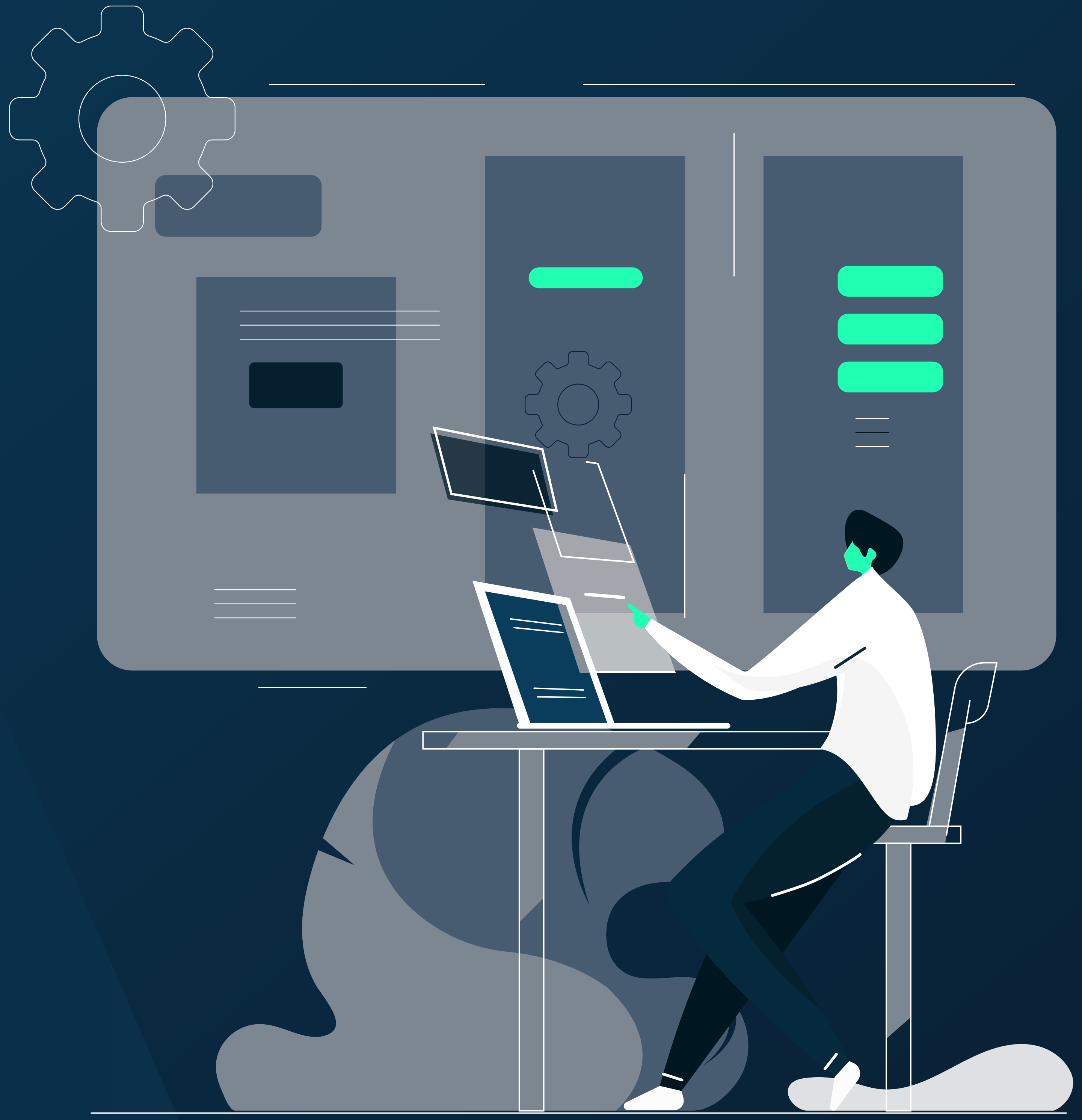
MillTechFX
by Millennium Global

The FX Risk Management and Hedging Guide for Corporate CFOs



Foreword

Having finally left the pandemic behind us, corporates now face an entirely new set of challenges. Against the backdrop of sharply rising inflation and currency volatility, over the past 12 months CFOs have had to adjust their priorities to reflect the changing environment in which their firms operate.

