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Should entrepreneurs shift their currency hedging in 2023?

Executives & Entrepreneurs

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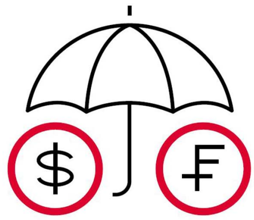
- For the rest of 2023, we think entrepreneurs will need to prepare for the dollar to weaken as US economic growth and inflation fall. The timing of the inflection points for US interest rates, inflation, and economic growth is still uncertain, in our view, but will be linked to the Fed's rate hiking path.
- We suggest three tips for entrepreneurs—regardless of where they are in the business lifecycle—for consideration when exploring their business' and personal currency management:

1. Build a systematic plan for currency management
2. Consider combatting interest rate differentials by using structured FX solutions
3. Don't overlook hedging for personal wealth, including liability management

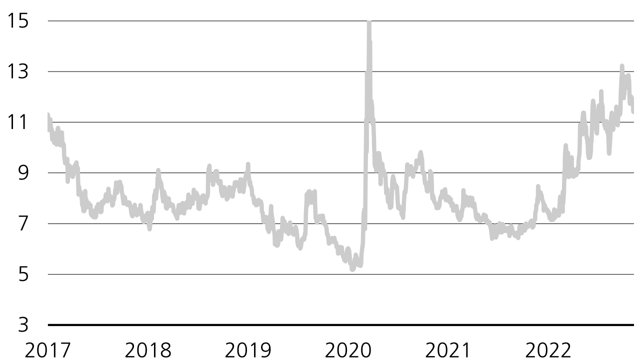


The US dollar is on course for its strongest year ever, rising 16% against a basket of major trading partners' currencies in the first 10 months of the year. Geopolitical uncertainty has led investors to seek perceived safe-haven currencies, while aggressive Federal Reserve rate hikes have underpinned the USD versus more moderate monetary tightening from other central banks.

Currency markets have also been more volatile than usual—as evidenced by the level of and change in the JPM Global FX Volatility Index (**Fig. 1)**. Over the course of the year, the euro, offshore Chinese yuan, and British pound hit historical lows against the US dollar, while the Japanese yen fell to its weakest level in more than three decades.

Fig. 1: Entrepreneurs may continue to face high currency volatility

JP Morgan FX Volatility Index



Source: Bloomberg L.P., as of November 2022.

Entrepreneurs and investors have also had to deal with hedging challenges from interest rate differentials. At the time of writing, entrepreneurs looking to hedge US dollars back into euros or Swiss francs are facing annual hedging costs of 2.6% and 4.2% respectively.

What's the outlook for world currency markets in 2023? Should entrepreneurs shift their FX hedging strategy in the year ahead? And are there potentially more cost-effective ways to shield commercial and personal wealth from currency swings?

Currency market outlook: 2023 and beyond

In the first part of 2023, we expect strength for the US dollar and the Swiss franc.

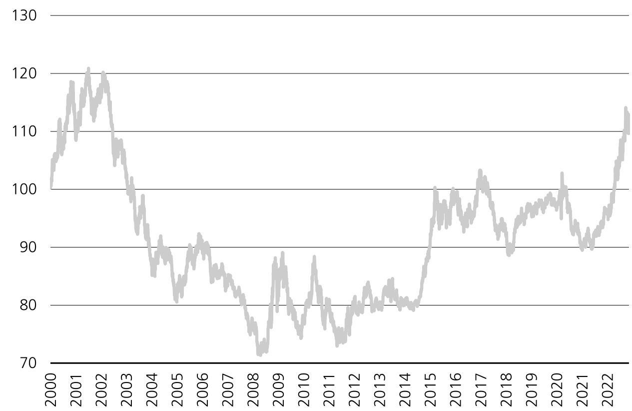
Relatively high US rates and slowing global growth should help keep the dollar strong in the coming months. Yet the greenback has already appreciated sharply and its current valuations are high. In real trade-weighted terms, the dollar rose around 16% in the first 10 months of 2022 and reached levels last seen in the mid-1980s. We therefore think its record run will struggle to go much further. We forecast EURUSD and GBPUSD at 0.96 and 1.10, respectively, by March of next year.

Looking beyond 1Q23, entrepreneurs will need to prepare for the dollar's weakness as US economic growth and inflation fall. The timing and speed of the inflection for inflation and economic growth are still uncertain, but they will be key for the Fed's rate-setting path. We expect uncertainty to stay elevated for now and the Fed to remain more aggressive at raising rates than other major central banks. This combination should play into the dollar's safe-haven dynamic. Still, we forecast EURUSD and GBPUSD at 1.04 and 1.21, respectively, by December of next year.

