Silicon Valley Bank

FX Navigator: 2020 Vision

Key insights and forecasts

2019 highlights

13.0%

Range in GBP/USD

3

Number of 0.25% rate decreases by the Federal Reserve

7,783

Number of tweets from Donald Trump

8.3%

Increase in the Israeli shekel against the US dollar

18.7%

Increase in the spot value of gold in USD per troy ounce

1.35

Strongest level GBP/USD reached

12/12/19

UK snap election. PM Boris Johnson big winner, securing mandate for a January 31, 2020 Brexit.

-0.50%

ECB Deposit Rate, the lowest on record

Seeing 2020

2019 saw politics impact FX markets across the globe. With investors weathering the effects of geopolitical tensions, trade disputes and economic data that is characteristic of a late-cycle global economy, effective management of FX risk remains a top priority for businesses operating globally.

In the FX Navigator, the SVB FX team reflects on what has guided markets over the past 12 months and forecasts some of the major drivers we expect to observe in the coming year.

We hope you find this report valuable as you make decisions regarding your FX policy and, as always, the team remains on hand for even deeper discussion.

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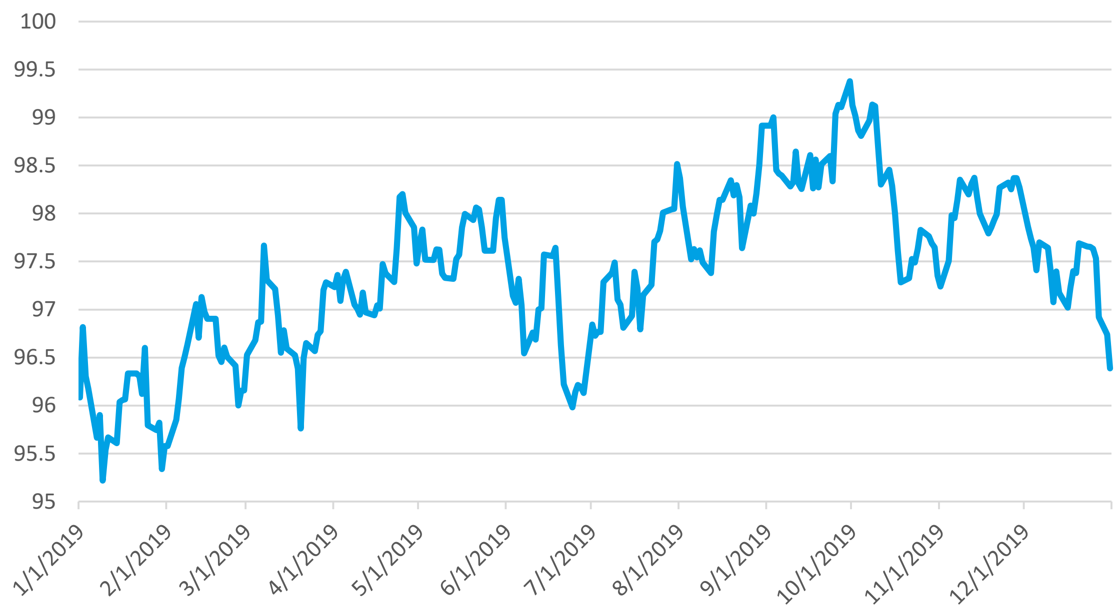
US Dollar (USD)

The dollar spent the first half of the year trending upwards, propelled by a relatively strong economy and its status as a safe haven currency.

Following a brief hiccup in June, the dollar index peaked in October. Then, as the effects of three interest rate cuts in four months were realized, gains were pared to close the year near opening levels.

Looking at the year ahead, the appeal of the dollar may lessen as it faces headwinds from continued trade tensions, the presidential impeachment inquiry and a Fed struggling to convince the market the economy is still mid-cycle.

What happened?



Dollar Index Spot (1 January 2019 – 31 December 2019)

Source: Bloomberg Financial (January 2020)

“A shift to risk-off sentiment, coupled with clearer guidance from the Fed, supported capital inflows that buoyed the US economy in the face of rising domestic and international political tensions.”

