svb

Silicon Valley Bank

FX Navigator H2 2021

Key insights and forecasts for the months ahead

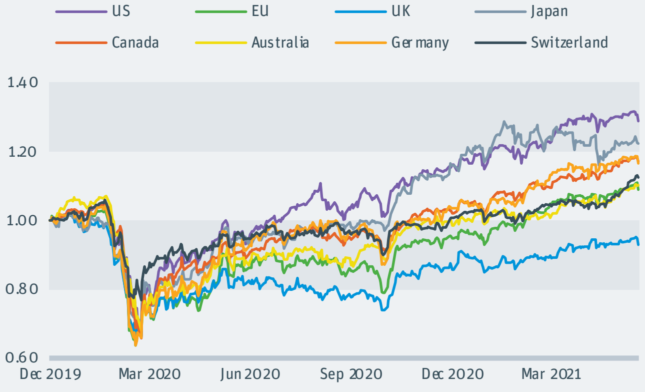
Contents

The macro lens – financial catastrophe averted once again

Governments responded to the COVID-19 crisis in unprecedented fashion. McKinsey estimates that the initial COVID-19 stimulus response, two months after the initial outbreak, had already reached 3 times that of the response to the Global Financial Crisis (GFC) of 2008 in total dollars, and even larger as a percentage of GDP[1].

The aftermath is a complex one, however. Stimulus, both fiscal and monetary, has found its way into asset prices. Equity markets across the developed world have staged tremendous recoveries, with most having returned to and even exceeded pre-pandemic levels. Windfalls from stocks have made their way into other markets, propagating gains in real estate, credit, commodity assets, and even crypto and igniting inflation concerns globally.

Performance of 1 unit of capital investment in equity market



Source: Bloomberg

> Equity markets across the developed world have staged tremendous recoveries, with most having returned to and even exceeded pre-pandemic levels.

1. https://www.mckinsey.com/industries/public-and-social-sector/our-insights/the-10-trillion-dollar-rescue-how-governments-can-deliver-impact

Central banks, however, remain apprehensive about removing the punchbowl too soon. Recall that following the GFC, the European Central Bank (ECB) hiked rates in April and July 2011 in response to rising energy prices and the fear of inflation. Not only did this did not manifest but combined with the threat of the collapse of the euro monetary union, this turned out to be a policy mistake. Rate increases were ultimately reversed by end of 2011. In similar fashion, Sweden, Norway, Australia, New Zealand, Canada, and Israel also hiked rates too quickly after GFC, only to subsequently cut them in response to ex post market conditions.

Thus, on one hand we have overheated asset prices and inflation showing up, to varying degrees, in national economic releases, pay checks, gas stations and grocers. On the other, you have an imbalanced vaccination response, stubbornly high unemployment, and monetary policymakers who will err on the side of caution and not taper stimuli prematurely. The end result is a market paradigm, in which good news is bad news and bad news is good news. Any data or evidence of an incomplete recovery (such as bad unemployment, lower than expected inflation) will be welcomed by markets as a sign that the accommodative bias will continue, further fuelling asset prices. In other words, risk-on. However, good news on the recovery front implies earlier than expected removal of central bank accommodation. As the punchbowl is removed, aversion to risk rises.

The end result is a market paradigm in which good news is bad news and bad news is good news.

16 June 2021 FOMC announcement

Prices	S&P 500	FTSE 100	DAX	US 10-year yield	IG spreads	EUR	CAD	GBP
Prior day's close	4246	7172	15729	1.49	49.2	1.2118	1.2188	1.4087
Close on day of announcement	4223	7184	15710	1.58	49.8	1.1996	1.2280	1.3994
Close 1 day later	4221	7153	15727	1.50	50.2	1.1909	1.2366	1.3936
Close 2 days later	4166	7017	15442	1.44	51.4	1.1870	1.2476	1.3830
Price change								
To close on day of announcement	-0.54%	0.17%	-0.12%	8.3	0.6	1.02%	0.75%	0.66%
To close 1 day later	-0.59%	-0.26%	-0.01%	1.2	1.0	1.75%	1.46%	1.08%
To close 2 days later	**-1.88%**	**-2.16%**	**-1.82%**	**-5.4**	**2.2**	**2.09%**	**2.36%**	**1.86%**
		Stocks up		**Yields down, credit wider**			**US dollar up**	

Notes: All data from Bloomberg. Stock and currency changes in % terms, while yield and spread changes in bps.

