FX Navigator
H1 2023

Key insights and forecasts for the months ahead

Silicon Valley Bank

Contents

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Introduction
Another brick in the wall

The first quarter of 2022 opened with an air of cautious optimism, characterized by expectations for a slowdown in inflation and hopes that markets would resume their upward trend. This rapidly became a distant memory as global supply chains buckled, commodity prices soared, and central banks were faced with their fiercest battle with inflation in recent history.

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February was marked with the beginning of the Russia-Ukraine war, the largest military activity across Europe since the second world war[1]. While the world hoped for a swift resolution, global economies were shaken by the wider ramifications of the conflict, energy prices spiked, global trade slowed, both adding to the mounting inflationary pressures.

In response, central banks ramped up the pace of monetary tightening, moving full speed ahead in their quests to slow inflation. The Federal Reserve (Fed) led the charge, delivering seven consecutive interest rate hikes, with the Federal Funds Rate closing the year at 4.25 - 4.50%[2]. Elsewhere, the European Central Bank (ECB) finally moved away from penalising deposits to deliver its first rate hike since 2011.

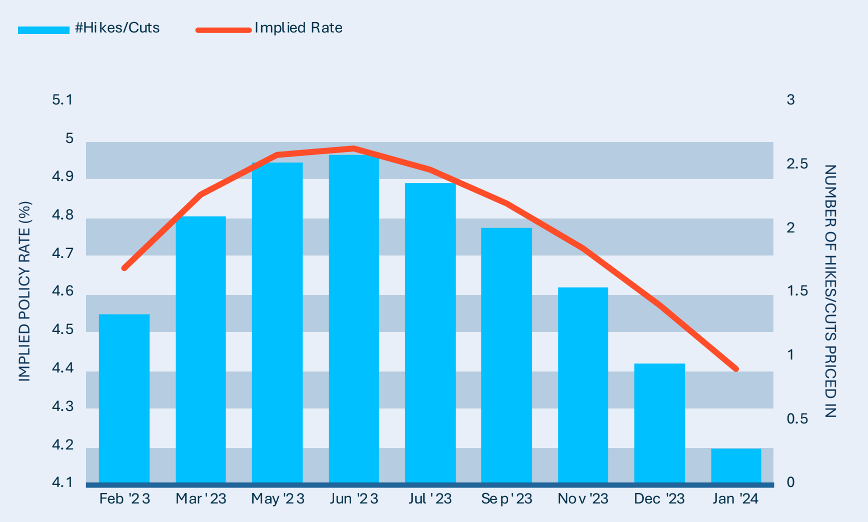
The new landscape prompted a risk-off attitude globally, sinking equity markets, boosting bond yields and pushing investors into haven assets. For currency markets, this translated into a stronger dollar across the board, with the Bloomberg dollar weighted index reaching a 20-year high.

“The new landscape prompted a risk-off attitude globally, sinking equity markets, boosting bond yields and pushing investors into haven assets.”

Warnings of an impending recession grew louder when year-end approached, as the impact of a higher interest rate environment prompted caution, despite labor statistics continuing to indicate a robust labor market. Purchasing Managers’ Indices (PMIs) headed towards contraction territory, while consumer confidence slumped in the face of uncertainty.

Historically, projections that forecast a fall in interest rates have been a bellwether for recessions, however there are some market participants who believe recent stock market corrections are simply a hangover from the longest bull market run in history. Regardless of direction, 2023 has enough economic and political headwinds to make it another memorable year ahead for both currency and wider markets.

US interest rate expectations



Source: Bloomberg Finance L.P. 2023

1. CNN
2. Bloomberg Finance L.P. 2023

Numbers you need to know

165

No. of days USD/ILS traded above 3.3 [3]

10.3%

Global Consumer Price Index (CPI) [4]

1.0350

Lowest GBP/USD Level [5]

€705.5bn

Sum spent by European countries in energy crisis (EU, Norway, UK) 29/11/2022 [6]

143

Days S&P500 has traded lower [7]

+227%

Price of Natural Gas compared to historic baseline higher than mean 2017-2022 [8]

4.97%

Fed's anticipated terminal rate [9]

3. [Bloomberg Finance L.P. 2023] As of 12/31/2022 **4. Organization for Economic Co-Operation and Development** [OECD] including energy and food As of 12/31/2022 https://data.oecd.org/price/inflation-cpi.htm **5.** [Bloomberg Finance L.P. 2023] As of 12/31/2022
6. [Breugal] As of 29/11/2022 https://www.bruegel.org/dataset/national-policies-shield-consumers-rising-energy-prices **7.** [Bloomberg Finance L.P. 2023 – S&P 500] As of 12/31/2022 **8.** Bloomberg Finance L.P. 2023] As of 12/31/2022 **9.** [Bloomberg Finance L.P. 2023, World Interest Rate Probability] As of 12/31/2022

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GBP
On the run

It has been a tale of two halves for the pound throughout the second half of 2022, with political turmoil and economic uncertainty taking centre stage. The pound started its decline in July, which saw the resignation of prime minister Boris Johnson after several cabinet members stepped down from their positions and spoke outwardly about the need for change. Liz Truss emerged as the new prime minister, after winning a head-to-head Conservative party member vote against Rishi Sunak.