- Sam Cooper, Vice President, Market Risk Solutions, Silicon Valley Bank

2019 themes		2020 forecast
President Trump became the third US president in US history to face an impeachment inquiry. The ongoing investigation and the President's responses to it continue to occupy much of the news cycle, and seem to be intensifying as we approach the election on November 3. Market reaction to developments has been muted as participants focus elsewhere.	**Impeachment?**	Although the House of Representatives have voted to impeach, many believe it is unlikely the president will be removed from office while Republicans hold a majority in the Senate. Despite the impeachment issue being a key theme, US economic performance may eventually dominate the news cycle in the run-up to the November 3 election. Steady US economic growth and an unusually low unemployment rate (now hovering at its lowest level since 1969), are propelling a stock market rally that has repeatedly set record highs. Also, history shows that incumbent presidents are more likely to remain in office, especially during a strong economy. A close election race of itself is not expected to adversely affect the dollar. However, investors and companies with material FX exposure will likely remain guarded until a resolute outcome is reached in November.
The Federal Reserve lowered interest rates three times in 2019 as it sought to support the economy and guard against a possible slow down. Fed Chair Jerome Powell described the easing process as "mid-cycle insurance," anticipating the cuts could encourage market optimism. President Trump regularly called on the Fed to lower rates and loosen monetary policy to help further stimulate the economy.	**Fed cycle**	Traders are not fully convinced the Fed's dovish monetary policy has provided enough 'mid-cycle insurance,' with investors leaning towards the likelihood of seeing at least one additional interest rate cut from the central bank this year or in 2021. If the Fed signals it might tighten policy, the attractiveness of the dollar could suffer.
US-China trade negotiations continued to rattle markets throughout 2019, with sentiment changing on a near-daily basis. Markets rallied following a verbal agreement to Phase One of the trade deal involving Chinese goods and US agricultural products, but markets remained cautious as the deal remains to be signed. A World Trade Organization ruling saw rumblings of a US-EU trade war as the US threatened to impose tariffs on EU manufactured planes and on French wines in retaliation for illegal EU aircraft subsidies and a 'digital services tax' on US tech companies. Closer to home, the US-Mexico-Canada trade agreement is currently awaiting ratification in the US Senate and Canada's Legislature. .	**Trade skirmish**	Trade has been a key priority during Trump's first term in office, and he shows little sign of relenting on his pursuit to secure 'fairer' terms from key trading partners. As Phase Two of the US-China negotiations begins, it is likely Trump's 'America First' posture will continue to drive turbulent talks. Although concerns over protectionism have stifled stock market rallies, clear gains continue to accompany any announcement indicating trade agreement is forthcoming. A concrete outcome with a long-term resolution could push equity indices to new record levels and renew dollar attractiveness.

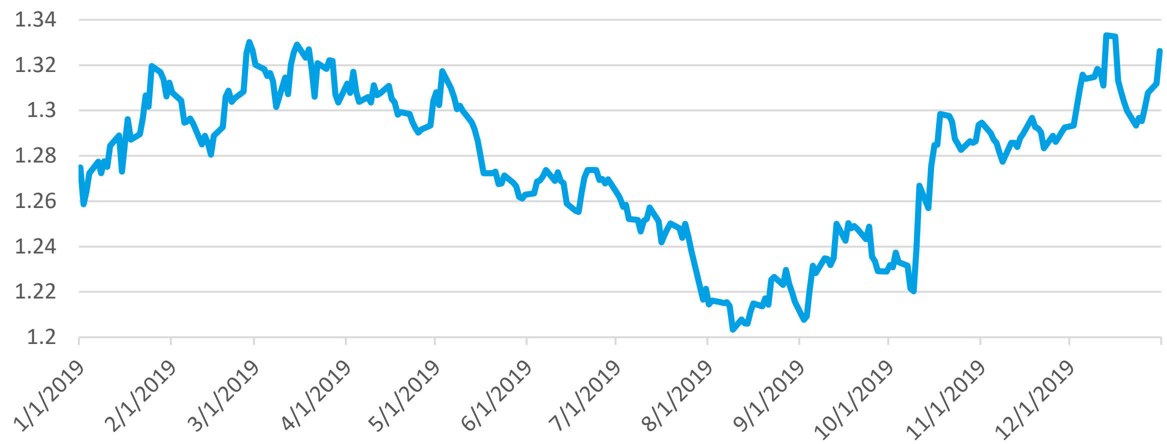
British Pound (GBP)

Sterling started 2019 strong, breaking above $1.30 GBP/USD in January as expectations for a smooth transition from the EU began to build.

The rally was short-lived as investors saw sterling sag to $1.20 in the second half of the year as a result of political headwinds including the possibility of a no-confidence vote, an ongoing Conservative leadership contest and Irish border conundrum.