The surging dollar has become one of the dominant macroeconomic trends of the year. The **Wall Street Journal Dollar Index**, which measures the US dollar against a basket of 16 major currencies, has surged repeatedly this year and reached a new 20-year high as of August 22nd - up 10% since the beginning of the year and 13% from roughly a year ago.

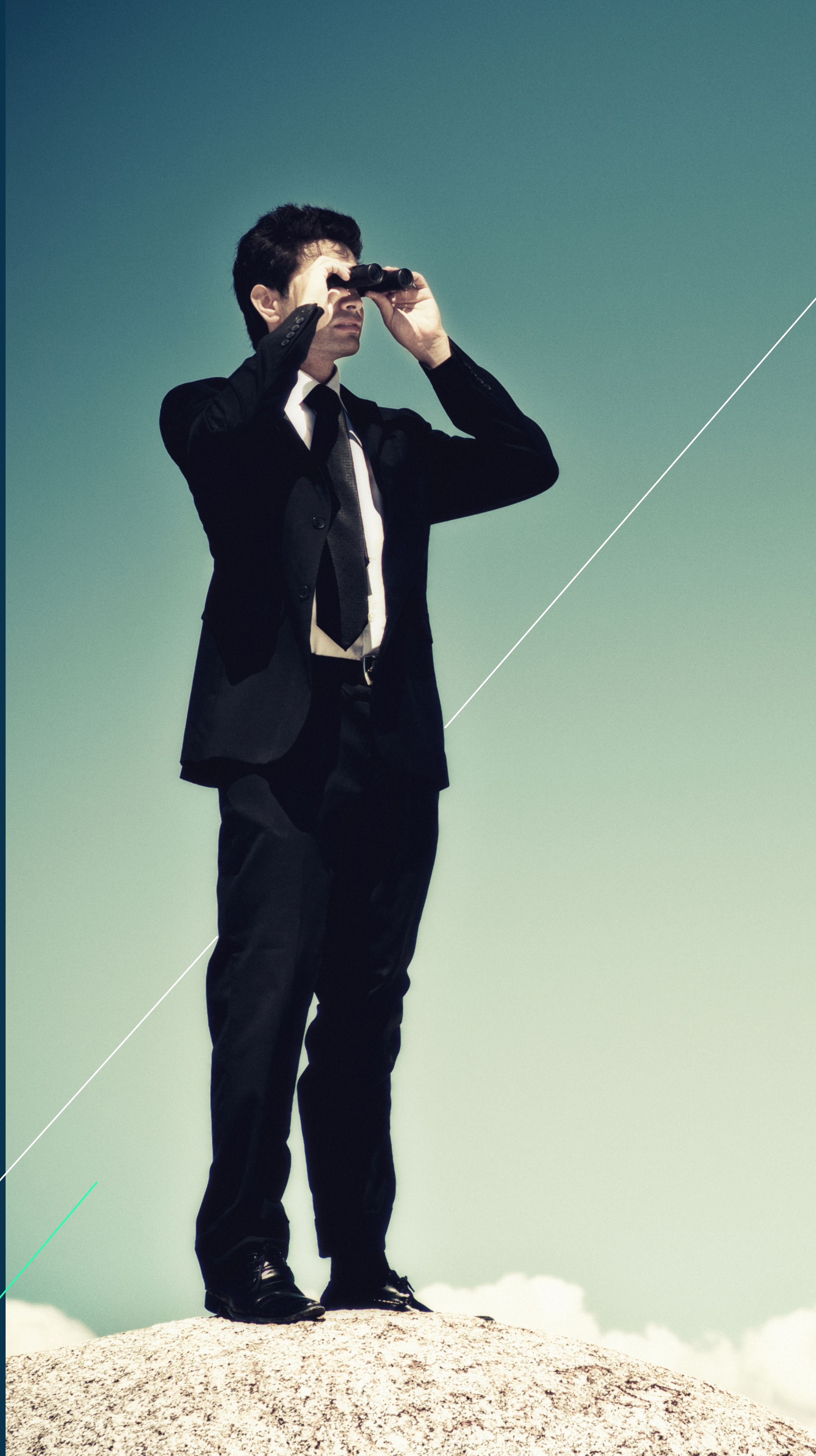
While the dollar's surge has brought some perks for American citizens – such as cheaper travel abroad – its rise has wiped billions off the earnings of global companies who consolidate in the US by lowering the value of their international sales. IBM, for example, has warned that further strengthening of the dollar could reduce its earnings this year by **$3.5 billion.**

The rise of the greenback has in parallel witnessed the depreciation of other major currencies such as the euro and the pound, which recently fell to a **20-year low** and **37-year low** respectively.

