FX Navigator
H2, 2022

Key insights and forecasts for the months ahead from our Market Risk Solutions 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.

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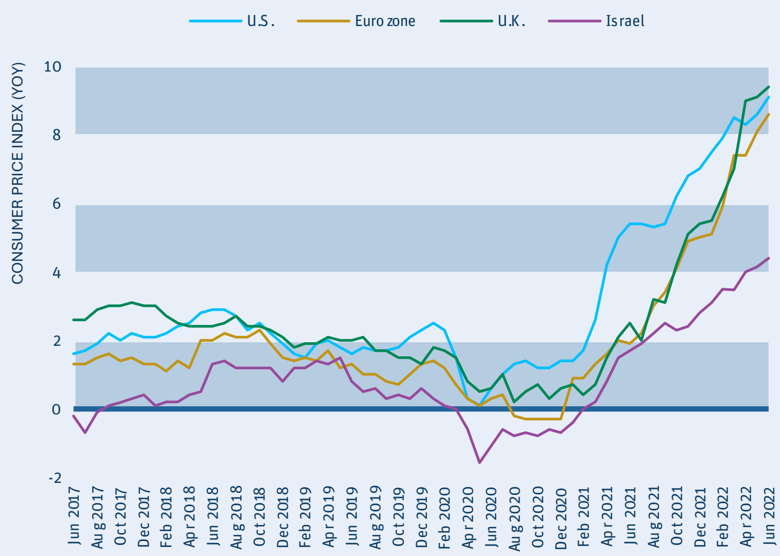
February saw the commencement of the Russia-Ukraine war, the largest military activity in Europe since the Second World War[1]. In response, Western governments subsequently sought to impose an economic penalty on Putin and his allies. A rewiring of much of the global energy markets began to take place, 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[2]



Source: Bloomberg Finance L.P. 2022

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

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Numbers You Need to Know

-30%

Decline in NASDAQ tech index through H1 2022 [3]

2002

Last time EURUSD traded below parity [4]

59%

Share of USD in World Reserves [5]

3.6%

Global Growth Forecast, down from 6.1% [6]

95%

Increase in average US daily travel in 2022 compared to 2020 [7]

67%

Percentage of the global population that have received at least one dose of a COVID-19 vaccine [8]

3. Bloomberg Finance L.P. 2022, as of 15/07/2022 **4.** Bloomberg Finance L.P. 2022, as of 14/07/22 **5.** IMF – COFER, as of 14/07/2022 **6.** IMF – WEO
7. US TSA, – Checkpoint Traveller Numbers as of 23/06/2022 **8.** WHO – Covid Vaccinations, as of 14/07/2022

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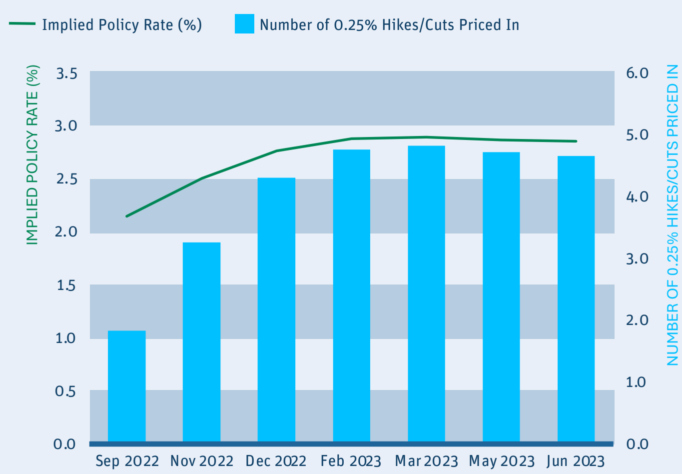
GBP
Like a Rolling Stone

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

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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.

