

# FX Navigator

## H2, 2022

Key insights and forecasts  
for the months ahead from  
our Foreign Exchange team.

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# Introduction

## The Times They Are A-Changin’



January opened the year with great expectations, as the world anticipated a welcome return to normal, even if normal is of a new variety following the pandemic turmoil. In the event the reality has been somewhat less sanguine. Early hopes for transitory inflation have been long forgotten as factors contributing to price pressures have multiplied and diversified across the globe, with much of the West experiencing levels of inflation not witnessed in the last four decades.



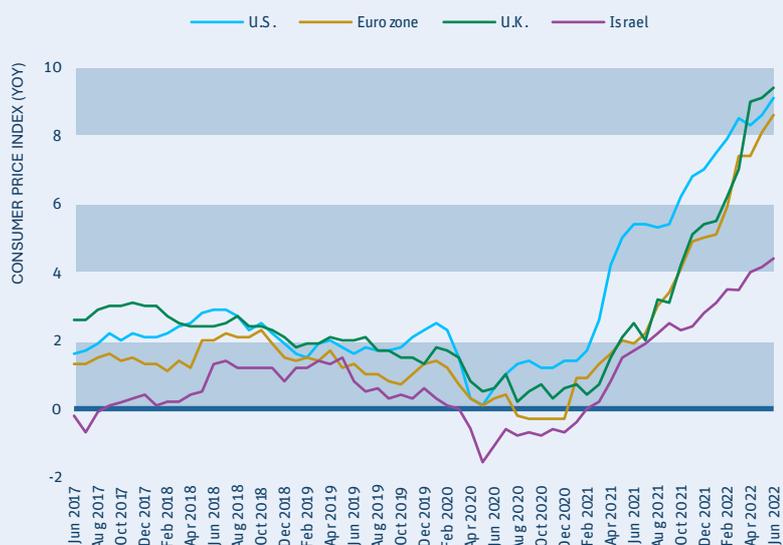
February saw the commencement of the Russia-Ukraine war, the largest military activity in Europe since the Second World War<sup>1</sup>. In response, Western governments subsequently sought to impose an economic penalty on Putin and his allies. A rewiring of much of the global energy markets began to take place, subsequently driving energy prices higher. The importance of Ukraine as a breadbasket for the world become apparent, as a negative impact on the country's capacity to ship exports has further amplified the commodity crisis.

As macroeconomic activity is buffeted by inflation headwinds, in addition to the broader economic questions posed by Russia's invasion of Ukraine, both monetary policy setters and governments are posed with a plethora of challenges. Central banks have sought to alleviate pressure through rate increases both realised and anticipated. This has driven divergent outlooks for economies, with the US dollar reigning supreme as investors sought both security and yield. The dilemma facing central bankers is determining their respective economy's capacity for forthcoming rate increases. Having already seen balance sheets rattled by the pandemic; how will the medicine compare with the disease?

**“Although difficult to define ahead of time, the next few months will represent a period of significant economic change.”**

At the industrial level, inflation is already beginning to stoke tensions. Different sectors feel the pinch of the last couple of years and are seeking to enhance their terms, catching up on ground lost to price growth. In combination with the potential for further energy bottlenecks in the winter ahead, governments and central banks will have their work cut out for them to successfully navigate ructions and maintain economic activity across many western economies. History suggests that US Federal Reserve rate increase cycles pose challenges beyond their borders too. Although difficult to define ahead of time, the next few months will represent a period of significant economic change.

**Inflation, a global problem<sup>2</sup>**



Source: Bloomberg Finance L.P. 2022

1. CNN 2. Bloomberg Finance L.P. 2022

# Numbers You Need to Know

-30%

Decline in NASDAQ tech index through H1 2022 <sup>3</sup>

2002

Last time EURUSD traded below parity <sup>4</sup>

59%

Share of USD in World Reserves <sup>5</sup>

3.6%

Global Growth Forecast, down from 6.1% <sup>6</sup>

95%

Increase in average US daily travel in 2022 compared to 2020 <sup>7</sup>

67%

Percentage of the global population that have received at least one dose of a COVID-19 vaccine <sup>8</sup>