Corporates subsequently find themselves in a highly volatile climate. According to the **July 2022 Kyriba Currency Impact Report**, global foreign exchange (FX) impacts surged to $24 billion in Q1 2022 while North American companies reported a 200%+ increase in currency headwinds.

As a result of this uncertain environment, **FX risk management has become a top priority for corporates across the board.** Companies are closely reviewing their hedging strategies, with many who had not previously hedged now considering doing so.

In this guide, we explore the challenges that corporates traditionally face when it comes to FX risk management and share information on new developments and techniques that can help finance departments protect their bottom lines during these turbulent times.



Macroeconomic outlook

When considering their key priorities for FX risk management, we believe it is important that businesses first gain a deeper understanding of the current global macroeconomic backdrop so they can monitor key developments closely and develop an effective strategy.

Non-profit research organisation **The Conference Board** forecasts that while a global recession is not in its baseline scenario, the global economy is likely to edge closer to recessionary territory over the next twelve months. It believes that:

Global purchasing manager indices are sliding into near contractionary territory

Headwinds to global growth expected to increase in coming quarters

Broad economic downturn likely to begin in early 2023

High inflation to remain present across markets and sour business sentiment

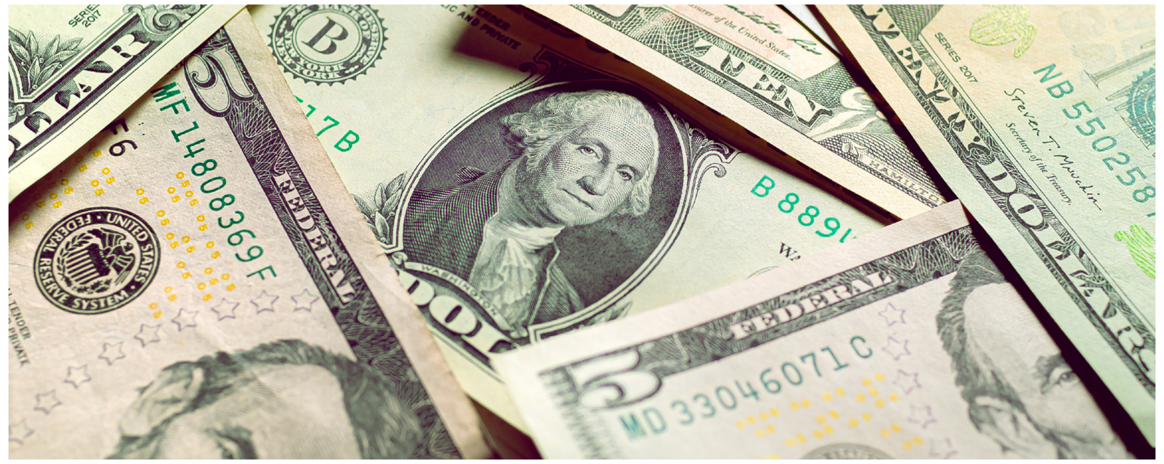
The Conference Board expects rising headwinds to significantly limit growth across the US and Europe. Persistent inflation and hawkishness by the Federal Reserve will slow US GDP growth to 0.3% in 2023, while soaring energy prices in Europe are likely to seriously limit economic activity and slow GDP growth to 0.2% in the Euro area.

It will be important to monitor the Consumer Price Index outlook which is likely to be critical in defining central bank monetary policy delivery.

