FX Navigator 2022

Key insights and forecasts for the months ahead from our Market Risk Solutions Team

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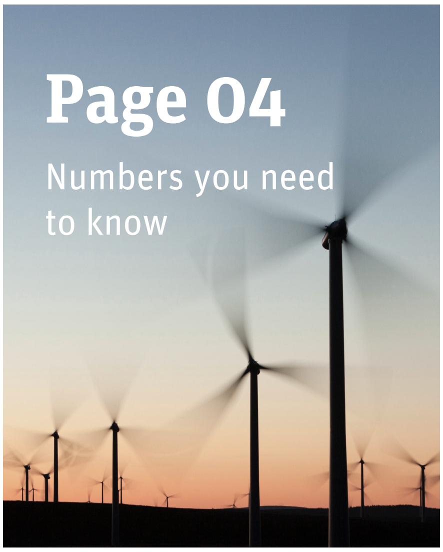
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Monetary Policy at the races

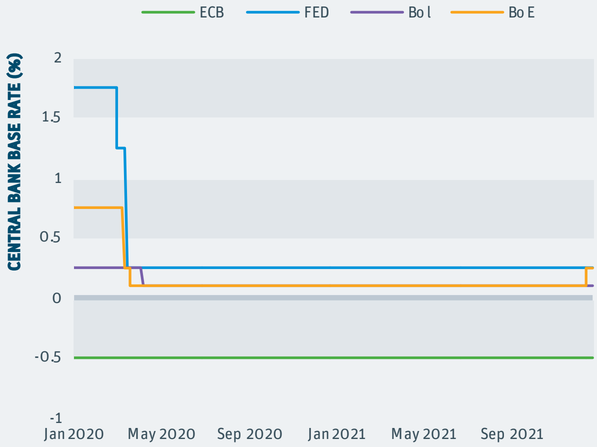
And they're off, with Bank of England amongst early movers to increase central bank policy rates. Inflation loomed large in policymakers' minds through the second half of 2021, as they weighed stimulating a pandemic recovery against longer-term inflationary concerns.

Rhetoric has begun to translate into action, as monetary hawks take the reins in most regions and central bankers look to dampen global price increases.

Having sat on the fence while the definition of 'transitory' inflation was debated through summer and autumn, discourse moved on in the final quarter of the year as pricing pressures became too great. Although the catalysts of this inflationary bout (whether supply or demand) remain up for discussion, policy setters have begun to conclude the longer-term cost of inaction may be worse than the medicine. The adjustment to outlook has seen an almost universal change in tone as central bankers reconsider their policy outlook.

As the monetary mood music shifted, the global pandemic began a new chapter: The Omicron Variant, which has spread rapidly across the globe, placing coronavirus concerns firmly at the front and centre of government minds. Having witnessed a nascent economic recovery, governments are stepping into 2022 with trepidation as the impact of this variant is further evaluated.

Let the tightening begin



Source: Bloomberg 2022

Against a backdrop of policy change and pandemic evolution, the year ahead will see the political steeple chase resume.

3

Rate hikes expected by the FED this year

Against a backdrop of policy change and pandemic evolution, the year ahead will see the political steeple chase resume. The US begins the long run into mid-term elections, oft viewed as a referendum on the sitting President. France prepares for its own Presidential election, with Macron looking to fend off opponents from both flanks. Germany and Israel see recently elected premiers continue to find their feet as the UK Prime Minister will try not to lose theirs.

Numbers you need to know

5.8%

Rise in OECD CPI [1]

22.4%

Increase in federal debt since Q1 2021 [2]

2.4°C

COP26 commitment to limit global warming by 2100 [3]

70

Number of days the S&P 500 closed at a record high during 2021 [4]

9.17 bn

Total COVID-19 vaccine doses administered worldwide [5]

3.0563

The lowest level USDILS traded during 2021 [6]

1. As of November 2021. Source: https://data.oecd.org/price/inflation-forecast.htm#indicator-chart 2. As of 31 December 2021. Source: https://fiscaldata.treasury.gov 3. Source: https://ukcop26.org 4. Source: S&P Global 5. As of 31 December 2021. Source: https://ourworldindata.org/covid-vaccinations. 6. Source: Bloomberg 2022