Beyond 2023, we expect the US dollar to depreciate further from its multi-decade highs (**Fig. 2)**. As markets begin to anticipate Fed rate cuts and a trough in economic activity, the dollar's overvaluation relative to the euro, Swiss franc, British pound, and Japanese yen should start to correct. The yen's and pound's significant undervaluation and the export-oriented nature of the Japanese and UK equity markets may lead entrepreneurs and investors to consider not hedging their exposure to these currencies.

At the turn of the year, the Swiss franc is likely to attract inflows thanks to its safe-haven appeal and as investors begin to anticipate Fed rate cuts. The Swiss National Bank has run ahead of the European Central Bank in raising interest rates. In September, it took its policy rate above 0% for the first time since 2015. This move, on top of the considerably lower inflation in Switzerland than in its trading partners, helped the franc reach record highs on a trade-weighted basis.

Fig. 2: The US dollar may decline from 20-year highs versus currencies of major trading partners
DXY Index



Source: Bloomberg L.P., as of November 2022.

Over the coming months, we think the franc should continue to strengthen against the euro on the back of a European recession, concerns around the Russia-Ukraine war, fears about sustainability in European government debt, Switzerland's strong trade surplus, and the central bank's intention to shield Switzerland from imported inflation by the means of franc appreciation. We forecast EURCHF and USDCHF at 0.91 and 0.88, respectively, by December of next year.

For a summary of our outlook for 2023 and the decade ahead, please explore *Year Ahead 2023 - A Year of Inflections* here.

What's the impact on private business owners?

Some business owners—especially family businesses with a long-term mindset or firms whose operating model is chiefly domestic—may say they don't especially care about global currency gyrations. The argument may be that the costs and complexity of managing currency exposure outweigh the potential gains, especially when looking across multiple business or economic cycles.

However, all business owners may do well to retest these assumptions in a world where cost pressures across raw materials, logistics, and labor have been high and are only gradually abating.

Currency management can be important for certain business owners' operating activities. Sharp movements in foreign exchange can have implications for the value of contracts for work with foreign customers, or change the final cost for materials to be delivered from foreign suppliers. For example, the bottlenecks in global supply chains since the pandemic's onset (and the relocation or near-shoring of supply chains in some instances) demonstrate the currency risks associated with delayed fulfilment.

Currency exposure can also impact business owners' balance sheets. Entrepreneurs incorporated in one country with substantive assets in another will likely have to translate the value of international assets into local currency, whether for reporting reasons or to monitor debt covenants if loans have been taken against foreign assets. In these instances, more pronounced currency swings can have consequences for a private company's balance sheet strength and the resilience of its asset/liability mix.

While every entrepreneur's currency management will differ depending on the company's particular business mix and risk appetite, private business owners may also need to understand how others' behavior impacts them.

For example, shifts in cost competitiveness abroad (potentially driven by both currency and inflation trends) may eventually make a business owner's products less attractive on international markets. Measures to increase international competitiveness could include more active currency management alongside other efficiency measures.

Similarly, the decision to manage currency exposure or not can also influence an entrepreneur's performance against its local competitors. Electing to remain unhedged while the competition hedges may even lead to loss of market share, especially in commoditized markets where price is the principal competition point.

Three tips for founders to manage currency exposure

We suggest three tips for entrepreneurs (regardless of where they are in the business lifecycle) to improve their business and personal currency management:

1. Build a systematic plan for currency management

If founders or entrepreneurs judge that their foreign currency exposure can have a material impact on their business's financial performance, it may be prudent to build a consistent plan for managing currency exposure—as opposed to an ad-hoc strategy whenever a particularly large foreign currency inflow or outflow is expected.

Business owners should be clear about the objectives of their currency management. Some may be focused exclusively on minimizing their foreign exchange exposure to reduce the volatility of their costs or earnings. Others may be looking to build foreign currency reserves for investment or acquisition purposes. And others may be seeking to manage foreign exchange exposure for income or capital generation.

Relatively new businesses with little historical sales experience might wait for a number of months to understand the average or median number and amount of foreign currency sales before formulating a currency management plan.

Conversely, the acquisition of a substantial foreign currency asset or interest in a foreign company may require a robust currency management plan from the outset, especially if there are liabilities and fixed costs secured against the international assets. Similarly, certain lenders may stipulate that a systematic currency management program be in place before they consider providing financing or debt facilities in order to minimize mismatches between the home currency used to service debt and the foreign currency interest accrued on the loan.

