Impact of the COVID-19 Crisis on FX Hedging Costs of Passive Currency Overlays

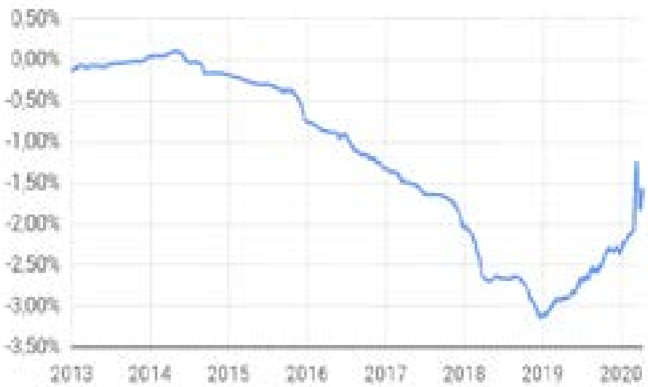
- The COVID-19 crisis has prompted central banks to cut key interest rates
- This has had an impact on interest rate spreads and cross-currency basis spreads
- Lower currency hedging costs across all maturities
- Recommendation: Review the hedging mix

Development of the 3-months interest rate spread

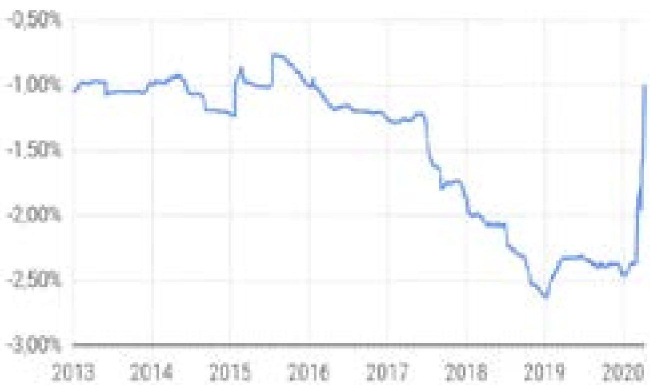
- Due to the COVID-19 crisis, the central banks of the USA, Canada, the UK and Australia, among others, have lowered their key interest rates several times, in some cases significantly
- Both the ECB and the Bank of Japan have started extensive QE measures, but have not lowered the key interest rate any further due to the already low interest rate levels
- Result: significant narrowing of money market interest rate spreads between the Euro and other G7 currencies

EUR/GBP

EUR/USD



EUR/CAD



EUR/AUD

Source: 7orca Asset Management AG. 01.01.2013 – 07.04.2020

Changes in interest rate spreads, cross-currency basis spreads and implicit hedging costs (3-month basis)

- The liquidity squeeze in the currency market was significantly reduced through swap lines between the major G7 central banks
- As a result, cross-currency basis spreads have eased significantly in most cases, coming back from historically very low and thus expensive levels for European investors
- In some currencies, such as EUR/USD, EUR/GBP and EUR/CAD, these basis spreads are currently even in positive territory.

EUR/USD

EUR/GBP

EUR/CAD

EUR/AUD

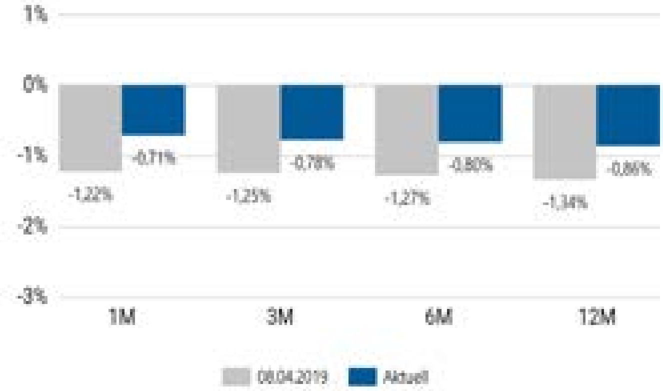
Source: 7orca Asset Management AG. 01.01.2013 – 07.04.2020

