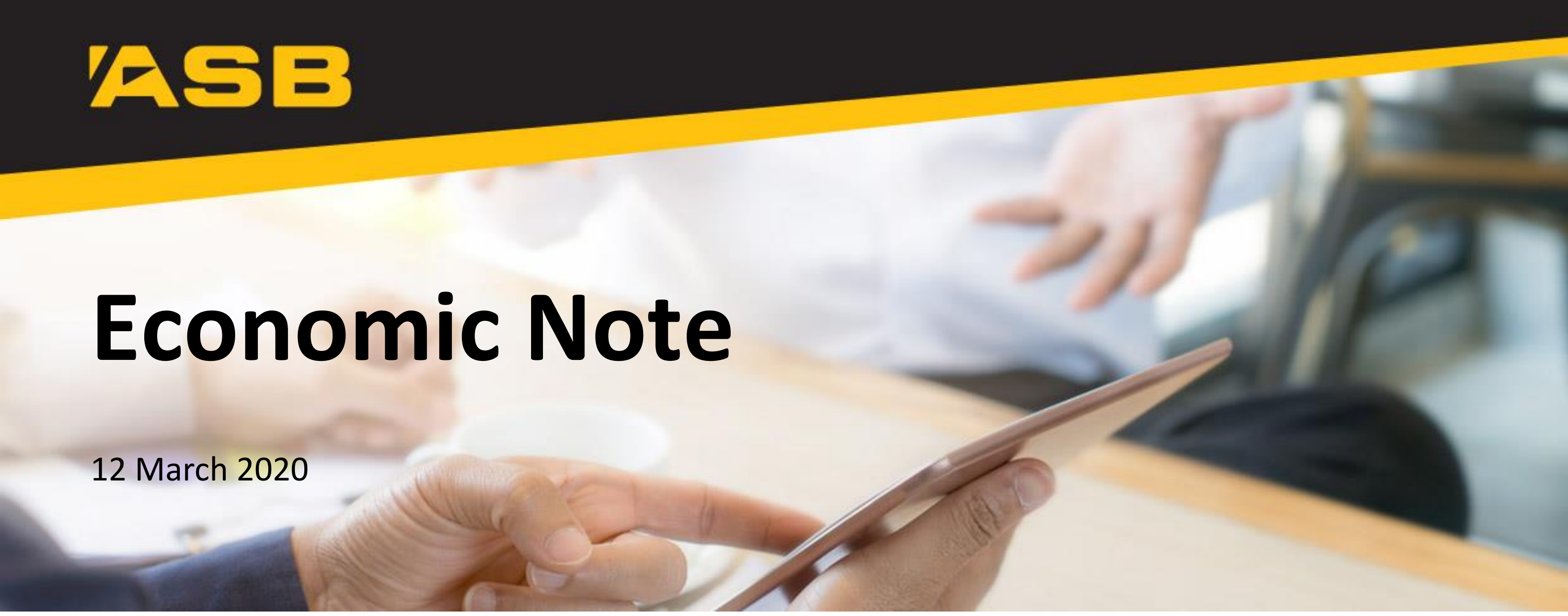

Economic Note

12 March 2020

COVID-19: Market impacts, responses, and ideas

- There's been a wide range of impacts on corporates from recent market turmoil and supply chain disruptions
- We put forward a few ideas on managing financial markets exposures during these increasingly uncertain times

Summary and key take outs

The global outbreak of the coronavirus COVID-19 is having an increasingly jolting effect on global financial markets. In this short note, we look at recent market movements through a NZ corporate lens, and ask a bunch of questions that many of our corporate customers will no doubt be pondering themselves:

What have been the key market impacts of the COVID-19 outbreak?

What's been the impact on corporates with financial markets exposures?

What are corporates doing?

What do we think?

This note focuses primarily on financial market impacts and possible solutions. We've already published on some broader business impacts, and will shortly release a note discussing the various economic scenarios currently confronting the global and NZ economies.

What have been the key market impacts?

