Infinity
International Foreign Exchange

Economic Outlook Q4 2020

Focus on FX Budgeting & Strategies for 2021

Prepared by Jamie Jemmeson for Infinity International

Special Edition

Introduction

Looking ahead to Q4 we find ourselves in a place where we should see the conclusion of various risk events that have been looming since the turn of the year; namely Brexit UK/EU trade talks and the US Presidential Elections.

We have seen a roller coaster with regards to both of these uncertainties. At the time of writing, RealClearPolitics has Joe Biden winning the race to the White House with its aggregated betting odds showing a 61.6% probability of a Biden win. In the meantime, Smarkets is showing a 66% probability of a trade agreement between the UK and EU by the end of 2020. However, Trump was trailing Clinton and the majority of pollsters predicted that the UK will remain in the EU back in 2016, so could we see a repeat and the volatility once again increase dramatically as a result.

COVID is once again rearing its ugly head with restrictions from various countries increasing as they attempt to control the spread and avoid further widespread lockdowns. The impact on the FX market of such a lockdown could increase volatility anew, but this constantly developing narrative is being widely and closely monitored.

In a move away from our normal quarterly outlook (after all these are abnormal times), we will be focusing on some of the challenges that businesses are facing as we look towards 2021.

We will cover ground on budgeting and deploying a currency strategy that is appropriate for the uncertain future.

We still recognise that there are economic risk and events such as Brexit, COVID 19 and the Presidential Elections. We have written up to date articles surrounding the following topics that cover this, including:

- A Double Dip Recession or V Shape Recovery?
  CLICK TO READ MORE
- Brexit UK-EU Trade Talks
  CLICK TO READ MORE
- Do US Presidential Elections Affect the Dollar?
  CLICK TO READ MORE
- Racing Towards The Final Furlough
  CLICK TO READ MORE

The purpose of this quarterly update is to produce something that helps both our clients and wider network contacts, hopefully prompting some food for thought surrounding budget setting, whilst allowing you to decipher what is the best path for your business as far as currency strategy is concerned as we approach year end.

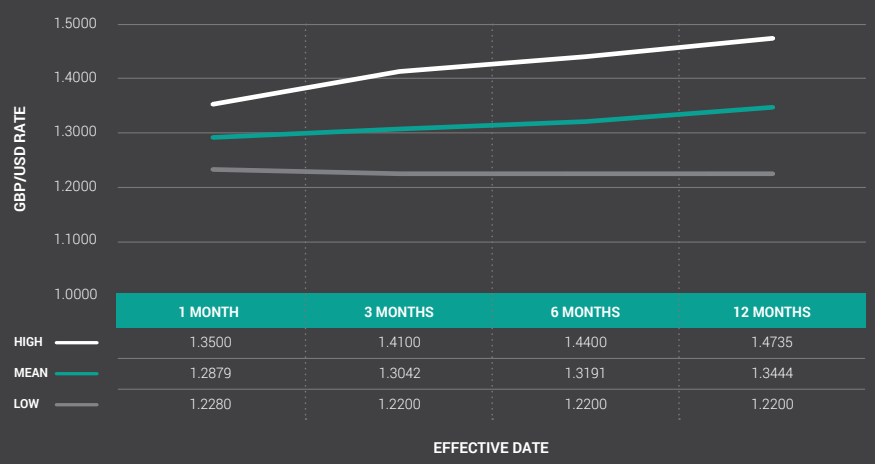
This year has been tough for many businesses, we are all hoping for an improvement in 2021, but in the words of James Cameron:

"Hope is not a strategy. Luck is not a factor. Fear is not an option."

FX Forecast

With so many unknowns that could materialise, we have collected the views of over 40 financial institutions to articulate the high, low and mean forecasts for the next 12 months in an attempt to provide this information to businesses.

As you will see, the forecasts still predict a high degree of uncertainty based on the differential.