For example, on June 16 the Federal Reserve surprised markets with minutes detailing upgraded inflation expectations, the projection of faster than expected rate increases and talk of scaling back asset-purchase programs. The economy, in other words, was getting closer to being able to sustain itself without being on life support. This seemingly good news was interpreted on a global scale as bad news for asset prices. Stocks sold off, corporate credit spreads widened, treasury bonds rallied on the unwinding of reflation trades, and the US dollar rose on the back of risk-off sentiment. The table above shows the evolution on prices during the week of the latest Federal Open Market Committee (FOMC) announcement.

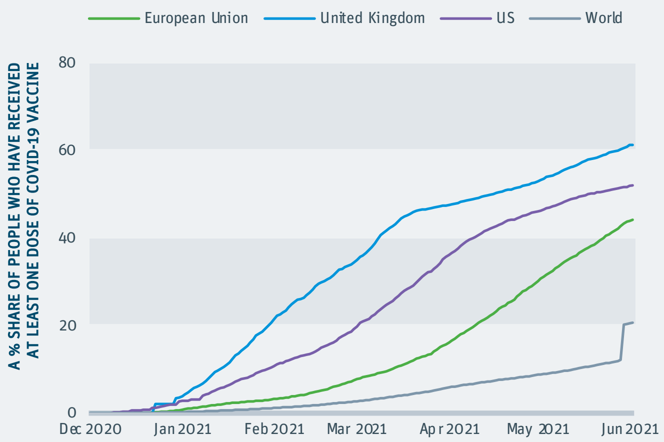
We expect that this market paradigm will continue for at least the rest of 2021. Markets will be choppy. Headlines about the state of the economic recovery, which rests on two pillars – employment and inflation – will dominate flows. For currency markets this means safe havens such as the USD, JPY, and CHF will suffer over other currencies as the accommodative landscape continues but will be favoured, at the margin, as the COVID-19 unwind period comes to its eventual close.

Vax to the future

The first half of the year was defined by the approval and rollout of vaccines across developed economies, with pandemic assessment rotating from 'R-number' to vaccine rollout efficacy and all the while seeing continued fiscal support. Concurrently, we saw shoots of the hoped-for recovery breaking ground as the economic shutters began to lift.

Although the themes and issues were global in nature, they differed in color and texture: The US saw the sun set on one presidency and rise on another. The first months were marked by an urgency to both vaccinate Americans and pass much needed fiscal support. In Europe the UK's greatly anticipated departure finally became a reality. In the event, the transition went comparatively smoothly, however it was largely overshadowed by pandemic realities. UK trade negotiators successfully rolled much of the pre-existing trade architecture and successfully negotiated its first trade deal from scratch. However a long tail Brexit is likely to remain. The European vaccination story was in part one of hubris as central vaccine acquisition and subsequent deployment saw the EU lagging behind both the UK and US, whilst Israel ably demonstrated the realms of the possible. Israel further drew a line under the premiership of Benjamin Netanyahu following 4 elections in 2 years.

Global covid vaccination progress



Source: ourworldindata.org

With recovery taking root, eyes of the market and central banks have begun to scour the horizon for inflationary stalks to determine if of a transitory, or a more enduring, nature. Monetary practitioners will continue to balance supporting their respective economies while remaining wary of sowing the seeds of any future crises. After over a decade at the central bank helm, the doves may fade to the rear-view mirror as hawks return over the horizon.

Pound Sterling (GBP) – Sailing in uncharted waters

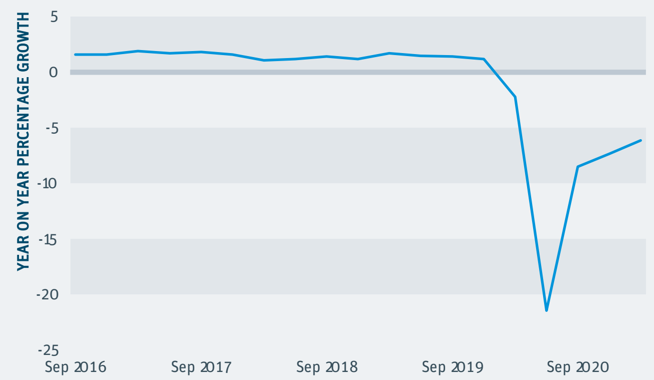
With Brexit finally coming into effect, 2021 marked the beginning of a new era for the recently departed United Kingdom.

Having driven sterling's performance since 2016, the agreed terms of departure finally lifted the fog of uncertainty, establishing the basis of future EU-UK relations. Removal of this uncertainty was to the benefit of the pound through the first quarter, as it rallied against the euro, establishing a new trade range of GBP/EUR 1.14 to 1.17 which has been maintained since. The news also offered a welcome catalyst for sterling to strengthen against the dollar reaching a high in excess of 1.42.

