FX Risk Advisory

US dollar on the move — what to do now?

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Key takeaways

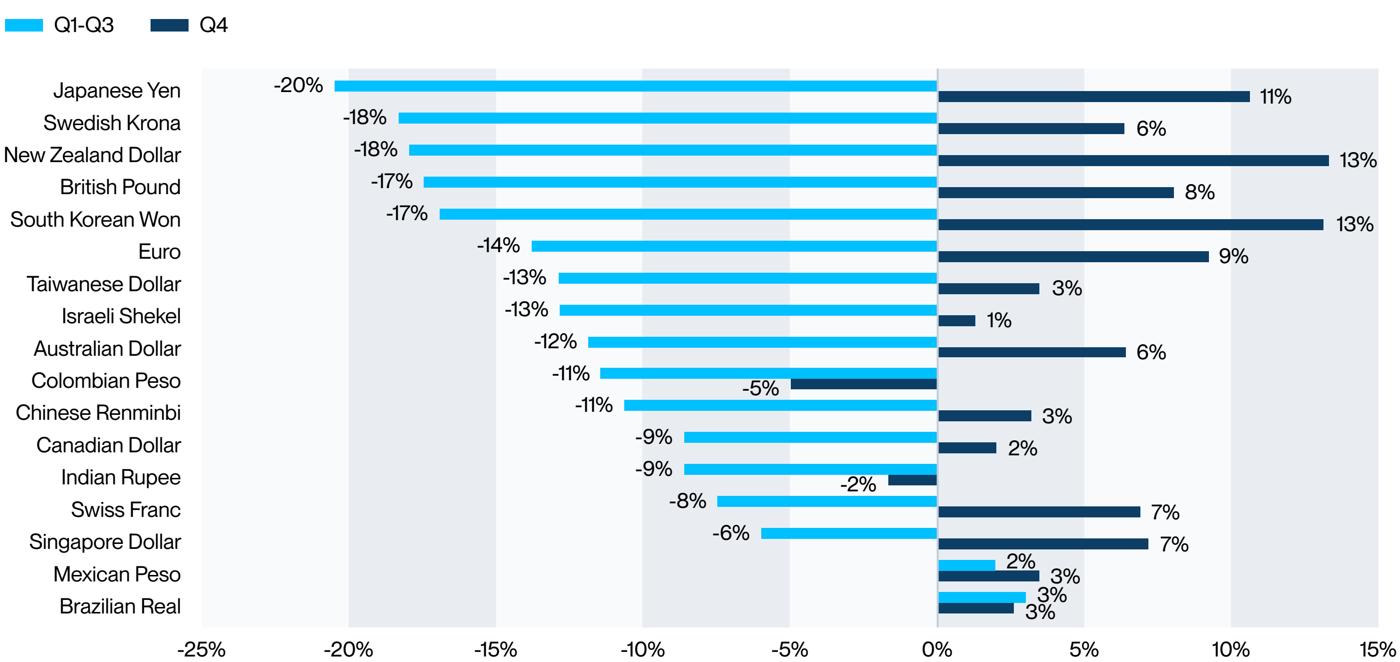
The pullback in the US dollar (USD) from 2022 highs has provided some relief to global institutions with foreign-currency-denominated assets and revenue.

It is, however, premature to call an end to the bull run in the USD. Two-way risk in currencies will likely persist as long as inflation and inflation uncertainty remain elevated.

Proactive currency risk management is especially important in the new paradigm for the innovation-economy; Narrower margins for companies and lower exit multiples for private equity funds means impacts from currency volatility may be more visible and material on bottom-line performance.

Silicon Valley Bank corporate and private equity fund clients with foreign-currency-denominated assets and cash flows faced significant headwinds from a stronger US dollar (USD) for the first three quarters of 2022. Then in the fourth quarter, a sharp reversal in the USD, propagated by a projected deceleration of Federal Reserve rate hikes and a recovery in equities, erased some of the USD FX losses for the year. Some currencies recovered more than 50% of the 2022 losses in the fourth quarter alone.

Chart 1: 2022 currency movements versus the USD



Source: Bloomberg as of 12.30.2022

Is it too late to hedge against a still strong USD? In other words, should global companies and funds remain unhedged to benefit from stronger foreign currency valuations ahead?

No, some reasons why:

1. There are no guarantees that the bull run in the USD is over

Although it is true that interest rate differentials in favor of the United States (US) will not provide much more lift to the USD as they've been mostly priced in, looking ahead the focus may shift to assessing the impact of higher interest rates on the global economy. Central banks have engineered demand slowdowns with the goal of taming inflation.

Economies have contracted to some degree and looking ahead recessions are probable as tightening has gone for longer than many expected as supply-side price pressures have complicated policy mandates.