Currency outlook

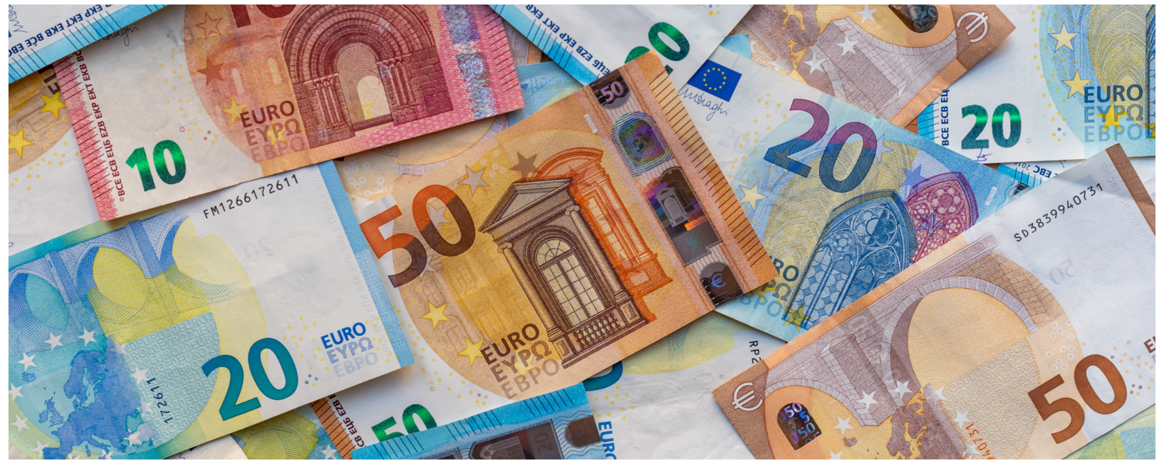
Following a period of relative calmness in 2021, currency volatility has soared throughout 2022. In parallel to the dollar's surge – driven by aggressive tightening monetary policy – other major currencies have fallen sharply against the USD. The euro has continually flirted with dollar parity and reached a **new 20-year low** as of 5th September, while sterling also reached its **lowest level since 1985** as of 7th September.

The Federal Reserve repeatedly raised interest rates over the course of 2022 which now stand at **3% to 3.25%** - higher than any other developed economy. **Scotia Bank** anticipates the Fed hiking rates to as high as 3.50-75% in 2023 which would support the dollar against other global currencies, such as the Euro, Sterling and Yen:



US dollar (USD) poised to remain firm: Supported by hawkish monetary policy

Despite the possibility of the US economy falling into recession, investors feel that there is no viable alternative to the USD given the high likelihood of further tightening monetary policy from the Fed. When this is combined with a backdrop of slower growth and high inflation, the USD will continue to strengthen.

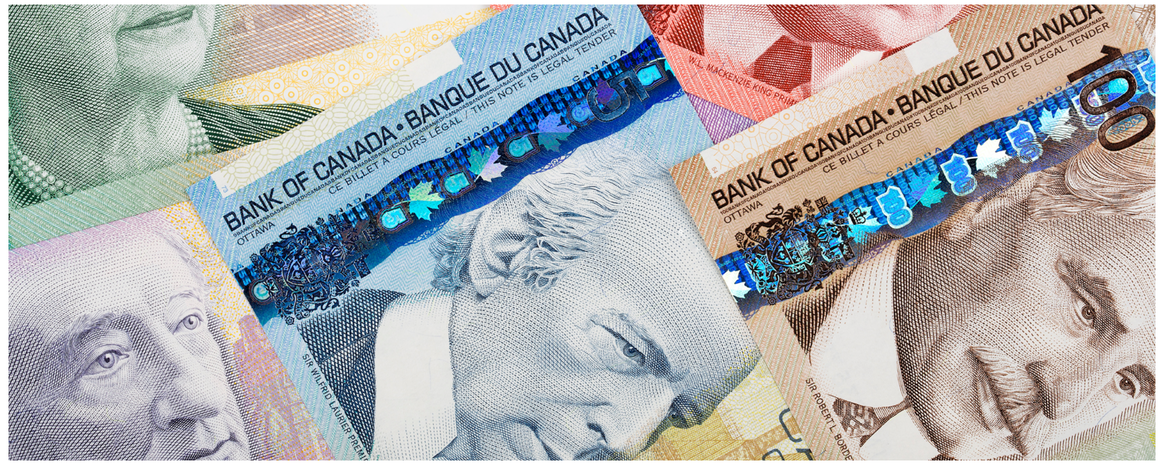


Euro (EUR) likely to extend below USD parity: Downside risks remain amid uncertainties