Day to day life is such that one might be forgiven for thinking little had changed post-Brexit when set against a pandemic backdrop. The tectonic nature of the agreement implementation betrays realities, as tensions visibly surface periodically. This was demonstrated in the deployment of Navy vessels to Jersey over disputed fishing grounds, but perhaps more consequentially surrounding the now contentious Northern Irish protocol. While some businesses have struggled to adapt to the new environment others have remained comparatively unscathed. Where the line of attribution is drawn for the economic impact of Brexit and the pandemic, is likely to be hotly debated for years to come.

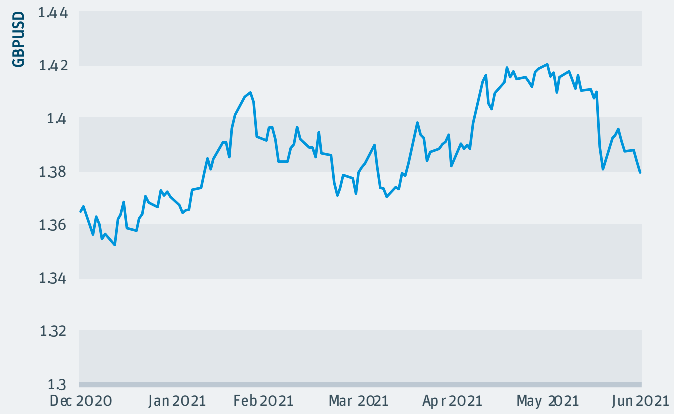
Though the year began with further social restrictions, a swift vaccine rollout has offered the prospect of an earlier return to normality for the UK.

The road to recovery



Source: UK Office for National Statistics

Retracing old footsteps



Source: Bloomberg

By the end of June, the UK had managed to fully vaccinate almost 50% of the population, while an additional 17% of the population had received at least one dose. All of this had served to suggest the UK would be amongst the first to ease pandemic restrictions, with the government continuing to debate when this might be. More recently the Delta variant has challenged the prospect of a return to normality, as its rapid spread runs against one of the world's most highly vaccinated populations.

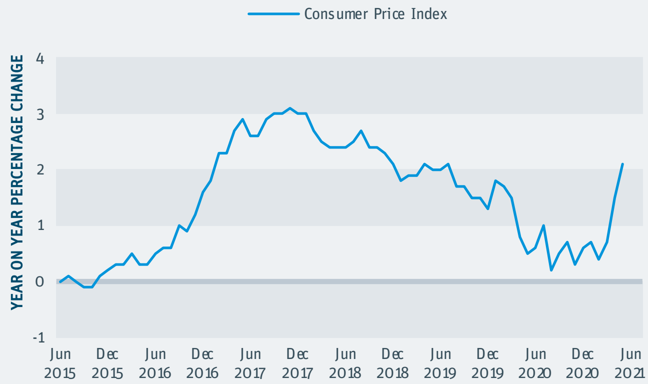
Data showed GDP contracting by 2.9% in January as Chancellor Rishi Sunak announced the extension of furlough scheme to conclude at the later date of September. The flagship support scheme labelled The Coronavirus Job Retention Scheme, is now set to be phased out from the start of July and conclude in September, to correspond with an expectation that most business will have resumed normal operations. With costs mounting and much uncertainty still lingering, Treasury officials will keep one eye on employment data for changes in the jobs market otherwise masked by the furlough scheme. Unemployment currently stands at 4.7% and there is no doubt officials will be scrutinizing the shape and character of the returning workforce in the post-pandemic world every bit as much as the headline rate.

Data showed GDP contracting by 2.9% in January as Chancellor Rishi Sunak announced the extension of furlough scheme to conclude at the later date of September.

Although much pandemic support has been fiscal, the Bank of England continued its accommodative policy stance via the £895bn quantitative easing bond-buying program and maintaining a record low base rate of 0.10%. Inflationary pressures are being interrogated by central bankers globally and no less on Threadneedle Street, as the Consumer Price Index (CPI) accelerated to 2.1% for May. While the Bank expects headline inflation to reach 3% in the coming months, it believes that it is transitory in nature, underpinned by a surge in demand as activity has rebounded strongly. With a mandate to maintain inflation at 2%, officials will be parsing the driving factors to ensure the accommodative tack remains appropriate.

The UK continued to pursue its objective to remain a key player within the world of international trade in the wake of Brexit.

