Silicon Valley Bank

2022 FX themes & strategies

for the innovation-sector

FX Risk Advisory
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Key takeaways

As inflation heats up, the outlook for the USD becomes murky. We anticipate greater foreign exchange (FX) rate uncertainty and volatility ahead.

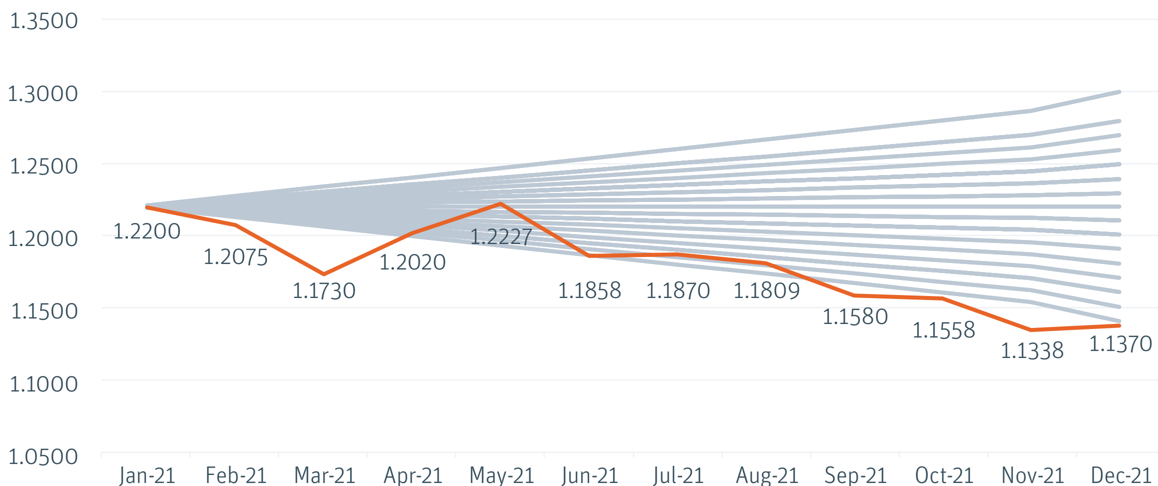
In this environment, reviewing hedging strategies that strike a balance between certainty and rate flexibility can be helpful.

Two straight-forward approaches to achieve this are: Partial hedging with forwards or using options-based hedging products. SVB can help you with both.

The aftermath of COVID-19 left the US economy with larger fiscal and trade deficits, more debt, and the highest inflation among developed economies. These are all factors that should have resulted in a weaker USD in 2021, a view shared at the start of the year by most financial institutions that publish currency forecasts on Bloomberg. The consensus view on the USD did not manifest.

Versus the euro, for example, the currency most often traded versus the USD by Silicon Valley Bank corporate and fund banking clients[1], the projections of 74 forecasters made on January 1, 2021 for year-end are represented by the blue lines below. The actual month-end exchange rates throughout the year, in orange, confirm that not only was the median forecast of 1.2500 incorrect, but in fact all 74 forecasts were above the end-of-year rate of 1.1370[2].

Chart 1: Forecast versus actual exchange rates



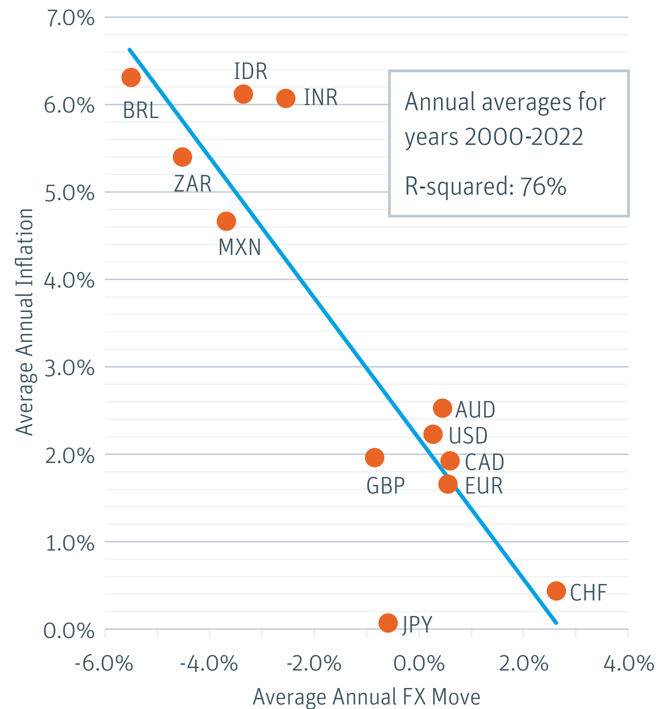
Source: Bloomberg 2021

1 According to proprietary flows for 5 years running through 2021.
2 Source: Bloomberg.

Chart 2: Higher yields have fueled USD appreciation

Source: Bloomberg

Chart 3: Over the long run, there is an inverse relationship between inflation and currencies



Source: Bloomberg

Why the divergence between forecast and reality?