	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS
HIGH	1.3500	1.4100	1.4400	1.4735
MEAN	1.2879	1.3042	1.3191	1.3444
LOW	1.2280	1.2200	1.2200	1.2200

GBPUSD Forecasts

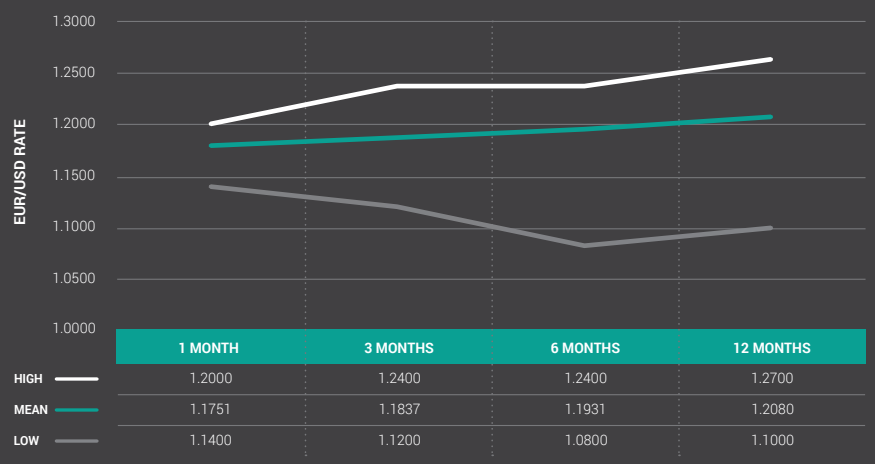
The differential between the high and low for the 12-month period:

25.35 cents

Circa:

19.5%

(based on the FX rate at time of writing).



	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS
HIGH	1.2000	1.2400	1.2400	1.2700
MEAN	1.1751	1.1837	1.1931	1.2080
LOW	1.1400	1.1200	1.0800	1.1000

EURUSD Forecasts

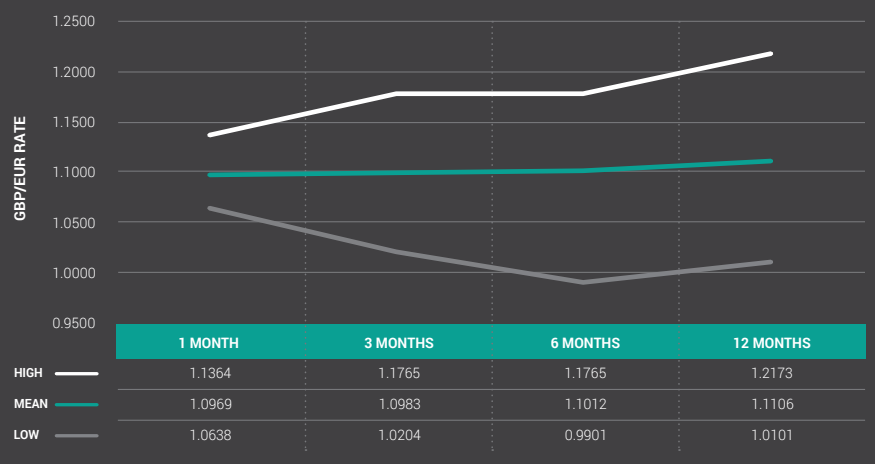
The differential between the high and low for the 12-month period:

17 cents

Circa:

14.45%

(based on the FX rate at time of writing).



	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS
HIGH	1.1364	1.1765	1.1765	1.2173
MEAN	1.0969	1.0983	1.1012	1.1106
LOW	1.0638	1.0204	0.9901	1.0101

GBPEUR Forecasts

The differential between the high and low for the 12-month period:

20.7 cents

Circa:

18.8%

(based on the FX rate at time of writing).

Setting your 2021 Budget Rate

FX budget rates are exchange rates used to convert projected non-domestic denominated revenues and expenses. They play a key role in the Financial Planning & Analysis process for companies operating internationally.

A budget rate should be - Attainable, Objective and Stable.