The EUR failed to seriously benefit from the European Central Bank's (ECB) rate hike in July, and although the ECB in September further raised deposit rates from zero to 0.75% to quell inflation, economic prospects remain questionable. The risk of high energy prices disrupting spending and a curtailed natural gas supply from Russia mean EUR losses are likely to extend below USD parity.

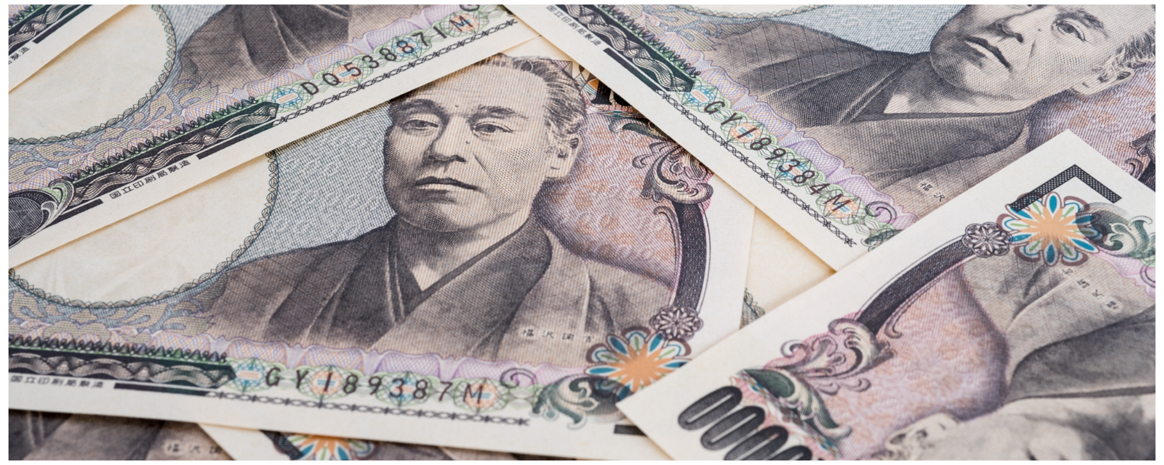
Negative British Pound Sterling (GBP): Negative outlook on surging inflation

Although the **Bank of England** looks set to continue tightening, sterling's outlook remains negative. Weak growth prospects and the rising cost-of-living crisis are likely to weigh heavily on the pound.



Positive Canadian dollar (CAD): Supported by Central Bank of Canada hiking rates

The CAD remains the best performing G10 currency outside of the USD this year. Hawkish central bank policy has supported the CAD against other major currencies – and with the Bank of Canada likely to continue to raise interest rates – the CAD is poised to hold firm.



Negative Japanese yen (JPY): Negative yields spreads curb upside

The Bank of Japan's decision not to tighten monetary policy like other developed economies has weighed down on the JPY, which reached a **24-year low** against the USD on 1st September 2022. High commodity prices have undermined Japan's traditionally strong external accounts position, adding to JPY-negative forces.

