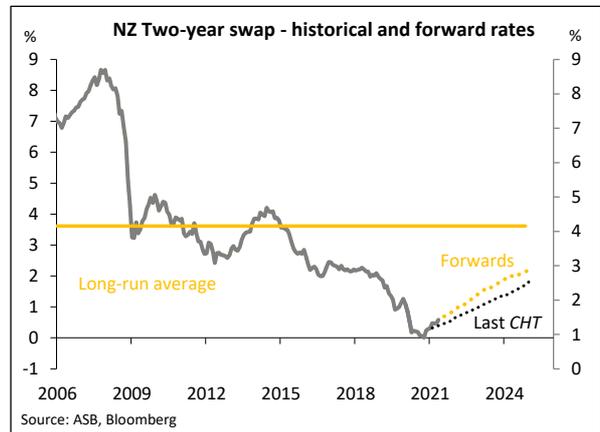
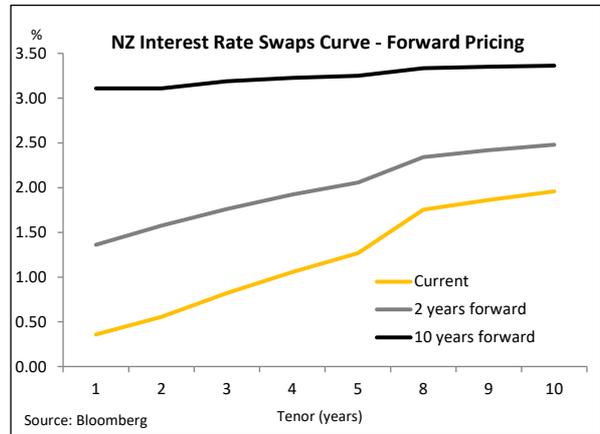
NZ Yield Curve – RBNZ pricing

- The timing of the expected first RBNZ rate hike has been brought forward, both according to our own forecast (May 2022) and market pricing (May/June). The RBNZ’s own forecasts imply July.
- We have no major quibbles with market pricing. Yes, a lot has to go right to have the Bank hiking by mid-2022. But we certainly don’t have enough of an issue with it to actively push back and hence flag the risk of a short-term correction in wholesale interest rates.



Forward Pricing & Breakevens

- The negative interest rate debate seems like a long-time ago. Not only has the current swap curve continued to trend higher over the past three months (see [market update](#)), but the forwards market has it rising another 50-100 bps over the next two years.
- This is a big move but we think its largely justified on the basis of changes to the risk profile. The NZ economy no longer needs ‘emergency level’ interest rate support.
- The shift up in forward rates makes it more expensive to hedge longer-dated interest rate exposures (for example by using forward-starting swaps).
- A decision to increase fixed interest rate cover now essentially ‘locks-in’ current pricing. That is, if the RBNZ ultimately hikes faster/earlier than currently pricing current hedge rates would have delivered value. The opposite is true if the RBNZ underdelivers against market expectations.
- One framework for examining this decision more closely is by using “breakeven” analysis. The table shows it is possible to obtain fixed-rate cover in the swap market for 3 years at 0.82% (all rates are indicative). The ‘breakeven’ on fixing for this 3-year term is for the 1y swap rate – which perhaps best encapsulates RBNZ OCR expectations – to be at or above 1.36% in 2 years time (from 0.36% now). If this is not perceived as likely, it’s better off floating. If it is, locking-in interest rate cover for that 3-year term offers some value.



NZ Swap Curve - Forward Start Matrix						
Swap term	Forward Period					
	Spot	6m	1y	2y	3y	5y
1y	0.36	0.52	0.76	1.36	1.79	2.43
2y	0.56	0.81	1.06	1.57	1.96	2.52
3y	0.82	1.06	1.30	1.76	2.11	2.61
4y	1.06	1.28	1.50	1.92	2.24	2.67
5y	1.27	1.48	1.68	2.06	2.34	2.72
10y	1.96	2.10	2.24	2.48	2.68	2.97

Notes: Rates are indicative only and based on market mids

Appendix - Which Hedging Instrument When?

