Treasury Trends

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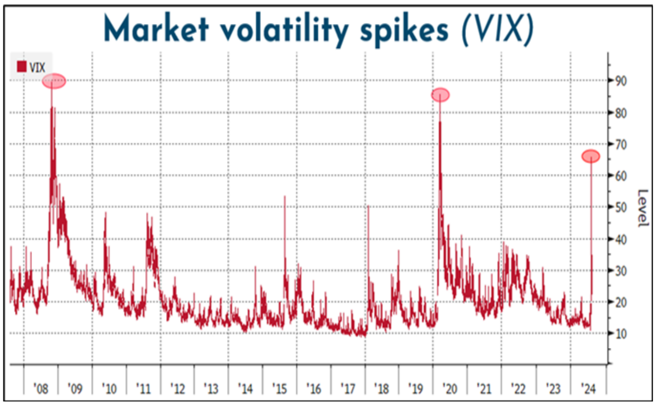
Volatility spikes

Managing market risk amidst the volatility

Early August saw the worst global financial market seizure since the first month of the pandemic in 2020, with big moves in the yen and across global equity and interest rate markets. Volatility rose to a peak only previously seen during major crises, to the point where some influential commentators were even calling for an emergency Fed interest rate cut. The brief episode reversed almost as quickly as it arrived but should be a wake up call nonetheless - volatility is back.



A period of policy transition

After several years of battling a global inflation bubble, central banks are now generally embarking down a policy easing path to help support their economies – at the same time continuing to withdraw the liquidity pumped into their economies during the pandemic. The Bank of Japan this month confirmed plans to steadily shrink its portfolio of bond holdings over the coming years while balance sheet 'normalisation' is already well progressed by other main central banks. So far, this unwinding has gone relatively smoothly, unlike the disruptions to money markets seen in 2019, when the Fed was forced to undertake a sudden policy shift amidst severe funding market pressures.

Big transitions in central bank policy or market positioning seldom

Key Points

- Cyclical changes will likely bring further disruption to financial markets and stimulate periods of heightened volatility
- Many treasury risks can be managed (hedged), with thoughtful and proactive risk management bringing stability, improving certainty around financial performance and allowing the business to focus on its core competencies
- Those managing financial market risks need a disciplined approach, starting with a relevant risk management policy framework and strategy execution typically implemented by regular 'small' decisions rather than infrequent 'large' decisions

go smoothly, suggesting further periods of market disruption lie ahead. Those tasked with managing market exposures, whether interest rate, currency or commodity, need to have the right policy framework, tools (and advisors) to help navigate through these unsettling events.

Don't rely on a crystal ball

Financial markets are great at reporting on what has happened. Email inboxes are typically inundated with updates from bank economic teams detailing the latest plethora of economic data releases, policy announcements and geopolitical developments. The reporting is typically presented alongside the daily/weekly/monthly financial market movements – implying a rational causation. However, anyone who has followed financial markets closely knows they can be far from rational, and that the really big moves are seldom visible in advance.

Those managing financial market risks therefore need a disciplined approach, starting with a relevant risk management policy, and with hedging strategy execution typically implemented by regular 'small' decisions rather than infrequent 'large' decisions. An incremental approach allows for the strategy to be regularly reassessed and positions averaged into, lessening the impact of any one decision. With markets in a constant state of flux, having a considered plan and implementation window will likely deliver a better outcome versus a 'big bang' or ad hoc approach.

While price volatility can be useful when setting orders or target levels (those with 'flyer' orders in place over the brief period of recent market volatility were well rewarded), any execution strategy should also be clear about what needs to happen if the targeted events or levels are not achieved within a set timeframe. Bank or other market forecasts may give a useful guide but any overreliance on specific views should be avoided. While a good story can often be derived to justify a particular trajectory, financial markets will travel their own path, not necessarily the rational one and not in a straight line.

Accepting that few in treasury have the luxury of monitoring financial markets 24/7, over many years of supporting clients in managing market risks we have found that dedicating as little as an hour or two per month is often sufficient for reviewing/updating hedging exposures and strategies and providing regular structure to the risk management process.