Development of FX hedging costs by maturity year on year

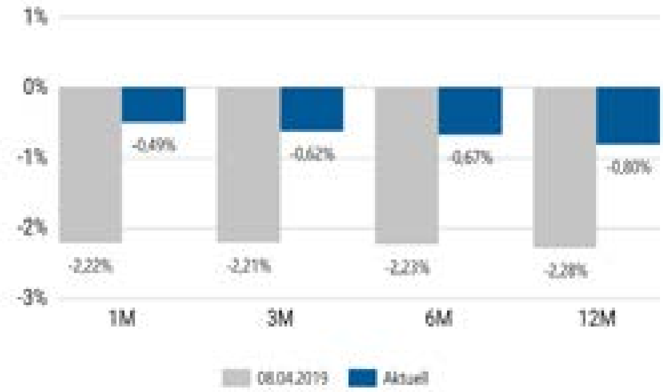
- In tandem with the reduction of the interest rate spread, positive basis spreads, especially in EUR/ USD, EUR/ GBP and EUR/CAD, lead to an additional reduction in the current FX hedging costs for European investors.
- The lower hedging costs are evident in all maturity bands

EUR/USD

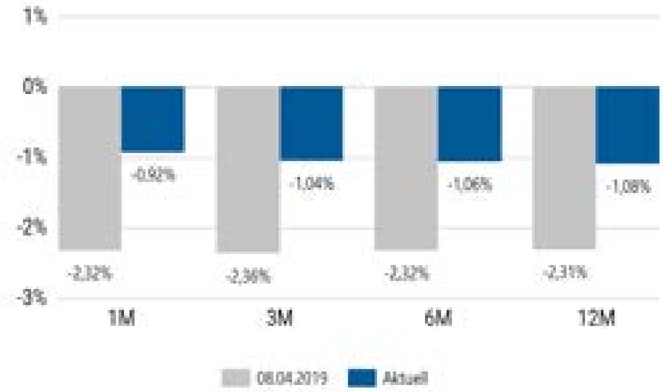
EUR/GBP



EUR/CAD



EUR/AUD



Recommended Actions

Reallocation of the hedge composition

Investors who focus on minimising hedging costs in their currency hedging should review their current hedge situation. For example, the hedging returns from a EUR/CHF hedge have decreased, but the hedging costs of other currency pairs, as shown before, have become significantly cheaper.

Optimisation of the hedging term

The current development has a direct impact on the optimal choice of maturity for hedging instruments. A European investor was able to achieve a significant saving in hedging costs ex post when hedging his USD risk in the short maturity range of 2 weeks (vs. a 3-month rolling hedge). The more dynamic and volatile the prevailing FX market situation, the greater the importance of the optimal maturity determination and its performance contribution. It can be assumed that this environment also holds performance potential for positions taken today. However, a sound decision-making process to determine maturities is based on a multitude of influencing factors. That is why the 7orca Tenor Management takes on the task of managing and determining the optimal hedge maturities for its clients. In 2018 and 2019, we generated a performance contribution in EUR/USD hedging of over 50 bps p.a. on average. Since the beginning of 2020, an attractive performance contribution of 8 bps has been generated using the Tenor Management.

Evalutation of the chosen FX brokers

Especially in the current market environment, the quality of FX brokers takes on an important significance. In addition to the ongoing review of the counterparties‘ creditworthiness, the continuous review of the execution quality is also essential. In particular, this concerns the transaction costs that arise when hedging transactions are concluded. In addition, it must be checked whether the optimal term of the hedging transactions can be presented. The prevailing market situation prompted a well-known counterparty not to conclude hedging transactions with maturities of more than 2 weeks despite collateralisation. Examples like this show that in addition to the selection of brokers, continuous communication with them is also crucial.

7orca is ready to advise you on all matters relating to the optimal hedging of your FX holdings, especially in challenging times.

Author

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Disclaimer
The strategy presented in this document for hedging currency risks (currency overlay management) is aimed exclusively at professional clients according to the German Securities Trading Act (WpHG) and can only be implemented for such clients (typically in a fund structure). All assumptions, forecasts and disclosures are based on the standardised set-up of the passive currency overlay management strategy, which was carried out at average market costs. Further information on this standard investment process can be found in the Generic RfP, which is available from 7orca Asset Management AG upon request. Due to the different investor needs and situations as well as the resulting specific pricing, further individual costs for administration and custody are not taken into account. However, 7orca Asset Management AG will be pleased to provide you with a specific offer that reflects your individual requirements and conditions. The investment strategy of a passive currency hedging has a trend-following character. It should therefore lead to the same results under the same market conditions. Since market conditions repeat themselves regularly, but not in identical form, the hedge ratios and performance indicators listed in this document can illustrate the characteristics of our strategy. **However, they refer to past price developments of currency pairs and are therefore not a reliable indicator of future results.** All information in this document has been compiled to the best of our knowledge based on the data available to us. Ho- wever, no civil liability can be assumed in this respect. References to specific financial instruments are purely exemplary and should under no circumstances be construed as recommendations in the sense of investment advice. A publication of 7orca Asset Management AG.

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