Halfway into 2021, US inflation pressures, present for months prior in grocery stores and gas stations, began to show up in headline economic releases. The year-over-year CPI index[3] crossed 5% in July, 6% in October, and 7% in December[4]. Over this period, market projections for Fed rate hikes in 2022 went from one single hike to five[5]. As illustrated in Chart 2, bond interest rate yields adjusted higher due to refreshed inflation expectations, fueling a sharp rise in the USD over the latter half of the year.

Is inflation always good for currencies?

Not exactly.

Over the short-term, higher inflation will result in higher interest rates, which support currencies as yield-seeking investors allocate capital in search of pence and pennies. This helps explain why the USD reigned supreme among developed economy currencies in 2021.

Over the long-term, however, inflation eats into purchasing power. What a pound, euro, or dollar buys today, it will not tomorrow. When thinking about inflation across borders, it is inflation differences that matter. If the inflation in the foreign country is higher than at home, the purchasing power of the foreign currency falls faster in a relative sense and the exchange rate between the two should adjust to account for the difference, meaning the foreign would depreciate against the domestic. Over the long-term, then, higher inflation is associated with weaker currencies. Plotting the average annual currency moves versus average inflation since 2000 (Chart 3) illustrates this dynamic.

[3] The CPI index is a measure of much consumer prices have risen in the preceding 12-month period.

[4] For context, the average reading since 2010 was 2%, which is also the Federal Reserve's long-term inflation target.

[5] According to fed funds futures prices as of February 1st 2022. Source: Bloomberg page WIRP.

Table 1: Partial hedging with forwards offers both certainty and potential upside

(a) Probability FX rate moves against your budget rate	(b) Hedge ratio with FX forwards		(c) Percentage of budget expected to be met	(d) Percentage of budget expected to receive upside	(e) Ratio of expected certainty to upside
50%	100%	→	100%	0%	N/A
50%	75%		88%	13%	7.0
50%	50%		75%	25%	3.0
50%	25%		63%	38%	1.7
50%	0%		50%	50%	1.0

Source: SVB FX Risk Advisory

a) Exchange rates moves resemble a coin toss, based on theory and practice
b) Hedge ratio is the perecentage of the foreign-dominated cash flow or asset that is hedged
c) Percentage of budget expected to be met net of hedging at the assumed hedge ratio. For example, with a 50% hedge ratio, you are left with 50% residual risk resulting in 75% of budget will be met → 50% from hedging plus 25% from chance.
d) Percentage of budget expected to receive upside net of hedging at the assumed hedge ratio
e) This is the ratio of (c) over (d) → A higher ratio implies a greater level of certainty per unit of potential upside (attained from incurring residual unhedged risk)

What are the implications for currency managers?

For 2022, the outcome for the USD will largely depend on how the inflation picture unfolds, and the jury is still out. Bond investors are notable dissenters from the inflation camp. With US 10-year bond yields trading below 2% and inflation over 7%, on paper this means that the projected return for a bond investor would not keep up with the loss of purchasing power, suggesting such investors do not believe inflation will persist. Otherwise, why would they commit capital to a money-losing proposition?

> Inflation uncertainty further adds to FX uncertainty[6]. Hedging strategies that balance certainty with some rate flexibility can be helpful in this environment.

Here are two ways to achieve this.

1 **Partial hedging with forwards:** Fully hedging a future non-USD revenue or expense cash flow with a forward contract[7] locks in certainty, but that certainty can introduce opportunity cost if the market goes against the forward. Suppose you lock in the price for the required amount of a currency, and then the price drops after you commit to the hedge. You would not be able to participate in the price improvement. **Hedging less than 100% of your projected non-USD revenue or expense gives you some protection and some rate flexibility.** The more (less) you hedge, the higher (lower) the ratio of certainty to potential upside. Table 1 above offers a structured framework for assessing the tradeoff.