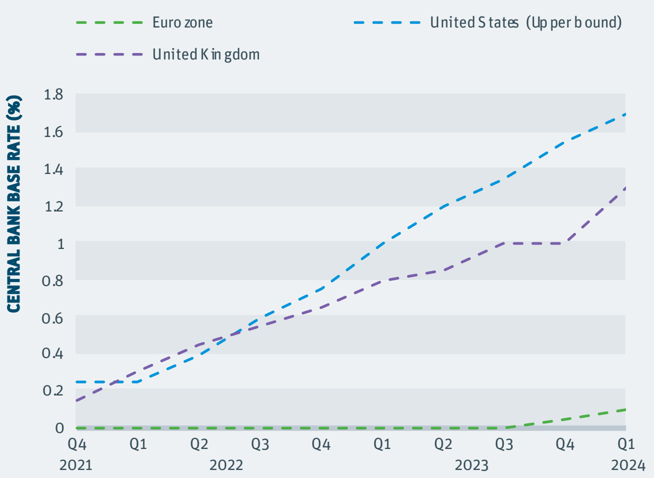
Euro (EUR) – Starting from a negative base

The economic recovery from the COVID-19 pandemic has continued to be the key driver in market direction, with the European Central Bank's (ECB) response to rising inflation and fundamental data as the key focus. The euro has come under significant pressure over the second half of the year, as the ECB's rhetoric struck a dovish tone, meaning expectations of tapering and any potential rate hikes fell significantly behind their US and UK counterparts.

As the Federal Reserve (FED) and Bank of England (BoE) press on with their plans to begin normalising monetary policy, the ECB has continued to push back on calls and market bets for tighter policy amidst ongoing inflationary pressures. With consumer price growth already double that of the ECB's target, Christine Lagarde has expressed concerns that abandoning its current monetary policy would have an unwarranted impact on the economic recovery of the bloc.

Despite the unwelcomed discovery of the Omicron variant towards the end of the year and forecasts for ongoing inflationary heat, the ECB has confirmed its intention for the pandemic emergency purchase programme (PEPP) to conclude, as scheduled, by the end of March. Unlike their UK and US counterparts, the ECB has remained cautious, giving no indications of rate hikes until 2023, whilst reinforcing the message that tools remain in their arsenal should they be necessary. The disparity with other central banks, most notably the FED, has dampened investor interest in the euro, with the single currency falling to 18-month lows against the dollar during December.

Bloomberg weighted average interest rate forecasts



Source: Bloomberg 2022

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The political landscape was dominated by the German election in September, marking the end of Angela Merkel's 16 years at the helm and opening the door to a potential revival for centre-left politics across Europe. Amid the highest levels of inflation in a decade and vaccine resistance across the country, the incoming administration takes on the burden of a troubled economy and segregated population.

The result saw Finance Minister Olaf Scholz's SPD take control in a three-party coalition, alongside the Greens and Libertarian Free Democratic Party. One of Scholz's first moves in power was choosing the polarizing figure of Karl Lauterbach as his health minister, someone who has strongly criticized the Merkel administration for the handling of the pandemic and an advocate for mandatory vaccinations, in a country where parts of the population are yet to receive a single dose of a vaccine.[1]

With the official appointment of Scholz in December being overshadowed by new COVID-19 restrictions amidst a fourth wave, the administration will focus on governing Germany out of the depths of the pandemic, transforming the economy and lessening its environmental impact, whilst managing the political differences among the coalition parties.

Looking ahead, political focus shifts to Germany's neighbour, with the first round of French elections due to take place in April. Emmanuel Macron continues his bid for a second term, currently leading the polls with 26% of the vote, despite ongoing unrest from the population with regards to the handling of the pandemic.

Stumbling into the new year

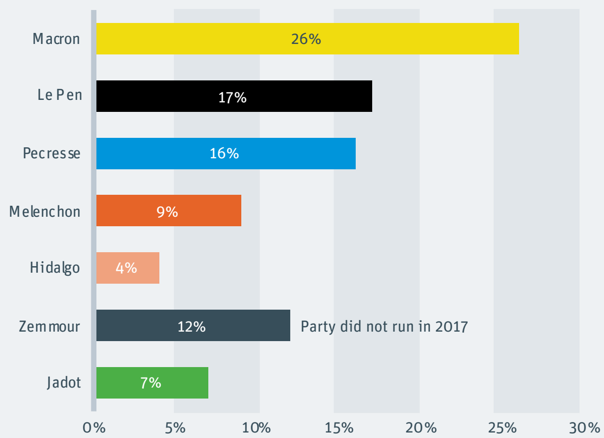
Source: Bloomberg 2022

Macron will be challenged once again by far-right candidates in the form of National Rally's Marine Le Pen and the newly formed Reconquête party's Eric Zemmour. Despite early support for Le Pen, voting intentions eased off in the second half of the year as the far-right vote divided and citizens seek economic and social stability following the pandemic.

