Reuters/Jon Nazca

The impact of Brexit on the MENA region: How can Corporate Treasurers look to navigate the financial risks of tomorrow?

By Ian Groome, Treasury Sales Specialist, Thomson Reuters MENA

the answer company™
THOMSON REUTERS®

The United Kingdom's decision on June 23, 2016 to leave the European Union prompted a change of political leadership in Britain, caught many investors off guard and sent shockwaves through the financial markets due to mounting economic and political uncertainty.

While this initial turbulence has (somewhat) subsided for now, financial volatility remains a pressing issue – and is expected to last while the UK unravels its economic, legal and regulatory ties with the bloc and negotiates new relationships across the globe. A few months on, there is still very little clarity as to how this will play out.

Factors such as expectations of United States Federal Reserve rate hikes, changing regulation, sluggish emerging market and Asia growth and uncertainty about the outcome of U.S. presidential elections are all adding to the fragility in markets.

In the GCC, the Brexit vote has thus far had limited impact; but analysts hold divided opinions on how the outcomes of Brexit will affect the Middle East and North Africa (MENA) going forward.

Sterling weakness could have both positive and negative outcomes for the region's economies. While a struggling GBP could erode the value of MENA investments in Britain, some analysts believe that continued downward pressure on the currency could stimulate investment flow from the region (specifically the UAE) into the UK.

Tim Fox, chief economist of Emirates NBD, explained that "exceptionally weak sterling levels" might represent "a once in a lifetime opportunity to purchase UK assets." He added, "Unlike other regions, GCC investments into the UK are for the most part not made with the motive of accessing European markets, but rather they are standalone investments made in their own right, in areas such as real estate and hospitality."[1]

On the other side of the coin, sluggish growth in the UK and eurozone could hinder tourism flows to the region. At the same time, a downturn in the EU could see one of the world's key crude importers reducing its demand for oil, which will impact MENA's oil exporters. And if uncertainty spikes and investors focus on safe haven assets, crude prices could feel further negative effects.[2]

GCC businesses and investors therefore face two major concerns: Firstly, the valuation of the British pound and its implication on inward investments; and secondly, the impact on GCC trade arrangements. Additionally, the volatility in currency markets can also have a bearing on other asset markets such as commodities and global monetary policy, all of which would have a direct impact on the region.[3] For countries such as Egypt, Morocco and Tunisia, which are heavily reliant on the UK for tourism, bilateral trade and investment (currently covered by EU association agreements), the valuation of the pound and the political implications from trade disruption are also top of mind.

Looking at this through the lens of corporate treasury and finance in the region, it is crucial to understand the inherent risks at hand and to have robust strategies in place alongside the analytics and solutions needed to give a clearer view on how to manage FX and liquidity risk more efficiently.

The sliding GBP

FX volatility and the British Pound (GBP) are pressing concerns for corporate treasurers in the referendum aftermath. The GBP fell against the USD by 14% in just two days after the vote to leave – recording the sharpest two-day dip by any major currency since 1973. While such moves are rare, the fact that they can happen is a motivation for routinely hedging foreign exchange exposure.

British Pound vs. U.S. Dollar

Source: Thomson Reuters Eikon™

However, with the Gulf currencies pegged largely to the U.S. dollar, a weaker pound could actually improve the trade balance with imports for those companies in the luxury goods, telecom, real estate and power sectors.

While the GBP has shown signs of improving a few months on, the sterling-dollar exchange rate could remain volatile until the Brexit trail is charted, with a range of implications for corporates depending on their lines of business. That said, many treasurers are grappling with the fact that this period of uncertainty is putting pressure on their forecasting, analysis, reporting, control and hedging strategies – a challenge made even more burdensome by increased senior management and stakeholder scrutiny.

IMF downgrades global growth forecasts

In the aftermath of the Brexit vote, the International Monetary Fund (IMF) has downgraded its economic growth forecasts for 2016 and 2017:

- The **global economy** is now projected to expand 3.1% during 2016 and 3.4% in 2017. This represents a 0.1% reduction for both years compared to the IMF's April outlook.
- The **UK economy** is forecast to expand 1.7% during 2016 – 0.2% less than predicted in April; and slow to 1.3% in 2017, down 0.9% from the original estimate.
- The forecast for the **Euro** area improved by 0.1% for 2016, to 1.6%; and fell by 0.2% in 2017, to 1.4%.

