How 2020 accelerated currency trends and how to position for what's ahead

Ivan Oscar Asensio | January 2021

Key takeaways

1. The tide has turned for the US dollar

2. A weaker USD presents a pain point to innovation-sector companies at the high-growth stage in the life-cycle; private equity and venture investors who have raised USD funds have seen their purchasing power eroded prior to overseas investment

3. Costs to hedge foreign currency liabilities via forwards have fallen significantly

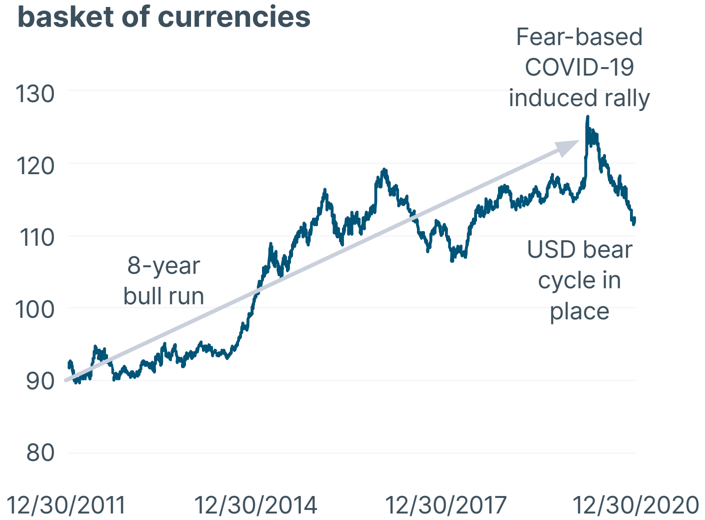
The USD outlook

Financial market participants came into 2020 with expectations that the 8-year bull run in the US dollar (USD) would finally turn.

Then COVID-19 hit.

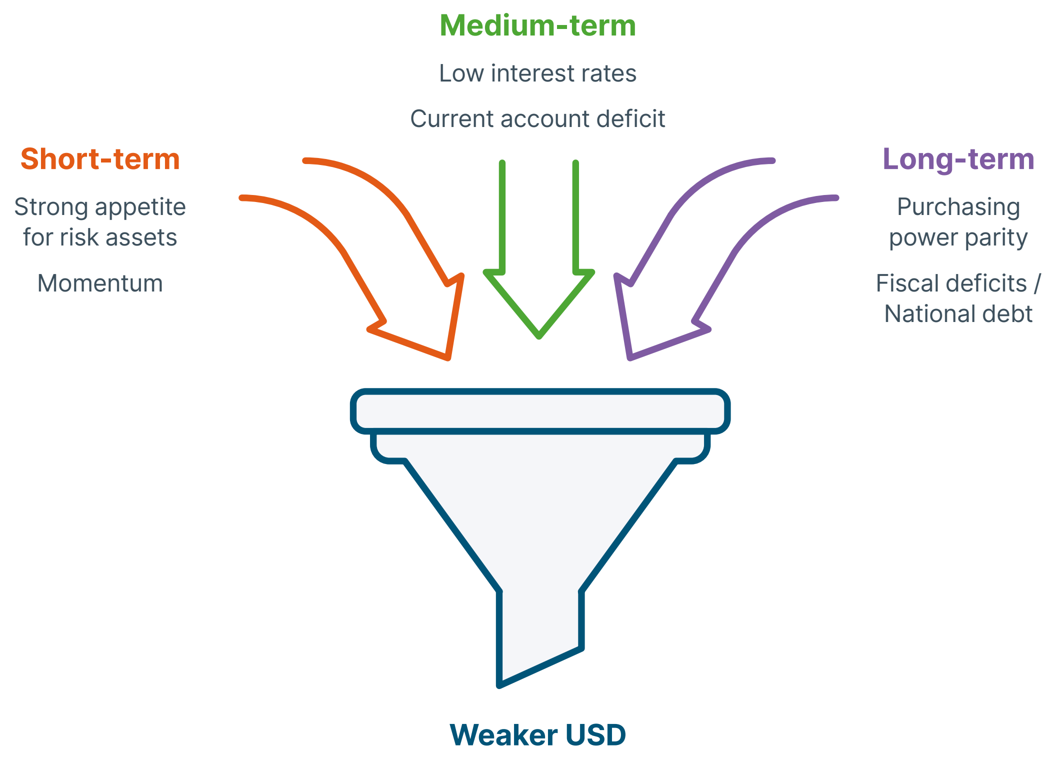
In-line with previous financial distress episodes, the USD defied expectations and went even higher. The rise was sharp and broad-based, but temporary. Governments and central banks responded to COVID-19 shutdowns with trillions of fiscal and monetary stimuli, resulting in an impressive equity market recovery and a quick end to the fear-driven USD buying. The year 2020 ended with the S&P 500 at its highest peak and the USD at multi-year lows versus other currencies[1].