<sup>3</sup>. Bloomberg Finance L.P. 2022, as of 15/07/2022 <sup>4</sup>. Bloomberg Finance L.P. 2022, as of 14/07/22 <sup>5</sup>. IMF – COFER, as of 14/07/2022 <sup>6</sup>. IMF – [WEO](#)  
<sup>7</sup>. US TSA, – Checkpoint Traveller Numbers as of 23/06/2022 <sup>8</sup>. WHO – Covid Vaccinations, as of 14/07/2022

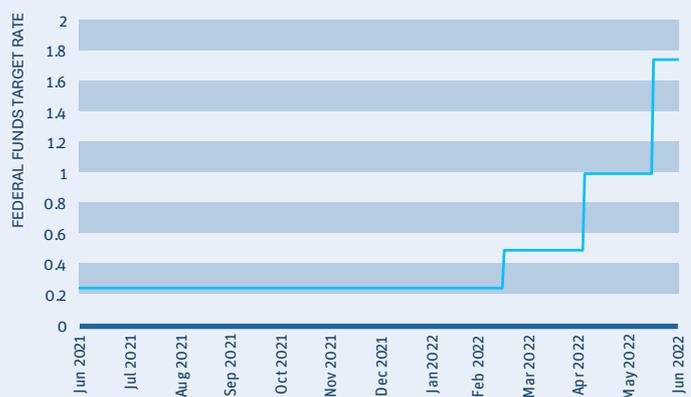
# USD Shelter from the Storm



After steadily climbing throughout 2021, the US dollar started the year on the front foot, strengthening against most major currency pairs, particularly as investors sought shelter from uncertainty evoked by the Russia-Ukraine war.

Since the start of the year, the US Dollar Index (DXY), which measures USD strength against a basket of currencies, has gained over 10%<sup>16</sup>. The challenging geopolitical climate and global inflationary pressures have spurred investors to flood to the safe-haven currency.

**A steep climb ahead**



Source: Bloomberg Finance L.P. 2022

# 9.1%

## CPI rose in June, the highest since 1981

Over the course of the year, the Federal Reserve (Fed) has been deliberating the speed at which to adopt interest rate increases and the pace and timing of such moves is significant in ensuring consumers and companies are able to stay afloat. On 27 July 2022, the Fed voted unanimously<sup>17</sup> to increase its benchmark interest rate by 0.75%, raising the federal funds target rate to 2.25% - 2.50%. The move, which is the fourth consecutive hike this year, extends the central bank's most significant try calm inflationary pressures. The FOMC (Federal Open Market Committee) and a number of economists are however concerned that rising rates too fast could push the economy into recession and are faced with a delicate balancing act, made even more real after the US recorded a technical recession in July.

The United States is currently experiencing the highest pace of inflation in over 40 years<sup>18</sup>. Many economists thought inflation had peaked when it fell to an 8.3% in April, however the CPI report then rose again to 9.1% in June<sup>19</sup>, the highest since 1981. The reopening of the economy was met with an increase in demand for goods as consumer spending remained resilient post-pandemic. Sustained retail activity<sup>20</sup>, paired with disrupted

supply chains and the Russia-Ukraine war have fuelled an increase in food and energy prices, leaving citizens to deal with a cost-of-living crisis.

Oil soared as high as \$130 a barrel in March<sup>21</sup> and although it has recovered, it still sits above \$105, levels not seen since 2014. The World Bank, Food Price Index, is currently sitting at 159.04<sup>22</sup>, up from last month, and up 24.6% from a year ago. A recent poll from the Pew Research Centre found that inflation is the biggest problem Americans believe the US faces right now<sup>23</sup>.

Last month the Fed Chair, Jerome Powell, vowed to keep raising rates until there was 'compelling evidence' of falling inflation<sup>24</sup>. June's CPI print signalled that the Fed is yet to gain control of runaway price growth with the number yet again beating forecasts. Fears that the Fed are behind the curve appear to be sustained, with most expecting an increasingly hawkish response from the FOMC. The swap market, often a reliable forecasting tool for the path of future interest rates, is currently undecided whether to expect a third

**“Since the start of the year, the DXY has gained over 10%.”**

consecutive 0.75% or a more dovish 0.50%-increase at September's meeting. Positioning<sup>25</sup> does however indicate that the Fed's hiking cycle will peak in the first quarter of the new year.