Downside risk for Australian dollar (AUD): Rally fades amid falling metal prices

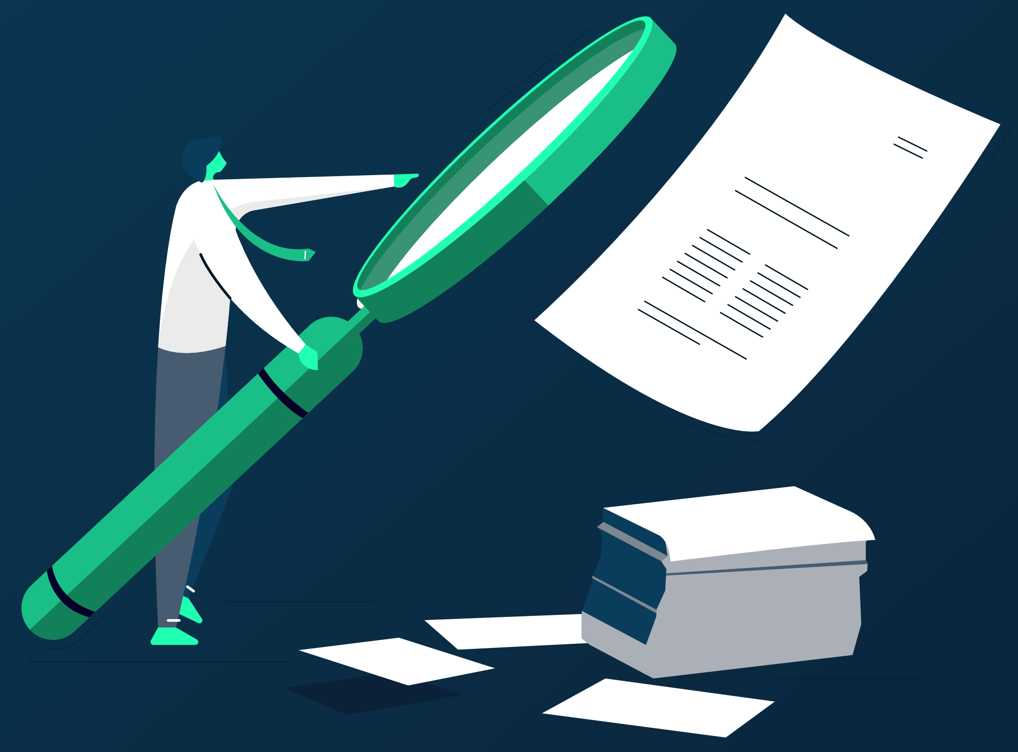
The AUD has weakened in 2022, primarily as a result of falling iron ore prices. With the Chinese economy experiencing a slow recovery, manufacturing hubs in the region are running on a low output which is expected to bear down on the AUD.

Persistent strength on Swiss franc (CHF): Supported by central bank policy

In June 2022, the Swiss National Bank (SNB) hiked rates from -0.75% to -0.25%. The SNB will take an active approach to making sure inflationary pressures do not spiral out of control and is likely to further raise rates in the coming quarters which will modestly strengthen the CHF against the EUR.

For more in-depth analysis and currency opinions from Scotia Bank, read the full report here:

https://www.scotiabank.com/ca/en/about/economics/economics-publications/post.other-publications.foreign-exchange.foreign-exchange-outlook--august-15--2022-.html



What are the challenges that corporates face when it comes to FX risk management?

From the research above, it's clear that volatility is trending upwards and is set to persist throughout the remainder of 2022 and beyond, driven by geo-political and economic factors.

So, in this context, what are the main barriers that corporates face in terms of devising an effective strategy to manage this difficult climate.

We believe there are essentially three main problems that corporates face when it comes to FX:

Inability to compare the market

For corporates who trade FX for payment or hedging purposes, FX can be seen as second-order: they transact in FX not because they 'want to', but because they 'have to' due to international business activities. It is thus often operationally inefficient for them to set up and manage multi-bank relationships.

This makes it difficult to compare the market – so when executing trades, corporates are often beholden to limited sources of liquidity. At any given time, they may not be able to trade at the best available rate as they have no other access points to the market.

Hidden costs

Pricing transparency is a recurring problem as FX costs are often hidden in the spread. The transaction cost on any given trade can be calculated as the difference between the rate traded at, and the mid-market rate at that point.

For example, if a business sells $5m into EUR at 1.0150 and the mid-market rate at the time was 1.0125, the transaction cost on the trade would be 0.25%, or $12,500. This is not an explicit cost as the treasurer won't receive an invoice for this amount; rather, it's a hidden implicit cost. Let's make no mistake though: it's just as much of a cost.

Tailored pricing

One of the main issues, in our opinion, is that banks and brokers reserve their most competitive rates for institutions that transact the highest volumes, meaning small and mid-sized corporates struggle to get the best possible deal – a concept called "tailored pricing".

This is no secret. The European Central Bank produced a **report** in 2019 that found that banks were overcharging their smaller corporate customers for FX services with hedging rates as much as 25 times higher than for their larger clients.