USD versus trade-weighted basket of currencies



Source: Federal Reserve, Bloomberg ticker: USTWBGD

[1] Source: Bloomberg as of 31-December-2020.



Looking ahead, the coming of COVID-19 has created a landscape that may accelerate the fall in the USD. We review the drivers that will be important over the short, medium, and longer-term.

Short-term drivers

A **strong appetite for risk** assets is generally associated with a weaker USD as institutional and individual investors in the US are incentivized to deploy capital overseas in search of higher potential returns. In the current environment, combined with near-zero yields in the US, this activity may be particularly strong, resulting in additional selling pressure on the USD.

Momentum is a strong force in financial markets. Investors are rewarded for buying into winning strategies more so than from executing contrarian plays. The USD posted double-digit losses versus most major currencies since the COVID-19 sell-off in March 2020. The strong downtrend has created an overall bearish sentiment among the investment community, which may translate into USD weakness by way of self-fulfilling prophecy.

Medium-term drivers

Low interest rates dampen the demand for and, by extension, the value of a currency. Current guidance from the Federal Reserve is for policy rates to remain at the zero lower-bound in the US until at least until 2023, while quantitative easing will anchor low interest rates across the term structure[2].

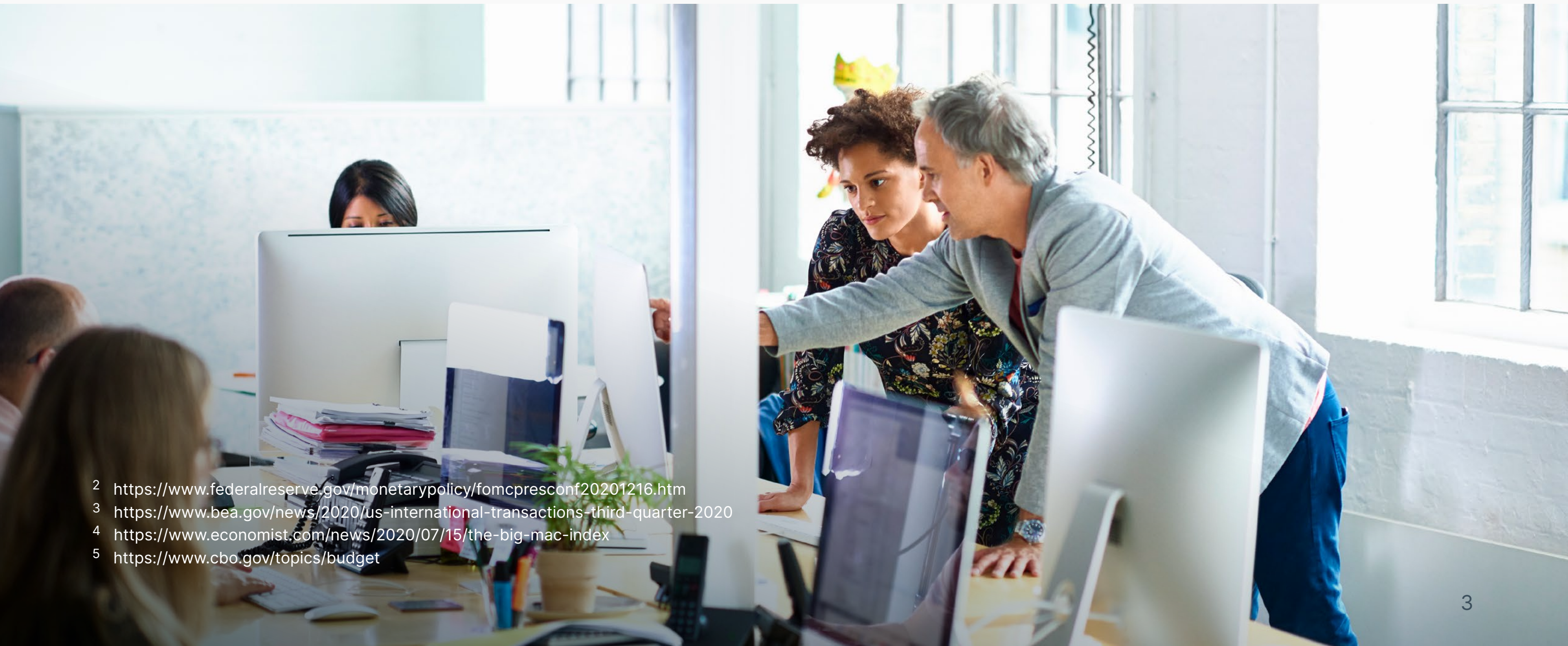
Furthermore, on an inflation-adjusted basis, US interest rates look even more unattractive as the yield earned is less than the loss of purchasing power from inflation.