Had it not been for the Brexit vote, the IMF was prepared to leave its outlook for 2016 unchanged and raise its 2017 forecast slightly. According to the IMF's World Economic Outlook Update, "The Brexit vote implies a substantial increase in economic, political and institutional uncertainty, which is projected to have negative macroeconomic consequences, especially in advanced European economies."[4]

The IMF made it clear that the updated forecasts were based on the assumptions that the EU and UK would manage to broadly overcome economic barriers and that financial markets would rally. However, the IMF cautioned that "more negative outcomes are a distinct possibility."

Ripple effect on trade relations

As discussed, analysts believe that the UK exit from the EU could affect MENA countries in different ways, depending on their existing economic ties with the UK and Europe.[5] At present, according to a recent Focus Economics report, Egypt's exposure to the UK is relatively high, while Algeria, Morocco and Tunisia have links with the EU.

Since initiating negotiations in 1988, the EU has been unable to formalize a Free Trade Agreement (FTA) with the GCC. However, economists expect bilateral trade between the Gulf and the UK to improve with British trade policy becoming more robust as it exits the EU – especially if it circumvents the stagnant EU-GCC FTA negotiation process.

The UAE, in particular, looks set to strike a trade agreement with Britain. The two nations recently signed a Double Taxation Agreement. In October 2015, the UAE and Britain also more than doubled their bilateral trade target to Dh135.24 billion by 2020. An exit vote is not expected to impact this.

On the other hand, weaker growth in EU countries could have negative knock-on effects across the MENA region. The EU currently accounts for around 12% of total exports from MENA, so the impact will depend on how the bloc is affected as the UK negotiates its departure.

U.S. rate hike postponed, but still on the cards

The United States Federal Reserve's decision to delay rate hikes could improve liquidity and financing conditions in the MENA region.[6]

On August 26, 2016, Janet Yellen, the chairman of the U.S. Federal Reserve, announced at a symposium in Jackson Hole, Wyoming:

"In light of the continued solid performance of the labour market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months."

Ms. Yellen noted that future rate increases would be "gradual" and data dependent. If these do come into effect, the MENA region could be impacted both directly and indirectly – in the form of higher global lending rates and an uptick in borrowing costs for regional governments and corporates. This, combined with depressed oil prices, could increase financial volatility across MENA.[7]

UK rate cut and increased quantitative easing

On August 4, 2016, as part of a four-point monetary stimulus package, the Bank of England cut interest rates to 0.25% – their lowest ever level in the Bank's 322-year history. Rates may be reduced further in coming months as the Brexit effect becomes clearer.[8]

At the same time, the Bank of England announced that it would extend quantitative easing (QE) by GBP 60 billion, extending the existing QE program to GBP 435 billion in total. With further monetary easing expected from Europe and Japan, some analysts predict an increased flow of capital into emerging market currencies, such as those in the MENA region. This happened in the wake of the global financial crisis.[9] Countries offering the best shelter from low rates are most likely to see the benefits.

Hedging FX exposure in this climate

Protection against currency volatility has never been more significant. There is a growing need for finance executives and treasurers to have access to real-time news and analytics, to evaluate their execution strategies and processes, and – if necessary – adopt a more robust risk management mindset when analyzing which currency hedges to use.

While hedging does in fact help to reduce volatility, it's more important for finance executives and treasurers to understand the underlying risks of FX rates and how to measure them before deciding on a hedging strategy for their company. And because choosing the right hedge can have a significant impact on a firm's bottom line, it's a good idea to analyze market pricing to uncover the most cost-effective hedge structure as well as stay abreast of relative liquidity during the day.

