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JOINED UP THINKING IN A VOLATILE WORLD

If you haven't the strength to impose your own terms upon life, you must accept the terms it offers you. **T S Eliot**

Up, down, flying around

Since the onset of the Global Financial Crisis, surveys of the priorities of company executives have demonstrated a clear rise in the importance of financial risk management. This is hardly surprising, given the increase in uncertainties across many inputs to businesses. Among Bancorp Treasury's client base we have noted (and encouraged) far more attention being given to internal business and cashflow forecasts and to improving two-way communication between the finance/treasury function and other relevant departments. On top of this, funding and liquidity conditions have been through periods of discomfort for all concerned, necessitating more thorough analysis of potential business scenarios to keep banks onside.

For foreign exchange rates and commodity prices in particular the level of market volatility remains elevated. Volatility is a measure for uncertainty, and it can be described empirically with standard deviation.

For example, the standard deviation of the daily movements in the NZD/USD over the five pre-crisis years 2002-2006 was 0.0042. In other words, about 2/3 of all daily movements were within 42 points and 1/3 were greater than that. From 2007 to 2011, as the GFC raged, the standard deviation was much higher at 0.0071 and in the two peak years of 2008-2009 it was 0.0079. This is very nearly twice the volatility of the pre-crisis period. The worst three month spurt saw a standard deviation of NZD/USD0.0129. Remember, this means that about 1/3 of days saw moves bigger than that.

Commodities reveal a similar pattern. Copper, for example, had a 2002-2006 pre-crisis daily price move standard deviation of USD80 per tonne. In 2008-2009 this rose to USD143, with a peak three month period within that of USD221.

In 2011 the volatilities have eased from their peaks but remain high. The comparable year to date figure for the NZD/USD is 0.0063 and for copper it's USD131 per tonne. The current spike in market volatility triggered by America's politicking and budgeting recklessness is doing no-one any favours.

How does business cope with such uncertainty? Before deciding what to do, it is essential to think carefully about how the company's business reacts overall to market movements, rather than taking each market risk in isolation.

Pulling it together

Much has been made of the strong performance of the New Zealand dollar and Australian dollar and how those moves have made imports cheaper while making it harder for (non-commodity sector) exporters. But there are other factors at work. As the US dollar declines, so the nominal number of them required to buy imports has increased too. The raw materials and wages costs of Chinese manufacturers are rising, so their output prices are on the up too. US dollars may be getting cheaper, but you need more of them to do business.

Companies with overseas subsidiaries or parents may have foreign currency funding arrangements to contend with. If the associated interest payments have to be converted to/from the home currency, then some foreign currency hedging may be required but again the quantity needing to be hedged may be variable due to potential interest rate volatility.

Even for ordinary domestic interest rate hedging, the bigger picture should be considered. If the company is strongly pro-cyclical with the economy, then hedging interest rate risk into fixed rate may be less desirable because the company's ability to pay moves to some degree in line with market interest rates.

Of course, the relationships between economic conditions, price inflation, commodity prices, foreign exchange rates, interest rates and company profitability are never perfect. Nor are they even stable over time. For a Chief Financial Officer or Treasurer to form a holistic view on the true **net** risks faced by the company, some effort needs to be expended on drilling into historical business patterns and engaging in meaningful discussions with fellow executives about the specific behaviours of the industry and markets in which the company operates. (And of course, this is not a one-off exercise!)

Making a scene

Once the basic picture is agreed, the next key step is scenario analysis. A single budget with one set of assumed input parameters

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AUSTRALASIA ECONOMY & MARKETS

A connected world

In the last issue of Treasury Trends, we discussed the closeness of the world's trade, financial and fiscal connections. Events since then have highlighted how very close those connections are and how much influence events on the other side of the world can have on the Australian and New Zealand economies as a whole and businesses and households in particular.

China's attempts to curb excessive economic growth and inflation have taken some of the gloss off the economic prospects for Australia and New Zealand. But that is only an adjustment of the Chinese economy. Of greater concern to Australia and New Zealand is the mess that some highly indebted nations are facing, a mess exacerbated by a refusal by the main offenders to face up to their own profligate debt-funded extravagance and the urgent need of households and governments to spend less, save more and to reduce debt.

Making adjustments

At its July meeting, the Reserve Bank of Australia ("RBA") again noted that *"Australia's terms of trade are at very high levels and national income has been growing strongly"*. The RBA highlighted just how strongly the resources sector and related services sectors were performing. But not all is well in the lucky country, because *"cautious behaviour by households and the high level of the exchange rate are having a noticeable dampening effect"*.

