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2022 FX Hedging Guide

Minimize Risk, Maximize Savings & Grow Your Business

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“If you don’t invest in risk management, it doesn’t matter what business you’re in, it’s a risky business.” –Gary Cohn

It’s Risky Business

Corporations lose billions to foreign exchange volatility each quarter. In Q2 2020, North American and European corporations suffered $9.54 billion in FX losses—a 55% increase from the previous quarter.[1]

Exchange rate fluctuations can impact your bottom line. However, businesses have long viewed currency volatility and FX losses as a necessary part of operations, almost an inevitable byproduct of being in the international market.

Fortunately, it doesn’t have to be this way.

A deeper understanding of global liquidity and more effective hedging strategies can minimize the impact and losses incurred by FX volatility.

Benefits of FX risk management

According to a 2020 survey, many SMEs with annual FX Volumes above $2 million endured financial losses due to currency fluctuations during the COVID-19 pandemic.[2] Yet half of those SMEs still haven’t implemented a proper hedging strategy.

Done correctly, an FX risk management strategy can:

- Protect profit margins and cash flow.
- Improve budgeting and financial forecasting.
- Enhance understanding of how exchange rates affect cash flow and balance sheets.
- Reduce earnings volatility.

[1] https://info.kyriba.com/kdc/curency-impact-report-july-2021?_mv=765941a2-1a17-485b-8f4c-7582352cd7c3
[2] https://insights.nordea.com/en/business/5-steps-to-manage-your-currency-risk/

FX Industry Expectations for 2022 and Beyond

Global trade took a historic dip during the height of the coronavirus pandemic. But less than a year later, the markets also experienced an unprecedented V-shaped recovery—a renewed (some would say continuing) bull market cycle that we are still riding into the end of 2021.

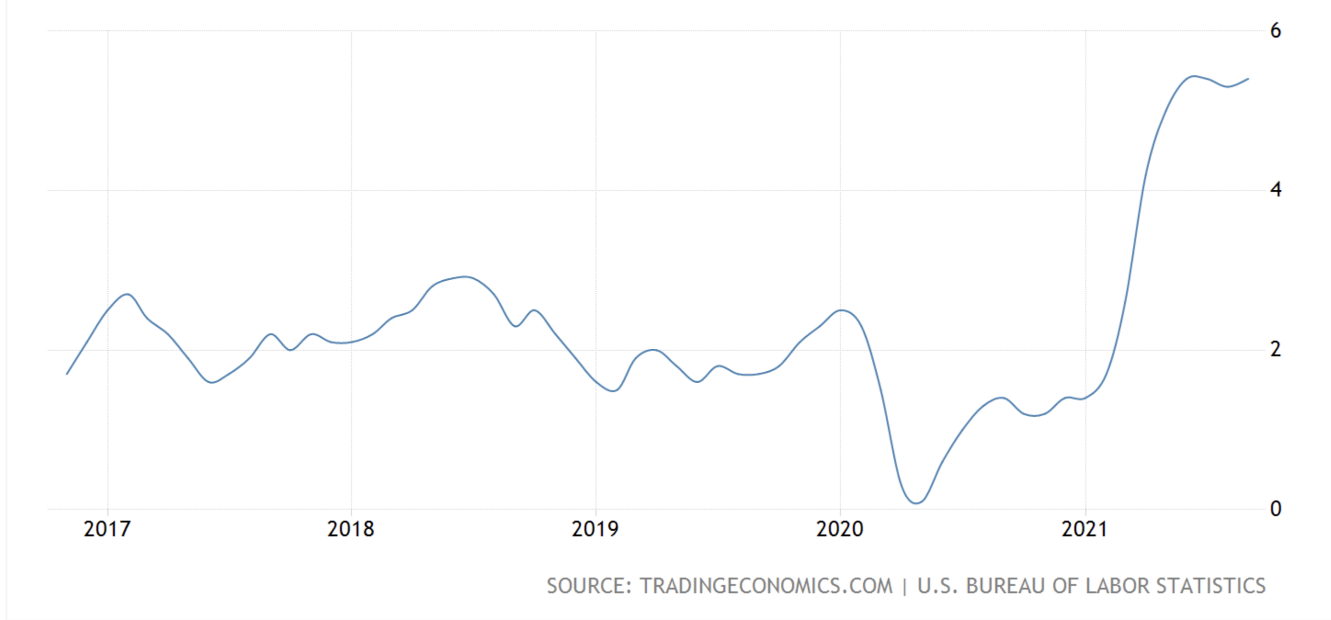
At the same time, inflation is back on the menu, recently reaching a 30 year high. As experts continually note, the Federal Reserve tapering of bond-buying could strengthen the US Dollar.[4] But due to ongoing delays in international trade, likely an appreciating greenback won't impact US export sales until early 2023.