- **Attainable:** Achievable through hedging or natural offsets.
- **Objective:** Represent an unbiased estimate of the future exchange rate and growth projections.
- **Stable:** Minimise 'gap' between the budget rate in one period to the next.

However, there are several methodologies in setting budget rates and the correct approach will be defined by what is important to your business.

Some things to take into consideration are:

- Current spot rate
- Current forward rate
- Post period average
- Institutional forecast
- Off market rate

Each of the above have their pros and cons and may come down to the currency strategy (we will discuss this in more detail later) that your business deploys along with the line of sight that your business has on its exposure.

Understanding your FX exposure

COVID 19 has undoubtedly altered many companies' ability to forecast its exposure with the degree of certainty that they may have had historically. Identifying your exposure for next year, it may be pertinent to consider the following questions:

1. Has your FX exposure changed?
2. Do you have line of sight on your currency requirements and what are the terms associated with your payments?
3. If a "no deal" materialises, how will WTO tariffs impact.

We will explain each of these.

QUESTION 1

Has your FX exposure changed?

Understanding your exposure in these times may be difficult as so many variables are still in play. Questions arise such as whether there be a second wave and its impact; will the UK lockdown happen again.

These are questions to which nobody has the answers. However, some factors can be accounted and planned for.

As a result of the current economic conditions you may be using different suppliers or may be in the position where you may need to consider new providers because of potential lockdown scenario, supply chains being impacted or even business continuity.

If this is the case, consider if you may be exposed to new currencies outside of what you have historically planned for whilst also understanding the level of volatility that these currencies may be subjected to.

Question 2 & 3 →

QUESTION 2

Do you have line of sight on your currency requirements and what are the terms associated with your payments?

When considering the line of sight of your currency requirement based on the current conditions, could this increase, decrease or remain constant? What scenario will your hedge be based on and will you be able to reallocate these financial requirements if necessary; for example, if demand drops and you reduce the order with your manufacturer, can you utilise the excess currency on another order?

It has often been said that in a crisis "cash is king". With this mind, have your terms of business with suppliers changed or are you being asked to pay increased deposits to secure your purchase order? Due to the unknowns of COVID 19 and the resulting potential for supply chain disruption, what impact could this have on taking delivery of the goods and the subsequent FX hedge if a deposit is taken to settle the invoice?

QUESTION 3

If a "no deal" materialises, how will WTO tariffs impact?

At the time of writing, there has been no trade deal between the UK and EU agreed. Should this stance continue then this could mean that we see the trading goods under WTO rules for a period of time.

Whilst the situation remains fluid, it is important to consider the impact of any tariffs and what effect this has on either the financial planning or any assumption derived from any FX budget rates. This may come down to how your pricing with the end user is structured and respective competition from your peers.

The average on imports from the EU into the UK would be around 5.7 percent[1]. However, tariffs in some sectors – for example in agriculture and food, the car industry and textiles – would be "significantly higher", in some case greater than 30%[2].

[1] https://www.euronews.com/2018/12/19/how-would-uk-eu-trade-be-affected-by-a-no-deal-brexit

[2] https://www.theguardian.com/politics/2019/feb/23/uk-food-imports-from-eu-face-9bn-tariff-bill-under-no-deal-brexit

Can I avoid FX risk?

An inherited factor of doing business overseas is currency risk. There are four typical approaches to dealing with risk: accept, avoid, transfer or reduce. This paper will focus on the reduction of risk, but it is worthwhile highlighting the other forms of addressing FX risk.

Below are some examples:

FX Risk

Accept Risk
Accept the risk of the currency market, as it is part and parcel of doing international business. You can choose to reduce this risk or transact FX without a policy and hope exchange rates move in your favour.

Avoid Risk
One way to avoid FX risk is look at other avenues of doing business. For example, instead of importing the goods required you could source a domestic alternative or source the international goods from a domestic supplier.