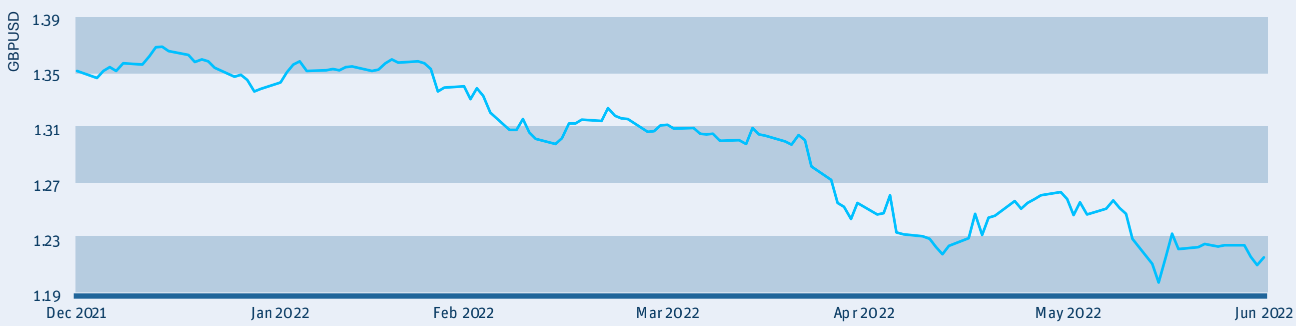
UK interest rates averaged 7.17% from 1971 until 2022[9], reaching a high of 17% in November 1979 and a low of 0.10% in March 2020. The BoE base rate sits at 1.75%[10] and the Old Lady of Threadneedle Street currently walks a tightrope, raising rates to tame inflation without suffocating the economy. Current market positioning is for the base rate to reach 3%[11] 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%[12]. 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 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.

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

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.

Sterling's slippery slope



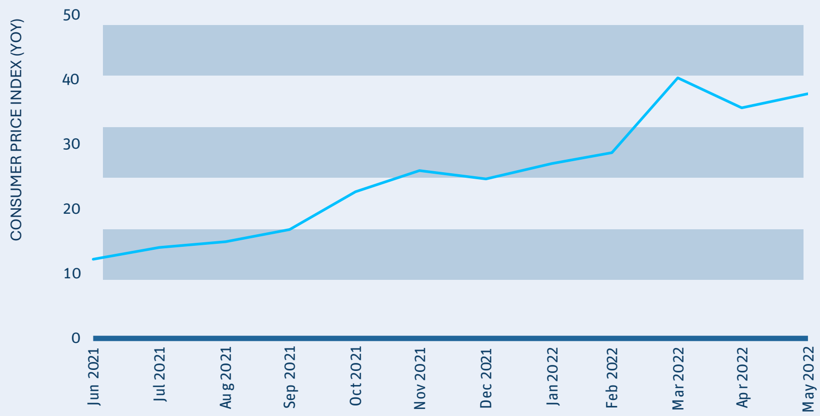
Source: Bloomberg Finance L.P. 2022

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

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[13] 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.[14]

20 years

The last time EURUSD was a parity

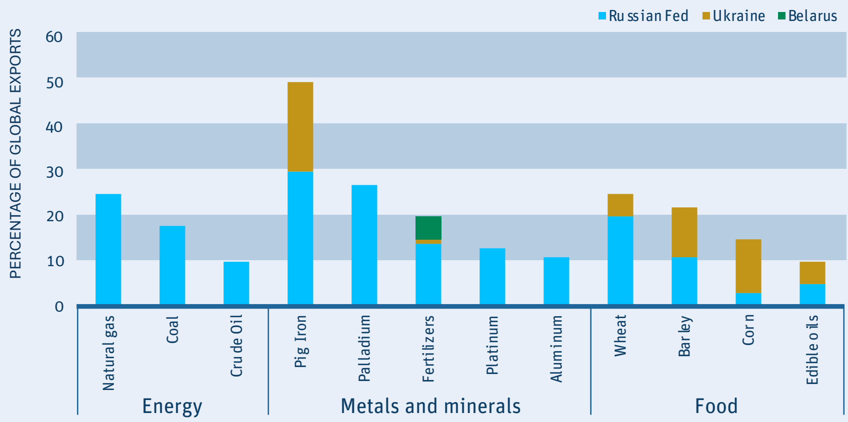
The political landscape across the bloc has been dominated by the ongoing Russia – Ukraine war and the subsequent economic impact of imposed sanctions. Six packages of sanctions have been imposed on Russia since the beginning of the war, including individual, diplomatic and economic measures. Economic measures have an ongoing disruptive impact on global markets, with trade restrictions leading to a particularly 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%[15] 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.

