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Silicon Valley Bank

SVB FX Quarterly Outlook: Q2 2022

FX markets contend with inflation, rising interest rates, and flatter yield curves

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Key takeaways

Inflation has been the primary driver of currency prices and volatility.

Investor pessimism and the USD both have the tendency to rise over previous yield curve inversion episodes.

Our currency spotlight section features three 'breakout' currencies to keep an eye on: Japanese yen, Chinese renminbi, and Israeli shekel.

Despite increasing traction, bitcoin behaves more like a leveraged high-beta stock, and less like a fiat currency or inflation fighter.

Macro overview

'Transitory' inflation isn't.

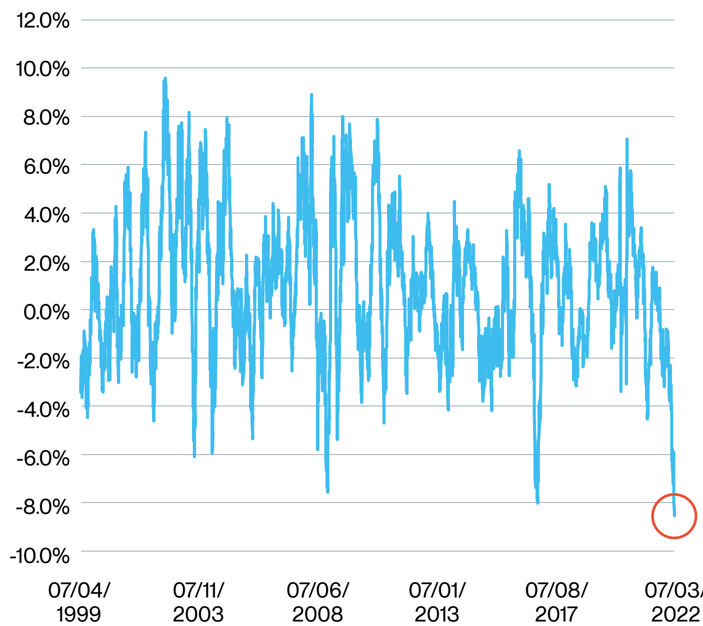
Opinions that post-COVID inflation was 'transitory' were silenced when the Russia-Ukraine conflict started in February this year. Prior to the conflict, prices were already stressed from strained supply chains, shortages of computer chips and other intermediate goods, and economy-reopening consumer demand spikes. Additional war-induced disruptions to food, energy, and commodity supplies left us with the perfect storm for spiraling inflation.

In the US, we registered the highest inflation in over 40 years. Euro inflation also hit its highest on record. With few exceptions including Japan, Switzerland, and China, inflation is ripping through both developed and emerging market economies, causing a re-pricing of risk across asset classes.[1] What's more, consumer price increases are starting to put upward pressure on wages.

Inflation has been the primary catalyst for financial asset price movements this year. With interest rates rising and expectations for further increases, **Q1 2022 was the worst quarter on record for global bonds (Chart 1)**.[2]

In equity markets, inflation has had a traceable and disproportionate impact on sectors. Technology stocks, which rely heavily on funding to deliver the high growth promised, were hit hardest. As of this writing, the Nasdaq 100 index is down close to 15% YTD, while the Utilities Select Sector index, made up of US-based communication services, electrical power providers, and natural gas distributor stocks, (sectors less reliant on funding and thus less exposed to interest rate fluctuation), is up close to 10% over the same period.[3] **A return divergence (an instance where the price of an asset is moving in a direction contrary to other data) of 25% between sectors after just one quarter is material.**

Chart 1: Rolling 3-month change in Bloomberg Global Aggregate Bond index



Source: Bloomberg 2022

1 Source of inflation data: Bloomberg
2 Based on Bloomberg Global Aggregate Bond total return index
3 Source: Bloomberg. Nasdaq 100 ticker is NDX, Utilities Select Sector index is IXUTR Index.

