

FX: Are corporates reconsidering US dollar hedges?

With US dollar hedging costs high, EUR/USD closer to fair value and the ECB story on hold, European corporates may be reconsidering their high hedge ratios on USD receivables

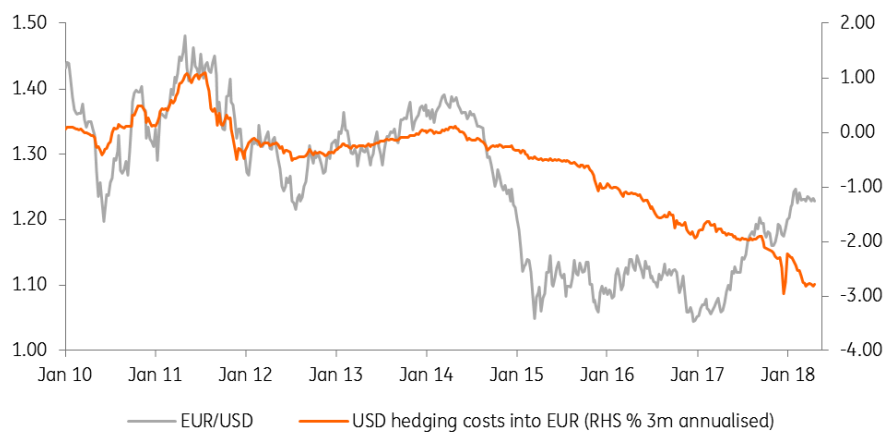


Corporates less convinced about a big dollar decline?

We may be a little premature in discussing this topic, but in speaking to some customers we are getting a sense that high US dollar hedge ratios are being reconsidered. In other words, corporates are possibly becoming less convinced about a further large dollar decline and, where hedging mandates allow, over coming months could be scaling back some of their more aggressive USD hedging.

While most corporate FX hedging decisions do sit within clear mandates, there is typically a little room for discretion. For example, when EUR/USD was below 1.10 in late 2016 and early 2017, larger European corporates typically held the view that the USD was overvalued (most fair value readings were in the 1.25 area) and that hedge ratios on expected USD receivables should be higher, e.g. closer to the top end of the 50-100% range and should cover longer tenors. Here, treasurers made special requests from the board to extend the horizon for USD hedging.

The cost of hedging



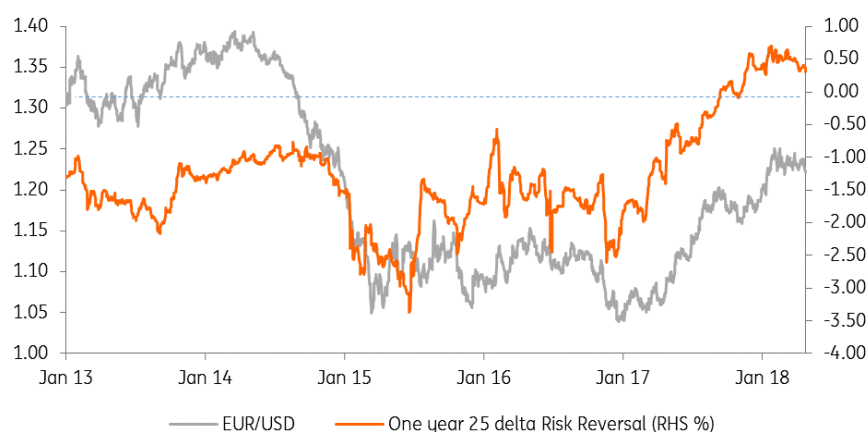
It now costs near 3% p.a to hedge USD into EUR

With EUR/USD a lot closer to fair value and now USD hedging costs near 3%, we get a sense that corporates may be starting to reconsider whether they roll those aggressive USD hedges – or perhaps cut those USD hedge ratios a little. Even a rolling three-month USD hedge into EUR costs close to 3.00% annualised – questioning whether corporate treasuries are right to be paying away 3% of their hard-won USD receivables.

We doubt that there is a magic number – e.g. 3% – where USD hedging costs become prohibitively expensive. But we would say that the EUR/USD bull story does need feeding – be it Trump’s protectionist policies which embody a need for a weaker dollar or some fresh news from the ECB that the end of QE is on track and that the 1Q18 slowdown has not altered the ECB outlook.

EUR/USD One Year Risk Reversal

The cost of buying a 25 delta EUR call over an equivalent EUR put



FX option market could give us clues on corporate behaviour

We also think it’s worth watching the 12-month EUR/USD risk reversal in the FX option market. This reflects the cost (in %) market players are prepared to pay for a EUR call option over an equivalent

put option. Corporates typically dominate this segment of the FX options market. As the chart above shows, the cost of a EUR call relative to a EUR put has been rising significantly since last summer. Recent stability in this risk reversal has gone hand-in-hand with EUR/USD consolidation in the spot FX market. But any decline in this risk reversal – perhaps below 0% - could be a sign that corporates were indeed reassessing their medium-term USD outlook.

As for our views – we're convinced EUR/USD will be a lot higher over the next two to three years on the back of: a) US twin deficits and a late cycle economy and b) portfolio flows returning to the Eurozone as the ECB winds down its QE programme. We think any move below 1.20 will be relatively short-lived this quarter and retain a 1.30 year-end forecast.

Author

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.