Economic focus is likely to remain firmly on the ECB and what action they choose to take in 2022 if any. As the new COVID-19 wave continues to force restrictions across the bloc, will the ECB fall even further behind their US and UK counterparts?

The Euro has come under significant pressure over the second half of the year, as European Central Bank rhetoric struck a dovish tone pushing expectations for tapering and any potential rate hikes significantly behind their counterparts in the US and UK.

France 2022 first round poll of polls



Source: https://www.politico.eu/europe-poll-of-polls/france Jan 11th 2022

1. Source: https://ourworldindata.org/covid-vaccinations?country=OWID_WRL

Pound sterling (GBP) – Leading the way

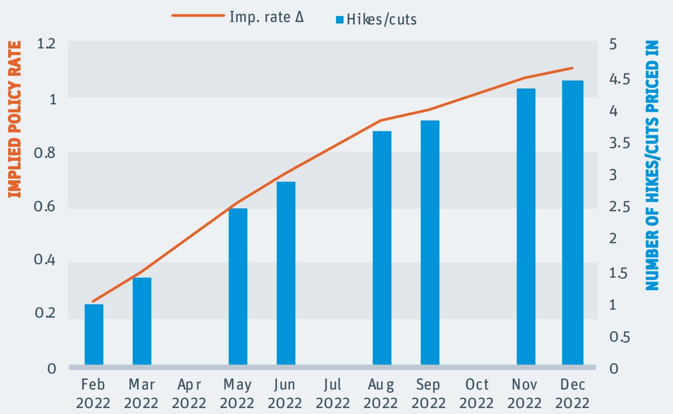
The Bank of England (BoE) stole the show, beating the Federal Reserve and European Central Bank to hike rates in December, as the long debated 'transitory' inflation became a little too much to bear. Sterling however headed for a near 1.2% yearly loss against the dollar, as concerns over the UK's economic recovery were inflamed by a surge in energy prices, record rises in COVID-19 cases over the Christmas period and post-Brexit tensions over the Northern Ireland protocol.

After surprising markets in November by keeping policy steady, the BoE voted 8–1 to lift borrowing costs by 15 basis points to 0.25%, delivering an increase that no other G7 central bank has made since the start of the crisis. The rise of the Omicron variant and the government's subsequent decision to tighten restrictions had lowered the chance of a hike, however the surging price gains in November became impossible to ignore. November's YoY inflation figure printed at 5.1%, more than double the central bank's target.

Following the meeting, policymakers stated that more tightening is likely to be needed as inflation heads towards a potential peak of around 6% by Spring.[1]

Labour market data impressed with the first official data on payrolls since the end of the furlough scheme showing that for October 160k jobs were added. Some redundancies are possible in coming months, although survey evidence suggests they will be limited.

Implied probability of a BoE rate hike



Source: Bloomberg 2022

1. Source: https://www.bankofengland.co.uk/knowledgebank/will-inflation-in-the-uk-keep-rising

It has now been over 5 years since the UK voted to leave the European Union and the post-Brexit UK-EU relationship is still under strain. The UK is now outside the EU and no longer subject to its rules. The new border and immigration rules between the UK and the bloc have resulted in huge disruptions to trade and the labour supply, both seeing attribution during the recent petrol crisis.

The Northern Ireland Protocol was agreed to facilitate an open border between EU members, the Republic of Ireland and Northern Ireland. Requirements now put in place for certain goods entering Northern Ireland from the British mainland have caused disruption and shortages at the start of the year, which has led the UK unilaterally imposing grace periods on agri-food controls to allow businesses to adapt to the new rules. These have now been prolonged indefinitely.

The EU responded by launching legal action, however, they have since frozen the process. Tensions will continue to remain high into 2022 as the two parties are yet to agree on a solution. If relations start to improve into next year, we may see the pound rise.