Reuters/Jason Lee

Brexit serves as a reminder that corporate treasurers have limited discretion in hedging. However, while there may be little wiggle room on when or if to hedge, there still remains potential discretion on how to hedge. Here are some areas to focus on:

- **Duration** – having shorter duration than the benchmark creates an opportunity to benefit from a favorable move in interest rates. Contrarily, the impact of an adverse rate move can be avoided by holding relatively long duration. An anticipation of a particular rate move would determine the duration bias. If there is no clear view, it is advisable to avoid durations where rates are unattractive from both relative and historic perspectives.
- **Structure** – Options are forward outrights, at-the-money, low-delta and risk reversals. A strong directional bias can provide a clear guide to an appropriate structure. In the absence of a view – again, relative value can help guide the choice of how to best take advantage of market pricing.
- **Time of day** – Even hedgers with little discretion on timing have some ability to decide when during the day to execute the trades needed to establish the hedge. Executing a large trade during periods of poor liquidity can have a significant adverse effect on the transaction price.

Currency volatility, almost regardless of direction, could make a strong case for greater use of currency hedging tools, requiring regional corporate treasuries to become more sophisticated. As discussed, decisions on the duration, structure and intraday timing of the hedge can all have a material impact on the cost and effectiveness of the hedge. In the absence of a market view, relative value can provide a guide to cost-effective hedging.

Demonstrating best execution in a changing FX landscape

Organizations are increasingly being asked to rationalize how they transact their FX business. The need to accomplish, assess and demonstrate best execution is also more important than ever now due to the structural changes introduced and heightened scrutiny in FX markets. At the same time, there's recognition among the buy-side that regulation is constraining banks' ability to provide liquidity.

Another change to the market landscape is the growing presence and influence of non bank liquidity providers that are replacing traditional bank market makers. People are watching with interest what impact this will have in volatility as well as access to liquidity, particularly in times of crisis.

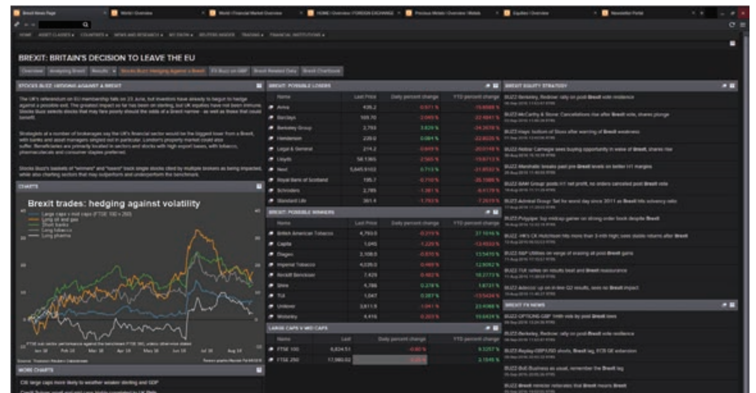
In an effort to adapt to this changing environment, many treasurers are using technology to access relevant, verified and up-to-date data and analytics. Current solutions are available that can equip corporations with the platforms, cross-industry insight and expert partnership to identify the right opportunities, consider them from every angle and execute with confidence.

Leveraging technology for greater transparency, better tools and bigger rewards

Choosing an external partner with the gravitas and global coverage to offer relevant and verified data on pricing and rates, as well as robust news and insights, is the cornerstone of a rigorous approach to FX risk management.

Here are some of the ways in which Thomson Reuters can support you:

1. **Keep pace with world markets and Brexit:** Eikon's Brexit page could be a great starting point to get a quick snapshot of what is happening across the globe. Or alternatively, tapping into any of the asset class/world overview pages offered on Eikon (such as the Financial Markets, Foreign Exchange, Precious Metals and Equities overview pages) can prove useful in monitoring your overall portfolio, FX exposures and liquidity to support decision making.



2. **Stay abreast of your relative liquidity during the day:** Thomson Reuters is able to provide an FX volume heat map that portrays relative trading volume and liquidity during the day in half-hour segments. Using foreign exchange trading data from the Thomson Reuters Matching platform, the map compares how the average volume in a particular segment compares with the average daily half-hour volume. It is apparent that liquidity varies substantially and that pockets of liquidity for different currencies do not occur in unison. So when transacting large orders, it makes sense to ensure trades are executed in periods of relatively strong liquidity.