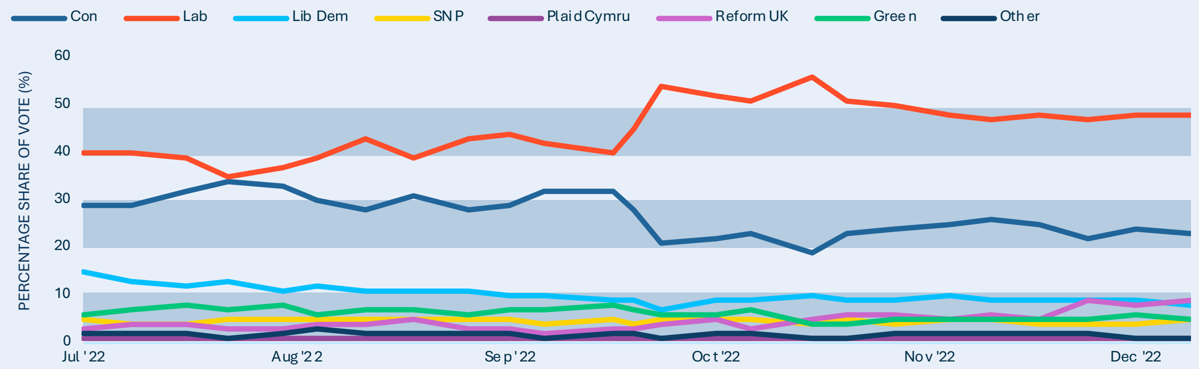
With tackling the deepening cost-of-living crisis and the rising interest rate environment top of her mandate, Liz Truss announced a new mini budget, designed to support households in managing inflation and rising energy bills. With the Bank of England (BoE) and Office for Budget Responsibility seemingly not prepped, market response was clear, with the pound and equities crashing further, as investors grew concerned over how the tax cuts would be funded. Sterling fell to record lows on the announcement, losing over 5% against the dollar to trade below 1.0700 for the first time since the 80s.[1] The Bank of England were forced to intervene to stabilise pension funds, buying government debt to stop their collapse.

"Sterling fell to record lows on the announcement of the mini budget, losing over 5% against the dollar to trade below 1.0700 for the first time since the 80s."

Following the turmoil, the new government received heavy criticism and a subsequent huge drop in the polls, with voting intentions shifting 10% in Labour's favour during the period. Liz Truss attempted to reclaim credibility, sacking Chancellor Kwarteng and allowing his replacement, Jeremy Hunt, to reverse the majority of the mini budget. Despite the attempt to regain trust, markets failed to recover until the eventual resignation of Liz Truss, confirming her as the shortest serving PM in modern history, managing only 44 days.[2] Sterling closes the year having reversed its losses, as the appointment of Rishi Sunak as prime minister led to some much-needed stability within markets.

The political landscape was not the only contributor to the direction of the pound. With a recession on the horizon, central bank interest rate decisions and controlling rising inflation became the key focus for markets. With inflation peaking at 11.1% in October, and GDP on the decline, the BoE raised rates consecutively throughout the year to sit currently at 3.5%, the highest rates in 13 years.[3]

UK voting intention



Source: https://www.politico.eu/europe-poll-of-polls/united-kingdom/ As of 12/15/2022

1. Bloomberg GBPUSD chart **2.** The 8 shortest serving UK prime ministers in modern history | Sky HISTORY TV Channel **3.** Interest rates and Bank Rate | Bank of England

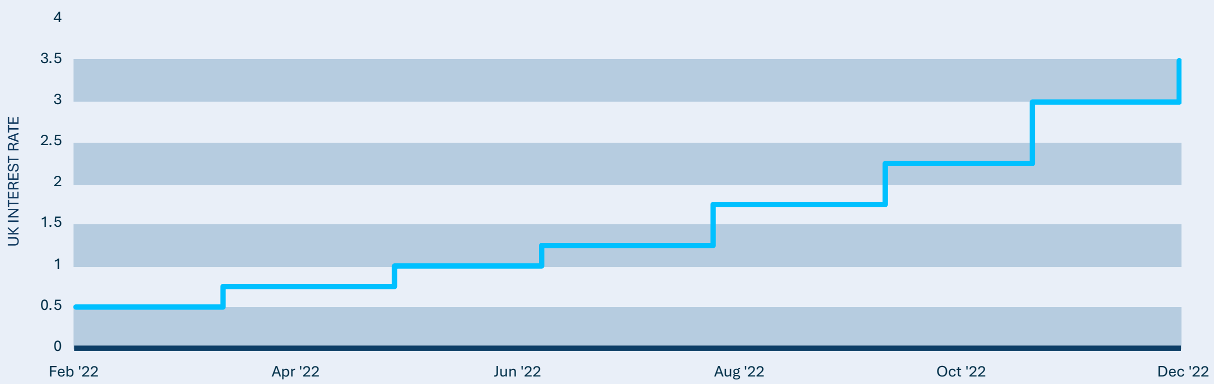
4.1%

Markets are forecasting further hikes throughout 2023, to reach an average peak of 4.1% mid-2023.