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



Source: World Bank, April 2022

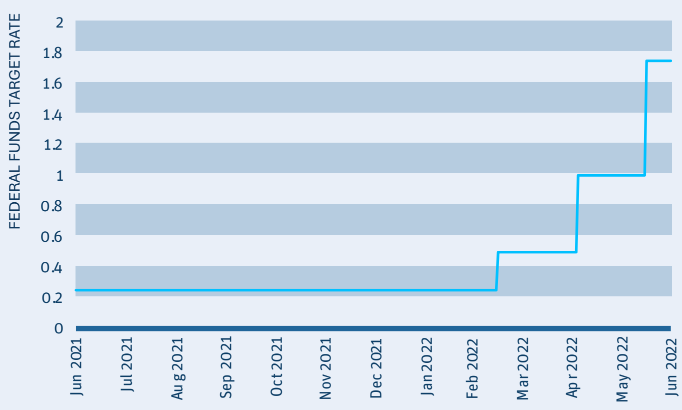
13. Bloomberg Finance L.P. 2022 **14.** European Central Bank 2022 **15.** Bloomberg Finance L.P. 2022

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%[16]. 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

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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[17] 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[18]. 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[19], 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[20], 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.

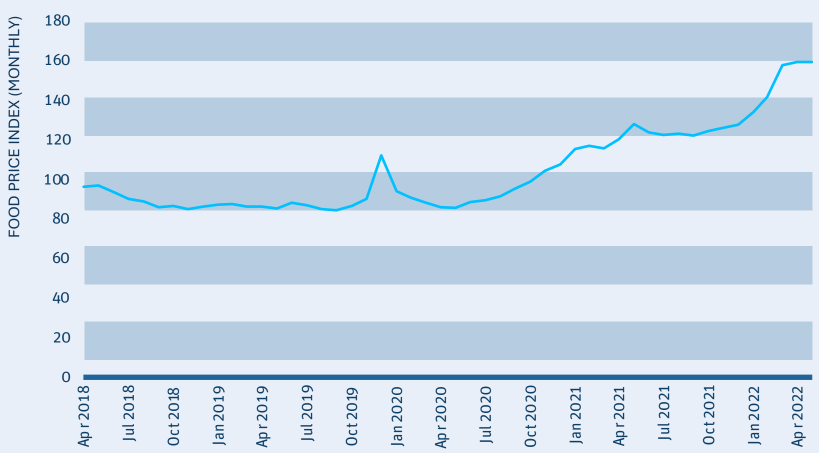
Oil soared as high as $130 a barrel in March[21] and although it has recovered, it still sits above $105, levels not seen since 2014. The World Bank, Food Price Index, is currently sitting at 159.04[22], up from last month, and up 24.6% from a year ago. A recent poll from the Pew Research Centre found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

Last month the Fed Chair, Jerome Powell, vowed to keep raising rates until there was 'compelling evidence' of falling inflation[24]. 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 consecutive 0.75% or a more dovish 0.50%-increase at September's meeting. Positioning[25] does however indicate that the Fed's hiking cycle will peak in the first quarter of the new year.