UK inflation – the only way is up?



Source: Bloomberg

£20.1bn

The amount of imports sourced outside the EU in April, the most since 1997

Trade routes were further diversified as the UK imported a record of £20.1bn in goods sourced outside of the EU in April, the most since 1997. Overall, exports to the EU have dropped since the UK's departure, however signs of recovery are evident, with the number recording a post Brexit peak for the month of April.

The future state of financial services remains top of the agenda, with the chancellor stating that a permanent equivalence agreement is unlikely, and the UK may need to compete under a separate framework. While the future state remains uncertain, the attention is unlikely to fade provided London is able to maintain its popularity within the fintech sector.

Although Brexit has now passed into the rear-view mirror, the recovery in sterling is likely to remain capped until the full details of a post trade agreement have been ironed out, with continued emphasis on the sticking points, which include the Irish border, fishing rights and financial services. Potential upside can still be delivered by further diversifying trade relationships, with the transpacific partnership being a key contender.

When viewed relative to its peers, the UK's vaccination program appears on course to lead the economic recovery through reopening all corners of the economy. This will translate into economic barometers such as GBP, inflation etc. And importantly could afford the BoE to be one of the first central banks to change gears and remove its life support in the form of loose monetary policy. A hawkish shift could be good news for sterling from a fundamental perspective and be the boost that moves sterling higher in the long term.

US dollar (USD) – The inflation game

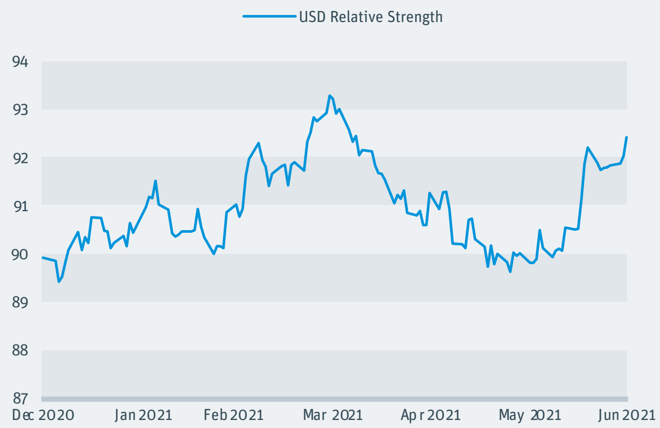
The COVID-19 pandemic has continued to drive both the political and economic agenda, affecting the dollar throughout the first half of 2021. As the global economy recovers, albeit slower than anticipated, USD has remained at 3-year lows.

In comparison to the heightened volatility we saw last year, the dollar has begun 2021 relatively stable, with prices fluctuating against a basket of currencies within a 4.7% range vs 2020's 13% range. The greenback gained some ground in the first quarter, as the US overtook all other G-7 nations with the speed of their COVID-19 vaccination delivery as a second wave of infections took hold of Europe and other regions. However, as the global economy continued to recover, US yields crept up and the USD began to flounder again. Most recently, the Federal Reserve (Fed) has changed its tone, no longer able to ignore the signs of recovery, becoming the first major central bank to adopt a hawkish stance. This indicates that they will raise rates before 2023 and the USD has since gained around 2.5%.

5%

YoY increase in US inflation

Greenback in fashion?



Source: Bloomberg

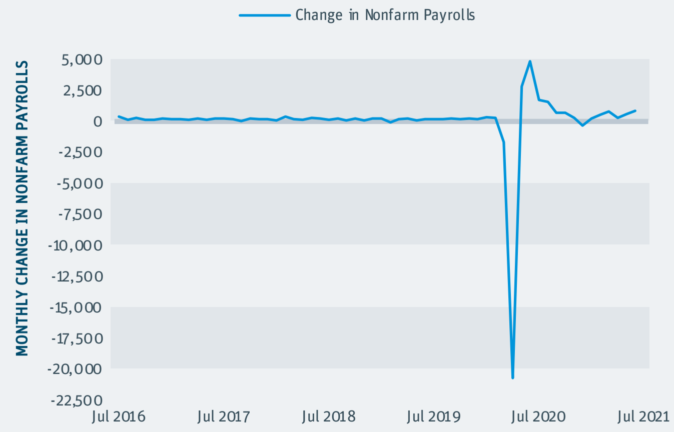
The Fed sustained its support for the US economy in the first half of 2021, continuing its commitment to low interest rates and $120bn monthly asset purchase scheme. The Fed funds rate has remained at 0–0.25% since March and the change of inflation target remained at 2%. In parallel, Joe Biden marked the start of his presidency by passing a $1.9tn coronavirus relief package though congress, aimed at boosting benefits to those who need support throughout the pandemic.