As its transatlantic counterpart, the Federal Reserve, slowed its pace of interest rate hikes towards the end of the year, the BoE followed suit, as soft economic data and ongoing stagflation concerns overshadowed the demand for aggressive hikes. With reports anticipating the recession to last throughout 2023[4], the longstanding effect on the economy and labor market continues to be at the forefront of the decision-making process. Markets are forecasting further hikes throughout the year, to reach an average peak of 4.1% mid-2023.[5]

Looking ahead, focus will turn to the impact of interest rate hikes and whether they have controlled the cost-of-living crisis. With inflation slowing in November,[6] markets will begin to question whether central banks have done enough, and the peak has already been seen. Politically, can Rishi Sunak and his team work alongside the BoE team to tackle recession and claw back the trust of voters?

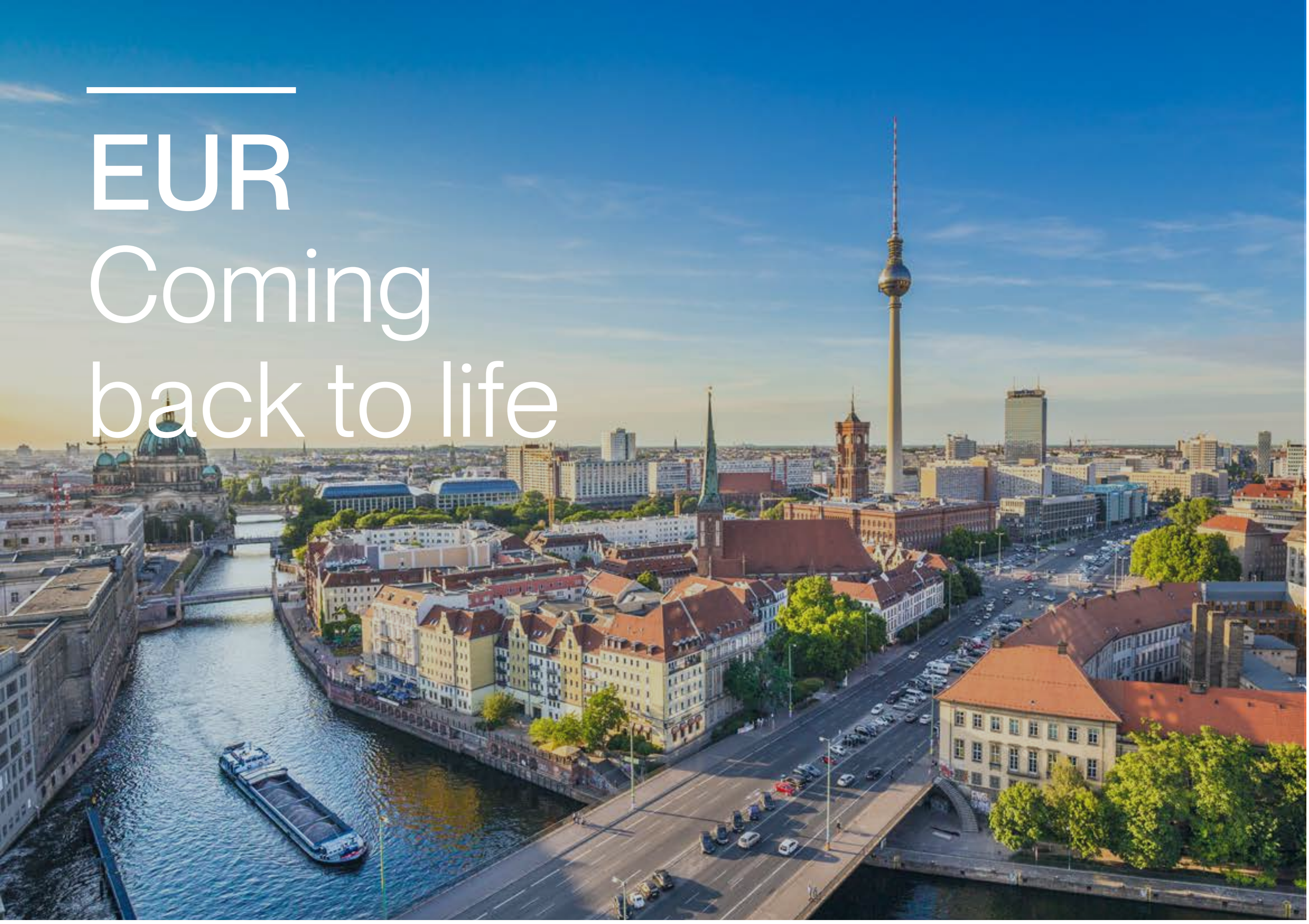
BoE's monetary staircase



Source: Interest rates and Bank Rate | Bank of England

4. Bank of England warns the UK will fall into recession this year | BBC News
5. Bloomberg ECFC **6.** Bloomberg UKRPCJYR

