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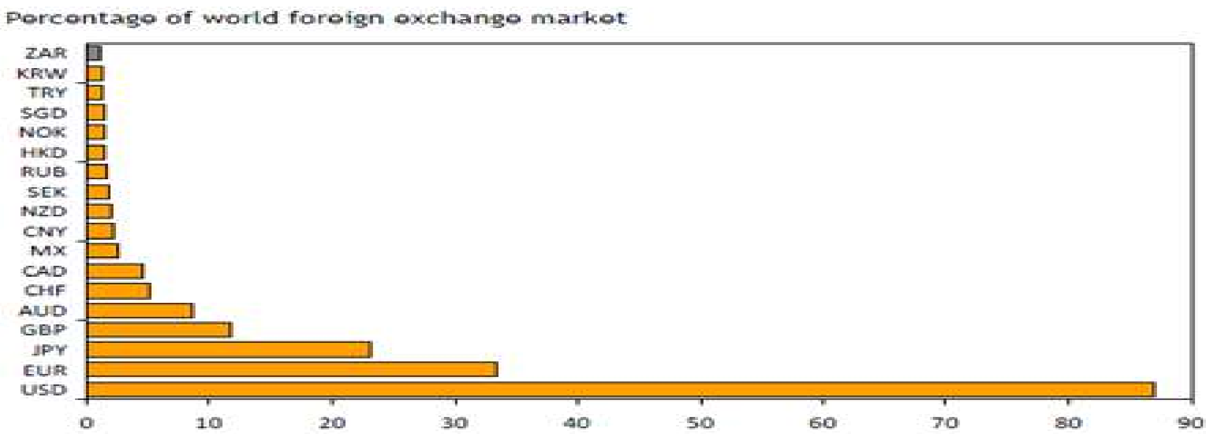
GBP/USD

Price movement of GBP/USD from January 2010 to September 2013

As shown above, the GBP/USD rate has been really volatile since the beginning of 2010 and currently, we can observe a strong uptrend in the market based on positive market fundamentals explained below. The conversion rate prevailing as at October 7th 2013 is 1.6070.

The composition of the world foreign exchange market



Source: Bank for International Settlements (April 2013)

Factors affecting the value of the pound sterling:

A. INTEREST RATE

If the Bank of England increases its key policy rate or if investors expect a rise in the interest rate, the value of the pound sterling moves upward. From 2001 until the end of 2006, the BOE kept its benchmark rate below 5%. However, by the beginning of 2008, the rate was increased above the 5% mark, leading to an appreciation of the pound sterling.

From March 2008 till date, the rate has dropped and has being stagnant at 0.5%. Subsequently, on February 15, 2011 the inflation in UK increased to 4%, double BOE's expectation. As a result, BOE is adopting a hawkish policy and announced the next increase in interest rate only in August, 2011.

B. TRADE DEFICIT

A large trade deficit in Britain implies less attractive foreign exchange value for the pound. In turn, this results in appreciation of the pound sterling against other currencies. This implication was clearly denoted in September 2010, when the UK Trade Deficit narrowed to 7.4 billion pound, leading to a rally in the cable up to a 1.5895 intraday high.

C. HOUSING SECTOR DEVELOPMENT

Developments in the housing market have a direct impact on the value of the pound sterling. For instance, the British Pound rose to $1.6186 on October 1, 2013 after UK house prices rose in September - average values in England and Wales rose by 0.5% while UK mortgage approvals rose to 62,226 in August 2013.

Hedging on Bourse Africa GBPUSD Futures contract

Suppose today, a sugar producer receives an order worth GBP 1,000,000 to export sugar to England in 3 months time. In today's spot market, the British pound is exchanging at USD 1.6200 per pound, while on Bourse Africa, a futures contract matching the order payment date is available at USD 1.6220 per pound. The present value of the order is USD 1,620,000.

To lock in the price of USD 1.6220 per pound, the sugar industry can enter into 80 Bourse Africa GBP/USD futures contracts (1 Bourse Africa GBP/USD futures contract is equal to GBP 12,500) to sell GBP 1,000,000 at USD 1.6220 per pound in 3 months.

Scenario #1: GBP depreciates significantly to USD 1.5000 per pound in 3 months

At the time of receipt of the payment after 3 months, the sugar producer would receive only USD 1,500,000, while converting the GBP 1,000,000 into USD due to the prevailing exchange rate.

As he had entered into 80 GBPUSD futures contracts to sell GBP 1,000,000 at USD 1.6220 per Pound in 3 months, the exporter would gain USD 122,000 [i.e. (1.6220 - 1.5000) x GBP 1,000,000] from hedging on the exchange.

Thus, overall the exporter would receive USD 1,620,000 (USD 1,500,000 from spot market plus USD 122,000 from hedging profit on Bourse Africa) for the GBP 1,000,000. This amount is equivalent to selling GBP 1,000,000 at USD 1.6220 per pound, i.e. the current price of GBP/USD.

Scenario #2: GBP appreciates significantly to USD 1.6700 per pound in 3 months

At the time of receipt of the payment after 3 months, the sugar producer would receive USD 1,670,000, while converting GBP 1,000,000 into USD.

Since he has entered into 80 GBPUSD futures contracts to sell GBP 1,000,000 at USD 1.6220 per pound in 3 months, the exporter would lose USD 48,000 [i.e. (1.6220 - 1.67000 x GBP 1,000,000] from hedging on the bourse.

Thus, overall the exporter would receive only USD 1,622,000 (USD 1,670,000 from spot market less USD 48,000 from hedging loss on Bourse Africa) for the GBP 1,000,000. Again, this amount is equivalent to selling GBP 1,000,000 at USD 1.6220 per pound, i.e. the current price of GBP/USD.

Despite the fact that the businessman can make gains or losses from hedging, the basic purpose of hedging is to know exactly how much income would have been generated from this export deal irrespective of the uncertainty associated with future exchange rate movements. This example depicts the elimination of foreign exchange risk using futures contract available on Bourse Africa.

BOURSE AFRICA LIMITED
Ebène House, 1st Floor, 33 Cybercity, Ebène, Republic of Mauritius.
T: (230) 404 0000 | **F:** (230) 464 7000 | membership@bourseafrica.com | www.bourseafrica.com