Starting the year with 19 million jobless claimants, markets had anticipated a strong up-swing in the number of jobs added to the US economy as it recovered. Although numbers have been relatively strong, most recent data releases have widely fallen short of expectations, indicating that workers are returning to the workforce as a slower pace than anticipated.

As lockdown restrictions were gradually lifted, US inflation began an upward march. Having dipped to a 5-year low in June of last year, as demand plummeted, US consumer-price data has increased at pace few had predicted, as inflation reached a 13-year high in June at 5% YoY. Although inflation remains well above the 2% target, Fed officials continue to be divided on whether the pickup in prices will persist, or whether it is a short-lived phenomenon. Although the central bank has remained committed to holding policy steady for the time being, the most recent Federal Open Market Committee (FOMC) meeting minutes showed anticipated forecast rate increases to include 2 hikes by the end of 2023, whilst bringing forward the dates they expect to taper QE. Fed members reiterated that these changes will not be anytime soon and that they will need to see further evidence of economic improvement.

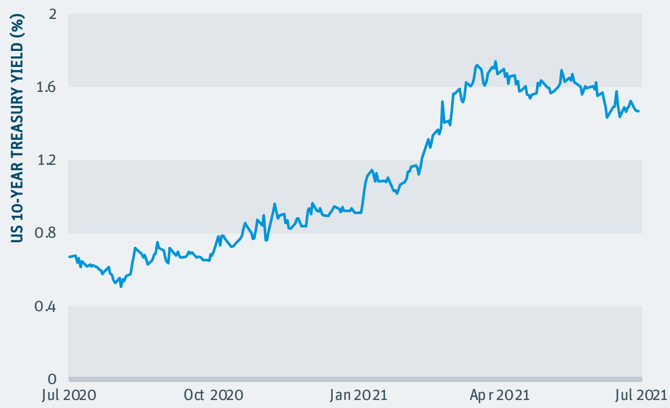
In recent months, the success of the rollout of COVID-19 vaccines and fiscal stimulus have raised investor's expectations that the economy will bounce back, causing investors to step away from traditional safe haven assets and venture into riskier fields. Yields on US Treasuries have surged to their highest level in more than a year from record lows hit in 2020. The rise in inflation, accompanied by the spike in treasury in yields, has exerted pressure on the Fed. However, the recent price action, in which bond prices have fallen sharply, supports the Fed's view that this may be short-lived.

The bigger the drop, the steeper the climb



Source: Bloomberg

Tapering expectations



Source: Bloomberg

2.8%

USD Relative Strength Index trades up this year

The unexpectedly hawkish pivot has altered the outlook for the USD over the next 6 months. Although there is a case for short term dollar strength with the impressive employment data, high yields and inflation figures, as the global economy continues to recover and we slowly start to return to normality, investment will gradually shift away from the safe-haven currency with investors seeking greater returns elsewhere. There may, however, be many bumps in the road to recovery, so the rate of correction is likely to be dynamic.

Despite the rise in treasury yields and inflation, the Fed continues to keep policy on hold.

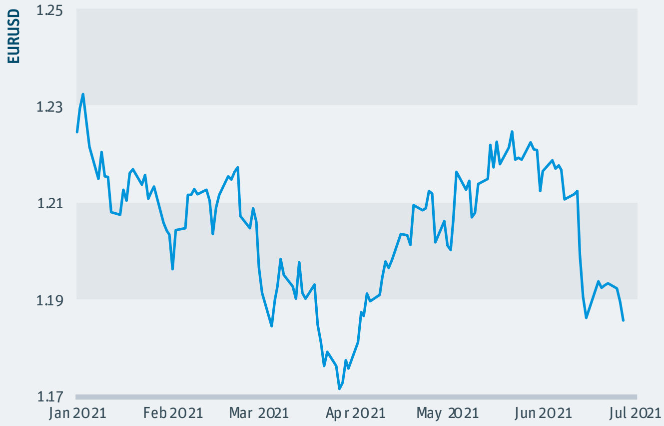
Euro (EUR) – Beginning the recovery

The ongoing Coronavirus pandemic has continued to be the key driver in euro volatility, with a tale of two halves broadly defining the year so far.

A surge in infection rates forced the bloc into a new lockdown, with the euro losing nearly 5% against the dollar in Q1 as EU countries failed to reach vaccine targets. This led to further central bank intervention, as the bond-purchase program was ramped up. Q2 saw the beginning of the euro's recovery, as investor optimism was buoyed with the easing of restrictions and improving rate of immunization.