The greenback has benefitted from the hawkish Fed and geopolitical uncertainty this year, but how much further will this go? Should optimism return to markets, we could see the dollar retreat in response as investors rotate out of safe havens, however, the attraction to buy the dip is likely to remain for some time and provide support against significant depreciation. The main concern for market participants relates to monetary policy, if tightened too fast, the economy could be pushed into a recession.

### Food prices feel the pain of the commodity crisis



Source: World Bank, June 2022

16. Bloomberg Finance L.P. 2022 17. Federal Reserve FOMC – Meeting Minutes 18. U.S. Bureau of Labor Statistics 19. Bureau for Labour Statistics - [CPI Home : U.S. Bureau of Labor Statistics \(bls.gov\)](#) 20. [Bureau of Economic Analysis 2022](#) 21. Bloomberg Finance L.P. 2022 22. [World Bank 2022](#) 23. [Pew Research Center 2022](#) 24. Federal Reserve - Semiannual Monetary Policy Report to the Congress 25. Bloomberg Finance L.P. 2022

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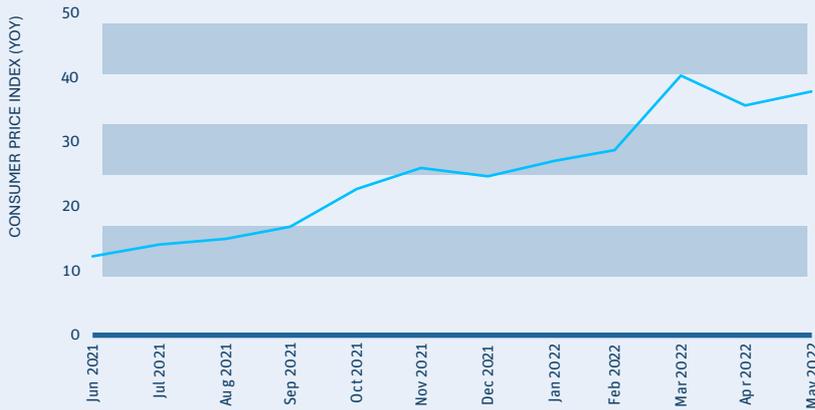
# EUR

## All the Way Down



The euro has come under significant pressure over the course of 2022, as monetary policy divergence and the Russia-Ukraine war have driven market sentiment. After starting the year at the 1.14<sup>13</sup> handle, the shared currency found itself at parity against its US counterpart. Central Bank peers push forward with consecutive interest rate hikes as the bloc struggles to shift from a negative interest rate environment to a positive one, while in parallel dealing with the fall-out from economic sanctions.

### Energy crisis across the bloc (Figure 1)



Source: Bloomberg Finance L.P. 2022

“On the decision to begin normalizing monetary policy, bond yields across the bloc started to surge, leading to concerns that flaws in the single currency may again be exposed.”

On the decision to begin normalising monetary policy, bond yields across the bloc started to surge, raising concerns that flaws in the common currency concept, may be exposed. Yields in Spain and Italy led the climb, forcing ECB president, Christine Lagarde, to introduce new anti-fragmentation tools to avoid further divergence between stable and more vulnerable sovereigns.<sup>14</sup>

sharp increase in commodity prices, (Figure 1) as EU countries heavily rely on Russian and Ukrainian supply (Figure 2).

The shock to commodity prices comes on top of an already strained supply chain network post-pandemic, with food shortages and rising inflation worsening the cost-of-living crisis and widening the income inequality gap, further complicating the policy decisions facing the ECB.

Financial sanctions have not just been imposed on high net-worth individuals, but ten Russian and four Belarusian banks have also been banned from the SWIFT network, as well as all transactions with the National Central Bank of Russia

being prohibited. The ruble weakened 80%<sup>15</sup> against the euro on the outbreak of the conflict, and despite ongoing new sanctions and frozen foreign currency reserves, ruble has reversed all of its losses and more up to the present day, with capital controls and high energy prices supporting the currency.