5.1%

November's CPI print, indicating inflation may not be transitory ...

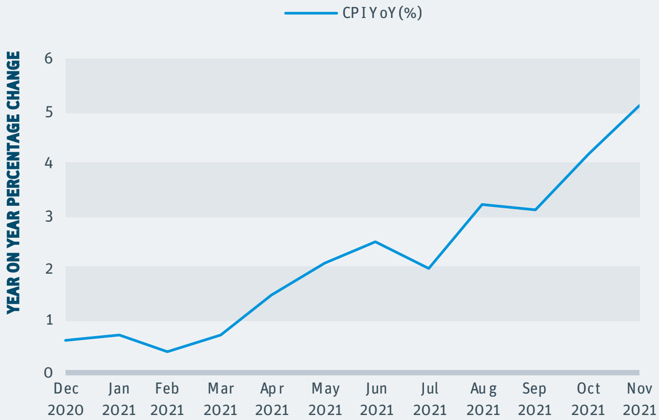
The rising cost of living is likely to weigh on household consumption over the first half of 2022, however the recovery of the UK labour market along with household savings accumulated throughout the pandemic should support the recovery. Markets have priced-in up to four BoE hikes next year.

The early BoE tightening is likely to provide GBP with a cushion as we enter the new year, and should the economic recovery continue across 2022 then the pound could push even higher.

Holding the holding pattern

Source: Bloomberg 2022

Inflating inflation



Source: Bloomberg 2022

The rising cost of living is likely to weigh on household consumption over the first half of 2022, however the recovery of the UK labour market along with household savings accumulated throughout the pandemic should provide support for the recovery.

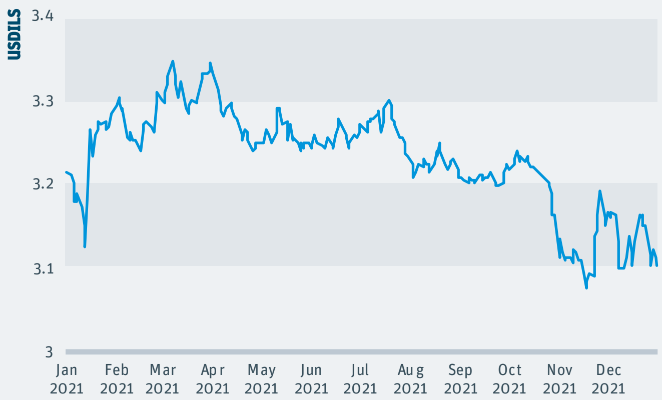
Israeli shekel (ILS) – A continued run of form

Despite a small bit of relief for USDILS in the second half of Q1, shekel strength continued to be the underlying theme for the currency throughout 2021. A sustained, robust reaction to the pandemic, paired with the driving success of the technology sector and the associated foreign investment as a result, the shekel rally remained well fuelled throughout the year.

The fourth quarter saw USDILS break long-held technical support at 3.20, falling to a 30-year low, dipping below 3.07. Fortunately for the many companies operating in the hi-tech sector, directly impacted by a stronger shekel, the move was short-lived and both central bank intervention and technical support saw USDILS rebound back above 3.15, re-calibrating its new range to USDILS 3.08–3.16 as the year closed.

In contrast to the last two years, politics stepped away from the spotlight after Benjamin Netanyahu concluded his 12-year tenure and a power-sharing agreement between right-wing Naftali Bennett and centrist Yair Lipid was formed. While shekel has historically been indifferent to politics, long term stability is likely to favour the currency.

The trend is not always your friend

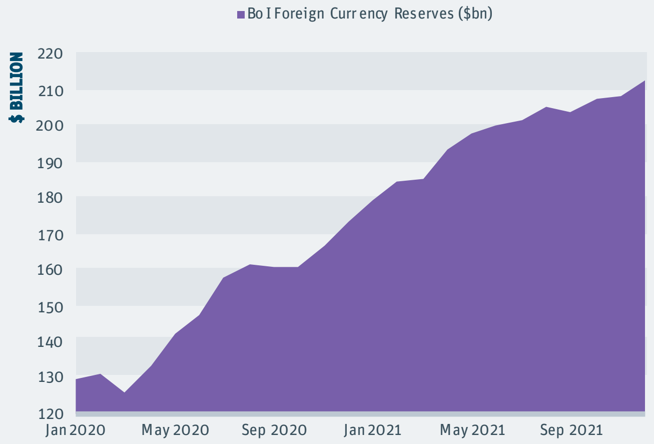


Source: Bloomberg 2022

With political tremors and recent geopolitical tensions now in the rear-view mirror, one could assume the headwinds for ILS appear to have faded, lowering the risk factors that could derail shekel strength. The economics bolster the shekel's case, Israel's current account surplus remained positive, with the latest data showing a balance of $5.3bn, which represented 4.9% GDP. The coffers received a boost as foreign direct investment persisted, while companies benefitted from the positive sentiment surrounding the tech sector.

