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FX Quarterly Update

Q4 2022

Core Macro Themes

At the December 14 policy meeting, the U.S. Federal Reserve (the Fed) unanimously raised the base borrowing rate by 50 basis points (bps) into the 4.25%–4.50% target range. The base rate is now firmly in restrictive territory as a part of a continued effort by the Fed to slow inflation. Since June, the Fed has raised rates by 75 bps at each of the four preceding meetings. Even though the Fed pulled back on the size of the December rate increase by 25 bps, the Fed's "dot-plot" and the press conference following the announcement were both viewed as slightly more hawkish than expected. The dot-plot summary of the Fed's economic projections points to a terminal Fed funds rate of 5.1%. This is the level, once reached, at which the Fed is expected to stop raising rates.

The big question facing the markets at year-end is how quickly the Fed will get to a 5% terminal rate and how long it will keep rates at that level before beginning to cut them. Markets could be too optimistic in predicting a Fed pivot, currently signaled by overnight index swap (OIS) curves in the latter part of 2023. If inflation continues to be sticky, the Fed may sustain the 5% terminal rate for longer than predicted, even in a slow-growth environment. To reinforce this potential scenario, and contrary to market sentiment, the Fed is signaling no rate cuts until 2024. Fed Chair Jerome Powell has reiterated that the market will have to experience some economic pain to get inflation under control and back toward the Fed's target inflation rate of 2%.

Looking to 2023

As the new year begins, growth is slowing, and Fed policy is no longer accommodative. With employee wage growth and household balance sheets being strong and healthy (per U.S. Bureau of Labor Statistics), consensus from industry analysts points to a mild recession in the first half of 2023. There have also been signs that Fed policy is having some of the desired effect on inflation. The decrease in the rate of inflation, or deflation, that we saw at the end of 2022 is being driven by a decline in the core price of goods and commodities. However, core services prices and rent costs of primary residences have yet to turn around.

Looking overseas, Europe's recession is expected to be deeper and broader than the U.S. slowdown. Any Eurozone economic recovery in 2023 will be uneven and take longer to unfold. China's recovery has the potential to sputter as well. COVID cases on the Chinese mainland and among Chinese travelers have been increasing as the government begins to lift restrictions.

2023 disrupters

Economic risk should be skewed to the downside per market experts if U.S. consumer balance sheets weaken along with real estate markets. Borrowing costs remain high for U.S. homebuyers as mortgage rates ended the year at roughly double where they were from the start of the year. Home prices are beginning to adjust lower because of decreased demand. Globally, China could assert its territorial claims on Taiwan, risking the start of an Asian conflict to mirror a European one. Lastly, escalation in the Russia-Ukraine war could further disrupt global food and energy supplies.

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Key Economic Data by Country

Country/ Region	Base Interest Rate	Budget Balance (% GDP)	Trade Balance (bn fc)	Current Account Balance (% GDP)	Consumer Price Index (YoY)	Unemployment Rate	GDP (QoQ)
United States	4.50%	(5.06%)	(78.20)	(3.74%)	7.10%	3.70%	3.20%
Eurozone	2.50%	(2.91%)	(28.32)	(0.31%)	10.10%	6.50%	0.30%
U.K.	3.50%	(4.04%)	(1.79)	(4.24%)	10.70%	3.70%	(0.30%)
Canada	4.25%	(12.50%)	1.21	(0.29%)	6.80%	5.10%	2.90%
Japan	(0.10%)	(5.51%)	(1,732.27)	2.42%	3.80%	2.50%	(0.80%)
Australia	3.10%	(0.38%)	12.22	1.00%	7.30%	3.40%	0.60%