Inflation is impacting currencies through two primary channels.

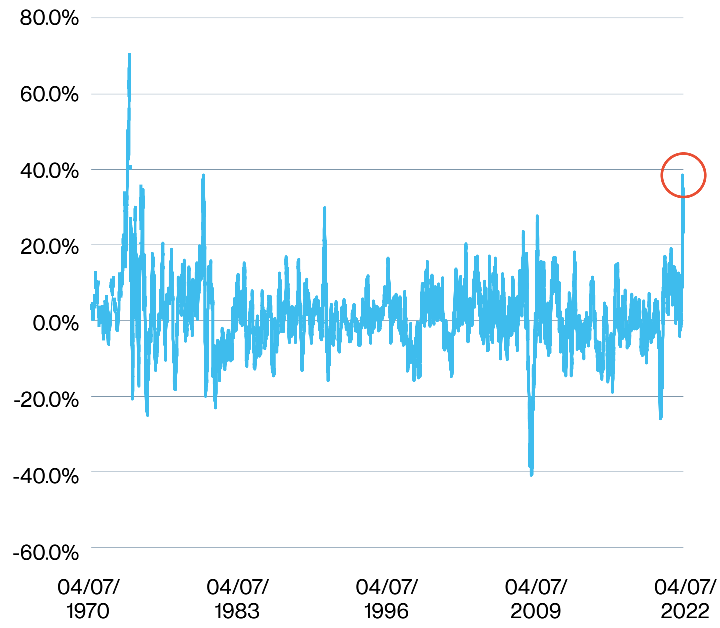
First, the rise in commodity prices, the magnitude of which has not been seen since the 1970's, is driving currencies of commodity-producing countries higher.

While the USD is up on the year, (DXY, +4.5%, BBDXY, +2.8%) the rise has not been uniform. Over the past year the existing commodity bull market was propelled by the Russian invasion of Ukraine. It also brought further tailwinds to the currencies of commodity exporters.

Sanctions on Russian commodity exports, a major source of global supply, added an additional level of scarcity to commodity markets and accelerated the trend of higher prices. Higher commodity prices may just be the beginning as we could be entering a new commodity super cycle (a sustained period of increasing commodity demand) fueled in part by the green energy transition.[4] **Watch for the return divergence to continue, or even accelerate if rates remain stubbornly low in funding currencies.**

> ... the rise in commodity prices is driving currencies of commodity-producing countries higher.

Chart 2: Rolling 3-month change in Bloomberg Commodity Index (BCOM)



Source: Bloomberg April 2022

4 https://www.economist.com/the-economist-explains/2021/06/02/is-a-commodities-supercycle-under-way

Second, rising global bond yields, coupled with central bank rate hike expectations, have rewarded the currencies issued by economies where rates have moved the most, in a relative sense.

The notion that higher interest rates signal greater concern about inflation, and thus the potential loss of purchasing power, is not at play at this stage. In other words,
the carry trade is back. Capital is flowing to places that pay the highest yields. In emerging markets, this means countries like Brazil, South Africa and Mexico are seeing some of this inflow.

Among developed economies, the US and Canada are paying much higher yields than Europe, Japan, Sweden, and Israel. Not surprisingly, the US and Canadian dollars are outperforming. Carry trades are strategies deployed by global investors in search of higher returns where capital originates in low interest rate countries and flows into high interest rate countries. The trade ends up being profitable provided the currency the investment is denominated in does not depreciate versus the investor's base currency, wiping out the nominal yield advantage. Carry trades may be expressed directly through bonds or yield-bearing instruments, or synthetically using derivatives. For most of the last decade, yields across the developed world have compressed to the point where carry trades were not compelling. This has changed, and the North American dollars are poised to benefit. Watch for this trend to continue as the central banks of lower yielding currencies remain slow or resistant to change policy course.

In other words, the carry trade is back. Capital is flowing to places that pay the highest yields.