The Bank of Israel (BoI) continued to act as a counterweight to currency gains, purchasing almost $40bn in foreign currency reserves throughout 2021 to help offset the impact of ILS appreciation. This was well-received onshore however the relentless pace of shekel strength was slowed rather than halted. After an aggressive start to the year, purchasing approximately 90% of the original pledged annual quota of $30bn by July, the pace dropped in the final six months. This activity drove the central bank's foreign currency reserves higher, piling up to $213bn by the end of the year. Another headache for the BoI comes in the form of a stubbornly low inflation growth, consistently in the lower bounds of the 1–3% target when measured monthly, restricting the ability for the BoI to hike interest rates higher than the current policy rate of 0.10%.

The cost of intervention

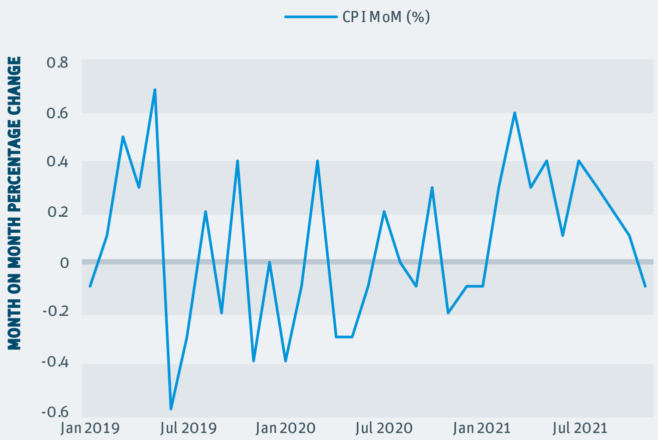


Source: Bank of Israel

There remains a cloud of uncertainty as to how effective central bank intervention is and if the technical floor of USDILS 3.0 is sustained or soon becomes a distant memory.

Structural factors continue to support the case for shekel to maintain its run of strength, particularly if the hi-tech sector continues to flourish. However, the BoI is likely to remain under pressure to ramp up its FX intervention programme and further build its foreign currency reserves in a bid to keep exports attractive. While the central bank may adopt an aggressive FX policy in 2022 and further build currency reserves, there remains a cloud of uncertainty as to how effective central bank intervention is and if the technical floor of USDILS 3.0 is sustained or soon becomes a distant memory. What is evident is many believed previous USDILS resistance levels were failsafe and have since become more prudent in their attitude to risk management.

Inflation – stunted growth



Source: Israel Central Bureau of Statistics

$213 bn

Amount of foreign currency reserves held by the Bank of Israel at the end of 2021

US dollar (USD) – A favourite in times of turmoil

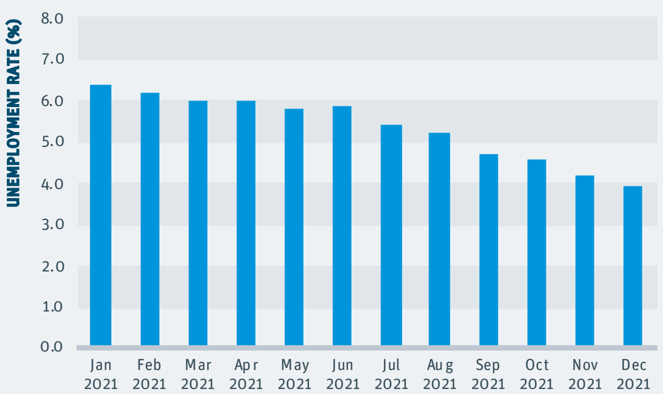
The world's largest economy continues to emerge from the pandemic strongly, with US unemployment falling to 4.6% in October, its lowest level since President Biden took office, however inflationary pressures persist. The dollar strengthened across the board in the second half of 2021, most notably against the euro with EURUSD falling from 1.2200 in June to a year low of 1.1180 in November, a move of 8.4%. The move was driven by a flight to the world's reserve currency as the pandemic persists and a market expectation that the Federal Reserve (FED) will have to raise rates soon due to inflationary pressures.