- **Volatility** has increased, from very low levels. Common global measures of volatility like the VIX index, implied currency volatility used in options pricing, and the actual traded ranges of market instruments have all jumped. For example, the average daily traded range of the NZD/USD has been 2.2% over the past week. This compares to the 10-year average of 1.1% and the 2019 average of 0.7%.
- **Interest rates have collapsed.** Global bond and swap yields have collapsed to fresh all-time lows and NZ yields have followed suit. At the time of writing, NZ 2- and 10-year swap rates are down 44bps and 68bps respectively for the year to date, at 0.8% and 1.10%.
- **FX markets** have been unusually calm, with the rather large exception of Monday's 'flash crash' in NZD and AUD. NZD/USD and AUD/USD have spurned their usual 'pro-cyclical' status and actually appreciated during the recent period of turmoil. This mostly reflects sharp falls in US interest rates and the resultant widening in NZ-US and AU-US interest rate differentials. It's been a different story amongst the NZD crosses where new lows have been made all over the place – NZD/GBP, NZD/EUR, and NZD/JPY have hit 4-,5-, and 8-year lows respectively.
- **NZD/USD and AUD/USD forward points have tumbled**, a mechanical pass through of the fall in relative yield differentials between NZ/Australia and the US. NZD/USD forward points are now negative at all tenors, thus ending the historically unusual period of the past two years during which forward points were positive.

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- **Credit markets** are starting to react. Funding spreads at both short-term and long-term tenors have widened. For example, the closely followed US three-month "Ted Spread" (difference between US Treasury and Libor rates) has widened from 11bps to 40bps while 10-year US corporate bond spreads are 30bps to 60bps wider than February levels. Spreads remain well below other "crisis" events like the European debt crisis, but it's nevertheless a something to watch. Corporate bond issuance has also been disrupted.
- **FX and interest rate market functioning** for the most part remains fine. Liquidity in longer-term NZD forwards (12 months and longer) has reduced but spot markets are fine with only negligible changes to bid/offer spreads in NZD/USD and NZD/AUD.

What's been the impact on corporates with financial markets exposures?

There's been a wide range of impacts, and severity of impacts, on corporates from recent market turmoil and supply chain disruptions. The list below is by no means exhaustive but provides a flavour of some of the more common issues.

- **Overhedging.** Both importers and exporters have been left with cover they no longer need. On the export side, export demand, particularly in China, has dried up in certain areas and existing or new orders have been cancelled. Meanwhile, some importers from China have been unable to source adequate supply given widespread shutdowns across Chinese manufacturing. There have also been big changes in the timing of some exposures as shipments have become lumpier.
- **Exposure uncertainty.** It's difficult to stick to a hedging plan when the nature of the underlying exposure is increasingly hard to pin down. This uncertainty extends not only to new exposures, but some existing contracts are also being renegotiated meaning hedges have needed to be re-set.
- **Cash management issues.** Delays in shipping/payments, contract renegotiations, and revenue volatility are posing cash flow and working capital challenges.
- **Accounting impacts** – As with any big swings in markets, there have been big changes in accounting valuations of hedging instruments. The impact of such will be less for those that use hedge accounting (at least in an earnings sense).
- **Market uncertainty** – The NZ dollar and NZ interest rates have fallen dramatically. Volatility has jumped. The outlook is murky to say the least. All of these things make it difficult to plan. Revenue and cost expectations must be revisited much more frequently, and forecasting and planning goes from hard, to borderline impossible in some situations.

What are corporates doing?

The range of responses and actions appears to encompass: being proactive and forward-looking at one end of the spectrum, to waiting for the whole thing to blow over at the other. Some of the actions noted below may prove instructive for those grappling with similar challenges.