Transfer Risk
Some businesses attempt to transfer FX risk by paying for the goods in their reporting currency, meaning the other party takes on the FX risk. While this is tough to negotiate, there are cases when it does happen. An example where transferring the risk may be possible is when the other party in the business relationship requires the currency to net their FX exposure risk down.

Reduce Risk
Two ways of reducing FX risk is to either net off currency requirements or deploy an FX hedging strategy. Netting off involves both receiving and paying for goods and service in a foreign currency, thus reducing the actual exposure that is required to buy or sell. However, it is very rare for this to be a perfect match, as most companies do not have this luxury. The other way to reduce risk is to deploy an effective hedging strategy.

Potential Currency Strategies

Set and Forget

OVERVIEW

This involves covering off each currency exposure when it arises for a future date with a forward contract, thus securing an FX rate that should be in line with the costing you have forecasted. This allows you to forget about the potential impact of future FX market volatility.

May be appropriate for:

- Businesses whose end user pricing is ineffective by FX movements.
- FX exposure and business largely unchanged during COVID conditions.
- Views currency management as a headache not opportunity.

BENEFITS

- Removes FX volatility at inception.
- Saves time and ambiguity, as it provides a simple and straightforward mandate.

CONSIDERATIONS

- If the FX market moves against your hedge, you could be subject to a margin call which could impact working capital.
- This strategy may be restrictive if end user price flexibility is required or your competition is able to adjust their pricing.

Blended Approach

OVERVIEW

A blended approach will consist of utilising a flexible forward and the spot market. When a currency requirement emerges, this approach will involve drawing down a proportion from your flexible forward and transacting spot on the remaining proportion, resulting in a blended rate for the currency required. Depending on where spot is trading, the notional amount left on the flexible forward and your outstanding requirements will be factors that you may wish to consider before deciding on the proportions you drawdown and transact at spot.

May be appropriate for:

- Businesses who may have some question marks surround supply chain and demand.
- Businesses that have limited certainty over future exposure.

BENEFITS

- Allows the business to obtain a level of protection whilst maintaining a degree of flexibility.
- Allows the business to benefit in part from advantageous moves.

CONSIDERATIONS

- Blended rate clarity may not be known until transaction.
- If market moves trends against you over a sustained period, your flexible forward may eroded quicker than expected, resulting in additional transaction at detrimental rates.

Layering approach (Partial Cover)

OVERVIEW

A layering strategy is a systematic approach to currency management that removes part of the emotion from decision-making. This involves buying multiple tranches of your currency requirement using hedging instruments for different maturity dates; a process that is repeated at a defined time; for example, at the end of each quarter. There will be multiple trades coming to value on the various maturity dates, which will provide you with an aggregated FX rate.

The aggregation of the multiple trades booked throughout the period acts to smooth the FX volatility during the duration of the exposure.