Think outside the box

While 'keep it simple' is our mantra, continuous improvement requires a periodic re-examination of how things are done, including the benchmarking of past performance to identify any opportunities for improvement in treasury operations and outcomes. Are there additional treasury exposures that could/should be managed (headlines covering spiking electricity prices provide a recent example of material risks often overlooked by treasury until market stress emerges)? Are we using the best hedging product, and when might alternative products be compelling or the restructuring of existing positions be advantageous? Are we receiving competitive bank pricing on our hedging / transactional banking / funding? Is our treasury reporting concise and communicating the appropriate information. Can cashflow forecasting and cash visibility be improved? Is additional upskilling or external support required? These are common areas explored when we are undertaking our Treasury Healthchecks with clients and often deliver incremental savings and/or practical process improvements. A fresh set of eyes can help to see where any gaps might be and ensure processes keep pace as a business grows and changes.

Be prepared for the unexpected

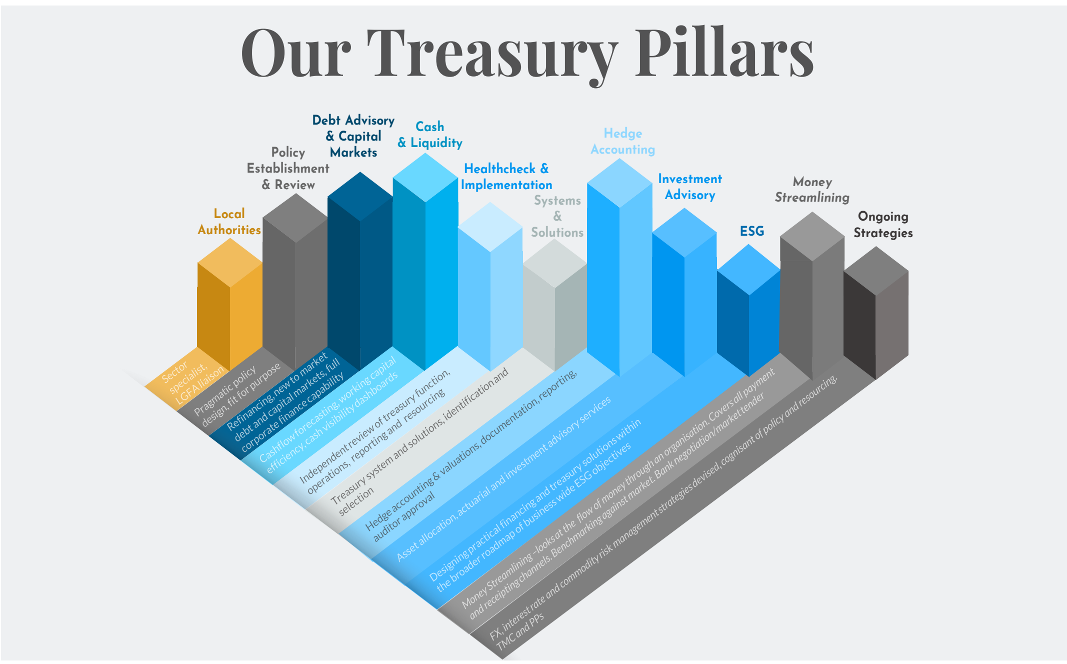
While the above might be an oxymoron, treasury's role is to prepare the company for the market environment that presents itself. While hedging may incur opportunity costs, it provides a valuable tool for managing specific types of market risk. When setting strategies, stress testing and scenario analysis can be useful in simulating how risk management activities might perform in adverse events, noting that each business has its own appetite for risk.

Assumptions around exposure forecasts are also key and can change dramatically in times of market turbulence, so having a good handle on these is imperative – meaning good communication between those creating the exposures (for example sales, procurement), and those tasked with managing the risk. There are plenty of case studies where an otherwise sound hedging strategy has unravelled due to a material change in the underlying exposures being hedged, often due to poor internal communication.

By actively monitoring exposures and managing risk within sustainable levels, treasury should be able to successfully navigate shifting financial markets (and the occasional storm) while providing a stable platform for business growth and decision making.

A final word - large shocks tend to cause a blowout in credit spreads, so companies should also plan any refinancing or secure any new borrowing needs well in advance. It is an attractive credit market at present, so even if you have time to run on your existing funding arrangements, there may be an opportunity to refinance early and secure a more favourable outcome.

WHAT WE DO



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