Table 1: Currencies respond to commodity prices and higher interest rates

Country	Currency moves versus USD (YTD)	Change in key policy rate from COVID low	Key element driving strength / weakness (all changes YTD)
Brazil	18.60%	9.75%	Soybeans +26%, Iron Ore +38%
South Africa	8.70%	0.75%	Gold +7.9%, Iron Ore +38%, Platinum +2.8%
Colombia	9.64%	1.75%	Brent Crude Oil +42%
Australia	2.15%	0.00%	Iron Ore +38%
Norway	0.40%	0.75%	Brent Crude Oil + 43%
Canada	0.27%	0.75%	WTI Crude Oil +43%
India	-2.42%	0.00%	Reliance on oil
Switzerland	-3.12%	0.00%	Low policy rate: -0.75%
Israel	-3.58%	0.25%	Low: policy rate: 0.35%
Europe	-4.77%	0.00%	Low policy rate: -0.50%
Sweden	-4.90%	0.00%	Low policy rate: 0.00%
Japan	-8.58%	0.00%	Low policy rate: -0.10%

Quantitative insights

Investor pessimism rises and the USD outperforms when the yield curve inverts.

The yield curve in the US was officially inverted as of the close of business on April 1 of this year, which meant that 2-year bonds offered investors a higher return than 10-year bonds (provided the investment was held to maturity).

This was not an April Fool's Day joke, but rather an expression of divergent views about the future state of the economy. Bond investors were demanding greater compensation for a 2-year period due to concerns about inflation and the Fed's ability to reign it in. **Longer-term, fears of a US recession have kept 10-year yields in check relative to shorter tenors.**

Inverted yield curves, although occurring in violation of core finance principles that dictate that asset returns should be commensurate with risk, are not a rare phenomenon. Since the mid-1970s, there have been six previous episodes in which the yield curve has been inverted, for a total of 13.2% of all trading days. **Yield curve inversion signals pessimism about the future. Historical data on stock performance confirms this.**

The annualized return for holding the S&P 500 index[5] only on days when the curve was inverted was over 8% worse per year than passively holding the investment throughout the period (Table 2). Stated differently, a $1 invested in the S&P 500 index would be worth close to $45 today, dividends aside. If an investor was long stocks only on days when the 2- versus 10-year yield spread was negative (aka inverted yield curve), a $1 invested in 1976 would only be worth $1.13, pointing to severe underperformance. This is important to the innovation-sector as fundraising is more difficult when equity markets are soft. There is evidence of this phenomenon in Q1 2022 according to techcrunch.

The risk-off feature of yield curve inversion is also manifested in currency performance. The USD has served for decades as both the premiere central bank reserve asset and the top choice for general flight-to-quality asset allocation. The outperformance of the USD[6] on days when the yield curve has been inverted, versus all days, validates this (Table 3). In fact, **the split between positive versus negative return days tilts in favor of the USD** on this subset of days.

Table 2: S&P 500 performance over 1976-2022 historical period

	All days	Only days when yield curve was inverted
Annualized return	8.62%	0.27%
Positive return days	51.5%	50.2%
Negative return days	48.5%	49.8%

Source: SVB FX Risk Advisory, Bloomberg

... fundraising is more difficult when equity markets are soft.

Table 3: USD performance over 1976-2022 historical period

	All days	Only days when yield curve was inverted
Annualized return	-0.16%	1.21%
Positive return days	48.5%	52.1%
Negative return days	51.5%	47.9%

Source: SVB FX Risk Advisory, Bloomberg

The USD has served for decades as both the premiere central bank reserve asset and the top choice for general flight-to-quality asset allocation.

5 Source: Bloomberg SPX Index. Dividends are excluded for expository purposes.
6 Uses Bloomberg DXY Index to compute USD returns

Currency spotlight

A global rise in inflation and yields may mark a turning point for the yen.

