



Silicon Valley Bank

FX Navigator – US Edition

H2 2019

FX market insights and forecasts



The numbers you need to know

Highlights from H1 2019

7.56%

Range in GBPUSD since the start of the year

4.00%

Range in EURUSD since the start of the year

2,629

Number of tweets from President Trump

4

Number of rate increases by the Federal Reserve in 2018

217%

Rise in value of Bitcoin since the start of the year

100%

Market implied probability of a rate cut from the Federal Reserve at the July meeting

1.00%

Market implied probability of the BOE increasing interest rates this year

-0.40%

ECB Deposit Rate

2019 Central Bank Politics: Economic data becomes secondary as market participants take direction from central bank policy and political developments

As we turn to the second half of 2019, we reflect on what has guided markets over the past six months and key factors that could spur momentum before the close of the year. With investors having to weather the effects of politics, trade tensions and central bank policy shifts, effective FX risk management remains a top priority for business operations globally.

We hope you find this report valuable as you make decisions on your FX strategy. We remain available for any further discussion.

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The Market Risk Solutions Team

SVB FX London

US Dollar (USD)

The dollar opened 2019 slightly lower, its index bottoming out at 95.03 in January. It has since strengthened (peaking in May at 98.37), viewed as a safe haven currency buoyed by relatively attractive interest rates, an economy still strong, and an outperforming equity market.

While the world still favors the dollar as its reserve currency, key headwinds at home in the form of trade tensions, political deadlock and a central bank under pressure to maintain independence leave the greenback open to significant and sharp reversal.

What happened?



Dollar Index Spot (Jan 1, 2019 – June 28, 2019)

“The market feels to be exercising caution. Long-term Treasury yields are pushing lower and causing sustained inversion in the curve – an event that has acted as a leading indicator for recessions in the past.”

– Nish Parekh, Managing Director, Market Risk Solutions

H1 Themes

With expectations that the Federal Reserve would remain vigilant throughout 2019, the market focused on the inversion of the yield curve as long-term treasury yields dropped.

Federal Reserve Chairman Jerome Powell urged patience with regards to any monetary policy adjustments, saying the Fed will use economic data to guide decisions. As a result, the central bank has felt pressure from President Trump who has been pushing for looser monetary policy in an effort to boost the economy.

Trump has been openly critical of the Federal Open Market Committee, disapproving of their economic judgement and previous decisions to increase interest rates. Rumors have also emerged that the president considered firing Jerome Powell, whom he hired in 2017. Powell has since confirmed his independence from politics and shown little signs of cracking under pressure.

The Politicization of the Fed

Trade tensions have continued to drive market sentiment throughout 2019 as the US president has maintained his “America First” agenda and targeted countries where he believes current trade agreements disadvantage the US.

The US-China dispute has dominated the headlines as Trump considers imposing additional tariffs on Chinese goods. Trade relations have worsened elsewhere, with ongoing dialogue in Canada, Mexico and Europe, to name a few.

Trade Tensions

H2 Forecast

Markets are currently pricing in a virtual certainty for the Federal Reserve to start loosening its policy strings. This leaves the central bank in a tough situation; if they decide not to cut interest rates they will disappoint markets, with shockwaves likely to reverberate across all asset classes.

The committee has gradually begun tilting to the dovish side of the spectrum, with Trump nominating Christopher Waller and Judy Shelton to the seven-member board – both of whom are perceived to favor lower rates.

The US has led developed economies down the path of tightening since the credit crisis. Any surprise developments that could point to a tighter monetary policy could see the greenback resume its upwards trend. However, additional stimulus measures may put the brakes on recent momentum.

Frictionless trade is a key ingredient for a healthy economy and if Trump is able to overhaul current agreements in his favor, this could be good news for the US.