Investor concerns faded as the UK headed to the polls in December, with sterling rallying following PM Boris Johnson's resolute parliamentary win.

What happened?



GBP/USD Exchange Rate (1 January 2019 – 31 December 2019) Source: Bloomberg Financial (January 2020)

Economists' forecasts

	Q1 2020	Q2 2020	Q3 2020	Q4 2020	2021	2022
GBP/USD	1.32	1.33	1.33	1.35	1.40	1.35

Source: Bloomberg Financial (January 2020)

"Brexit emotions ran high and GBP whipsawed as the market repeatedly repositioned with each dramatic turn of events."
– Nish Parekh, Managing Director, Market Risk Solutions, Silicon Valley Bank

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Bank of England

2019 themes

The Bank of England (BoE) played a supporting role throughout 2019. BoE Chair Mark Carney and his committee always explained that their actions would be dependent on the future of Brexit and its effect on the economy.

2019 performance indices reflected investor concerns. The second half of the year saw inflation decline, wage growth and the manufacturing and services Purchasing Manager's Index (PMI) continue to hover in contraction territory. The BoE endured mounting pressure through the year to further safeguard the domestic economy from a potential protracted slowdown.

It appears the BoE is unwilling to take a stance until they receive further clarity on Brexit outcomes. Even the most experienced forecasters are second-guessing the likely path of monetary policy.

2020 forecast

This year the spotlight will gradually return to the Bank of England. As its 'wait-and see' approach changes, investors will be looking for clearer guidance regarding policy.

Investors currently favor a more dovish stance, and the Monetary Policy Committee (MPC) agrees, voting to cut interest rates at their last meeting. Markets placed odds of the adjustment occurring before year-end at 44%.

Should the central bank succumb to economic pressure and further cut rates, the relative attractiveness of sterling will likely diminish, increasing down-side risk to the pound and compounding Brexit-related currency concerns.

A political Brexit

2019 themes

Investors were obliged to keep one eye on news headlines throughout the year as political headlines repeatedly sent shockwaves through FX markets. The pace of announcements showed no signs of easing with Theresa May surviving a vote of no confidence before stepping down in response to mounting pressure from within her own party.

Ms. May's resignation left the door open to a leadership contest that saw Boris Johnson fend off a number of close rivals to take the helm as the Conservative Party leader and become prime minister.

Boris Johnson brought a fresh face to the fatigued Brexit negotiating table. His convincing victory reduced the level of political uncertainty that had been a drag on sterling, with the market responding optimistically over the belief that a stalemate with the EU could be overcome.

2020 forecast

Boris Johnson now has a commanding majority of 80 MPs, affording him the parliamentary backing to pass his withdrawal agreement. With the cliff-edge exit date set for December 31 and Johnson refusing to seek any further extension, long nights remain in store for those involved in the negotiations.

Although the market generally welcomes political certainty—which has driven sterling to recent highs—significant 'known unknowns' remain ahead of the UK's departure from the EU, many of which could negatively impact the pound.

Should a smooth Brexit departure path be identified and agreed upon, investors could see the pound recover. However, if lawmakers remain at loggerheads and the UK crashes out with a reversion to WTO rules, the pound could once again lose footing.

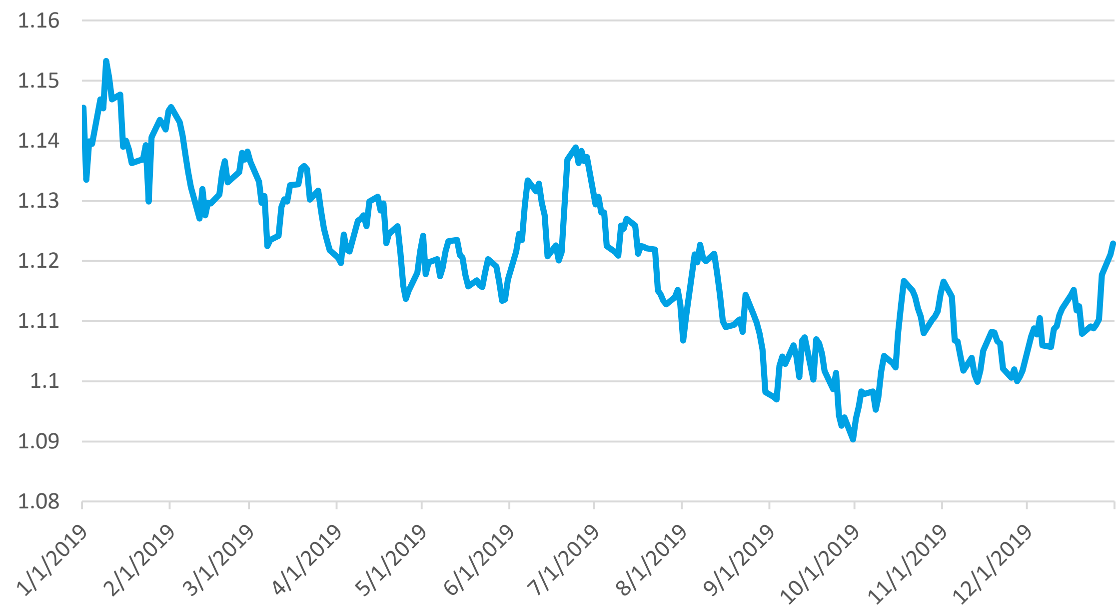
Euro (EUR)