As the rest of the world grapples with runaway inflation, Japan continues to face the same stubborn low growth and inflation as it has over the past two decades. High global inflation has caused a dramatic rout in fixed income markets, pushing yields much higher.

Japanese 10-year government bonds haven't been immune, selling off through Q1 from a yield of 8 to 25 basis points (0.25%). This move caused the Bank of Japan to curb the rise in yields at 0.25% by committing to buy unlimited amounts of JGBs (Japanese Government Bonds).

The yen was previously negatively impacted by wider yield divergences (versus the US) and imports of expensive commodities following Russian's Ukraine invasion. **With the BOJ committed to keeping 10-year JGBs at 0.25%, it must buy large amounts of bonds which puts more pressure on the yen to sell off. It's as if the BOJ is sacrificing the yen to keep JGB yields low.**

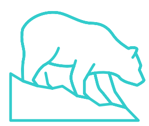
From March 11 to April 14, the yen has sold off 7%, sending the currency to 20-year lows versus the USD. In fact, over the last decade along, the yen has lost over 50% of its value versus the USD. This continued sell-off in the yen marks a potential change of course for the long time safe-haven and reserve currency and its multi-decade trend of strengthening against the dollar.

The yen should be closely watched for a safe-haven bid, or buying interest, if we see a traditional risk-off move (where equities sell-off and bond yields come down from recent highs). This would mean the safe-haven status would remain intact. Most of 2022 has seen stocks and bonds sell-off in tandem, (a deviation away from typical assumptions used for investment portfolio optimization) and if this continues, the yen's safe-haven status may be the biggest victim.

A drastic move lower could mark a turning point in the yen's declining role as a reserve currency. If one is looking for a country to keep as a reserve asset, why hold assets of a country with no significant natural resources, a limited army, poor economic growth, low to negative yields and a central bank which is enacting policy that directly weakens its currency? Markets may have to look beyond the yen as a barometer of risk-off sentiment in FX markets. Crypto may be emerging as a leading choice, one that is available 24/7.

The renminbi has held strong despite major headwinds.

Despite facing numerous 'negative' factors/events, the **Chinese renminbi has continued to rally over the past year (+2.8%)**. Headwinds include:

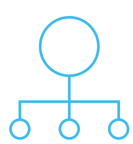


An equity bear market with the Shanghai/Shenzen CSI 300 Index down 22% from June 2021 highs.

A bursting property bubble with major real estate developers on the brink of default.

A COVID 'zero policy' closing cities of tens of millions of people and shutting down the economy.

Regulator apprehension towards currency speculators pushing a stronger CNY.[7]



A divergent monetary policy from the Fed versus the Peoples Bank of China.

7 https://www.bloomberg.com/news/articles/2021-11-21/china-fx-committee-urges-banks-to-cap- speculation-as-yuan-surges?sref=4rlaOYXw

Despite these headwinds, the Chinese currency has continued to benefit from a glut of foreign savings, resulting in strong inflows. Admission into the IMF's basket of SDR's in 2016 (international reserve assets created by the IMF to supplement the official reserves of member countries) has been a positive factor. Furthermore, the fundamentals, underpinned by a COVID-fueled export boom, have favored the currency, as have higher interest rates versus developed economies.[8] Relative to peers, 10-year **Chinese government bonds offer a yield advantage of 2-3%. This will continue to attract carry investors away from US, European, and Japanese assets and into Chinese bonds and cash deposits, potentially giving the CNY a larger role as a reserve currency.** Although still small (under 3%), global reserve assets denominated in renminbi are growing. This is happening at a time when the trajectory of the **US dollar's share of global exchange reserves is in decline, however, over 1 in 2 reserve assets are still denominated in USD.**

Despite being a top performing currency in 2021, the shekel poised to weaken.

Israeli shekel's weakening trend should continue over the medium term. In 2021, ILS was the world's top performing currency versus USD. It earned 3.5%, while most currencies lost value. This year, however, the shekel has struggled to make gains, and, in fact, it's declined in value (- 4.4% YTD) and looks likely to weaken more.