The US is better positioned to weather a global recession, in relative sense. The job market is strong, household debt loads are amongst the lowest in the developed world, and the real estate market may prove resilient due to more sustainable levels of borrower leverage and a higher proportion of fixed-rate mortgages. Also, against the structural headwinds of geopolitical tensions and anti-globalization that may persist into 2023, the energy self-sufficiency of the US can greatly help insulate its economy.

Amid the aftermath of aggressive tightening, market uncertainty and volatility are likely to persist. Equities and other risk assets will likely remain under pressure, favoring the USD due to flight-to-quality inflows. This is especially true today as other traditional safe-haven assets such as the Swiss franc, the Japanese yen, gold, and crypto did not perform well in the 2022 downturn.

2. Consensus predictions about currencies are right about as often as they are wrong

For the third year straight, Bloomberg consensus forecasts[1] are pointing to a weaker USD over the course of the year. The view did not manifest in 2021, and it did not manifest in 2022.

Charts 2 and 3 track, in blue, the ex-ante EUR/USD forecasts made as of 1 January of each year versus the ex-post exchange rate, in red, that materialized throughout the course of the year. In 2021, the ending spot rate for the year was below that of all contributor forecasters. And in January 2022, not a single forecaster saw the EUR reaching parity, and yet parity was materially broken to the downside.

In practice, forecast accuracy is challenged by the presence of unknown unknowns. In the last three years alone, we had a once in a hundred-year global pandemic, a once in fifty-year flare-up in global inflation, and a geopolitical conflict with close ties to energy and food supplies. To varying degrees, all these events were unexpected, thereby distorting even the most robust model, crystal ball, or carefully formulated signal.

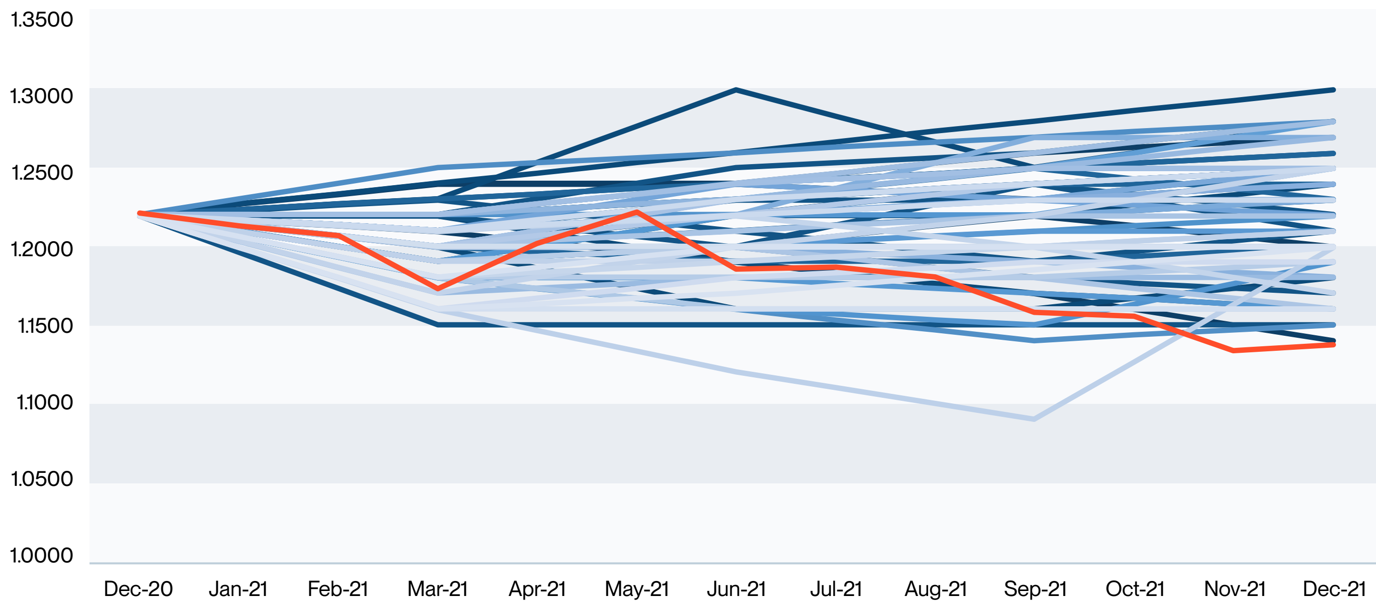
For 2023, forecasters are once again pointing to a weaker USD. Will the third time be a charm? In practice, most forecasters are right about as often as they are wrong about currency calls. If a forecaster makes 100 individual currency forecasts a year, there is a 3% chance that he/she will be right on 60 or more of 100 calls[2]. Stated differently, to break into the elite top 3%, of all forecasters, you only need to be right 60% of time. It is imprudent, then, with such odds to base currency hedging decisions on forecasts.