Instrument	What	When
<p>FX forward</p>	<p>Hedging an FX exposure using a forward contract 'locks-in' a future exchange rate, thereby costlessly providing certainty.</p> <p>Forward exchange rates are determined by adding market-determined forward points to the spot rate.</p> <p>Forward points are driven by relative interest rates between two countries.</p>	<p>Prudent situations to hedge using FX forwards might be when an FX exposure becomes certain (for example a future foreign currency payment is contracted) or when the currency is currently at an acceptable level for a corporate but the risk of an adverse movement would materially impact revenue or cost lines.</p> <p>We don't necessarily advocate "view-based" hedging, but a forward would also be the best hedging product for an exporter (importer) that had a strong view that the currency was about to appreciate (depreciate). Bear in mind though, that if the currency moves in a favourable direction, you are still locked in to deal at the agreed rate, that is, there is zero participation.</p>
<p>FX option</p>	<p>FX options provide the buyer with the right, but not the obligation, to buy/sell foreign exchange at a pre-agreed rate (the option "strike") at some point in the future.</p> <p>Options are usually structured to protect a 'worst-case' rate, while also allowing varying amounts of participation in favourable currency movements. There is usually a premium payable.</p> <p>Implied volatility (currency "vol") is the key market-determined component of option pricing. The other components – spot rate, maturity, strike, amount – are usually stipulated by the buyer.</p>	<p>Options provide flexibility. Buyers of options are not 'locked-in' to do anything (other than pay the option premium).</p> <p>This being the case, situations where options offer value are when a future exposure is uncertain in terms of timing, size, or probability of occurring. Options can be used to hedge or partially hedge the exposure but, if it doesn't materialise or it changes, a buyer can simply walk away or sell the option back to a bank. All that would have been lost is the option premium.</p> <p>Options also offer a prudent alternative to corporates going 'un-hedged'. For example, an exporter requires FX cover at a lower rate than current spot and believes there is a good chance the NZD can fall. Going unhedged carries significant risk. But by buying a call option, the exporter is protected at a worst-case rate in the event they are wrong.</p>
<p>Interest rate swap</p>	<p>An agreement between two parties to exchange a stream of interest payments for a set period of time.</p> <p>In a corporate context, swaps are most commonly used to convert a series of floating interest rate payments (for example on bank debt) to fixed interest payments, as a means of hedging against the risk that market interest</p>	<p>A corporate will enter a fixed for floating swap anytime it wishes to increase the percentage of debt hedged onto fixed rates.</p> <p>This could be for business reasons, for example a corporate's debt load is increasing, or it needs to protect covenants or rating agency metrics from the possibility of higher interest costs. Or it could be for market reasons, for example the economy starts running hotter, increasing the risk market interest</p>

	<p>rates might rise.</p> <p>Note that an interest rate swap can only hedge against market or base rates rising, a swap cannot hedge the funding/credit component of interest costs.</p>	<p>rates rise.</p>
<p>Interest rate swap – forward start</p>	<p>An interest rate swap contract agreed today but with a delayed start date.</p>	<p>A corporate wishes to hedge future interest rate risk now. For example, debt might be low now but forecast to increase materially in three years time, and a corporate wants to hedge against the risk that interest rates rise between now and then.</p>

Glossary

Option Moneyness – A description of where an option’s strike price lies in relation to the spot rate. The further “out-of-the-money” an option is the further away the strike price is from market and the less valuable and cheaper the option is.

NZD Put Option – The right but not the obligation to sell NZ dollars and buy foreign currency at an agreed rate on a particular date.

NZD Call Option – The right but not the obligation to buy NZ dollars and sell foreign currency at an agreed rate on a particular date.

Option Strike – The price at which foreign exchange is transacted in an option contract if the option is exercised.

FX Implied Volatility (often referred to as option “vol”) – Forward looking view of the likely volatility of a particular currency over a certain period. Key determinant in option pricing.

FX Collar – Obtained by the simultaneous purchase and sale of out-of-the-money put and call options, thus locking in a narrow range of possible hedge rates. A collar provides a worst-case rate but also limits participation to a best-case rate in beneficial currency movements.

Zero-Cost Collar – A collar structured for zero cash cost to the buyer. The cost of purchasing an option offering protection to the buyer is exactly offset by premium earned from the simultaneous sale of another option limiting participation in favourable moves.

Option Volatility “Skew” – The difference in implied volatility between a call and a put option that are the same distance out of the money. The skew is essentially the market’s (traded) preference for puts over calls and hence affects the pricing of collars, which incorporates both.

ASB Economics & Research

Chief Economist
 Senior Economist
 Senior Economist
 Senior Economist
 Economist
 Senior Economist, Wealth
 Data & Publication Manager

Nick Tuffley
 Mike Jones
 Mark Smith
 Jane Turner
 Nathaniel Keall
 Chris Tennent-Brown
 Judith Pinto

nick.tuffley@asb.co.nz
mike.jones@asb.co.nz
mark.smith4@asb.co.nz
jane.turner@asb.co.nz
nat.keall@asb.co.nz
chris.tennent-brown@asb.co.nz
judith.pinto@asb.co.nz

Phone

(649) 301 5659
 (649) 301 5853
 (649) 301 5957
 (649) 301 5661
 (649) 448 8778
 (649) 301 5915
 (649) 301 5660

www.asb.co.nz/economics

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