Countries across the bloc have relied extensively on central bank intervention to counter the negative economic impact caused by the pandemic. The ECB announced in March that the rate of bond purchases would be made at a significantly higher pace during the second quarter, buying €80bn per month under the ECB's Pandemic Emergency Purchase Programme (PEPP) and €20bn per month under the regular asset purchase program. The PEPP is due to run until March 2022, but rising treasury yields and inflation are likely to be in the forefront of Christine Lagarde's decision making when looking into tightening policy.

Will doves fly?



Source: Bloomberg

€700bn

of overall €1.85tn left to spend in the PEPP

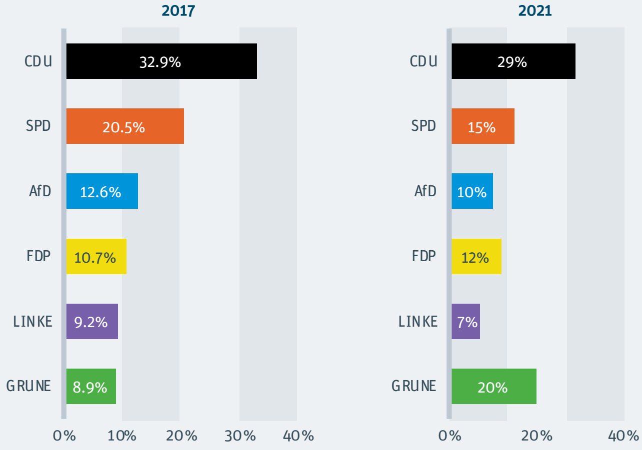
Much focus over the year has been given to vaccine rollout discrepancies which have had a continued impact on the euro. The EU Commission initially struggled to acquire enough vaccine doses as they negotiated contracts slower than their peers and suffered significant supply chain issues. Concerns regarding possible side-effects of the AstraZeneca vaccine set the bloc back even further, as 13 European countries suspended the use of the vaccine. Consumer confidence gradually began to climb over the quarter to reach the highest level since October 2018 in May, as the economy began to reopen further, and the vaccine rollout continued.

The narrative over the second half of the year remains to be seen, as the bloc's two main engines enter a period of political uncertainty with elections in both Germany and France.

Significant attention will be given to the changing political landscape, with a potential shift in power taking place in the two leading EU economies of France and Germany. With Angela Merkel due to retire from office in September after over 15 years at the helm, Germany has looked to continuity candidate Armin Laschet to replace her as head of the CDU, continuing Merkel's consensual course in times of uncertainty following the pandemic. The CDU remains ahead in the polls, followed by the Green Party and then German Finance Minister Olaf Scholz's SPD. The federal election is expected to be held on September 26.

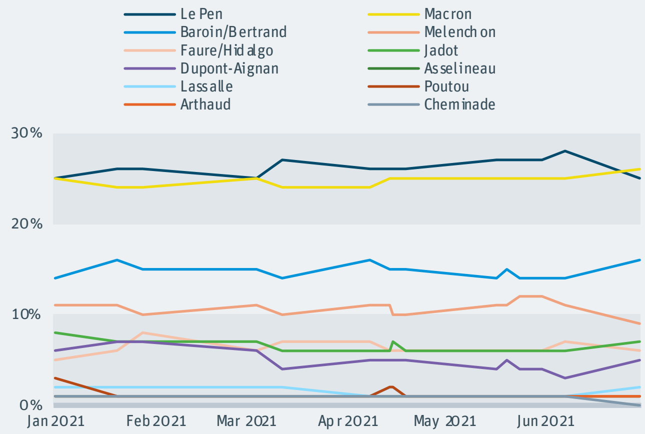
Emmanuel Macron will begin his campaign to serve a second term in the coming months ahead of the April 2022 election, challenged once again by far-right candidate Marine Le Pen. France has encountered bouts of civil unrest during the handling of the pandemic, with Macron's approval rating dropping 5% since the beginning of the year. Voting intention polls show Le Pen gaining ground against Macron, with the recent polls too close to call at 25% against 26%. As a result, the narrative over the second half of the year remains to be seen, as the blocs two main engines enter a period of political uncertainty.