In January 2019, the euro opened at $1.15 EUR/USD—the highest level for the year. Despite widespread resistance from policymakers expressing concern over the effectiveness of an unconventional policy and depletion of the European Central Bank's monetary arsenal, ECB President Mario Draghi stuck to his pledge to do 'whatever it takes' and pushed through a fresh round of stimulus. Nevertheless, the eurozone economy remained sluggish throughout the year.

The euro eventually bottomed out at $1.09, and then turned up to finish the year as investors began to sense that rates would go no lower.

Political developments and economic health in the largest eurozone economies are being closely watched to determine if there continues to be enough fuel to support the euro.

What happened?



EUR/USD Exchange Rate (1 Jan 2019– 31 December 2019)

Source: Bloomberg Financial (January 2020)

Economists' forecasts

	Q1 2020	Q2 2020	Q3 2020	Q4 2020	2021	2022
EUR/USD	1.12	1.13	1.14	1.15	1.18	1.20

Source: Bloomberg Financial (January 2020)

2019 themes

2020 forecast

European Central Bank

2019 themes

The ECB consistently lagged its target inflation rate of 'at or below 2%,' as global economic and political headwinds translated into a manufacturing slump and dampened investment growth within the eurozone.

Before handing the reins over to Christine Lagarde, former ECB president Mario Draghi used his final policy setting meeting to reinstate quantitative easing measures, cut deposit rates and introduce a tiering system, in an effort to encourage lending while reducing the burden of excess reserves.

2020 forecast

While the market evaluates the effectiveness of the latest policy package, the ECB is expected to leave policy unchanged through 2020. New ECB President Lagarde has pledged to remain neutral, labelling herself a "wise owl" as opposed to a hawk or dove. Lagarde's immediate focus will likely be on building cohesion in the Governing Council, promoting more active fiscal policy and a wholesale review of ECB strategy.

The first formal review (since 2003) is expected to assess the ECB's mandate around price stability and build an understanding of whether the economic lethargy is a function of short-term cyclical or long-term structural factors.

The threat of additional trade tariffs and protectionism following Brexit could further weigh on the euro, especially if uncertainty persists and eurozone member countries with budget surpluses can't be persuaded to bring investment back to (or above) pre-crisis levels.

Key Economies

2019 themes

Germany: Germany saw a slight improvement in underlying economic conditions during the second half of 2019, as jobless rates stayed stable and investor sentiment and business confidence remained optimistic. Germany managed to stave off a 'technical' recession, but faces increased political polarization amidst calls within the EU for Berlin to start spending their fiscal surplus to avoid economic stagnation in the eurozone.

France: 2019 saw instability for the EZ's second largest economy. President Macron continued to encounter roadblocks to his reformist agenda in the form of the 'yellow vests' movement, which hampered his attempts to modernize the state. The yellow vest movement, coupled with a budget deficit that continues to exceed the eurozone maximum of 3% of GDP, signaled investors to exercise caution.

2020 forecast

Germany: Ongoing political gridlock and diverging views between coalition parties could force a snap election before Chancellor Merkel steps down in 2021. Her Christian Democratic Union party continues to stick by its balanced-budget policy. Lack of domestic fiscal stimulus in the face of export uncertainty fueled by global trade tensions could worsen an economy already stifled by a car industry pivoting to non-traditional electric vehicles, growing inventories and sagging demand.