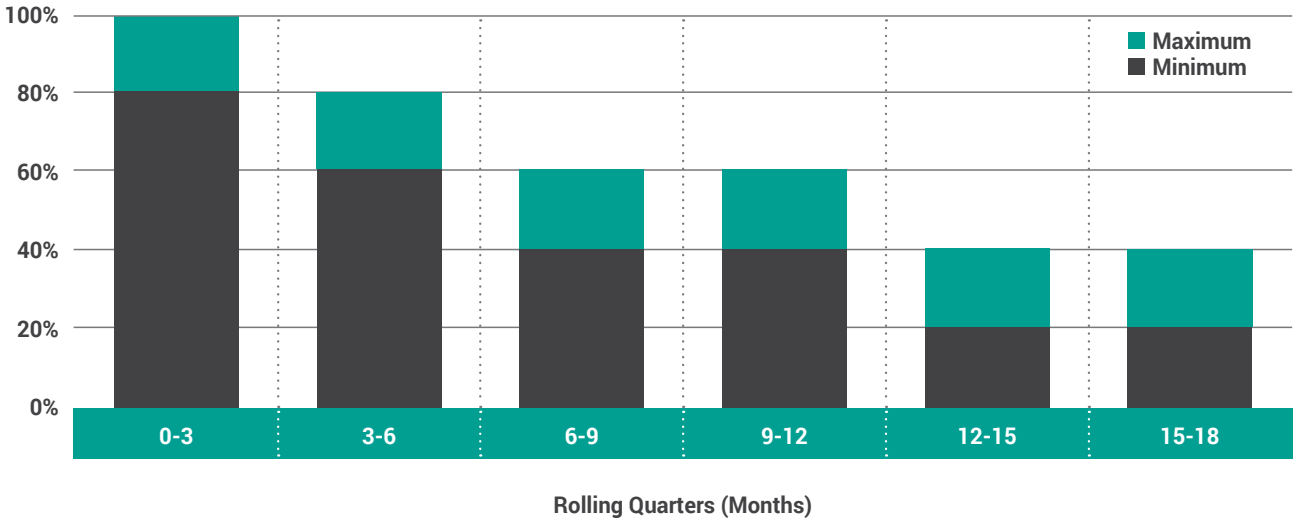
It is worth noting that an article by Bloomberg in 2016 highlighted that: "companies have been moving away from the annual, static set-and-forget hedging programmes and finding solace in the layering strategy that creates a continuous rolling hedge[3]."
Below is a diagram showing how this works.

In this current environment, this may help companies who are looking to get some partial cover in place and then booking additional tranches as the settlement of the invoice approaches or certainty increases.

May be appropriate for:

- Businesses who may have some question marks surrounding supply chain and demand.
- End user pricing might be more appropriate with smoothed FX rate.
- Businesses who have the ability to agile in currency management.

ASSIGNING HEDGE RANGES FOR FX FORECASTS



Source: Bloomberg

BENEFITS

- Systematic approach removes emotional decision-making.
- Acts to smooth FX volatility.
- Reduces likelihood of a margin call (dependent on your credit facilities and margin terms).
- Ability to be flexible with market conditions.

CONSIDERATION

- Final aggregated FX rate will not be known until all FX transactions for that tranche are completed. If the markets continue to move against you, the aggregated FX will continue to worsen.
- More complicated than "Set and Forget" so may require internal discussions.

[3] https://www.bloomberg.com/professional/blog/treasurers-rolling-flexible-fx-hedging-strategies/

Portfolio Approach

OVERVIEW

A portfolio approach to hedging generally involves multiple product classes, such as spot, FX forwards and structured products combined in a manner that fits the company's hedging mandate. An example is a 40/40/20 model – 40% structured products, 40% FX forwards and 20% spot.

May be appropriate for:

- Businesses who may have some question marks surrounding supply chain and demand.
- End users that are sensitive to price.
- Businesses who have the ability to be agile in currency management.

BENEFITS

- Provides a level of protection on company's FX exposure.
- Provides the ability to be flexible with product selection.
- Ability to benefit from advantageous movements on a proportion of the business's currency flow.

CONSIDERATIONS

- As a portfolio approach this may involve structured products, which could result in your final FX rate not being known until expiry of these products.
- Time factors involved in decision-making on product selection.
- Understanding of a wider range of products required and the potential impact of these.

What is right for your business?

In what was described as "Business as Usual" conditions, there was no silver bullet in setting a FX budget rates let alone the currency management strategy that sat behind it. The way that your business determines its budget rate and the currency strategy will be chosen on several factors such as risk appetite of the business, turnover certainty, the market sector and strength of the competition your business faces, to name a few.

The budget rate set at inception could be a factor in determining profit margins of the goods/services and therefore should not just be plucked from thin air; Remember Attainable, Objective and Stable. The currency strategy that sits behind the budget rate you set will be determined on the line of sight of exposure you currently have and the objectives you have.

Infinity International Head Office 25 Canada Square, London E14 5LB
Tel: +44 (0) 203 384 7280 | **Email:** info@iifx.co.uk | **Website:** www.iifx.co.uk