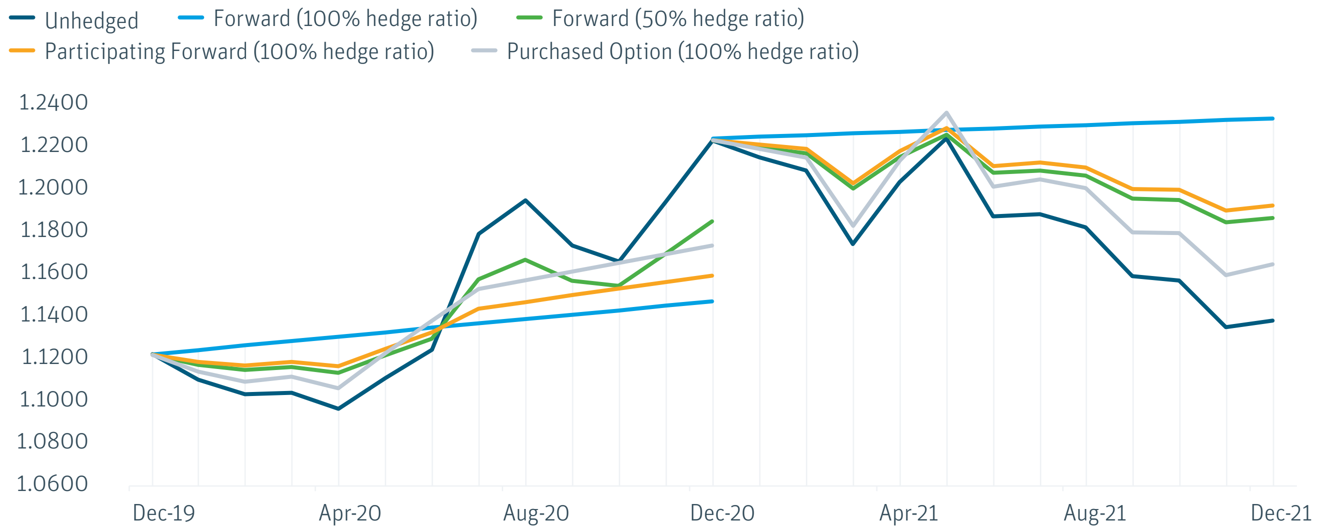
A 50% hedge strikes an attractive balance between certainty and potential upside.

Partial hedge ratios may be achieved by hedging future cash flow at the same hedge ratio, or according to a cascading approach where nearer term cash flows are hedged at higher ratios and longer-term at lower hedge ratios.

6 Uncertainty is another word for volatility or two-way risk.

7 An FX forward contract represents a contractual obligation to exchange one currency for another at a predetermined rate and date in the future. When used for risk management purposes, forwards offer price protection, but no flexibility for upside. In certain situations, the opportunity cost described does not necessarily discourage forward use. For instance, the purpose behind balance-sheet hedging is to insulate the income statement from FX remeasurement volatility. Losses on hedges are offset by gains on remeasurement of assets and liabilities, and vice versa. The target net gain/loss is zero, and how you get to zero does not matter.

Chart 4: Simulated hedging strategies for buying euro



Source: Bloomberg

2 **Using options-based hedging products:** Purchased options represent the other end of the risk management spectrum. Options provide protection, but the hedger or end-user is not obligated to buy or sell currency at that rate in case the market improves, thereby eliminating the opportunity cost. The catch, of course, is that an upfront premium payment is required.

The market has also developed option combination strategies such as collars and participating forwards which offer both protection and flexibility, at zero or low cost. If used systematically, option-based alternatives achieve smoother outcomes from period-to-period regardless of rate moves.

For example, Chart 4 above tracks the simulated rate to buy euro monthly for 2020 and 2021 needs based for various strategies, assuming hedging is done once a year on January 1 of each year. Notice that the variability of rates achieved for the partial forward hedge and the options-based strategies is generally lower from one year to the next than the unhedged and fully hedged strategies.

As inflation persists and the debate around it intensifies, the outlook for the USD becomes murkier. Anticipate greater FX uncertainty ahead, especially after years of muted volatility in FX markets. SVB can help you assess the merits of hedging strategies which strike the appropriate balance of protection and rate flexibility for your business or overseas investment.

If you'd like to discuss your specific situation or for information regarding SVB's tailored FX risk management services, reach out to your SVB FX contact or GroupFXRiskAdvisory@svb.com.

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