The **current account deficit** swelled to 3.4% of GDP[3] in Q3 of 2020, an increase of about 75% from pre- COVID-19 levels, indicating that the US continues to spend more overseas than it takes in from foreign counterparts. COVID-19 has aggravated the situation as spending habits have shifted away from services offered domestically, out of necessity (haircuts, restaurants, gyms, shared rides), to goods primarily imported from overseas and procured online. The perennial selling of USD that arises from this represents a headwind for the USD.

Longer-term drivers

Purchasing power parity (PPP) says one unit of one currency should buy the same amount of goods in one country as one foreign unit does in the foreign country, adjusted for inflation. According to one such measure, the US dollar is overvalued versus all other currencies except the Swiss franc, the Lebanese pound, and the Swedish krona[4]. Furthermore, the Fed's recent commitment to let inflation run higher than the previous target of 2% will put even more pressure on the dollar according to this valuation approach (i.e. as currencies with higher inflation are expected to depreciate).

The fiscal deficit finished 2020 at approximately $3.3 trillion[5], the largest annual sum since 1945 as a percentage of GDP and about three times as much as the deficit in the previous year. A large fiscal deficit simply means the US is living beyond its means, as spending exceeds tax revenues. The shortfall is met through borrowing, primarily through bond issuance. Deficit spending is not necessarily bad, in fact, carrying some leverage promotes organic growth for an economy, much like it does for a corporation. Deficit spending is also not a new phenomenon for the US economy. However, the annual amount is rising, and the accumulation of the deficits, the national debt, topped 100% of GDP in 2020. Some believe the rapid one-way trajectory of all this is hurting the credibility of the USD as a reserve currency, and even putting into question our fiat currency system. Recent strength of gold and crypto currencies can be attributed, at least in part, to this sentiment.



[2] https://www.federalreserve.gov/monetarypolicy/fomcpresconf20201216.htm
[3] https://www.bea.gov/news/2020/us-international-transactions-third-quarter-2020
[4] https://www.economist.com/news/2020/07/15/the-big-mac-index
[5] https://www.cbo.gov/topics/budget

Why this matters now

For years prior to 2020, US-based innovation sector companies have been blessed with US dollar (USD) strength. Most, at the start-up to IPO stage in the lifecycle, are net sellers of USD[6]. Venture and private equity USD funds sitting on USD's earmarked for overseas investments would similarly find the purchasing power of their USD generally improved over these years between the time of the fund raise to the time the capital was deployed. This windfall goes away should the USD embark on a multi-year bearish cycle. Year one may be upon us.