France: France's electorate will head to the polls in March for local elections, which should show whether Macron's La République En March party (today at loggerheads with the far-right Rassemblement National) will be supported. The outcome, if in Macron's favor, could support Macron's long-term reform agenda.

The macro view

With US equity indices recording new highs, one could be forgiven for ignoring those portending a recession. The technology sector has enjoyed another strong year of performance, with the MSCI World Information Technology Index ending 2019 up 46%.

Bond prices continue to benefit from a low interest rate environment and gold has returned to fashion over the duration of the year as investors remain guarded and cautiously optimistic—but is this optimism sustainable?

Below are things to keep in mind as 2020 unfolds:

1. US consumer credit continues to climb as borrowers take advantage of low borrowing costs. Are we observing the formation of a credit bubble?

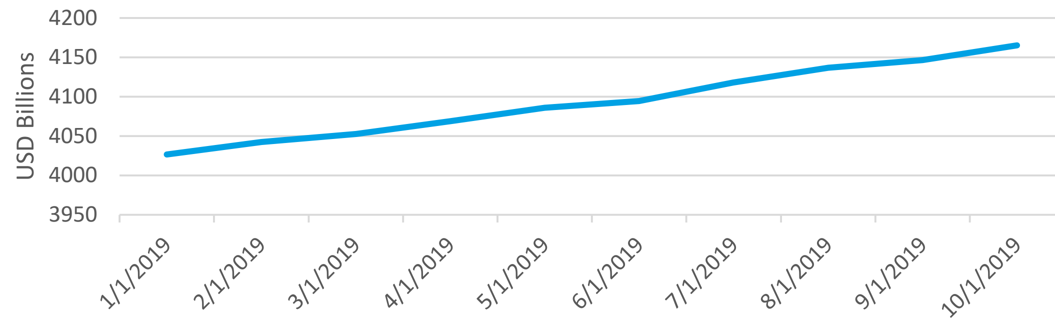
2. Volatility measures appear relatively low in the FX market, potentially indicating that corporate Capital Expenditures (CAPEX) are depressed in the face of uncertainty.

3. The Fed pledged to reduce its ballooning balance sheet in 2018, but data indicates that it has actually picked up the pace of open market operations, purchasing assets like treasuries in an effort to stimulate growth and liquidity.

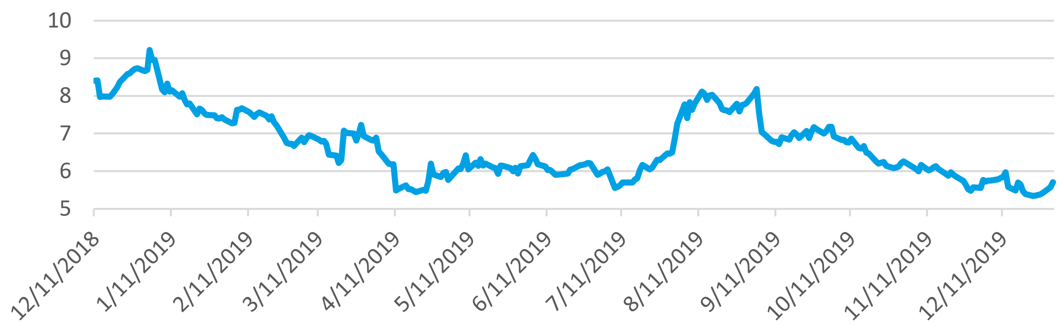
4. In September, a big cash shortage in the repo market forced the Fed to jump in with a quick $75 billion liquidity injection. The need for a liquidity bailout in a historically smooth market may be a sign of deeper problems ahead.

How sustainable is the stock market rally?

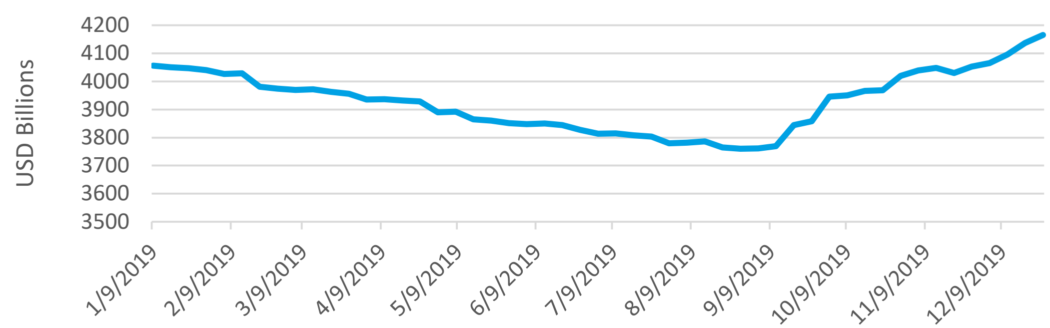
Federal Reserve consumer credit outstanding