President Biden nominated FED Chair, Jerome Powell, for another 4 years at the helm and he is expected to have greater autonomy to deliver on the central bank's mandate while facing less political pressure from the White House to maintain a dovish stance.

6.8%

US inflation in November, the highest reading in 30 years

Has the US reached full employment?



Source: Bloomberg 2022

The FED's balance sheet has continued to swell in the second half of 2021 and has increased by $1tn in the last 12 months, reaching $8.6tn in December as the FED looked to ensure there was ample liquidity in the market. However, in Q4 of 2021, the committee announced it would start to taper asset purchases and, with inflation hitting 6.8% in November, recognised that inflation is an addressable concern. It is anticipated that the central bank will continue its tapering of asset purchases and start its tightening cycle in Q1 of 2022.

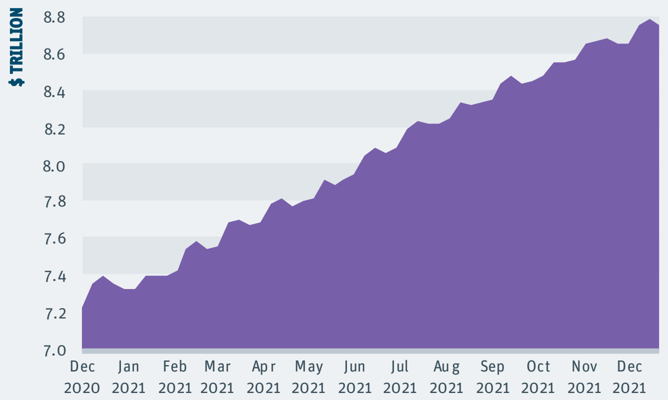
President Biden scored a significant victory in November as his $1.2trn bipartisan infrastructure bill was approved by the Senate and the House of Representatives, with elected officials from both sides supporting the legislation as several Republicans opposed to the bill. The President's attention now turns to his flagship $1.75trn 'Build Back Better' bill however it faces fierce opposition and will once again take careful diplomacy and negotiation on its path through Congress. Such pieces of legislation are key requirements to help support and drive US economic growth.

The US economy continues to emerge from the pandemic strongly with unemployment falling to 4.6% in October, its lowest level since President Biden took office.

Further afield, the US continues to be at loggerheads with the world's second-largest economy, China, on a host of issues including but not limited to tariffs, Human Rights and Intellectual Property. Such friction between two pivotal economic powerhouses may be damaging to global economic growth as the world emerges from the pandemic.

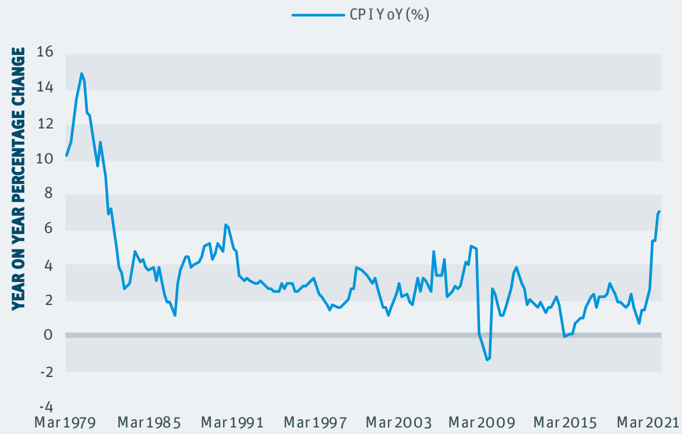
Given US inflation data released in November touched 6.8%, its highest level in 30 years, market attention is fixed on the FED's ability to manage market expectations and meet its mandate of bringing inflation down to 2%. As the pandemic persists globally with variants of COVID-19 emerging, the ability of the US economy to maintain its economic recovery will be watched closely with any deviation likely resulting in further USD strength as investors rush to the world's reserve currency, a haven amidst uncertainty.