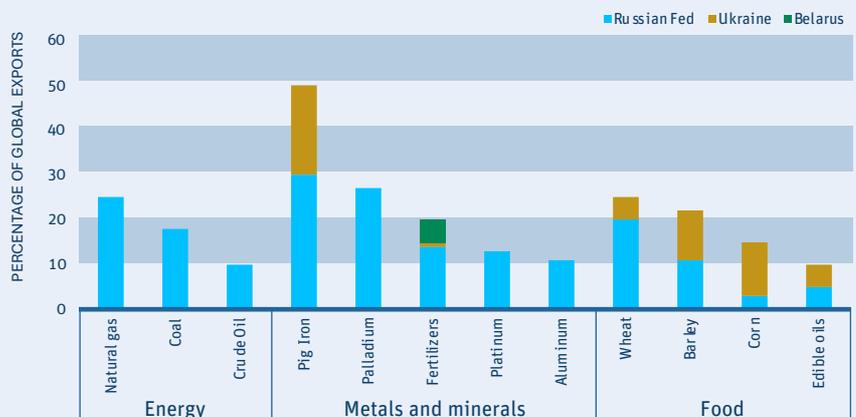
Whether a temporary reversal or a realignment, the impact of the euro reaching parity against the dollar for the first time in over 20 years will ripple throughout the bloc. An aggressive turn from the ECB may go some way to helping the shared currency rebound, however it is difficult to see confidence return while conflicts at the border remain.

20 years

The last time EURUSD was a parity

The political landscape across the bloc has been dominated by the ongoing Russia – Ukraine war and the subsequent economic impact of imposed sanctions. Six packages of sanctions have been imposed on Russia since the beginning of the war, including individual, diplomatic and economic measures. Economic measures have an ongoing disruptive impact on global markets, with trade restrictions leading to a particularly

### Russia and Ukraine's share of commodity exports (Figure 2)



Source: World Bank, April 2022

13. Bloomberg Finance L.P. 2022 14. European Central Bank 2022 15. Bloomberg Finance L.P. 2022

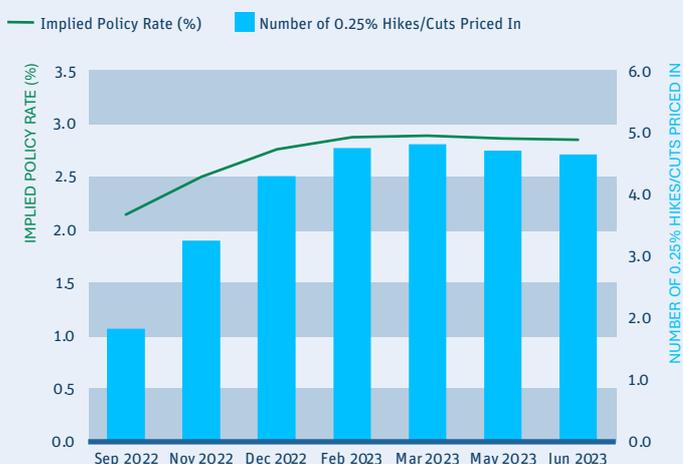
# GBP Like a Rolling Stone



Much like its major counterparts, sterling started the year with bounds of optimism. On the horizon was a long and stable government, a gradual path of interest rate hikes to tame inflation and a Brexit deal that would soon be a dot in the rear-view mirror.

Turn the page and expectations for the second half of the year are quite the contrast. Like many of its peers, the UK grapples with inflationary pressure, amplified by the impact disrupted supply chains are having across all corners of the economy. Brexit lingers and its impact continues to be felt across the labour market, as companies remain reluctant to commit to long-term projects without an unclouded vision of the future.

**Implied BoE base rate projection**



Source: Bloomberg Finance L.P. 2022, as of 04/08/2022

Since mid-January sterling has been on a slippery slope, consistently losing ground against its transatlantic counterpart, influenced by both geopolitical and domestic political events. Although less dramatic, the pound's appeal relative to the euro has also faded as the year has progressed.

7.17%

UK interest rates averaged from 1971 until 2022

Theory would suggest that as signs of a cost-of-living crisis and recession start to emerge, monetary policy would flex to support the economy, however the Bank of England's (BoE) toolkit is limited as markets have become accustomed to a low interest rate environment. Nevertheless, the Monetary Policy Committee has joined the US Federal Reserve (Fed) in committing to a rapid tightening cycle to get a handle on inflation while avoiding halting economic growth.