2. Consider combatting interest rate differentials by using structured FX solutions

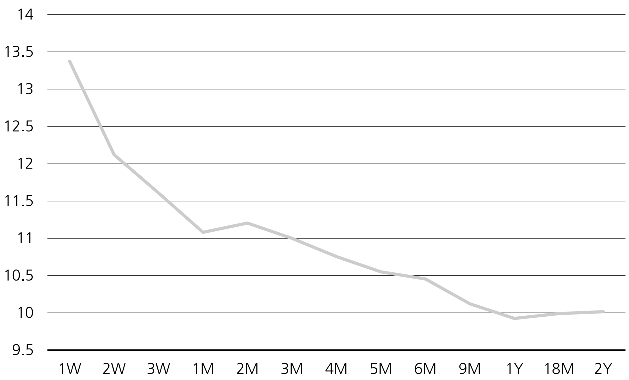
There are a host of tools that entrepreneurs could use to manage their currency exposure.

One of the simplest is a currency forward contract, where an entrepreneur's company would enter into an agreement to buy or sell one currency against another at a predetermined date and predetermined price. This is a frequently-used method to minimize foreign exchange fluctuation risks, but may have some constraints (limited availability for an entrepreneur's reference currency and time horizon needs) or risks (the founder may not benefit if the spot exchange rate becomes more favorable than the contractual forward rate, or the cost of shorting a currency with higher interest rates may outweigh any potential move in spot rates).

At the time of writing—November 2022—conditions in the FX options market may provide entrepreneurs alternative, more cost-effective means to hedge currency exposures. For some currencies subject to geopolitical, economic, and policy uncertainty, implied volatility may be higher for near-term contracts than longer-dated ones **(Fig. 3)**. Differences between demand for FX calls and puts—rights to buy and sell one particular against another—could allow entrepreneurs to cheapen hedging costs (or even implement at zero cost) by selling downside risk.

Fig. 3: Differences between near-term and long-term volatility could allow entrepreneurs to reduce hedging costs

EURUSD at-the-money volatility term structure (W= week, M=month, Y=year)



Source: Bloomberg L.P., UBS, as of November 2022.

One of the most common tools to hedge corporate—and personal—currency exposure over a 1–6-month horizon is via a reverse convertible. These are structured solutions that seek to earn an excess return on cash by taking on the risk of being paid in a depreciating alternative currency if certain currency levels are breached. Typically, reverse convertibles provide a range of prices over which entrepreneurs might convert. It is possible to add barriers for mandatory conversion in exchange for a rate that's more favorable than prevailing spot rates—but this approach may risk unhedged currency exposure if the barrier is breached.

For more details on the mechanics—and risks—of using reverse convertible strategies, please click here.

Entrepreneurs with greater familiarity of FX markets and options may also be able to use elevated volatility to make their hedging cheaper or increase leverage.

Examples could include:

- Introducing window barriers (knock-in or knock-out) that may offer lower costs or more appealing exchange rates in exchange for mandatory conversions through buying or selling particular currencies if key levels are breached in a particular time period;
- Using certain structured forwards may allow an entrepreneur to convert in the future at a better rate than prevailing forward rates, provided the entrepreneur agrees to the use of leverage and a cap on possible profits should the exchange rate move favorably beyond a certain threshold.

3. Don't overlook hedging for personal wealth, including liability management

While entrepreneurs' primary hedging focus will likely be their business, it could be a sound investment at the turn of the new year to review personal FX exposures—both on the asset and liability side—and potentially revisit hedging instruments.

Entrepreneurs who invest in other private businesses through private equity may have a need of US dollars to meet capital calls, but may be reluctant to buy USD given CIO's view that the dollar may soften in 2023. In this instance, entrepreneurs might consider using FX swaps—simultaneous spot and forward transactions at the same spot rate—to borrow US dollars and sell them back at a future trade date. This may make sense if entrepreneurs expect the currency they need to depreciate, and if calls on the foreign currency have uncertain timing.

Similarly, FX swaps may also help entrepreneurs to shrink the cost of using a structured solution to add or reduce foreign currency exposure systematically. Entrepreneurs with a single security or concentrated position in a foreign currency could use so-called decumulators to offset their foreign exchange position and build domestic currency exposure, while building a loan in the foreign currency of the concentrated asset. FX swaps, for example, may help to reduce the cost of USD loans, especially in instances where US interest rates are substantially higher than local borrowing costs.

For more on how entrepreneurs can manage concentrated equity positions, please see a recently published three-part series here (part 1), here (part 2), and here (part 3).

Conclusion

In the first half of 2023, we expect strength for the US dollar and the Swiss franc.

For the rest of 2023, we think entrepreneurs will need to prepare for the dollar to weaken as US economic growth and inflation fall. The timing of the inflection points for US interest rates, inflation, and economic growth is still uncertain, in our view, but will be linked to the Fed's rate hiking path.

Over the medium term, we expect the US dollar to depreciate. As markets begin to anticipate Fed rate cuts and a trough in economic activity, the dollar's overvaluation relative to the euro, Swiss franc, British pound, and Japanese yen should start to correct.

We suggest three tips for entrepreneurs—regardless of where they are in the business lifecycle—for consideration when exploring their business' and personal currency management:

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Appendix

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