Treasury Trends

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Adjusting to a high(er) interest rate environment

Whether a temporary 'blip' in the longer-term downward trend, or a more structural shift in market dynamics, the impacts of recent sharp interest rate moves are being felt far and wide. In less than eighteen months we've quickly transitioned from talk of negative interest rates, to the most aggressive interest rate tightening cycle in recent history. The pace of change has taken many by surprise and shaken long-held assumptions following years of generally downward-trending interest rates and low inflation. From managing sharply rising funding costs, to dealing with derivative mark-to-market volatility, we outline the key challenges (and opportunities) below.

Key Points

- Cash is no longer 'free'. Sound liquidity management makes [cents]
- Funding costs are on the rise, hampering business growth
- Recognise the value in swap hedging portfolio's
- There is a market forecast for every scenario. Good risk management is about reducing volatility and protecting against the extremes, not gambling on 'a view'
- Central bank policy is driving FX rates

Cash is no longer 'free' – good liquidity management is back in focus

While cash preservation was the priority for many organisations in the early stages of the pandemic, this was quickly followed by the urgent need to fund higher inventory levels as the supply chain challenges emerged. Although there are signs that at least some of the supply chain pressures are beginning to ease, significant levels of liquidity remain trapped in supply chains, suggesting it may take some time for working capital levels to return to pre-pandemic norms. A recent US-focused treasury survey found corporate cash levels are at a ten-year high, averaging around 20% of sales — versus 3-5% typical in normal times. This cash buffer often includes 'trapped cash', sitting internationally or in different parts of the business.

Maintaining these high liquidity levels may be acceptable when capital is plentiful and interest rates are near zero, but as interest rates rise and external borrowings become more expensive, the opportunity cost of this cash buffer also increases and is already prompting companies to better mobilise internal idle cash for self-funding and working capital purposes. Strategies for centralising funds, improving liquidity visibility, virtual accounts and cash pooling structures are quickly regaining top priority for many Treasurers, in line with the never-ending drive for cost efficiency and lower operating costs.

Having undertaken a number of *Cash and Liquidity Management Reviews* for clients over recent months, we continue to be pleasantly surprised at how a little tweaking in account structures and transactional banking arrangements can instantly unlock real dollar savings for those organisations prepared to test the status quo.

External borrowing becomes more expensive

Efforts to optimise liquidity management may influence debt management strategies, although few organisations can escape the realities of external funding requirements. The cheap funding provided to banks via central bank initiatives during the pandemic have now largely run their course, with

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prevailing bank wholesale funding costs now around 0.50% higher than the artificially low levels of last year. We are already seeing these higher bank funding costs putting upward pressure on the funding margins banks are offering to corporates.

A gradual increase in regulatory bank capital requirements is also contributing to the upward pressure on funding margins, and in some instances, banks are introducing 'undrawn' or 'non-utilisation' fees into corporate funding structures to recognise the increasing cost of capital. With the cost of maintaining funding headroom increasing dramatically for some, the importance of 'right sizing' funding facilities and implementing the most appropriate bank facility structure has never been more important. Testing the wider market can also prove fruitful, with the current funding market characterised by a wide variation in pricing and differing structures.

While many organisations were happy to undertake short funding extensions over recent years given the pandemic uncertainties, we are now seeing clients re-engaging with more strategic funding plans and re-examining capital structure for a post-pandemic (and higher interest rate) environment. While bank funding consistently offers the lowest cost of funding, there are important questions to be worked through in any funding plan, such as funding and counterparty diversification, tenor, flexibility, headroom, covenants, security, timing, as well as pricing.

Adding some strategic thinking, in the form of a broader funding plan, and supporting it with a professional looking funding *Information Memorandum*, will help ensure a proactive approach to funding and improves the likelihood of an optimal outcome. 'Best foot forward' should always be applied, as sometimes you only get one chance. As economic momentum slows and funders become more discerning, we expect this will increasingly become the case.

Managing risk for all occasions

Given the rapid interest rate tightening cycle (and rise in building costs), we are seeing an increasing number of capex plans being shelved or delayed. These strategic decisions often have a material bearing on borrowing forecasts as well as interest rate risk management strategies. Many borrowers are also recognising significant value in their swap hedging portfolios, something rarely seen given the general downward trend in interest rates over recent decades. This value presents new opportunities around interest rate hedging strategy, with swap restructures allowing interest costs to be realigned (or crystalised) to accommodate business objectives.

While the Reserve Bank of Australia's pandemic guidance that interest rates would not rise until at least 2024 now reads as an embarrassing error, it provides a good illustration of the challenges inherent in modern business — brought on by the rapid pace of change and the interconnectedness of financial markets. Similarly, while those managing FX exposures are right to canvas views on future market direction, the fact that last month one of the big four banks drastically altered its 2023 NZD/USD FX forecast, from 0.7500 down to 0.5600, highlights the risks of relying too heavily on market views. Sound risk management is about enabling the delivery of core outcomes under a range of scenarios. Stress testing, stop-loss limits and 'what-if' analysis should be part of the risk management toolkit, as should regular review.

Few can predict the global events which drive financial markets and ultimately shape business performance. If recent events have taught us anything, it's that those businesses that thrive need to be nimble and attune to both the risks and opportunities. Supported by unparalleled market intelligence and a proactive strategy approach, our Treasury Advisory services can help you navigate the ever-changing landscape, and potentially unlock treasury cost-saving and efficiency gains.

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