The cautious behaviour of Australian households might be dampening the economy, but that is part of the necessary and painful process of de-leveraging by households. That process is being checked by the allure of cheap imported consumer goods, especially those bought directly on the internet with the more valuable Australian dollars.

The Reserve Bank of New Zealand ("RBNZ") expressed a similar sentiment in its July OCR Review, noting that *"the recovery is getting back on track supported by a strong terms of trade"* but it is also worried about global financial risks that have since increased and the *"downside risk to trading partner activity"*.

Similarly, New Zealand households are changing their ways, shifting away from debt towards savings and resisting being tempted to buy imported consumer goods made cheaper by the higher New Zealand dollar.

Exchange rates as economic indicators

Both the RBA and RBNZ claim that their respective currencies are very high in relation to underlying fundamentals. Based on recent commodity price moves, neither seems to have a credible claim. The RBA's Commodity Price Index was up 35.5% in US dollar terms over the July year and up 9.9% in Australian dollar terms. The ANZ New Zealand Commodity Price Index was up 16.3% in US dollar terms over the July year and up 4.7% in New Zealand dollar terms. Those high prices of commodity exports justify the high Australian and New Zealand dollars. Further rises in commodity prices could equally justify still higher Australian and New Zealand dollars.

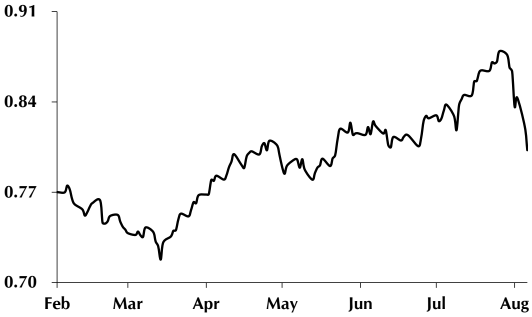
Coming out the other side

Just as the world was a different place after previous global upheavals, so it will be a different place after this one. Australia and New Zealand are well placed to come out of this upheaval in good shape. Not only did they enter the Global Financial Crisis in better shape than most but also they have some positive underlying fundamentals, notably exports of products in demand by fast-growing creditor nations in Asia and a fortunate geographic location (i.e. away from the troubled US and Europe).

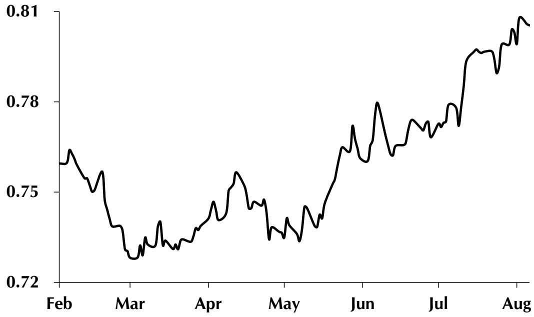
But complacency is dangerous. Australian and New Zealand currencies and interest rates will nevertheless remain vulnerable to domestic uncertainty, global financial market volatility, any slowdown in the global recovery , further shocks (whether natural or man-made) and the shape of the new post-GFC world.

A robust and disciplined risk management regime that matches hedging instruments with the underlying business risks is a necessity not a luxury.

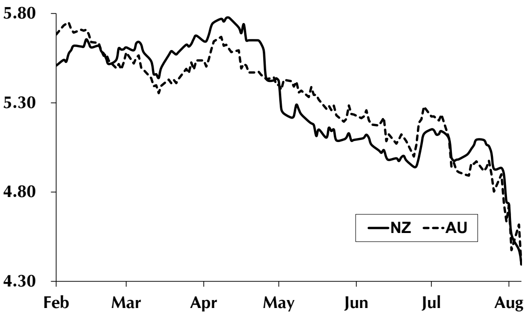
New Zealand dollar/US dollar



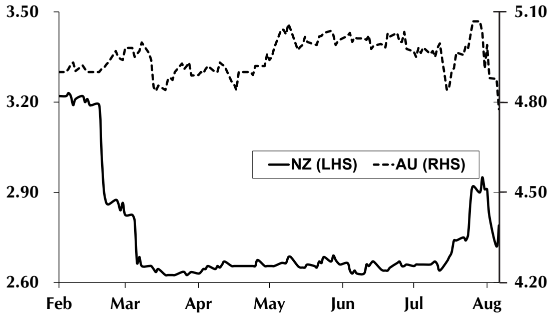
New Zealand dollar/Australian dollar



10 year government bonds



90 day bank bills



WORLD ECONOMY & MARKETS

Key threat to global stability – sovereign debt

Could sovereign debt be the next subprime? Who is to know but the signs are sure looking concerning. The Global Financial Crisis ("GFC") has forced individuals to reduce their debt levels and try to live within their means. Unsurprisingly the focus has now turned to governments. It all comes down to the simple philosophy of not spending more than you have. However credit has been too easy to come by and debts have mounted.