1 Banks, broker-dealers and other financial institutions publish forecasts of where currencies will be in the future. Bloomberg acts as a central repository for this forecast data and actively monitors and reports contributor forecast accuracy. The consensus forecast is the median of all Bloomberg contributors, and this is commonly referred to as the 'market forecast' for a particular currency pair.

2 Calculation assumes binomial distribution where n=100, p=0.50, mean is 50, and standard error is 5, and Bloomberg consensus forecasts.

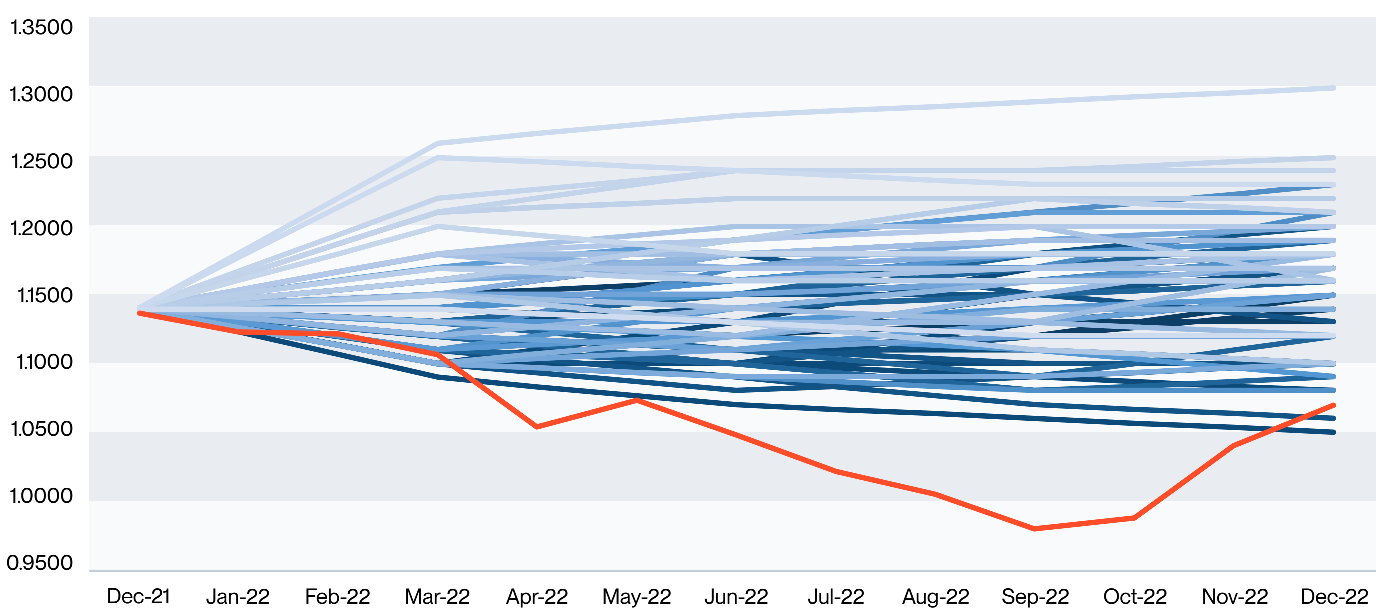
Charts 2 and 3: Forecasts versus actuals for EUR/USD exchange rate

2021 Ex-ante forecasts (in blue) versus ex-post actuals (in red)



Source: Bloomberg

2022 Ex-ante forecasts (in blue) versus ex-post actuals (in red)



Source: Bloomberg

3. FX hedging corrects the unfortunate asymmetry faced by global companies and funds

Currency managers overseeing risk at either the operator or fund level face an asymmetric problem. Gains from currency swings are welcomed but not necessarily rewarded by Management or the owners of the company. Currency losses, however, are scrutinized. Hedging can be used to correct this unfortunate asymmetry.

At a fundamental level, hedging involves giving up some or all the currency upside in exchange for downside protection. As established, the bearers of currency risk value avoiding losses more than they value reaping in FX gains. Thus, the value proposition of hedging is favorable. In hedging, you receive more of what you value (avoiding losses), in exchange for giving up some of what you value less (receiving gains).

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4. Currency impacts are more visible when business growth slows

The inflation-induced interest rate hikes of 2022 resulted in a global repricing of equities and other capital assets, hitting the innovation-sector particularly hard given its heavier reliance on debt to fuel growth. With fundraising down, revenue projections, along with valuations and other performance metrics, have adjusted commensurably lower. As a result, companies in the sector have moved away from a growth-at-all costs mentality, and instead now prioritize cash preservation, cost control, and delivering bottom-line dollars.