Against the backdrop of an uncertain and volatile landscape, these factors make the task of FX risk management all the more difficult.

How can corporates improve their FX risk management strategies?

Streaming giant Netflix is the latest big name to highlight the need for an effective hedging strategy, outlining that it did not use FX derivatives to hedge volatility exposure and that revenues would have been approximately **"$619 million higher"** had exchange rates remained consistent with those of 2021.

Fortunately, there are a number of steps that firms can take to improve their FX risk management infrastructure. These include:

1

The use of Transaction Cost Analysis (TCA)

Transaction cost analysis (TCA) was created to provide transparency on the hidden costs in FX. It helps firms understand how much they are being charged for the execution of their FX transactions and exposes any costs hidden in the spread.

While TCA has been present in equity markets for some time, it has taken longer to become a staple of the FX market. This is because of the bilateral and decentralised nature of the market, which makes it much more complex to track trades and transactions than the exchange-based markets.

Nevertheless, the use of TCA in FX has grown in recent years, coinciding with a global push to promote transparency in a market that has been dogged by opacity and a lack of trust between providers and participants.

The **FX Global Code of Conduct** - developed by the Global Foreign Exchange Committee as a way to restore trust - includes the use of TCA reporting. Ongoing, quarterly TCA from an independent TCA provider can be embedded as a new operational practice to help ensure consistent FX execution performance.

2

Outsourcing

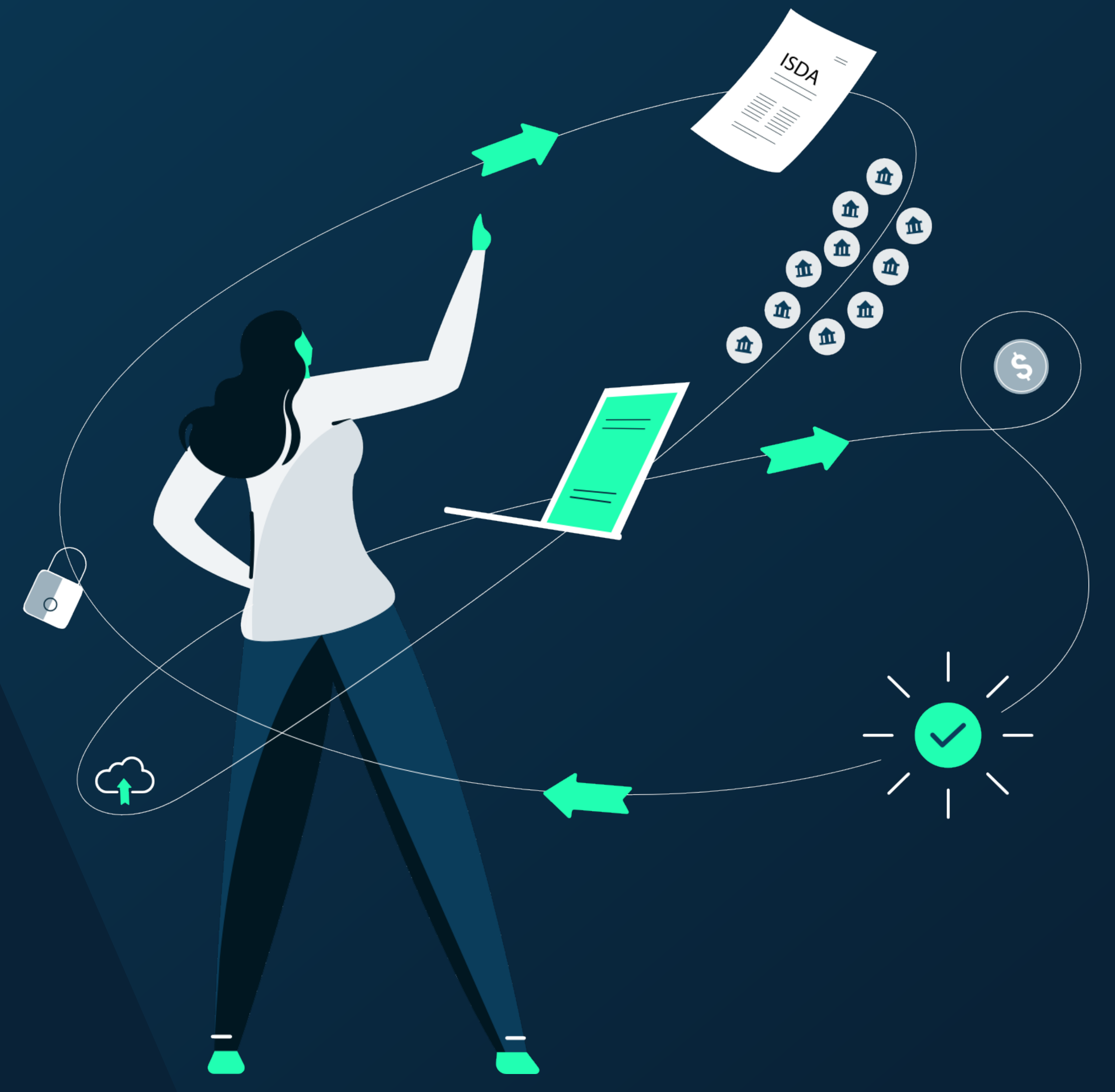
Outsourcing has emerged as common practice not just across the financial services industry, but all walks of business, with the global outsourcing market valued at **USD245.9 billion** in 2021.