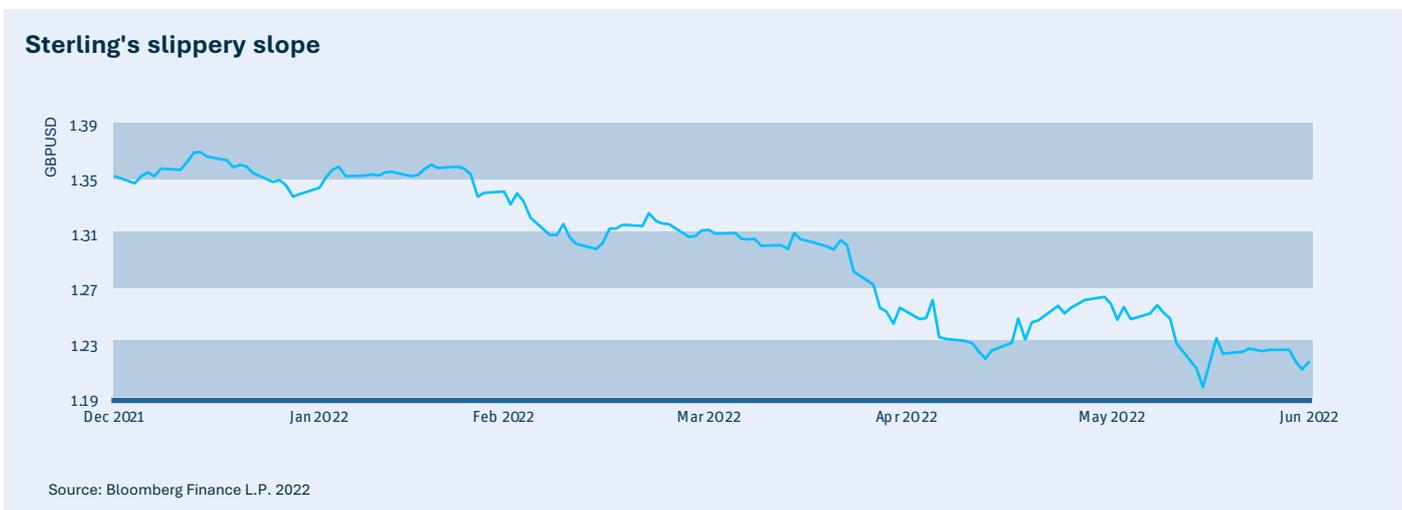
UK interest rates averaged 7.17% from 1971 until 2022<sup>9</sup>, reaching a high of 17% in November 1979 and a low of 0.10% in March 2020. The BoE base rate sits at 1.75%<sup>10</sup> and the Old Lady of Threadneedle Street currently walks a tightrope, raising rates to tame inflation without suffocating the economy. Current market positioning is for the base rate to reach 3%<sup>11</sup> across four further rate hikes (see chart). In tandem, the government is grappling with a cost-of-living crisis, likened to the turmoil seen in the 1970s, with the Chancellor's office cautious to provide surplus aid for fear of stoking inflation further, which has recently reached a rate of 9.1%<sup>12</sup>. On the other side of the table, public sector workers are voicing their disgruntlement regarding pay and threatening strike action, requests that come as the UK needs to address the debt burden incurred from the pandemic.

Boris Johnson resigned as prime minister after continued pressure from his own party and the process has now started for a new Conservative Party leader to be elected. The contenders have been whittled down to former Chancellor, Rishi Sunak, and Foreign Secretary, Liz Truss, with the new party leader and Prime Minister to be announced on 5th September 2022, a few weeks before the annual Conservative Party

“Market forecasts are for the base rate to reach 3% across four further rate hikes.”

conference. Alongside this, Brexit continues to rumble on causing headaches, with the UK government facing criticism over their handling of the Northern Ireland protocol and potentially stoking trade tensions with the EU. The next general election is not due until December 2024 and the new PM and government are likely to try and move the political and media agenda away from recent events and on matters such as the cost-of-living crisis and the war and humanitarian situation in Ukraine.

