We live in a far more integrated global financial network. Forward FX is one of the risk management tools for efficient global payments and to effectively smooth timeline and payment mismatches. Tutorials always refer to the time value of money and the merits of prudent risk management to limit downside risk of un-hedged exposures.

In Forward FX the interest rate differentials of the two currencies calculate a price component and equate the forward points added or subtracted to the spot rate. The mathematical examples always depict a low interest rate currency and a high interest rate currency to emphasise the merit of the product and its responsible use.

A subliminal message reinforces the notion investors should migrate available low interest rate funds within the low interest rate currency to optimize returns in the higher interest rate currency. Market participants in the high interest rate economy intuitively seek to borrow at a cheaper rate than their own domestic market.

During the recent accelerated credit cycle global banks and corporations have taken on a disproportionately large share of foreign borrowings in their liability mix predominantly in the currency offering an attractive low interest rate and the greatest liquidity, the USD. Upward pressure on US interest rates has narrowed traditional spreads for all emerging economies and in the case of Australia created an inverted yield difference. The cost of servicing existing short term US debt or undertaking debt reduction strategies is now an urgent priority for those who have heavily expanded these exposures and compromised their P& L and Balance Sheet in the process.

The prospect of these gaps narrowing or inverting further is a stark reality with 2 further hikes in the Federal Funds Rate this year and two next year to approach a terminal FED Funds rate of 3.00 – 3.50%.

The sudden and significant tightening of financial conditions is currently one of the most commented topics in global financial markets. FX Forwards deserves close commentary.

Yesterday, the 3 month implied rate of AUD/USD in Forward FX was 2.40% versus 3m BBSW @ 2.07%. This spread of 33 bpts was 10 bpts wider than the previous day.

	Days	FWD Points	USD Rate	Implied AUD	BBSW	Implied USD
T/N	1	-0.08	1.9259%	2.3432%	1.5000%	1.0942%
1 Mth	32	-0.95	2.0775%	2.2516%	1.9842%	1.8138%
2 Mth	62	-0.85	2.1718%	2.2691%	2.0300%	1.9359%
3 Mth	92	-0.7	2.3331%	2.4029%	2.0675%	2.0023%
6 Mth	186	3.88	2.5088%	2.4405%	2.2103%	2.2816%
9 Mth*	274	10.9	2.6401%	2.4789%	2.1364%	2.3018%
1 Yr**	365	20.03	2.7759%	2.5398%	2.0600%	2.3015%
*Interpolated						
** No BBSW - 1 Yr Swap						

Source: Geordie Foster-Hall | Broker ICAP | geordie.foster-hall@icap.com.au

re clients extending spot obligations into longer-term forward contracts because they are unable to deliver the previously acquired USD? Is there a liquidity squeeze in available USD for delivery?

Foreign borrowings in low yield short term USD have become economically expensive to service or repay. USD used to be like sloppy liquid “MUD”, but is fast turning into having the characteristics of a global “DUST” storm.

Emerging markets are the epicentre of vulnerability. The Bank for International Settlements published a review titled “End of QE and Rising Interest Rates: Implications for Advanced and Emerging Economies”.

This article should be read as if you were reading the referee’s review of the 1st quarter of a tough and competitive football match. They draw particular attention to the under-pricing of liquidity risks, increased interconnectedness and in general draw attention to the current array of financial stability challenges.