This year’s 12% plunge in the euro has ignited the biggest rally on record in automakers and helped push the DAX Index above 12,000. Demand for ways to protect those gains is also soaring.

Options on BMW AG and Volkswagen AG are the most expensive in more than two years relative to those on the Euro Stoxx 50 Index and contracts on Daimler AG climbed to their highest price since October 2013, data compiled by Bloomberg show. All three companies have rallied more than 36% this year.

Carmakers have become Europe’s hottest stocks, partly because traders bet a weaker euro will translate into higher profits. But investors such as Dirk Thiels at KBC Asset Management say the advance may have gone too far, in part because currency hedges from companies will limit the benefit to earnings.

“The effect of the weaker euro will only come later and more slowly than the market is hoping,” Thiels, KBC’s head of investment management, said by phone from Brussels. “People need to be more careful with their expectations. We might get some disappointments in first-quarter earnings.”

The European Central Bank’s quantitative-easing program that caused the downward spiral of the euro region’s currency helped trigger record inflows into a fund tracking auto shares last month. A weak euro makes European goods more competitive abroad, which can lead to higher demand or wider profit margins.

Carmakers in the Stoxx Europe 600 Index fell 2.5% from a record on Tuesday.

24% Jump
The rally for BMW, Volkswagen and Daimler has sent their valuations to levels not seen in four years and pushed the DAX up 24% in 2015, the most among 24 developed markets. While analysts say annual profit will rise 9% at BMW, 10% at Volkswagen and 17% for Daimler, those estimates represent a slower rate of growth than in 2014, data compiled by Bloomberg show.

Hedges owned by automakers against currency swings mean they’ll reap sales windfalls only if the euro slumps more, BNP Paribas SA said in a March 12 note. If it stays at the current level, the impact on revenue won’t be as significant, according to the note.

BMW has managed currency risks by increasing production outside the euro area, including new plants in the U.S., China and Brazil. Both BMW and Daimler’s Mercedes-Benz assemble most of their popular SUV models at factories in the U.S.
In 2013, BMW used derivatives to hedge up to 60 months of foreign-currency sales, according to its annual report for that year. BMW will give its 2015 outlook on Wednesday after reporting a gain in annual profit last week.

Reduce Impact

Volkswagen holds similar instruments to reduce the impact of exchange rates, saying this month it uses more contracts with maturities between one and five years than shorter-term ones to protect against euro fluctuations.

Daimler has protected 80% of its risks for the year and predicts a currency gain of as much as EUR 500 million (USD 530 million), a spokesman said. The company is hedging less for 2016 and will get more benefits if the euro remains weak, he said.

Representatives of BMW and Volkswagen didn’t reply to e-mails and calls seeking comment for this story.

But revenues will probably pick up at home too as economic data beat forecasts and fuel costs tumble. European car-sales gains accelerated in February, the European Automobile Manufacturers’ Association said on Tuesday.

Not Broken

“Car manufacturers are firing on all cylinders,” said Kevin Kelly, chief investment officer at Recon Capital Partners in New York. “Even after a great run, we’re still very bullish. Don’t fix what’s not broken.”

Fund managers agree, making the sector the most-favored in Europe, according to a Bank of America Corp. survey last month. Twelve of the 14 members of the Stoxx 600’s autos group are up at least 30% this year. For Peter Garnry, Saxo Bank A/S’s head of equity strategy in Hellerup, Denmark, the risk of disappointment is big. “Expectations are running so high that if earnings growth, primarily driven by big FX gains, does not arrive on schedule then European export stocks will be sold off -- and fast,” he said.

Questions

1. Explain the economic exposure (EE) of European car makers.
2. Given the information in the first two paragraphs, provide a rough estimate of the EE of the big three German car makers.
3. Explain why FX hedging reduced the EE of the big three German car makers.
4. BMW has relied on operational hedging –i.e., increasing production outside the euro area. It is often argued that operational hedges are more costly, imprecise and time-consuming than financial hedges. Do you agree with this statement? Describe a scenario BMW’s operational hedging are worst than financial hedging.
5. Daimler has protected 80% of its FX risks for the year. Explain how they do this. What are the pros and cons of selective hedging?
6. Daimler is hedging less than 2016. Why? Given what you learned in class, do you agree with this decision?