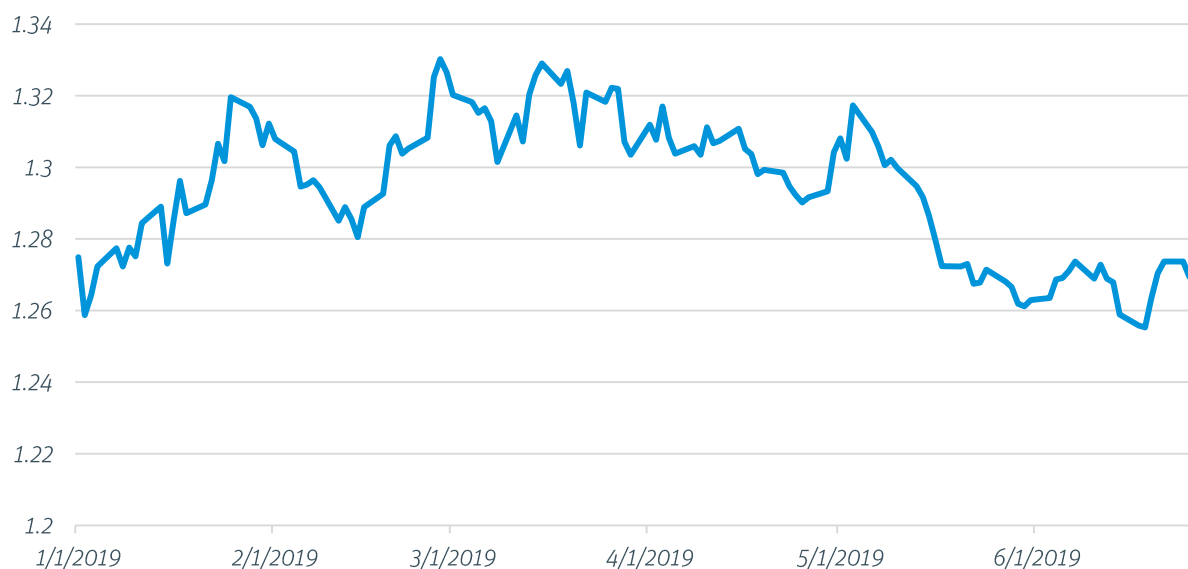
Should the president push too hard with imposing his tariffs and isolating agenda, we could see protectionism rear its head, causing a stall in the global economy and a rise in popularity of haven assets. Although the dollar can often benefit from risk-off sentiment, it is uncertain if this will be reliable in such a situation. If so, we could see a rise in popularity of the Japanese yen and Swiss franc.

British Pound (GBP)

The pound started the year on a high note, testing resistance at the 1.34 barrier. Despite sterling's best efforts, it has been unable to shake off market doubts surrounding Brexit. As a result, the second quarter saw the pound lose purchasing power as uncertainty continued to cast a shadow.

On July 24th, Theresa May resigned as UK's Prime Minister, and was replaced by Boris Johnson. His convincing victory over Jeremy Hunt to lead the ruling Conservative Party was highly expected, and he has already begun to reshuffle his cabinet. The UK pound initially sold lower on the news, but as traders were positioned to short the pound going into the election, a short-covering rally was seen. The UK stock index closed 0.50% lower on the day and 10-year gilt yields dropped by 1 basis point. Speculators put the odds of a 'no-deal' Brexit at 35% and a snap 'general election' prior to the October 31 deadline at 50%.

What happened?



GBP/USD Exchange Rate (Jan 1, 2019 – June 30, 2019)

Economist Forecasts

	Q3 2019	Q4 2019	Q1 2020	Q2 2020	2020	2021
GBP/USD	1.27	1.29	1.30	1.33	1.36	1.34

“Sterling’s attraction continues to diminish as weak economic data paired with political uncertainty weigh on the value of the currency.”

– Sam Cooper, Vice President, Market Risk Solutions

Source: Bloomberg Financial (July 2019)

2019 Themes

Mark Carney and the Bank of England (BoE) managed to fly under the radar for most of the year's first half as the central bank caveated its commentary with reference to dependency on the Brexit transition.

Healthy inflation numbers, consistently around the 2% target, and wage growth that continues to outstrip price increases has afforded the MPC some breathing space to date. However, a reluctance to commit to any future tightening weighs on sterling.

The BoE appears reluctant to take a stance until we have further clarity on Brexit outcomes, with even the best forecasters second-guessing the expected path of monetary policy.