The ballooning of the FED balance sheet



Source: Bloomberg 2022

Inflation – more than transitory



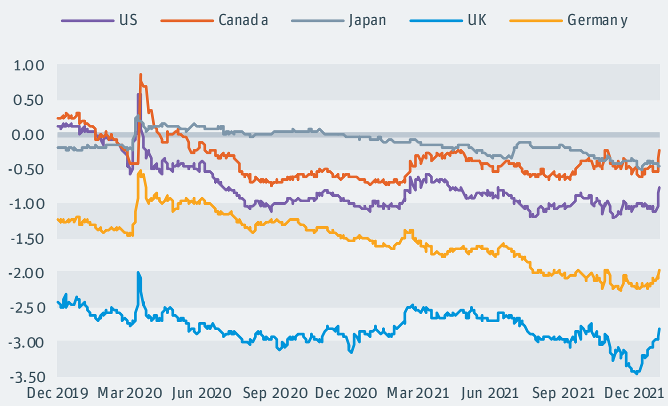
Source: Bloomberg 2022

The macro lens – Great inflation expectations

An overwhelming majority of central banks are either hiking rates or have signalled they plan on doing so in 2022. The common goal is to tame inflation. Have we finally reached a consensus that inflation is in fact real and non-transitory? Hardly. Bond investors are not convinced that inflation pressures will persist once the COVID-19 influences, namely stimulus and supply chain disruptions, are behind us.

If bond investors truly believed inflation is here and on the rise, they would not be willing to park capital in an investment whose yield does not keep up with the loss of purchasing power.

10-year government bond yields adjusted for inflation



Source: Bloomberg 2022

Government bond yields across the developed economies of the US, Canada, Japan, UK, and Germany, when adjusted for inflation, are still in negative territory. And, as further illustrated in the chart, real yields are lower today than they were during pre-COVID times. If bond investors truly believed inflation is here and on the rise, they would not be willing to park capital in an investment whose yield does not keep up with the loss of purchasing power.

Bond investors, the dissenters from the inflation camp, make up an especially large contingent of the financial markets community. As of the end of 2020, the size of global bond markets exceeded the size of global equity markets – $123.5 trillion versus $105.8 trillion.[1] Their collective opinion matters.

Disagreement between financial markets participants (such as bond investors, derivatives market-makers, private-side forecasters) and central bankers about the direction of interest rates is common. For example, the Bank of England (BoE) was the first developed economy central bank to hike interest rates post-COVID in December 2021.

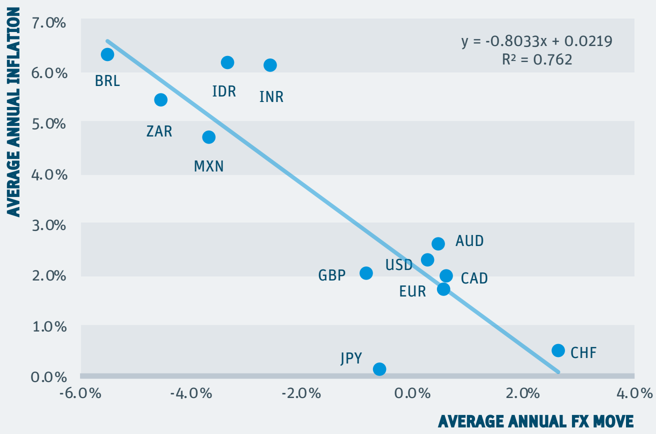
1. Source: SIFMA

The move was considered a surprise as prior to the announcement, there was a 1 in 4 chance of a hike according to derivatives markets. The previous month was also a surprise. Markets assigned a 64% chance of a hike before the announcement, yet the BoE decided to remain on hold.[2]

Often, there is disagreement within a particular central bank. In the US, monetary policy is decided by a majority vote involving 11 Federal Reserve ('the FED' hereafter) officials[3] and in about one-third of these meetings since 1936 the vote for policy action has not been unanimous.[4] Furthermore, every quarter the FED publishes their 'dot plot', a 3-year ahead outlook for the policy rate. The median of 19 opinions from FED officials and regional FED presidents constitutes the FED's ex ante 'forecast' for the policy rate, which as illustrated in the chart, has not had a good track record for most of the last decade. Ex ante projections have consistently overshot ex post actuals.