EUR
Coming back to life



The euro came under substantial pressure throughout 2022 as the ECB sluggishly kept pace with the Fed's aggressive policy tightening, which saw the euro trade below parity for the first time since 2002[1]. The outlook is shifting as the end of the Fed's hiking cycle approaches, with the euro recovering by 11.7% since September's lows[1]. Amid high inflation and a growing upward pressure on borrowing costs, the path to recovery is clouded with risk, with escalation in Ukraine or a surprise US recession able to regress the euro's rise.

1. Bloomberg Finance L.P. 2023

"Amid rampant inflation and war in Europe, the euro slipped below parity for the first time since 2002."

Since February, the political and economic tone across the continent has been heavily dictated by the Russia – Ukraine war which only exacerbated the issues faced by the euro-area as it mounts its post-pandemic recovery. As war continues to rage on, rampant inflation also continues to dominate both the fiscal and monetary agenda, prompting the ECB to press ahead with rapid tightening, raising the deposit facility from -0.5% to 2% in the last six months[2].

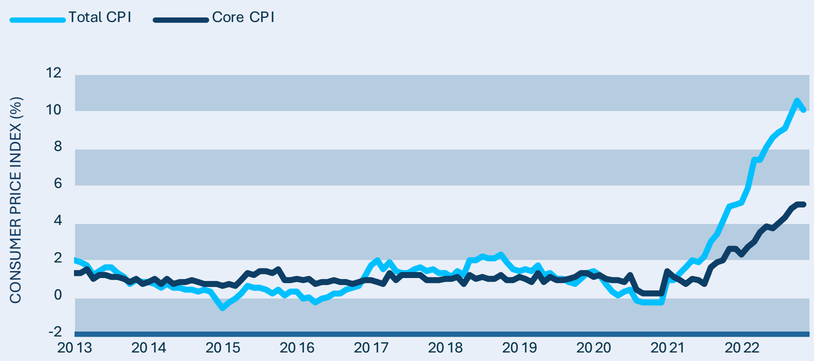
Inflation continues to resonate as the key talking point for markets, and this is no different in the euro-area. Headline inflation has edged away from record highs in November, falling from 10.6 to 10.1%[3]. Meanwhile core inflation could prove more persistent as it remained unchanged at a record high of 5%[4]. This is likely driven by higher manufacturing costs trickling through to consumers, whilst wage inflation turbocharges services inflation.

The fear of rising inflation expectations continues to trump recession worries for the markets and the ECB's governing council. Wedged between the pressure of soaring inflation and a weakening economy it is anticipated that the ECB will continue with interest rates rises through 2023[5]. This could suggest some upside for the euro through the first half of 2023, as the end of the Fed's hiking cycle approaches. As the ECB presses ahead, it will have to act delicately to ensure higher borrowing costs don't push bond yields too high and trigger a repeat of the debt crisis seen after 2008.

It's no doubt that the Russia – Ukraine war has weighed against European growth through this year, however some of the risks may have been alleviated. In 2021, the EU has imported 83% of its natural gas[6], and the subsequent exposure to higher spot prices and bloc-wide efforts to protect consumers has led government funding to soar past €700 billion by December 2022[7]. Energy driven volatility may be more muted moving forward, the bloc's dependence on gas imported from Russia has fallen from 41.2% to 17.2%[6] which might lessen the impact of Russian escalation on the euro-area economy and the euro.

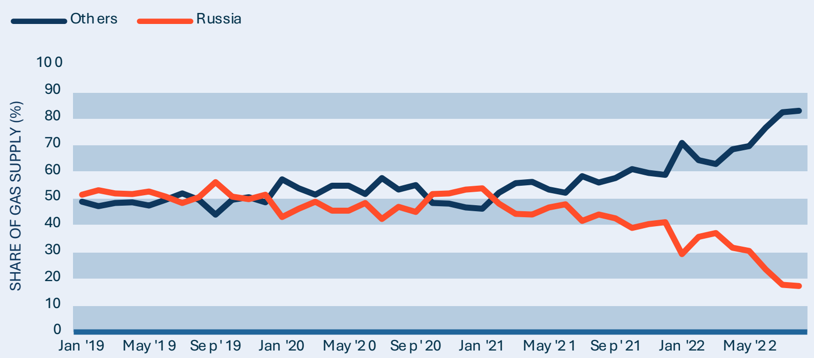
The euro's recovery hangs in the balance and uncertainty is likely to dominate early in 2023. To facilitate an aggressive euro recovery towards the $1.10 handle, several factors are in play. Cooling inflation, easing geopolitics and a Chinese reopening could all stoke the flames of a euro resurgence. Nonetheless surprises to the downside could easily tilt the euro back towards parity.