UK politics continued to rattle markets with 3 attempts from Theresa May to pass her Brexit bill through parliament. Lawmakers failed to go along, remaining at loggerheads as to the future state of the UK – EU relationship.

Consequential pressure from her own conservative backbenchers saw Theresa May resign from her post as prime minister, triggering a leadership contest.

Even now that the election between Boris Johnson and rival Jeremy Hunt has been settled, the political turmoil and future state of the EU remain in flux.

Bank of England

Brexit

2019 Forecast

The spotlight will gradually return to the Bank of England when its 'wait-and-see' approach expires. At that point, market participants will need more than a stock Brexit-related response for policy direction.

The market currently favors an interest rate cut rather than an increase, however the odds of a movement before the end of the year stand at 19%; evidence that there is a distinct lack of conviction within the market.

Should the central bank reverse its last adjustment and pursue policy loosening by cutting interest rates, the relative attractiveness of sterling will likely diminish, increasing down-side risk to the pound.

Politics will remain in focus for the second half of the year as businesses and investors alike lobby for certainty around the future state of the UK – EU relationship.

The stage is set for Boris Johnson to lead the Conservative Party headlong into the Brexit conundrum.

Although market reaction to both Brexit and political developments have softened as negotiations have drawn out, the long-term direction of sterling hinges on the eventual outcome. Market participants will welcome a decision as concerns begin to manifest in economic data.

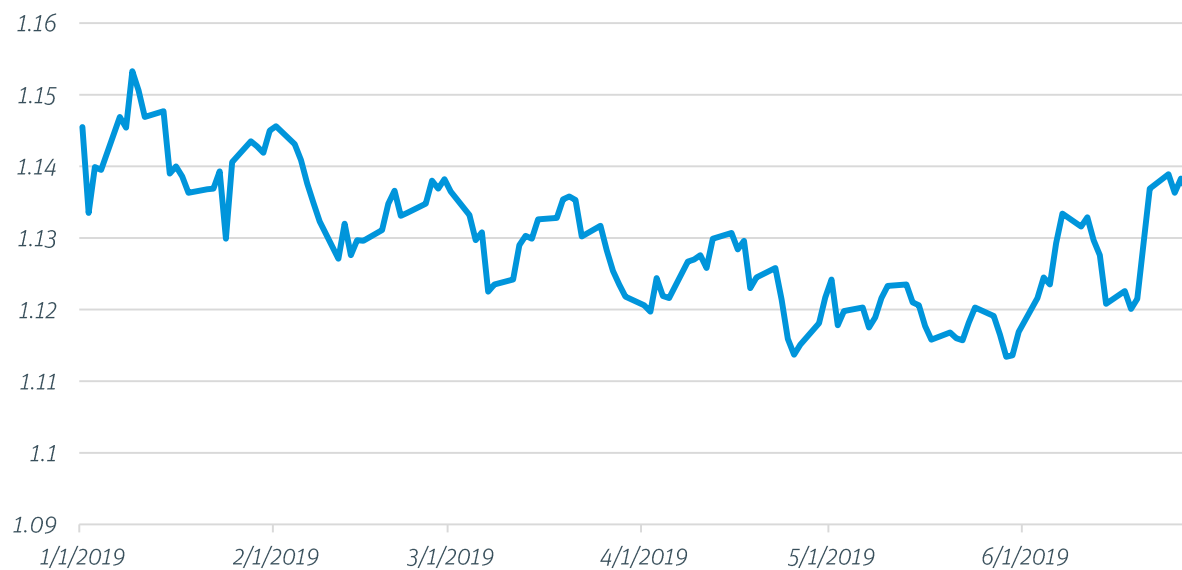
Any indication that a hard Brexit is the more likely option could see GBP/USD fall back below its recent support levels.

Euro (EUR)

At the end of 2018, the ECB announced measures to turn off the QE tap and enter a hiking-cycle to pursue policy normalization. The central bank has since reversed course, now considering their options to remain accommodative.

With low inflation expectations, weakening growth forecasts, threats of protectionism and increasing geopolitical uncertainty, the EUR struggled to break 1.1500, having bottomed out at 1.1129.

What happened?