To understand the scale of the problem consider the size of global sovereign debt relative to GDP. Since the credit crisis global sovereign debt has grown by 50% to around USD50 trillion or 80% of GDP. Greece's debt as a percentage of GDP is around 140%, or nearly 450% of tax revenues, while the US sovereign debt to GDP ratio is close to 100% or 400% or tax revenues.

Not only has the amount of sovereign debt grown but the cost of financing it has increased in some nations. Fears that the debt crisis in Europe is spreading to larger economies such as Italy and Spain have seen their sovereign bond yields rise. Many believe these economies are too large to be bailed out. The cost of insuring sovereign debt has also soared. Credit default swaps on the sovereign debt of Italy, Greece and the US is around 8, 48, and 3 times higher respectively than in September 2008.

As fears heighten investors demand higher yields, thereby raising debt costs. This in turn adds to the country's debt burden and may force the introduction of harsh austerity measures, thereby slowing growth. So there is a fine line to tread.

US Treasuries – a safe haven?

Markets talk about investors flocking to traditional safe haven investments such as the USD, JPY and CHF. But why are these called 'safe havens' and what are investors actually running to? The term safe haven refers to a major traded investment or currency where investors place funds in periods of market turmoil. The 'safe haven' investment may appeal to investors due to a country's fiscal soundness, its political stability or a strong economy that is relatively sheltered from the rest of the world. Based on these criteria the CHF would have the greatest safe haven appeal while the US does not fare so well. However the US remains by the far the single biggest global economy attracting around USD4.5 trillion of foreign investment in US Treasuries as at the end of May this year. The Chinese and Japanese are the two largest holders of US Treasuries. Both countries have been looking to diversify away from USD assets, however are there really any alternatives?

Alternative safe havens

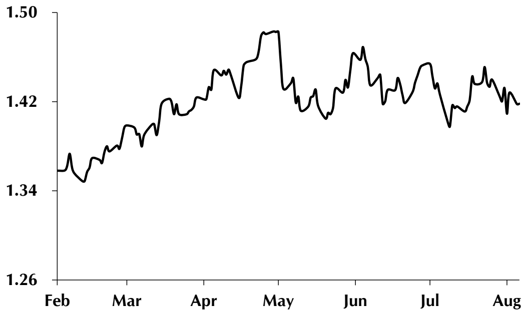
So what happens if investors do start to turn their back on US Treasuries? Are there viable alternatives that are liquid enough? Market moves over recent years have clearly highlighted a shift towards other traditional safe havens even well before media started to focus on the US economic problems and sovereign debt concerns. The Swiss franc and Japanese yen have been the strongest currencies by a large margin if looking back over the three years following the GFC. However these two currencies are thought of as safe havens for quite different reasons.

Japan's sovereign debt to GDP level is far worse than that of the US but most of this debt is held by Japanese nationals. The reason for such a strong yen is that Japanese investors, who became extremely wealthy during the economic heydays of the 60s, 70s and 80s, have been repatriating money back from offshore investments.

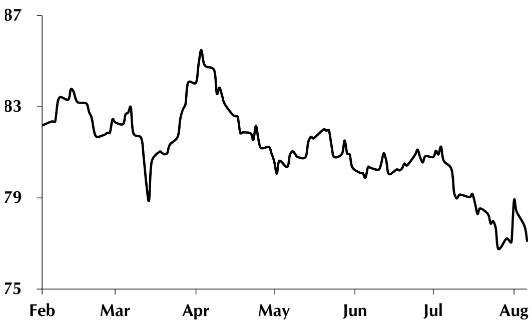
The Swiss franc on the other hand is a much safer bet when looking at purely economic fundamentals. The country prides itself on its fiscal stability, makes trade and current account surpluses and has always managed to keep itself relatively insulated from the financial and political carnage that goes on around it.

Thoughts that commodity currencies like the NZD and AUD have joined the ranks of safe haven status have been quickly rebuffed following the latest market volatility. While we may look more attractive as an investment than the US, due to our stronger fiscal positions and higher yields, the reality is that our markets are just too small and illiquid to be taken seriously as a safe haven during periods of significant market fear.