A byproduct of the new paradigm is that exogenous impacts, such as those that would arise from adverse currency movements, are more visible when there is less revenue or return to absorb losses.

The impact of this is seen both at the corporate and at the fund level. The median revenue multiple for publicly traded SaaS company valuations in the US was 4.9x in Q4 2022, down from 14.2x in Q4 2020[3]. For funds, the median IRR (internal rate of return) for 2017 vintage private equity investments was 24%, versus only 8.4% for the 2021 vintage according to Pitchbook. A 10% currency hit is naturally more material to a single digit IRR investment and warrants greater consideration for hedging.

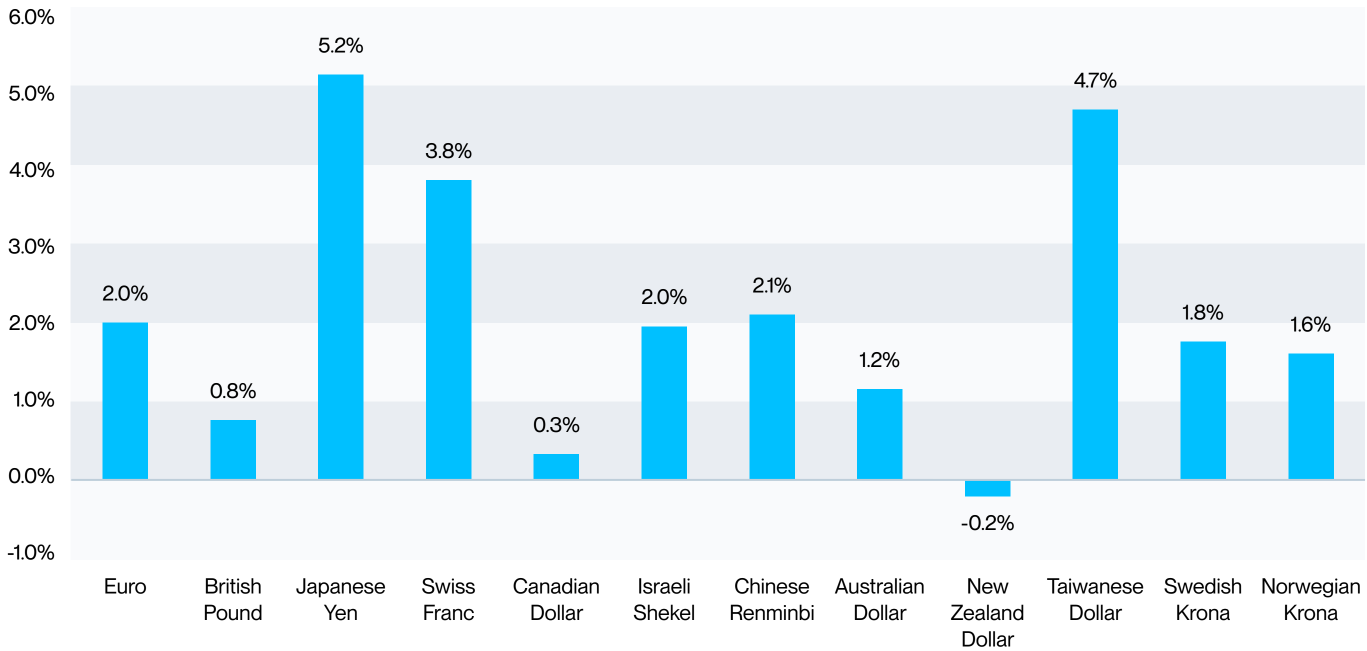
5. Hedge pricing to protect against a rising USD has improved

The 2022 Fed rate hikes have outpaced those of most developed economies, widening the interest rate differential in favor of the US. This interest rate benefit has improved the pricing for US-based firms and funds buying USDs via FX forwards to hedge future cash flows and returns. Specifically, the forward rates are more favorable than the prevailing spot rates for most of the key currencies traded by SVB clients. As shown in Chart 4, the magnitude of the benefit, known as the carry pick-up, is on average 2.0% per annum but can exceed 4.0% for a number of currencies[4].

3 Blossom Street Ventures.

4 SVB Q4 2022 FX Outlook.

Chart 4: Carry pick-up for buying USD's versus currencies as of January 2023



Source: Bloomberg

Summary

In closing, the pullback in the US dollar from 2022 highs has provided some relief to global institutions with foreign-currency-denominated assets and cash flows, but there is no guarantee that the USD's recent headwinds will continue or remain. In today's environment, FX swings are more visible and impactful. Hedging is about meeting business objectives and removing one element of uncertainty out of the equation.

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**.