Ongoing economic uncertainty also remains a concern. In times like these, there are no guarantees in the global markets. Recoveries will be uneven and highly dependent on the unique policies and actions of governments taken on a case-by-case basis.

Raw materials and labor shortages[5] are another concern. In the summer of 2021, 90% of US builders reported material shortages. The global chip shortage dominated financial headlines this year, with corporations from Volkswagen[6] to Apple[7] taking financial hits. In October 2021, job vacancies in the UK reached record highs, largely due to labor shortages and wage issues.[8]

A dynamic FX risk management strategy can both minimize the risk of currency volatility, as well as address the chronic supply chain issues globally.

[4] https://www.forbes.com/sites/billconerly/2021/09/21/economic-forecast-for-us-exports-2022-2023/?sh=3019cc033b75
[5] https://nahbnow.com/2021/06/record-number-of-builders-report-material-shortages/
[6] https://www.cnbc.com/2021/10/28/chip-shortage-continues-to-wreak-havoc-on-vw-and-stellantis.html
[7] https://www.bloomberg.com/news/videos/2021-11-01/the-chip-shortage-slams-into-apple-at-the-worst-time-video
[8] https://apnews.com/article/coronavirus-pandemic-business-european-union-europe-economy-d271730f25fb55c-75c7f8e775f55645c



Runaway inflation may take a big bite out of the US Dollar.

Consider the following statements from some of our customers. Although simple, they each give quite different, but important details around hedging objectives that we can use to support you in establishing a path forward.

"My margins on this product are so tight, if the euro moves higher next year I'll be losing money."

"I have inconsistent cash flows, so flexibility is really important to me with regard to timing and amounts."

"My view is that the euro is going to weaken the first half of next year, so I can probably wait it out and review then."

"I should've hedged CAD 3 months ago when it was weaker, now I'm underwater with my budget rate and need the rate to improve 1-2% before I can hedge."

GIVE ME A CALL

Getting Started with Hedging

First, you'll need to get a better understanding of when and where your organization is most exposed to FX market fluctuations before you can tailor a flexible risk management strategy that aligns with your business goals.

1. Understanding FX Exposure

Having accurate, up-to-date data offers a clear picture of your FX exposure which can help determine a prudent FX hedging strategy.

Forecast foreign-denominated exposures by answering these questions with your team:

- Do you have a budget rate or breakeven exchange rate?
- Do you have any desire to outperform your budget rate?
- What are your anticipated FX volumes for 2022?
- What impact would a 10% adverse currency move have on your business?
- Would you like to benefit from a positive move in exchange rates?
- What are your future plans? (Upcoming contracts, acquisitions, or divestitures?)
- How do you fund overseas subsidiaries?
- Any natural hedges?
- Do you have any competitors domiciled in the countries you do business?

2. Managing Forecast Uncertainty and Currency Volatility

Every organization has different points of FX exposure. These may include:

- Overseas purchases
- Exports
- Multi-Currency Operations
- International Partners
- Supply Chain Costs

https://tradingeconomics.com/united-states/inflation-cpi

FX Risk Management Strategies to Employ

Now, let's dive into how companies can employ forex risk management strategies to protect themselves from currency volatility.

Strategy #1: Forward Contract

Looking to maintain budget certainty? Then forward contracts may help you stay within budget and minimize the impact of adverse exchange rate movements.