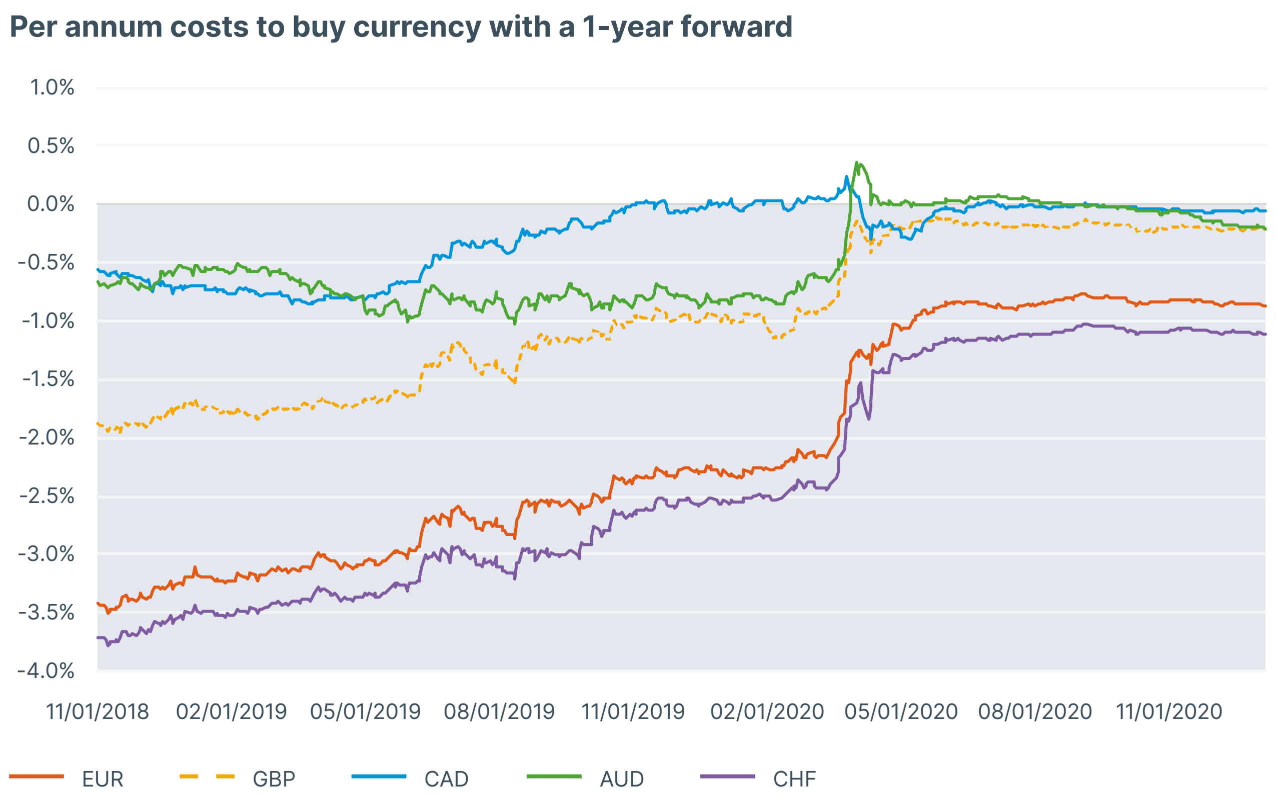
The table below offers some valuable perspective. A year-end analysis of the most actively traded currencies by innovation-sector companies and funds reveals two key findings.

1. The rates to buy currency oscillated by double-digit percentages in 2020 for all but one from this set of currencies in 2020. The average movement for all currencies was 21.2%, and the largest moves were registered by the Australian dollar, the Brazilian real, and the Mexican peso (See columns B, C, D).
2. A subset of 8 currencies ended 2020 within 1% of the highs for the year, suggesting this broad- based move in the USD has room to run (See Columns E, F).

A CCY	B Best rate to buy CCY in 2020	C Worst rate to buy CCY in 2020	D Difference between best & worst rate to buy CCY in 2020 (in %)	E FX rate (as of 12/31)	F Difference between current and worst rate to buy CCY (in %)
EUR	1.0636	1.231	14.6%	1.2243	0.5%
GBP	1.1412	1.3686	18.2%	1.3684	0.0%
AUD	0.551	0.7742	34.0%	0.7720	0.3%
NZD	0.547	0.7241	28.0%	0.7197	0.6%
CAD	1.4668	1.2688	14.5%	1.2745	0.4%
CHF	0.9902	0.8795	11.9%	0.8851	0.6%
JPY	112.23	101.19	10.4%	103.3700	2.1%
CNH	7.1965	6.4886	10.4%	6.5028	0.2%
INR	76.9088	70.705	8.4%	73.1325	3.4%
BRL	5.9714	4.0044	40.0%	5.1985	26.1%
MXN	25.7849	18.5237	33.1%	19.9823	7.6%
ILS	3.8894	3.2063	19.3%	3.2125	0.2%
ZAR	19.3508	13.9326	32.9%	14.7002	5.4%
		Average	21.2%	Average	3.7%

Data: Bloomberg, Analysis: SVB FX Risk Advisory (all % calculations are in log terms)

[6] According to flows we see at Silicon Valley Bank, there are 3 net USD sellers for every net USD buyer.



Data: Bloomberg, Analysis: SVB FX Risk Advisory

Looking ahead

As you think about your currency needs for 2021 beyond, consider the following:

- For corporations, how will another double-digit move higher in currencies impact global FP&A and other business performance metrics? For USD funds, to what extent does the loss of purchasing power from holding USD earmarked for non-USD investment impact performance?
- Currencies do mean-revert, but they may not on your timetable, so waiting for a pullback can be costly[7].
- The cost to lock into currency purchases via FX forwards, from a USD perspective, has fallen this year due to a narrowing in interest rate differentials on a global scale. The chart above illustrates this dynamic over the last couple years.

[7] For more on currency behaviors, read our white paper on the subject: https://www.svb.com/blogs/ivan-asensio/how-currency-movements-can-affect-your-global-business

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