Sterling is likely to remain volatile into the second half of 2022. The market needs to digest developments and data from a range of variables including inflation, interest rate environment, the political landscape and a cost-of-living crisis. All this whilst the UK government tries to deliver on its promise to demonstrate the value that can be achieved by the UK leaving the European Union.



9. ONS 10. BOE - Interest rates and Bank Rate | Bank of England 11. Bloomberg Finance L.P. 2022 12. ONS

# ILS

## Tangled Up in Blue



2021 marked the third successive year in USD/ILS downward trend as relentless shekel strength continued to grind the pair lower, as the hi-tech nation continued to benefit from post-pandemic optimism. The low water mark for the year was set at USD/ILS 3.08 when the pair hovered around a two-year low.

To the benefit of the many companies operating within the tech sector, with local operating costs directly impacted by the USD/ILS rate, a clear reversal eventually took hold and the pair adopted a linear trend upwards, with a few minor blips on the way. Central bank intervention, valuation revisions within the tech sector and geopolitical tensions all played their part, with USD/ILS closing the first half of the year within touching distance of the key 3.50 handle.

Retracing old steps



Politics avoided the spotlight for most of the year, with Naftali Bennett remaining in office in accordance with the power-sharing arrangement with Yair Lapid. However, in June, the news broke that the nation would for the fifth time in less than four years vote for a new government. In true shekel tradition, the currency was unperturbed by the news and USDILS barely flinched. Elections will take place on 1st November 2022, with many expecting a broad coalition to be formed and have minimal initial impact on fiscal policy. Despite speculation growing that former prime minister Benjamin Netanyahu could be set for a return to office, shekel has historically been indifferent to politics and another shuffle within the Knesset is unlikely to change that.

The Bank of Israel (BoI), often a key player in keeping the brakes on shekel rallies took, by its own standards, a backseat so far this year, opting to slow the rate of its foreign currency purchases and allow its bloated balance sheet an opportunity to shrink, falling \$19bn year to date.<sup>26</sup>

With a shift away from its traditional drivers of currency strength, the second half of the year will test the shekel in a new manner. With the tech market facing increased downward pressure, valuation revisions and less pressure for the central bank to play a key role, forecasting enters unfamiliar territory. A lower inflationary environment provides the BoI with an advantage relative to its peers, with price growth lagging that of the US and Europe, affording the central bank more flexibility to act if necessary. This has been acknowledged by its governor, Amir Yaron, who recently indicated he was determined not to let inflation reach levels seen across Europe and the US.

**“Shekel has historically been indifferent to politics and another shuffle within the Knesset is unlikely to change that.”**

Should we see a recovery in tech and growth stocks, then it is likely the shekel will follow suit, potentially bringing the BoI back into play. However, if recession is indeed around the corner, the market could be testing the roof of USDILS rather than the floor for a change. Regardless of the direction, due to the sensitivity companies operating in the tech space have on USDILS, the pair will be closely watched.

0.50%

interest rate increase delivered by the BoI during July's meeting, the largest hike since 2011

Macroeconomic factors continue to play their part in the local currency market, with global sentiment around the tech sector plummeting throughout the first half of the year and foreign direct investment falling as a result. The economy has not been spared from the negative impact of the Russia-Ukraine war. Due to the significant presence of tech companies operating in Israel, the shekel has a natural exposure to market sentiment as the correlation between a selloff in tech stocks and the shekel is evident.