Trending lower?



Source: Bloomberg Finance L.P. 2023

Changing supplier



Source: https://www.consilium.europa.eu/en/infographics/eu-gas-supply/

2. ECB Deposit Facility – Bloomberg Ticker EUORDEPO Index **3.** Euro-Zone Consumer Price Index – BBG CCPEMUY Index
4. Euro-Zone Consumer Price Index (Exclud. Food/Energy) – BBG **5.** Bloomberg Finance L.P. 2023, World Interest Rate Probability
6. https://www.consilium.europa.eu/en/infographics/eu-gas-supply/
7. https://www.bloomberg.com/news/articles/2022-12-18/europe-s-1-trillion-energy-bill-only-marks-start-of-the-crisis?leadSource=uverify%20wall

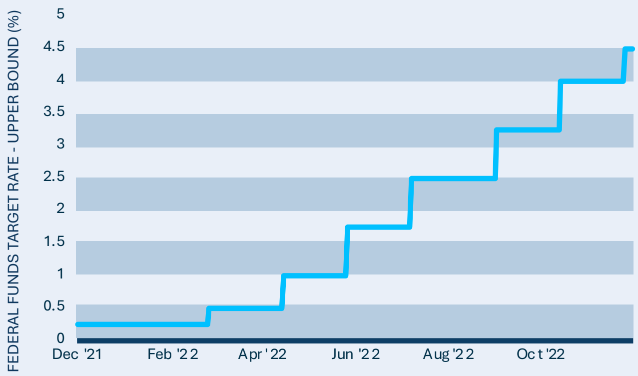
USD
Us and them

2022 has been a remarkable year for the greenback. The end of September saw the dollar index reach its highest level since 2002, and since then the safe-haven currency has fallen more than 9%.

The success of the dollar this year can be attributed to several factors; the Fed's rapid response in hiking rates with the goal of taming inflation, the European energy crisis and China's zero Covid policy. All of which caused investors to seek shelter from the storm in the form of USD.

Over the past 20 months inflation has surged globally, with US consumer prices increasing 9.1% YoY in June, the largest increase in 40 years fuelled by a surge in oil and commodity prices[1].

Mind the gap



Source: Bloomberg Finance L.P. 2023

1. Bloomberg Finance L.P. 2023

5%

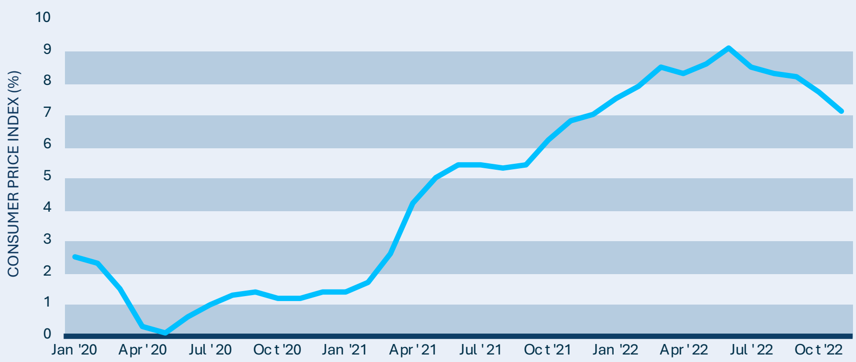
Markets anticipate that the Fed will slow down and eventually stop hiking around 5% by mid-2023

The Fed kicked off the global hiking cycle, being the first major central bank to tighten monetary policy in March in response to rising inflation, and since then, has increased rates six more times to arrive at an Upper Bound target rate of 4.5%. Five out of the seven increases this year were unanimous, indicating the strong hawkish tone coming from the central bank[2].

As inflation looks likely to ease into next year, the Fed has indicated that they will slow down and eventually stop hiking at around 5% by mid-2023[3]. With its annual rotation of voters, it has been argued by some, including Bloomberg Economics[4], that the Fed's voting members are likely to be become more dovish in 2023, with three typically hawkish members (Bullard, Mester, and George) losing their voting rights, whilst a dove (Goolsbee) and two centrists (Harker and Logan) will enter the voting party.