3. **Achieving best execution:** Bank algorithms and benchmark orders are two methods corporates are using more and more to justify how they transact their FX business and prove best execution. Thomson Reuters WM/Reuters 2 p.m. CET benchmark, for instance, is a new FX benchmark service designed for corporates looking to value, hedge and settle cross-border transactions. The benchmark also solves for the ECB's euro foreign exchange reference rate time change to 16:30 p.m., which can prove problematic for intraday and closing fixes.

   Firms that perform best execution analysis on their FX transactions can evaluate performance based on actual trade data and identify improvement strategies accordingly. To assist in evaluating execution quality, Thomson Reuters offers Execution Quality Analysis reports (EQA).

4. **Risk data:** Corporations are recognizing that they need to have timely, accurate and market-based pricing mechanisms to price existing assets as well as new products, particularly if they have businesses in multiple countries and exposures spread across multiple asset classes and counterparties. Having near-time pricing mechanisms ensures assets are marked to market accurately and enterprise risk management is efficient. Thomson Reuters Pricing Service (TRPS), for example, is an independent global pricing service covering over 2.6 million fixed-income securities, derivatives and bank loans, and distributing over 2.5 million price updates per second.

   The benefits of being able to slice and dice risk data across the firm are relatively untapped due to the complexity of institutions and their databases. In addition, aggregating data for risk reporting opens up opportunities to proactively use this data to drive better business decisions for superior risk management, capital allocation or even identification of fresh business opportunities.

Conclusion

It is difficult to predict exactly what will happen to markets across the region and the globe when the UK navigates its exit from the EU. What is clear, however, is the fact that nearly every aspect of the corporate treasury role is impacted – and this function is evolving beyond managing working capital to serve a more strategic role in keeping corporations profitable.

The full extent of the Brexit effect on MENA could remain unclear for some time. In addition, other global events such as sluggish growth in China and potential political change in key countries across the region could mean that uncertainty has become the new certainty – and treasurers have no choice but to develop robust strategies for managing effectively through this volatile period.

About the author

Ian Groome has over twenty years' experience in financial markets focusing on Treasury – fourteen years working in trading and sales in the City of London at First Chicago, Banque Paribas and ABN Amro. He is specialised in FX derivatives and technical analysis and has conducted training courses in FX Options in Europe, Asia and the USA.

Ian has been working at Thomson Reuters for seven years, covering the Middle East and Africa as a Treasury specialist responsible for pre-trade, trading and post-trade solutions. He has a BA (Hons) Economics from the University of Leeds.

[1] http://gulfnews.com/business/economy/gcc-investors-likely-to-benefit-from-brexit-and-pound-decline-1.1851747

[2] http://focus-economics.com/regions/middle-east-and-north-africa

[3] Khaleej Times

[4] https://imf.org/en/News/Articles/2016/07/18/18/11/NA07192016-IMF-Cuts-Global-Growth-Forecasts-on-Brexit-Warns-of-Risks-to-Outlook

[5] http://khaleejtimes.com/business/economy/brexit-has-mixed-impact-on-gcc

[6] http://focus-economics.com/regions/middle-east-and-north-africa

[7] http://atlanticcouncil.org/blogs/menasource/how-might-the-fed-s-policy-affect-the-middle-east

[8] https://theguardian.com/business/2016/aug/04/bank-of-england-cuts-uk-interest-rates

[9] http://blogs.ft.com/beyond-brics/2016/07/11/could-brexit-spark-a-revival-in-growth-markets/

Visit financial.thomsonreuters.com/en/markets-industries/corporate-treasury-services.html

For more information, contact your representative or visit us online.

Thomson Reuters brings together a unique combination of corporate treasury services and solutions, designed to help you drive down risk and cost while giving you tools to simplify processes and power global growth opportunities – enabling you to make the right decisions and act with confidence. Your world is complex, global and competitive. You require a partner who truly understands your role and designs solutions to help you across your entire workflow. From capital markets data to deep market analysis, from unique views of credit risk to direct access to FX liquidity, our treasury services help you seize opportunities. Get trusted information, intuitive technology and insightful expertise, all from a single source.

© 2016 Thomson Reuters S039483/10-16

The intelligence, technology and human expertise
you need to find trusted answers.

the answer company™
THOMSON REUTERS®