EUR/USD Exchange Rate (Jan 1, 2019 – June 30, 2019).

Economist Forecasts

	Q3 2019	Q4 2019	Q1 2020	Q2 2020	2020	2021
EURUSD	1.13	1.15	1.16	1.17	1.20	1.21

Source: Bloomberg Financial (July 2019)

H1 Themes

The ECB remained responsive in the face of global economic headwinds and kept an ear close to the ground amid whispers of a two-tier economy. The following factors are driving this concern: a fresh unemployment low point, the fastest wage growth in a decade, increased household spending, and struggling industrial and manufacturing output.

European Central Bank

Germany: Despite beating consensus on growth at the start of the year, the 3rd largest exporter in the world suffered in Q2 as US tariffs and a decline in demand pushed the Bundesbank to revise growth down from 1.6% to 0.6%, dampening investor sentiment.

France: Running at an annual growth rate that is outpacing the German powerhouse, the French have benefited from tax cuts and recovering sentiment which has helped provide support to a falling euro.

Italy: Politics has been the consistent theme in Italy as the ruling coalition has remained at loggerheads over policy changes while battling with the European Commission over its fiscal and budgeting policies. The market responded with a spike in Italian bond prices and a fall in the euro as investors rotate out of politically exposed assets.

Key Economies

H2 Forecast

Global trade tensions and a challenging external backdrop pose downside risks to the growth outlook in the export-led economy.

The market agrees that the ECB should re-introduce an easing bias with changes to forward guidance, reinstating the asset purchase program, further lowering deposit rates and tiering of excess reserves.

October will be a busy time in Brussels as Draghi's successor, Christine Lagarde of the IMF, takes the helm amid the approaching Brexit deadline. Any deviation from the existing approach could be delayed until the changing of guard.

Germany: Forecasts from Bundesbank reflect more downbeat prospects in the near future. The central bank highlights trade disputes weighing on global commerce as one of the reasons for the forecasts. Germany will be particularly exposed to the additional car import tariffs that Donald Trump has considered.

France: The long-term results of Macron's labor-market reforms will be closely monitored for impacts on domestic demand. However, the effects of a gloomy outlook from their closest trading partner, Germany, could dampen pace.

Italy: The market will continue to monitor the political landscape in Italy as anti-EU rhetoric from certain Italian politicians remains evident.