> **"Since the start of the year, the DXY has gained over 10%."**

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 deprecation. 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

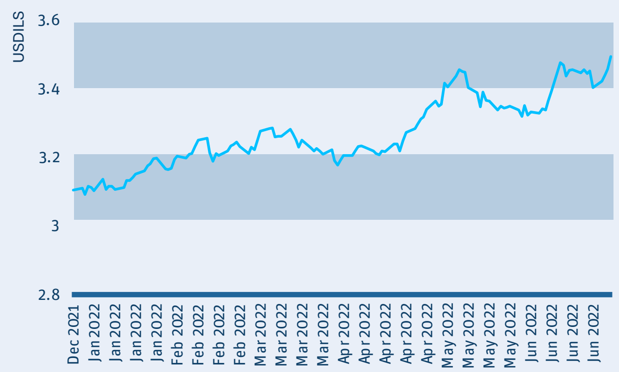
ILS

Tangled Up in Blue

2021 marked the third successive year in USDILS 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 USDILS 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 USDILS 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 USDILS closing the first half of the year within touching distance of the key 3.50 handle.

Retracing old steps



Source: Bloomberg Finance L.P. 2022, July

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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.

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.

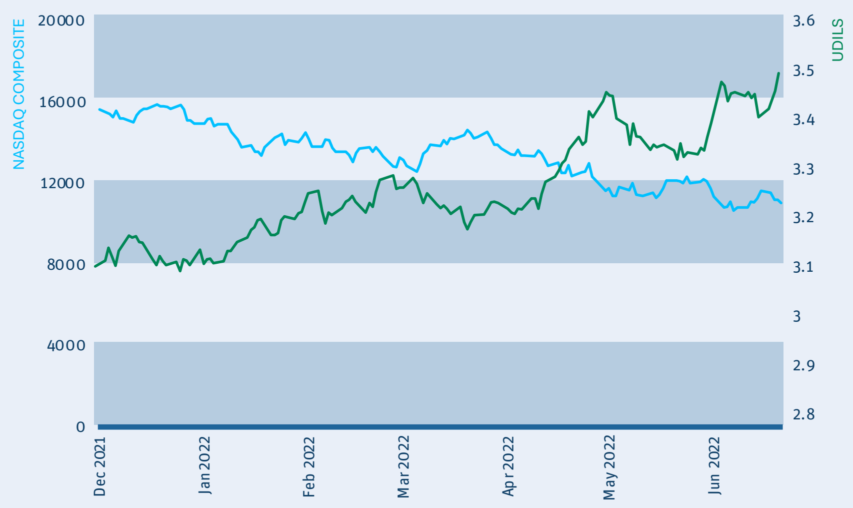
The Bank of Israel (BoI), often a key player in keeping the brakes on shekel rallies took, by its own standards, a backseat so far this year, opting to slow the rate of its foreign currency purchases and allow its bloated balance sheet an opportunity to shrink, falling $19bn year to date.[26]

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.

Tech sector, the leading indicator



Source: Bloomberg Finance L.P. 2022, July

26. Bank of Israel 2022

The Macro Lens
High inflation or low growth – The lesser evil?

Central banks across both developed and emerging economies have begun to battle inflation, no longer considered transitory as it is beginning to make its way into the stickier elements of the economy such as wages. The task at hand for central banks is tall for two reasons: First, central bank efforts may address demand-side inflation pressures, but not supply side aggravators such as trade and supply-chain disruptions. Second, policies aimed at fighting prices will, in parallel, cool economic output and growth.

50%

economic growth is projected to fall in 2022 by roughly 50% from growth registered in 2021, according to the IMF.[2]

The UK's economy unexpectedly shrank by -0.3% in April, after also having contracted in March[27], registering its first back-to-back declines since the COVID-19 closures in 2020. The United States is one negative GDP growth print away from officially being in a recession[28]. On a global scale, economic growth is projected to fall in 2022 by roughly 50% from growth registered in 2021, according to the IMF[29].

What we have in 2022 is rising inflation and deteriorating economic growth, a very bad combination that is very much on par with a high-calorie, tasteless dessert. Central bankers are hopeful for a soft-landing, a perfect manufactured deceleration of the economy that brings prices in check but one that avoids recession. Pull policy levers too hard or too little and we are left with one extreme, motivating the question, 'which is worse?' History suggests low growth is the greater evil.