Over the past two years, inflation has surged globally to levels not experienced in almost 40 years. After reaching its peak in June at 9.1%, US inflation has begun to ease, and market experts anticipate it to fall gradually throughout 2023 to around 4.2%[5]. However, there have been times over the past two years where markets expected it to fall, only for it to surge higher yet again, a concern reiterated by Fed Chairman Powell - "We've continually expected to make faster progress on inflation than we have, ultimately." Most of the recent slowing of inflation has been the result of falling energy prices. An easing of supply constraints and recessionary dynamics support a fall in inflation in 2023. However, demand will remain strong and is therefore expected to support inflation above the 2% Federal Reserve target.

A welcome reversal



Source: Bloomberg Finance L.P. 2023

2. Bloomberg, Federal Reserve Snapshot, 2022 **3.** Aratani, L. "How high did US inflation get this year and where is it headed in 2023?" *The Guardian*. 26th Dec. 2022. https://www.theguardian.com/business/2022/dec/26/inflation-explainer-2023. **4.** Bloomberg L.P. (2022) *US INSIGHT: Doves to Gain More Traction on FOMC in 2023*. 12/01/22. Retrieved from Bloomberg terminal. **5.** Bloomberg L.P. (2022) *US Consumer Price Index (Annual YoY %) Forecast*. 01/09/23. Retrieved 01/09/23, from Bloomberg terminal.

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> "US consumer prices increased 9.1% YoY in June, the largest increase in 40 years."

Two years after the Democrats won the Presidency, the first test of political support for Biden and his party arose at the US midterm elections in November. The Republicans were able to take control of the House of Representatives, after they passed the threshold of 218 seats, whilst the Democrats managed to retain control of the Senate by gaining the state of Pennsylvania[6]. The defeat in the race for the Senate highlights the poor performance of the Republican party against the historical trend for mid-term opposition performance.

The year ahead will likely be difficult to predict. Investors are expecting a recession to occur, inflation to eventually moderate and the Fed funds terminal rate to peak around 5%[7], which should all contribute to a stronger dollar. The year ahead doesn't come without downside risks for the greenback. If the Fed climbs down from its hawkish policy stance as expected, we could see a return of monetary policy divergence if rate expectations in the UK and euro-zone continue to rise in parallel. This could see a reversal in much of the dollar strength, which was the primary theme throughout much of 2022.

King Dollar

Source: Bloomberg Finance L.P. 2023

6. G. Wright, BBC News. 2022 (US midterms: Democrats retain control of Senate after key Nevada victory - BBC News)
7. Forbes https://www.forbes.com/sites/simonmoore/2022/12/14/fed-now-sees-rates-topping-5-in-2023/

ILS
High hopes

2022 opened with USD/ILS trading around a two-year low as a resilient economy continued to translate into a stronger currency. Fast forward 12 months and the downward trend has now turned into a rebound. The pair closed the year above the key 3.50 barrier and the shekel recorded its worst performance against the dollar since 1998 as its correlation with US equities continued to dictate direction. Due to the concentration of the tech sector within Israel and a large proportion of companies having operations locally and collecting revenue globally, movements in the exchange rates had an amplified effect on the local market.

0.5%

0.50% Interest rate increase delivered by the BoI at the January 2023 meeting

Over the past four years, Israel has become very familiar with completing a voting ballot, with five elections taking place in this time. The results saw the return of Benjamin Netanyahu to the helm, celebrating his sixth term in office, after his Likud party formed one of the most right-wing coalitions in Israel's history. Again, ILS demonstrated its indifference to politics, remaining largely unperturbed by the developments within the Knesset.

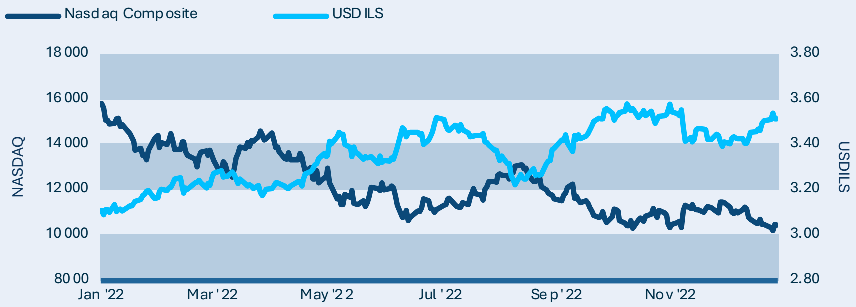
The Bank of Israel (BoI), previously a key player in keeping the reigns on shekel rallies, remained on the sidelines throughout the year trusting market equilibrium and allowing its relatively bloated balance sheet the opportunity to shrink as the central bank kept foreign currency reserve purchases to a minimum. In contrast, governor Amir Yaron has made reference to a weaker shekel and the subsequent impact it has on inflation, indicating that the central bank is prepared to intervene should the pressure prove too much. Historically, a strong shekel has remained a key factor in keeping inflation under control.

To kick off 2023, the BoI increased its benchmark interest rate to the highest level since 2009, delivering a 0.50% hike to reach 3.75%.[1] The Monetary Committee also hinted that rates are likely to remain elevated for some time.