<u>Foreign Exchange</u>

- **Addressing overhedges**. Corporates finding themselves in this position have either taken cover off, or rolled it further into the future for use later in the year. Those that have removed cover have generally done so only where the marked-to-market valuation is favourable (i.e. importers). Exporters rolling cover will at least be doing so at forward points that are more favourable (more negative) than two weeks ago.
- **Exploring optionality.** Either via purchasing options outright, or by funding options through the value available from (in-the-money) forward contracts.
- **Hedging less.** Some are choosing to pause hedging programmes until the fog clears a little.
- **Looking at additional financing** to cover cash flow gaps and extra working capital requirements to manage increasingly lumpy inventory/orders.
- **Being opportunistic where possible.** Some exporters have pounced on the opportunity of the lower NZD spot rate to lock-in lower hedging rates by either a) converting FX options into forward contracts, effectively "banking" the lower currency, or b) increasing cover using forwards.

Interest Rates

- **Watching and waiting,** for the most part.
- Some, more active market-watchers, have leapt on the opportunity the collapse in NZ interest rates provides and used it to average down weighted-average interest rate hedges. This has been done either via entering new interest rate swap hedges or "blending and extending" existing interest rate cover (lowering the fixed rate on existing interest rate cover by extending the duration).

What do we think?

We don't profess to have any silver bullets. Everyone's situation is different and the future has suddenly become wildly uncertain. But we have offered a few pointers below on managing financial markets exposures during uncertain times.

- **Ignore forecasts**. We'd argue FX and interest rate forecasts shouldn't be a major factor in formulating a hedging strategy anyway, but this is even more pertinent in the current environment of elevated uncertainty.
- **Stress test exposure expectations.** If there is a chance that forecast revenue or cost lines could be affected by recent and likely upcoming disruptions, err on the side of caution and hold off on hedging, or hedge less. This may require approvals/exceptions from Treasury policies. But in shock type scenarios, it is crucial to take steps to avoid getting into over-hedged situations. Cover may later need to be removed, potentially at a loss.
- **Think about lowering FX hedge ratios towards the bottom of policy bands, or explore using FX options**. Both of these strategies help preserve flexibility and mitigate the issue of hedging uncertain exposures. True, options have become more expensive in this volatile environment but it's worth noting that implied currency volatility (the key market-determined component of option pricing) is still *below* the 10-year average.
- **A similar approach is prudent for interest rate exposures.** It might be worth holding off hedging interest rate exposures until the dust settles. Time is on your side in any case. Interest rates in NZ and around the world look set to be slashed further.
- **For importers, think about budgeting at worse NZD rates than current spot.** Domestic and global recessions have typically spelled bad news for the NZD, particularly when they occur at the same time.
- **Be prepared for more volatility.** For example, if your budget rate is usually derived by taking the spot rate and adding/subtracting two cents, we'd suggest now adding/subtracting four cents.
- **There will be opportunities** for businesses relatively unaffected by the disruptions. We've already seen some corporates taking advantage of the steep falls in the NZD and NZ interest rates.
- **Related to this, try and use increased volatility to your advantage**. For example, FX orders left a long way away from market might previously have stood only a small chance of getting filled. But in this environment, leaving "flyers" on the order board might allow you to snatch a bargain. The NZD/USD traded a 4½ cent range on Monday!
- **Talk to your bank**. Your financial markets dealer is likely to be talking to a bunch of corporates in similar circumstances and may be able to help with your situation. Similarly, have a chat to your banker early doors if additional financing may be required to facilitate higher working capital requirements, cash management challenges, or cover revenue holes.
- **Be proactive –hope is not a strategy.** Examples of front-footing it include:
    - Using value embedded in existing forward contracts to support a new option-based strategy. Options can be helpful in this environment for allow participation in favourable currency moves (i.e. not locking you into a certain rate) while still offering protection at a "worst case rate", all on a no-obligations basis. For importers, there are a range of option structures that can be used to effectively "buy time" if current spot/forward rates are not viable. Talk to your FX dealer.
    - For those corporates with less uncertain exposures, extending hedge duration (via forwards or options) at current market rates will "average down" the rate on your hedge book. This has benefits in terms of smoothing the impact of FX on costs/revenues and lessening the shock factor of old cover running out and rolling onto lower rates.

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