SVB FX Risk Advisory carried out an empirical analysis to assess the 'health' of the economy when both inflation and growth have been stretched in either direction[30]. For the UK economy, we identified 32 of the 102 quarters since 1997 as being in one of four stretched states: high inflation combined with either high or low growth, and low inflation again combined with high or low growth[31]. The table below reports the average annual performance of the FSTE 100 for each stratum, as well as the overall performance for benchmarking purposes.

For both quarters so far in 2022, the UK economy has been in the 'high inflation/low growth' bucket, a situation commonly referred to as stagflation. This is the least desirable combination from those in the study, and thus it is no surprise that the 10 quarters are characterized by sharp equity market underperformance (average annual return of -8.6% versus +2.2% for all quarters[32]). The other end of the spectrum, the goldilocks scenario of low inflation and high growth, registers strong outperformance, also not a surprise. What is illuminating, however, is that stocks outperformed in the 'high inflation/high growth' quarters but underperformed in the 'low inflation/low growth' quarters. In other words, the data suggest that high inflation is fine, provided growth is strong. In general, stocks have struggled in periods characterized by low growth, even if supported by low inflation.

"Economies have shown greater resilience against high inflation, less so against low growth."

Developed economy central banks, including the BoE, the Fed, and the ECB have been criticized for displaying a level of complacency during the current flare up of inflation. For some, rate hikes did not come quick enough when the first signs of inflation began to show up in 2021, following the reopening of economies post pandemic. Now that inflation is here and rising, policy rates are currently below the rate of consumer price growth.[33]

The results of this study suggest their patience may have been warranted, especially in light of the strong employment picture. Economies have shown greater resilience against high inflation, less so against low growth.

FTSE 100 performance
1997 - 2022

	All QUARTERS	High inflation/High growth	High inflation/Low growth	Low inflation/High growth	Low inflation/Low growth
Average annual return	2.2%	15.2%	-8.6%	10.3%	-36.4%
Number of quarters	102	8	10	9	5

Notes

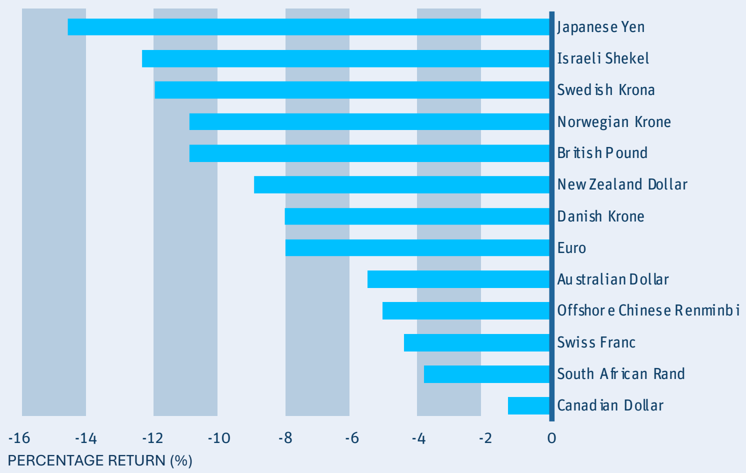
High inflation/high growth is defined as being above 70% percentile based on quarterly data from 1997-2022; Similarly, the economy is considered to exhibit low inflation or low growth if the reading is below the 30% percentile. Over the 25-year period analyzed, the UK economy has been in one of the 4 states defined in 32 of 102 quarters.

Data: Bloomberg, Analysis: SVB

27. Bloomberg Finance L.P. 2022 **28.** Bloomberg Finance L.P. 2022 **29.** World Economic Outlook, April 2022: War Sets Back The Global Recovery **30.** We use equity market over-or under-performance as a suitable proxy for the health of the economy. **31.** High and low defined as being above the 70th and below the 30th percentiles, respectively. **32.** Bloomberg Finance L.P. 2022 **33.** Measured by Consumer Price Index YoY. Bloomberg Finance L.P. 2022

Returns Against USD

Currency performance against USD



Source: Bloomberg Finance L.P. 2022, July

Your Market Risk Solutions team are on hand to help you navigate your FX requirements.

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