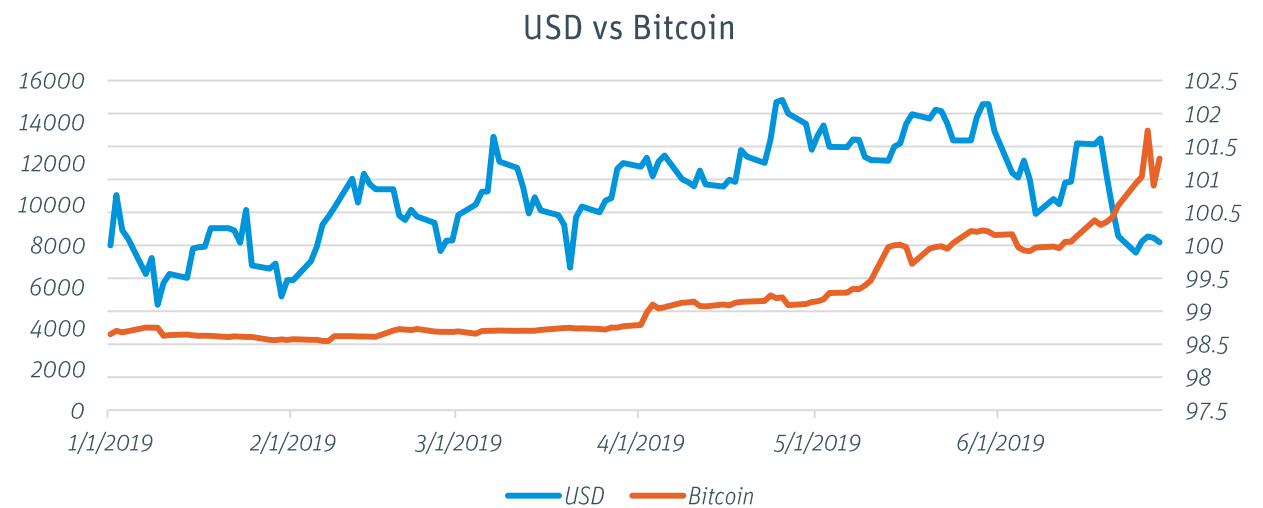
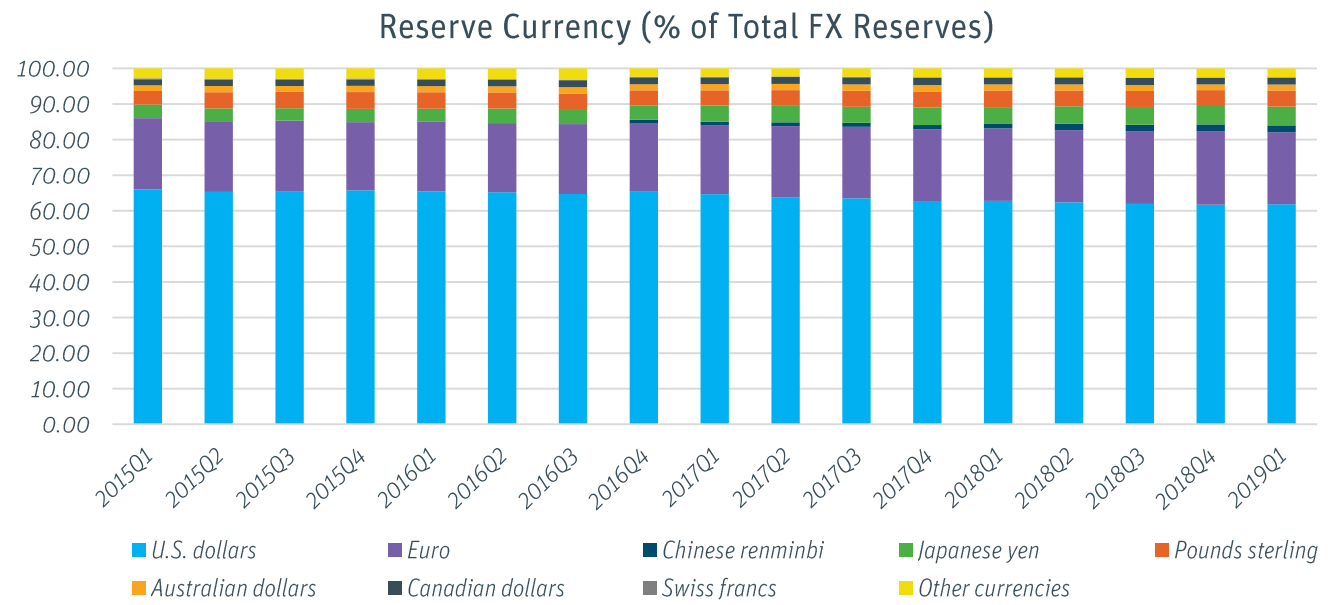
The Macro View

Are we seeing a shift in the dynamics that drive currency holdings? Traditionally the US dollar has been the reserve currency of choice. However, with the rise of geopolitical tensions and trade disputes, we investigate if the greenback is still in fashion.

IMF data has shown that the relative amount of dollar denominated central bank reserves fell to a five-year low of 62.3% in the second quarter. At the same time, overall foreign holdings of US treasury debt also lost its attraction, falling to a 15-year low of 41%. Developed economies appear to be lowering their reliance on the greenback, with governments considering payment mechanisms in alternative currencies such as the euro, partly due to the US protectionist shift. Will the recent resurgence in cryptocurrencies help present the asset class as a new-era safe haven? As illustrated in our graph, the decentralized nature of bitcoin clearly exhibits investor appeal.