We have noticed that the trend is gaining particular traction in the FX industry, where the growing number of third-party solutions available to fund managers are enabling firms to outsource various parts of the trade workflow – from calculating the FX position, to execution, margining and settlement.

FX is the world's **largest and most liquid market**, but it is also one of the most complex. Setting up and onboarding new FX counterparties, centralising price discovery and navigating the post-execution phase often have their own complications and can be a headache for the finance function.

For these reasons, businesses are moving towards external solutions that can assist with these functions. According to **HSBC and Acuris**, 44% of CFOs in larger companies have outsourced some of their day-to-day functions to increase automation and digitisation.

Outsourcing frees up resources for more effective use elsewhere, enabling firms to dedicate more time to core business matters. The end product is also more likely to be of higher quality, leading to improved execution and helping save money in the long run.



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Compare the market

Having the ability to put trades up for competition is central to ensuring access to the best price – which is key to effective hedging. However, many treasurers are hampered by their inability to access Tier 1 FX liquidity, since they often rely on a single bank or broker to meet their hedging requirements.

We think that moving away from the traditional, single bank-based approach can help corporates gain a clearer picture of the market.

Instead, we believe they should seek new technology-driven solutions that enable them to access live rates from multiple banks and to execute at the best available rate, all whilst reducing the operational burden traditionally associated with this kind of market access.

How can MillTechFX help?

With economic changes such as further interest rate rises on the horizon and ongoing geo-political tensions, we feel it is imperative that CFOs prioritise FX risk management to protect their firm's bottom line or investment returns.

Against this backdrop we believe it is vital for those trading in FX gain a transparent view of their execution setup, streamline their operational workflows and implement hedging strategies in order to carefully manage their currency exposures in the year ahead.

MillTechFX is an FX-as-a-Service (FXaaS) pioneer that enables corporates to access multi-bank FX rates via an independent marketplace, helping to democratise the FX landscape.

Our end-to-end solution automates the FX workflow and ensures transparent best execution – saving clients time and costs.

We offer:

- **Easy and quick onboarding –** Rather than spending months (even years) setting up multiple FX facilities with different counterparties, firms can sign up to a multi-bank marketplace and transact within weeks with up to 15 Tier 1 counterparty banks.
- **Best execution and hedging management –** Firms benefit from multi-bank access without having to manage multiple relationships and processes. Firms can transparently compare and execute FX rates from multiple providers on a single marketplace and ensure best execution with a simple click of a button.
- **Cost savings –** MillTechFX has saved clients up to 80% on their execution costs
- **Transparency –** MillTechFX offers a fixed fee service, including third-party Transaction Cost Analysis (TCA) to ensure total cost transparency

Get in touch today to find out more

To speak to us directly, please contact Tom Hoyle **thoyle@milltechfx.com** and Jason Gaywood **jgaywood@milltechfx.com.**