How forwards work (FX payable): Locks in a purchase of currency (sales of USD) at the forward rate for a set period, protecting the hedger for 100% of needs against the strengthening of the currency against the USD. At the expiry of the contract, the hedger will exchange USD for currency at the forward rate regardless of where the then market spot rate is. This enables you to more accurately forecast costs when managing operational expenses, receivables, and payables across countries and continents.

Strategy #2: Forward Extra Contract (Zero Cost)

Looking to protect against adverse exchange rates, maintain budget certainty while also potentially taking advantage of a favorable move in exchange rates at the expiry of the contract? A forward extra may be the way to go.

How forward extras work (FX payable): Locks in a purchase of currency (sales of USD) at the strike rate, protecting hedger for 100% of needs against the strengthening of the currency against the USD, while allowing participation in a weaker currency, but only to a pre-defined (knock-in) rate. Similar to forward contracts, forward extras offer protection against adverse rate movements and a diluted degree of participation in favorable rate movements.

Strategy #3: Combine Strategies

Most likely, your business will require a mix of FX hedging strategies to best minimize risk. No forecasted FX exposure will ever be 100% correct. To deal with inevitable uncertainty, you can:

- Forecast FX risk in ranges of high, low, and best estimate. Plan accordingly for each scenario. This way, if the worst happens, you're ready for it. Then, regularly reassess your FX risk management playbook.
- Layer hedges over time. For example, at the beginning of the fiscal year, your firm could initially hedge 25% of expected exposure. At the beginning of each subsequent quarter, you could hedge an additional 25%. This spreads out your risk.

GIVE ME A CALL

Case Study

ABC Company is confident they will have monthly payables of at least EUR 250,000 (€3m per year), and for 2022 their budget is based on a Euro rate of 1.1500. Assuming yearly exposure of EUR 3 million (roughly $3.5m) – the consequences of a material move in the exchange rate are significant.

If euro shifts by 5% = approx. $172,500
If euro shifts by 10% = approx. $345,000

FX hedging strategy #1- Forward Contract

ABC Company can lock in a worst-case exchange rate of 1.1400 to purchase EUR 250K per month, for each month in 2022. With this scenario, regardless of where exchange rates are at the settlement of each contract, ABC Company is guaranteed to purchase no better or worse than 1.1400.

With this strategy, you have the benefit of budgeting the USD cost of your EUR payables today, for the next twelve months. Of course - with the benefit of hindsight - if exchange rates move in your favor, it would always have been better to not hedge your risk.

Conclusion:
Provides 100% protection against a EURO move higher, the rate is locked. There is no potential for upside/ downside.

FX hedging strategy #2 - Forward Extra (Zero cost)

ABC Company can lock in a worst-case exchange rate to buy EUR at 1.1500 while being able to participate 2.6% lower at 1.1195. At the expiry of each monthly contract; if the EUR/USD exchange rate is;

- Above 1.1500 then ABC Company will purchase euro at 1.1500
- Between 1.1500 and 1.1195, then ABC Company can buy euro at the current market rate (or do nothing) as there's no obligation.
- Below 1.1195, then ABC Company will be hedged at 1.1500 for only that contract.

With this strategy, you pay no upfront payment or fee. Rather, you pay for the currency protection by giving up a portion of your opportunity for currency gains. Of course - with the benefit of hindsight - if exchange rates move in your favor, it would always have been better to not hedge your risk.

Conclusion:
Provides 100% protection against a EURO move higher (albeit at a worse rate than the forward) and also provides a benefit of a rate improvement down to 1.1195 (below 1.1195 knocked into 1.1500)

Prepare for 2022 and beyond

The foreign exchange market never stops moving. Let us do the work to ensure you not only minimize risk and maximize savings but also have more time and money to focus on what matters: growing your business.

At moneycorp, our goal is to help our customers understand all the possible hedging strategies available to them, and associated pros and cons. If you'd like to learn more about creating a tailor-made risk management solution please contact us to set up a call.

GIVE ME A CALL

Contact us

Office hours

8:30 am - 5:30 pm EST

Monday to Friday

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