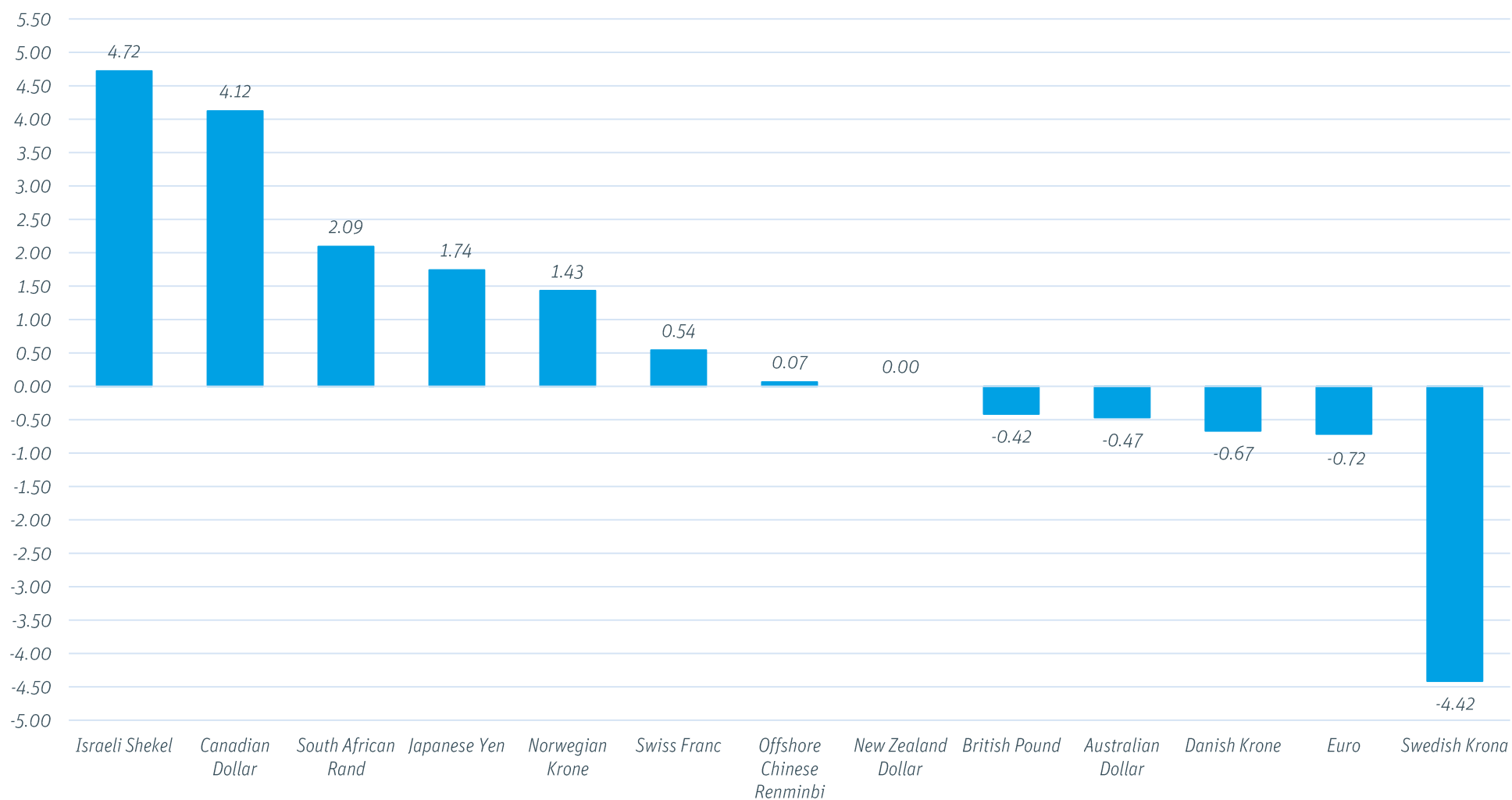
Elsewhere, bond prices have rallied as developed market interest rates push lower. Within the global equity world, cheap money is always welcomed and the shift in expectations from central banks have helped markets set new record highs.

The stock market rally continues as investors welcome the prospect of cheap money



Source: Bloomberg Financial (July 2019) & Currency Composition of Official Foreign Exchange Reserves (COFER), International Financial Statistics (IFS)

Returns against USD Jan-June 2019 (%)



Source: Bloomberg Financial (July 2019)



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