Bottom line, the inflation debate is far from settled. But, since every investment, asset allocation, or hedging decision involves some opinion about inflation, it is poised to drive financial market prices for some time to come. From a policy perspective, the evolving inflation picture will anchor both fiscal and monetary policy decisions as well. What we can count on is for the path to resolution to bring uncertainty and volatility to markets. For example, according to Bloomberg, there is a 26% difference between the high and low forecast for the benchmark S&P 500 index for year-end 2022. This level of disagreement is among the highest in a decade.

Inflation Vs FX 2000–2022



Source: Bloomberg 2022

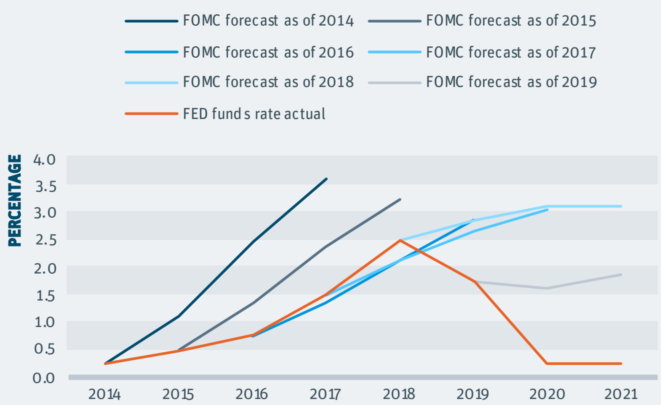
Lastly, we review inflation in the context of exchange rates. Inflation eats into purchasing power. What a pound, euro, or dollar buys today, it will not tomorrow. When thinking about inflation across borders, it is inflation differences that matter. If the inflation in the foreign country is higher than at home, the purchasing power of the foreign currency would fall faster and the exchange rate between the two should adjust to account for the difference, meaning the foreign would depreciate against the domestic. This is theory, however, and in the real world, the 'stickiness' of prices and wages means these adjustments take some time to manifest themselves.

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 the relative strength of the GBP, USD, CAD versus the EUR and JPY in 2021. Rate hikes are either here or expected for the economies of the former three, but nowhere in sight for the latter.

Over the long-term, however, higher inflation is associated with weaker currencies, as theory would dictate. Plotting the average annual currency moves versus average inflation since 2000 illustrates this dynamic.

Granted, inflation was not a huge problem in developed economies, it was emerging economies that battled with it and the impact it had on their currencies. Looking ahead, however, if inflation bugs are right, this would be a problem that would spread to developed economies, something not seen in several decades.

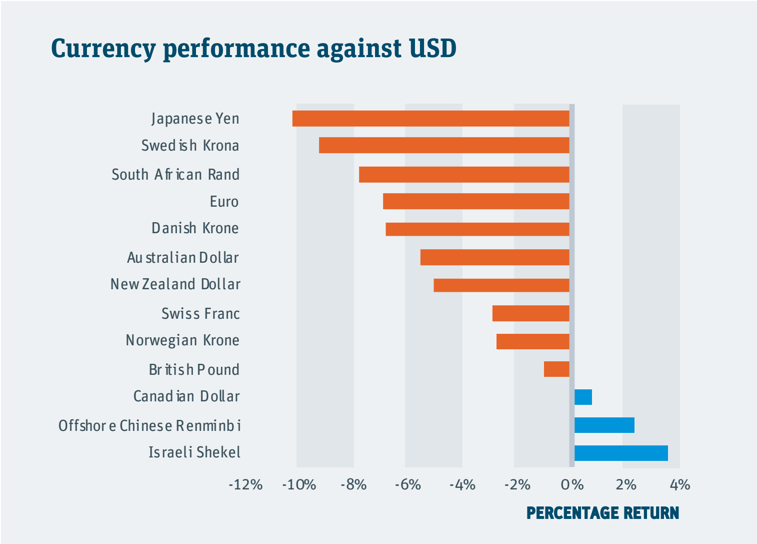
Accuracy of FOMC FED funds median rate forecasts



Source: Bloomberg 2022

2. Source: Bloomberg page WIRP
3. There are 11 votes currently, but the number of votes has been as low as 8 and as high as 12.
4. Source: "Making Sense of Dissents: A History of FOMC Dissents." Federal Reserve Bank of St. Louis Review, Third Quarter 2014 Vol. 96, No. 3

Returns against USD



Source: Bloomberg 2022

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