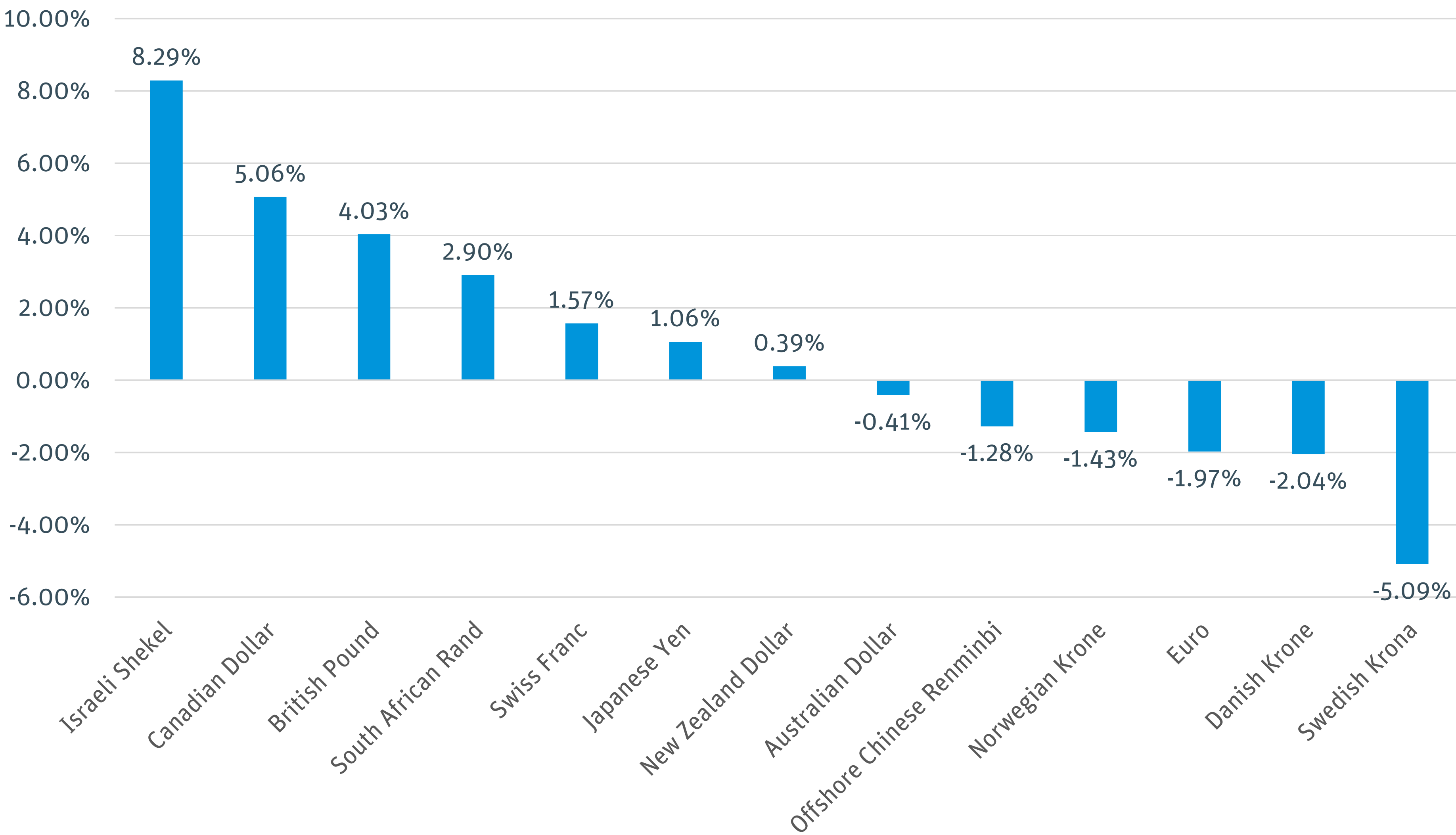
Implied currency volatility (%)



Federal Reserve total assets



2019 Returns against USD (%)



Source: Bloomberg Financial (January 2020)