With some market participants forecasting a deceleration in growth as opposed to a contraction, which most of the developed world is bracing for, the Israeli currency could be set to benefit from some outperformance. However, if the tech sector continues to face a confidence crisis and investor optimism depletes further, USD/ILS may be set for another year losing ground to its US counterpart should its correlation with the US equity market continue to hold.

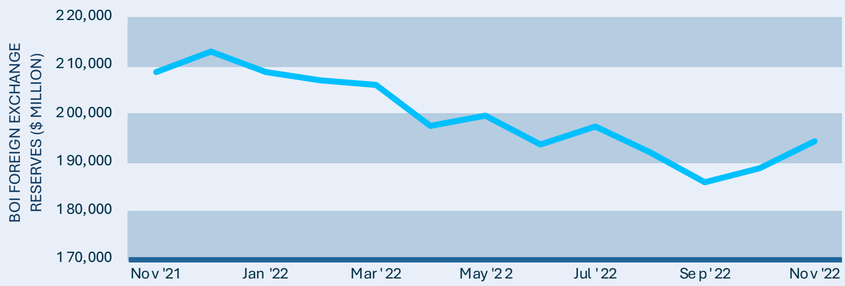
"Historically, a strong shekel has remained a key factor in keeping inflation under control."

Correlation of Tech Sector and USD/ILS



Source: Bloomberg Finance L.P. 2023

Trimming the Balance Sheet



Source: https://www.boi.org.il/en/communication-and-publications/press-releases/foreign-exchange-reserves-at-the-bank-of-israel-november-2022

1 The Times of Israel, Jan 2, 2023

The macro view

We start 2023 closer to the end than the beginning of the global rate hike cycle.

In notable ways, that will be important in understanding the full ramifications in the year ahead, as the current monetary policy episode has been unlike previous others.

First, most central banks were late in responding, as the first signs of inflation were deemed to be transitory effects of COVID-19 economy re-openings. When it turned out that price pressures were not transitory, rate liftoff came at a fierce pace, the fastest in decades[1]. All the while, central banks have operated with questionable independence, seemingly under the political spotlight and under tremendous pressure not to be perceived as being complacent. Furthermore, the task this time around has faced structural challenges from the start. Central banks can address demand-side price pressures, but the current flare-up in inflation was primarily driven by supply-side pressures resulting from pandemics and geopolitics[2]. And finally, today's hawkishness comes after more than a decade of ultra-loose policies and cheap money, which propagated sky-high prices in well-understood assets such as stocks, bonds, real estate, credit, as well in some of the newer and murkier corners of the investment world including crypto and monkey jpegs[3].

The severity of today's tightening is then, to a certain degree, a byproduct of the policy mistakes of yesterday.

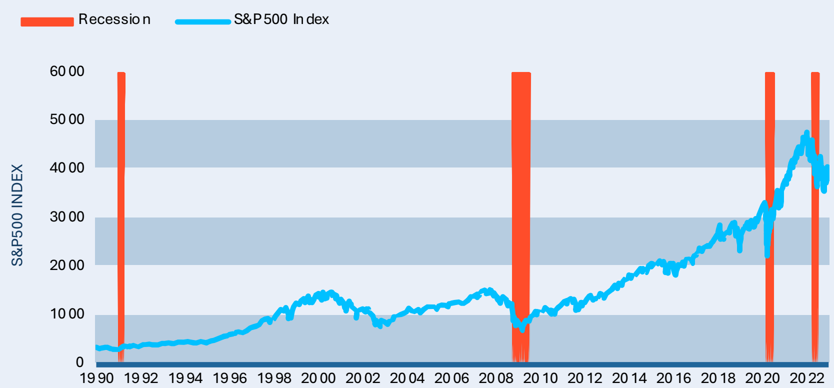
Two questions remain.

Inflation, while not yet tamed, has most likely peaked as the contributions from key culprits - supply chain disruptions, energy supply shocks, stimulus-induced consumer spending – have waned. But where will it settle? Even a sizeable 50% retracement from the consumer price index reading highs posted in 2022 in the US, UK, and Europe[4], would result in inflation plateauing in the 4-5% range, about double the central banks' targets. In such a macroeconomic reality, interest rates will likely remain higher for longer[5].

And two, what will the impact of more expensive money be on the global economy? Central banks have engineered demand slowdowns to manage down price pressures. Economic contraction is therefore inevitable, but recessions are probable as tightening has gone on for longer than many expected since central banks were late to get started, operated under great scrutiny, measured progress by focusing on backward looking metrics, and assumed the responsibility of undoing the excesses of previous policies. The re-opening of China complicates the picture somewhat. On one hand, this important development represents a strong tailwind to global trade and economic output. However, in the end, this may turn out to be an inflationary spark, as the Russia-Ukraine crisis turned out to be, further forcing the hand of central banks.