Multiple factors are making the shekel increasingly vulnerable:

Broad strength in the US dollar as a safe-haven currency amid heightened geopolitical risks with Russia and China, and soaring US interest rates/bond yields

The global sell-off in growth/ tech stocks (Israel is a tech-heavy economy) in response to rising interest rates and high volatility

Recent security tensions in Israel / rioting in Jerusalem

All eyes are on the Bank of Israeli (BoI). On April 11, the BoI hiked interest rates for the first time since 2018 – the benchmark rate was raised from 0.10% to 0.35%, greater than the market's expectations to 0.25%. The BoI said it acted in response to rising inflation (CPI at 3.5% YoY for March is a 10-year high) and housing prices (increased by 20% YoY in January & February) amid an economy that continues to register "strong financial activity" (Q4 GDP YoY at 17.8%) and a tight labor market (3.9% unemployment, the lowest in 2 years).

The bank signaled this was the start of a gradual tightening of its monetary policy. Traders are currently pricing in a further 150 bps in BoI rate hikes over the next 12 months. However, will this be enough to reign in inflation? Currency markets are not rewarding the shekel for being behind the curve on inflation.

8 A $1 Trillion Reason Why the Yuan Won't Collapse: China Today, Ye Xie, Bloomberg. 4/12/22

Trending topics

Cryptocurrencies gain traction, but have not delivered as inflation fighters or fiat currency replacers.

While the actual use cases have not been fully defined or adopted across the space, investor enthusiasm for cryptocurrencies in recent years has been fierce.

According to Binance (a cryptocurrency exchange), in 2021 alone, $9.3 billion poured into Bitcoin from institutional investors (a 36% increase from 2020).[9] Retail demand has also increased, as investors grow more comfortable with ownership via digital wallets. Coinbase's Super Bowl ad and the sponsorships of Crypto.com, FTX, and others in major US sports have helped. Finally, the **endorsements received in the form of investments into the space from legacy finance institutions further adds to a bullish outlook.**

However, what type of exposure do investors get from crypto holdings? We tracked the returns of Bitcoin versus the Nasdaq 100 (NDX), the Bloomberg Commodity Index (BCOM), and the US dollar index (DXY), as proxies for stocks, inflation and fiat currencies, respectively (Table 4). **The results suggest that in 2019 and 2020, as Bitcoin was gaining traction, correlations to other asset classes were low.** Last year as inflation pressures began to surface, bitcoin returns were materially associated (40% correlation) with commodity returns, which are a suitable proxy for inflation. So far in 2022, however, **bitcoin is trading less like an inflation fighter or fiat currency replacer and more like a leveraged high-beta stock** (with a 73% correlation to the Nasdaq 100 index – a good proxy for high-beta stocks).

Table 4: Correlation to bitcoin (XBT/USD)

	Nasdaq 100	Bloomberg Commodity index	US dollar index
Proxy for	High beta stocks	Inflation	Fiat
2019	-15%	0%	-4%
2020	16%	35%	-14%
2021	29%	**40%**	-9%
2022 YTD	**73%**	14%	-16%

Correlation coefficient calculations based off weekly returns. Reading above +/-30% considered material. Readings above +/-70% describe a strong presense of co-movement.

Source: Bloomberg, SVB FX Risk Advisory

9 Source: https://www.binance.com/en/news/top/6693616

Looking ahead

Reigning in inflation comes at the expense of supporting organic growth.

The prices of equities and other risk assets have adjusted lower based on this outlook. Some currencies, however, are enjoying phase 1 of this inflation cycle. This is the phase where interest rates rise faster than the loss of purchasing power. High-yielding currencies, currencies issued by commodity exporting economies, and the USD have done well as a result. If you're active in these currencies, we recommend refreshing budget rates to assess recent impact, and if warranted, taking action to remedy unwanted outcomes.

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