German election poll of polls



Source: politico.eu

French 2022 presidential election voting intention



Source: politico.eu

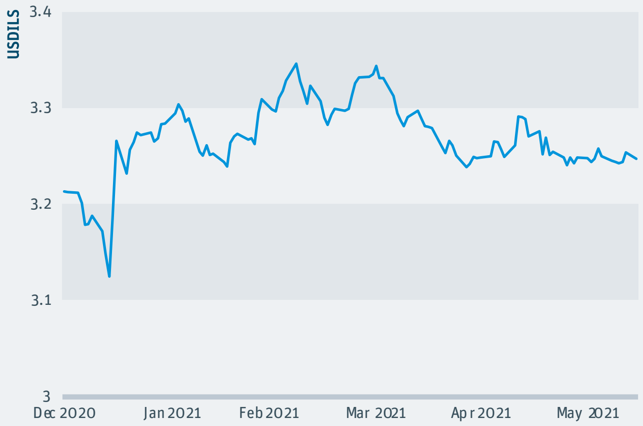
Israeli shekel (ILS) – Resilience in the face of uncertainty

After spending 2020 moving lower, USD/ILS rapidly accelerated the trend at the turn of the year, with the surge in shekel strength driven by Israel's early and robust reaction to the pandemic.

Strict quarantine and lockdown measures helped contain the fallout from the virus and a swift vaccination rollout saw economic confidence soar, pushing the pair to trade as low as USD/ILS 3.12 – levels last seen in 1995. Fortunately for companies adversely impacted by a stronger shekel, such as those in tech sectors, the move was short-lived, as both central bank intervention and technical support saw USD/ILS rebound back above 3.20, re-calibrating its new range to 3.20–3.35.

Politics remained in the spotlight throughout the first half of the year with the fourth election in two years initially without a clear winner, leading to a transition period with a temporary coalition ruling. Eventually, after 12 years at the helm, Benjamin Netyanhu's record tenure concluded, bringing an end to over two years of political uncertainty. The Knesset cleared right-wing Naftali Bennett and centrist Yair Lapid to hold office in a power sharing agreement that will see Bennet hold office until September 2023 when he will pass the torch to Lapid. Shekel strength remained resilient in the face of political turmoil in an indication that confidence in the economy is upheld, regardless of who holds office.

The trend is not your friend



Source: Bloomberg

In the face of political turmoil, shekel strength remained resilient, an indication that confidence in the economy is upheld regardless of who holds office.

After 12 years of 'Bibi' and the Likud party, economic change could be on the horizon for the government. While difficult to predict the long-term agenda, passing a budget is likely to feature at the top of the coalition's 'to do' list. With political instability and recent geopolitical tensions now in the rear-view mirror, one could assume the headwinds for ILS appear to have cooled, lowering the risk factors that could derail shekel strength. The economics bolster the case: Israel's current account surplus grew $5.9bn in the first quarter to add to the $20.3bn accumulated in 2020, which represented 5% GDP. The coffers continued to receive a boost as foreign direct investment remained elevated, with $6.9bn received in Q1, as companies benefitted from the positive sentiment surrounding the tech sector.

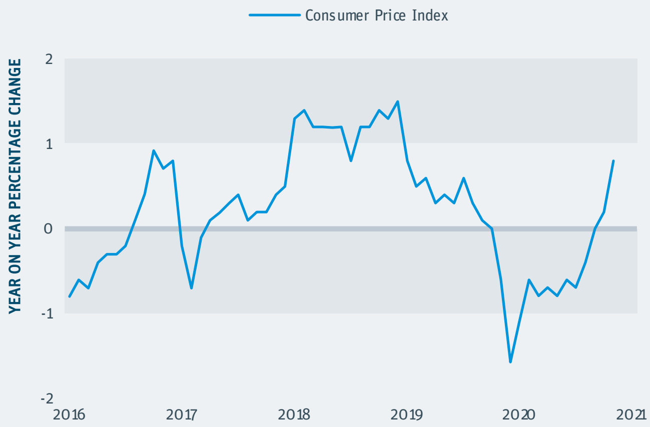
The Bank of Israel continued to act as a counterweight to shekel strength committing to purchase up to $30bn in foreign currency reserves throughout 2021 to help offset the impact of currency appreciation. This was well received onshore however the relentless pace of shekel strength has prompted the central bank to purchase approximately $25bn of foreign exchange reserves in the first 6 months of the year, which is 83% of the pledged annual quota of $30bn, ballooning the BOI's balance sheet to $200bn in the process.