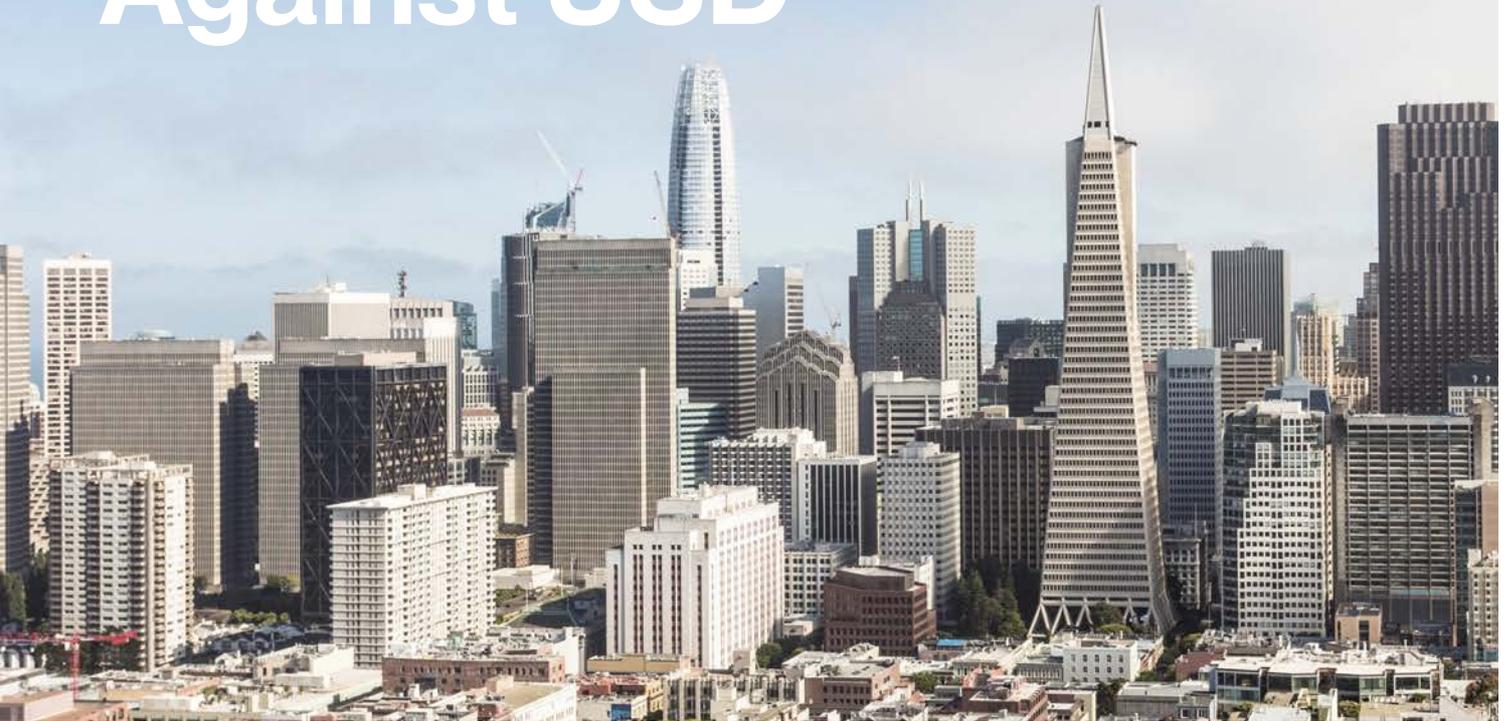
Tech sector, the leading indicator



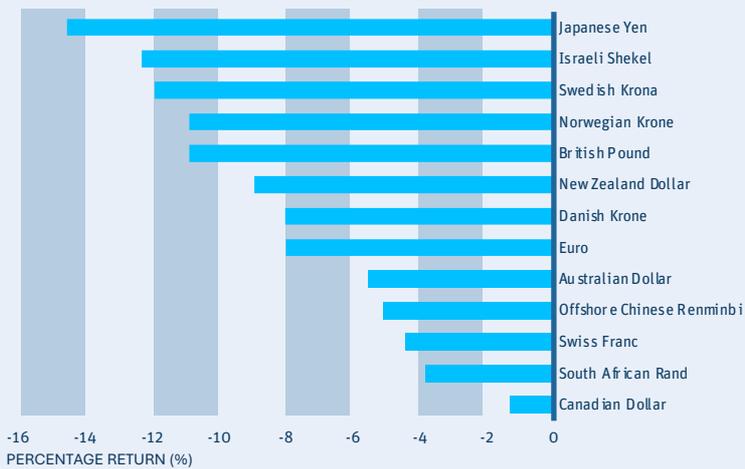
Source: Bloomberg Finance L.P. 2022, July

26. Bank of Israel 2022

# Returns Against USD



## Currency performance against USD



Source: Bloomberg Finance L.P. 2022, July



If you have questions or to discuss your specific risk management situation, contact your SVB FX Advisor directly or the SVB FX Team at [GroupFXRiskAdvisory@svb.com](mailto:GroupFXRiskAdvisory@svb.com).

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