In closing, market volatility is likely to persist in the year ahead. Central banks may have overtightened when the rate cycle is done. When growth does eventually slow, we cannot count on central banks to bail us out with accommodative policies. The cheap money era is dead and buried. And if history is a guide, asset prices may not yet have bottomed. For US recessions dating back to the 1990s, the S&P 500 index hit its cycle low after the start of the recession[6]. Global businesses and investors will need to adjust to a new normal where capital has a cost that is more aligned with risk, and one where equity investments will have to compete with deposit rates for investor capital.

Crash and rally

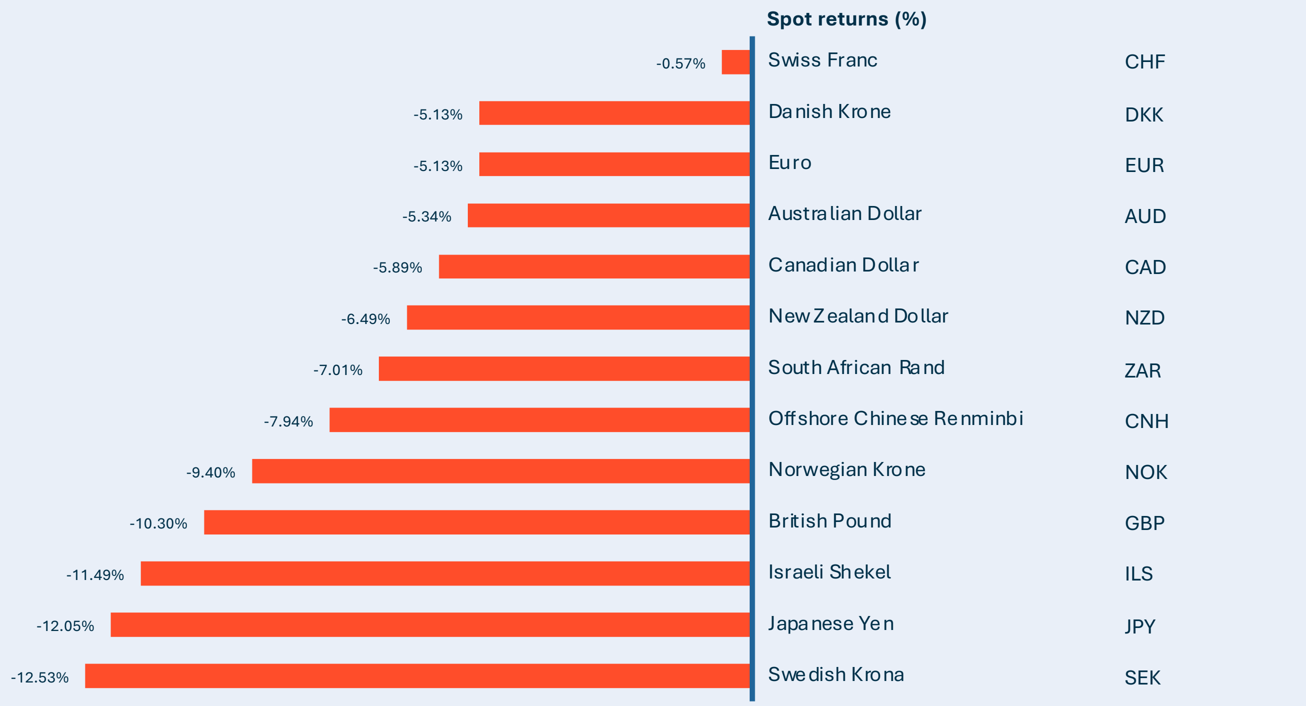


Source: Bloomberg Finance L.P. 2023

1. https://www.visualcapitalist.com/comparing-the-speed-of-u-s-interest-rate-hikes/
2. https://www.frbsf.org/economic-research/publications/working-papers/2022/18/
3. https://www.reuters.com/lifestyle/set-bored-ape-nfts-sell-244-mln-sothebys-online-auction-2021-09-09/
4. Source of data: Bloomberg **5.** Bloomberg Finance L.P. 2023, World Interest Rate Probability
6. Source of data: Bloomberg. Does not include the brief technical recession of 2020 following the COVID-19 breakout.

Performance against USD

Currency performance against USD



Source: Bloomberg Finance L.P. 2023

Disclosures

Foreign exchange transactions can be highly risky, and losses may occur in short periods of time if there is an adverse movement of exchange rates. Exchange rates can be highly volatile and are impacted by numerous economic, political and social factors as well as supply and demand and governmental intervention, control and adjustments. Investments in financial instruments carry significant risk, including the possible loss of the principal amount invested. Before entering any foreign exchange transaction, you should obtain advice from your own tax, financial, legal, accounting, and other advisors and only make investment decisions on the basis of your own objectives, experience and resources.
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