83%

The amount of foreign exchange reserves the BOI has purchased against its pledged annual quota

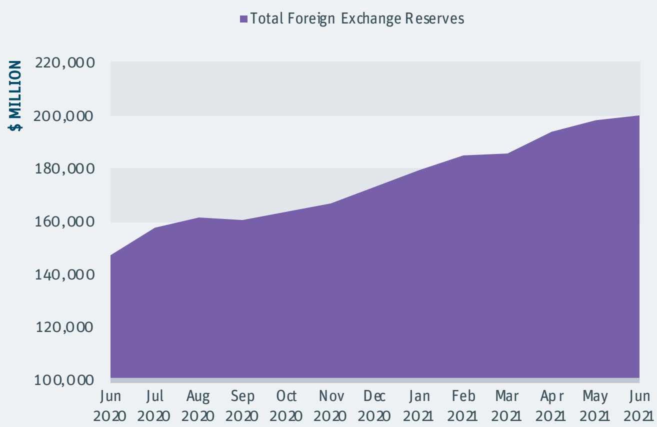
Governor Amir Yaron has confirmed the Bank of Israel is willing to build currency reserves further if it deems appropriate. The question remains however as to how effective central bank intervention becomes after a continued period of activity and where the real floor is in USD/ILS, after testing 3.12. The committee will likely continue to review the tools available in their monetary policy kit to counteract building pressure from the tech-sector who collect a substantial portion of revenues in USD and fall victim to a weaker USD/ILS, however even with the best intentions, reversing a long-term trend is no easy task.

Inflation; a flash in the pan?



Source: Bloomberg

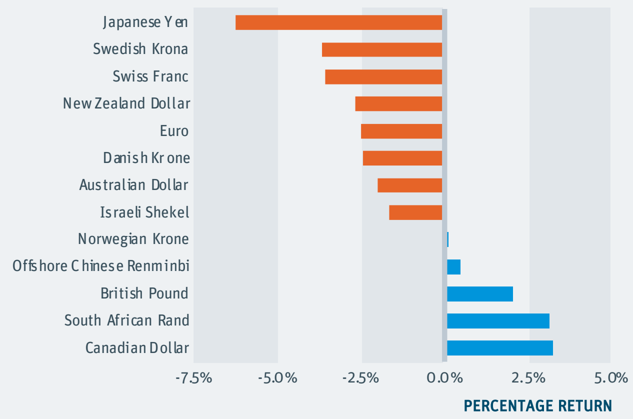
A balloon or balance sheet?



Source: Bank of Israel

Currency performance against USD

Currency performance against USD



Source: Bloomberg

Contact us

For more analysis on FX markets or information regarding SVB's global payment services, contact your SVB FX Advisor or the SVB FX Advisory Team at fxadvisors@svb.com

FX innovation: Tech companies talking the talk, through financial automation

Technology firms push the boundaries within their unique niches of the innovation economy, advocating the efficiencies and benefits of their tech to clients and the wider ecosystem. Yet these same leading innovators drive inefficiencies and manual processes within their own finance functions, rather than valuing industry modernization within finance.

One common element is financial risk from foreign currencies; there is a point where FX risk mitigation becomes inefficient through manual process apathy and whereby technology supports growth. For early-stage start-ups, FX is not a topic they have on the radar from the very beginning, it tends to only become a priority once they are 'big enough'.

However, these building blocks are foundational and much easier to implement when financial risks are small. Many companies that do not set-up FX properly from their beginning often incur unnecessary costs related to lengthy, costly and painful IT projects once the company has grown.

Protect international growth without additional headcount resource to Finance teams, and let tech do the heavy lifting.

Successfully embedding FX risk mitigation in processes that provide international scalability supports financial planning, meets audit requirements – plus provides a Finance function with the tools (and confidence) to support the business for future growth.

Foreign exchange transactions can be highly risky, and losses may occur in short periods of time if there is an adverse movement of exchange rates. Exchange rates can be highly volatile and are impacted by numerous economic, political and social factors as well as supply and demand and governmental intervention, control and adjustments. Investments in financial instruments carry significant risk, including the possible loss of the principal amount invested. Before entering any foreign exchange transaction, you should obtain advice from your own tax, financial, legal, accounting, and other advisors and only make investment decisions on the basis of your own objectives, experience and resources.

This material, including without limitation to the statistical information herein, is provided for informational purposes only. The material is based in part on information from third-party sources that we believe to be reliable but which has not been independently verified by us, and, as such, we do not represent the information is accurate or complete. The information should not be viewed as tax, investment, legal or other advice, nor is it to be relied on in making an investment or other decision. You should obtain relevant and specific professional advice before making any investment decision. Nothing relating to the material should be construed as a solicitation, offer or recommendation to acquire or dispose of any investment, or to engage in any other transaction.