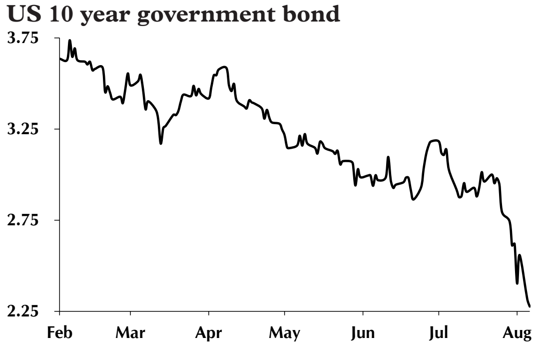
Euro/US dollar



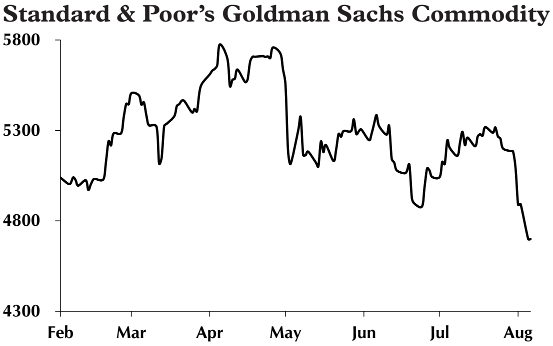
US dollar/Japanese yen



US 10 year government bond



Standard & Poor's Goldman Sachs Commodity Index



may well be the company's best guess for the coming year, but it is by no means adequate for proper risk management.

There are two main levels of analysis. First, look at 'normal' behaviour and try to work out specific sensitivities. For example, what's the effect of a 1 cent move in the exchange rate? What's the impact of a 0.50% rise in the 3 month interest rate? Only when you know your sensitivities can you judge what amount of hedging is appropriate.

Second, think bigger. "What if?" is a question for every situation. What if New Zealand interest rates stay unchanged for another two years? What if the recent market ructions develop into a fully fledged collapse of the US dollar and by the end of 2011 we have the NZD/USD at 1.0000 and the AUD/USD at 1.2500? What if China over-suppresses its GDP growth, causing a drop in hard commodity prices while maintaining food demand and the NZD/AUD moves back over 0.8500? Such moves may have a low probability but they are possible and you need to be prepared.

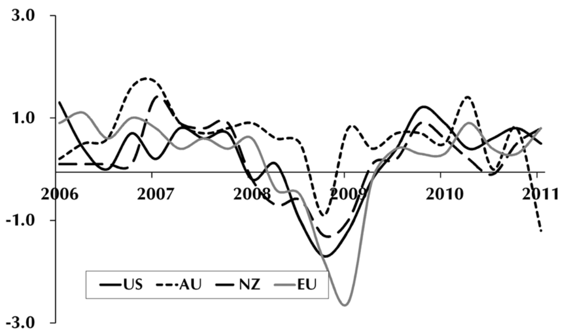
Choosing your weapons

When interest rates appear historically low, or when the currency is making all-time highs, the lure to *"fill yer boots"* with extra hedging is strong. But we urge caution in these unusual times. Don't get sucked in by over-confident market commentators. (They'll change their mind tomorrow anyway.) Always focus on your business dynamics, risk horizons and risk sensitivities. Have a corporate Treasury Policy that limits the minimum and maximum levels of hedging to prudent ranges.

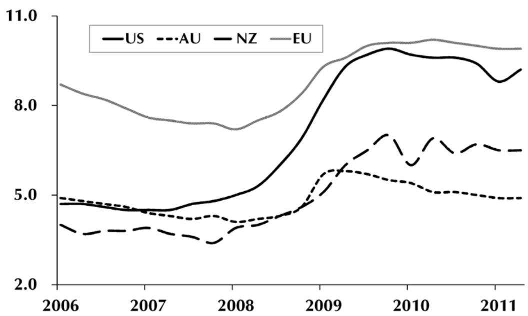
One of the most damaging outcomes from a hedging programme is to be over-hedged at unattractive rates, especially if business is declining. The cost of closing out such hedges or the drag on profitability of working through them can be ruinous. The recent extended rise in the NZ dollar has caught out many importers who jumped in too soon. Better to hedge little and often.

If you are determined to capture value from apparently 'too good to be true' market prices, options are the ideal instrument. Unlike forward exchange contracts, you are not committed to the deal and the initial premium defines your worst case outcome. In essence, buying options is risk-free. A couple of cents in premium, when the standard deviation for daily moves is over a cent and moves over a six month horizon can be 10 cents or more, can be good value.

GDP growth (QoQ)



Unemployment rate



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