U.S. Dollar

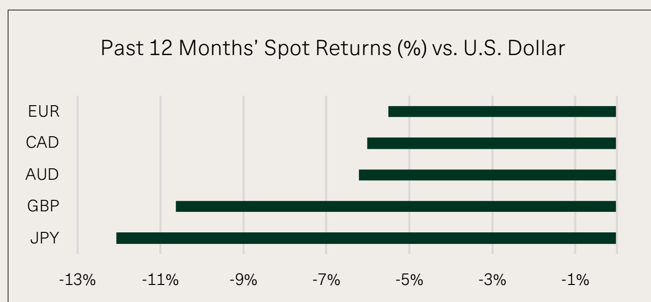
Mapping a new course

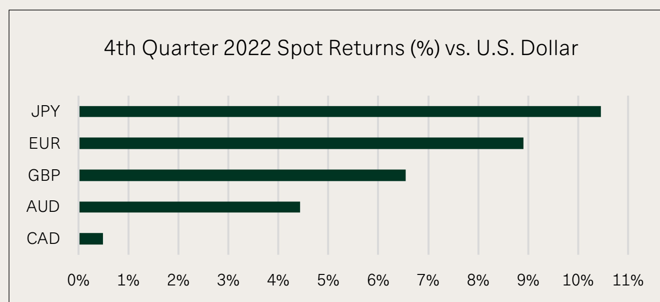
Even with a small pullback to end the year, the U.S. Dollar strengthened against every G10 currency in 2022. U.S. Dollar strength was directly correlated with an aggressive Fed that raised the base interest rate from 0.25% to 4.50% over seven meetings in 2022. The 425 bps of rate increases were delivered over seven meetings between March and December to battle U.S. inflation driven primarily by a hot economy, tight labor market and associated higher wages. As inflationary pressures accelerated, the Fed responded with four consecutive 75-bp increases over the summer and fall. Global interest rate differentials favored the U.S. Dollar for the majority of the year as the Fed remained on a steady path of monetary policy tightening.

Heading into 2023, markets are expected to be more data dependent than ever. Investors will be looking for signs of easing in inflationary pressures with hopes that the Fed's restrictive policy has not done too much damage to economic growth. With two better-than-expected Consumer Price Index reports in a row to end the year, the Fed may be forced to acknowledge progress being made on the inflation front. Inflationary data points are starting to connect to form a positive narrative as freight rates and factory lead times are also falling. Wage pressures should also ease with declining job openings causing sticky wage-push inflation to become less of a threat.

The Fed's evolving approach to interest rate policy will be a major determining factor in the path of the U.S. Dollar in 2023. At the December meeting, the Fed was content with a smaller rate increase but positioned itself aggressively with hawkish forecasts and rhetoric. This two-sided approach may be to create some space for the Fed to maneuver as they approach peak policy rates. The Fed has more room to raise rates while the labor market is still strong and the economy hasn't quite turned as it will be much harder to raise rates in a recession.

Powell seems dismissive of the thought that there will be any rate cuts before the end of 2023. Market participants seem a bit more impatient, calling for the Fed to raise rates quickly to a 5% terminal rate and then begin cutting rates in the second half of 2023. The Fed is showing to be much more patient in letting demand decrease to better align with supply. These opposing views between those that set policy and those that trade from it could lead to volatility in the U.S. Dollar in the first quarter of the year.





Currency Forecast

		1Q 2023			2Q 2023			3Q 2023			4Q 2023		
Country	Currency	Low	Mean	High	Low	Mean	High	Low	Mean	High	Low	Mean	High
Eurozone	EUR/USD	**0.96**	**1.03**	**1.09**	**0.95**	**1.04**	**1.11**	**0.98**	**1.06**	**1.15**	**0.98**	**1.08**	**1.15**
United Kingdom	GBP/USD	**1.09**	**1.18**	**1.23**	**1.10**	**1.19**	**1.26**	**1.13**	**1.20**	**1.28**	**1.11**	**1.22**	**1.31**
Canada	USD/CAD	**1.30**	**1.36**	**1.42**	**1.28**	**1.34**	**1.43**	**1.25**	**1.33**	**1.41**	**1.23**	**1.31**	**1.43**
Japan	USD/JPY	**128**	**137**	**148**	**125**	**134**	**151**	**120**	**132**	**150**	**118**	**130**	**148**
Australia	AUD/USD	**0.63**	**0.66**	**0.70**	**0.60**	**0.67**	**0.72**	**0.62**	**0.69**	**0.76**	**0.64**	**0.70**	**0.78**

Key Events Calendar

Country	Central Bank Meeting	GDP	Trade Balance	Consumer Price Index	Employment Data
United States	2/1/2023	1/26/2023	1/5/2023	1/12/2023	1/6/2023

Source: Bloomberg FX Forecast Contributors Composite, as of December 31, 2022.

EUR/USD

Putting a foot on the gas pedal

The European Central Bank (ECB) raised rates by 50 bps in mid-December, immediately following the Fed's similarly sized hike. Contrary to the Fed decision, which was unanimous for a 50-bp increase, more than 1/3 of ECB policymakers favored a 75-bp hike. In her press conference immediately following the announcement, ECB President Christine Lagarde emphasized that a decision to hike rates by 50 bps does not signal a slowing down of rate increases in 2023. She made it clear that the smaller rate increase in December was not an ECB pivot on the upward trajectory of the base rate and that markets should expect the continuation of the base rate at a higher level to battle inflation. Lagarde is seen as talking the toughest among the central bank heads.

The ECB commenced rate increases slower than the Fed but looks to finish stronger in this cycle of monetary tightening. Over 2022, the ECB increased the base borrowing cost by 250 bps, raising rates at the final four meetings of 2022 to bring the base rate to 2% at year-end. While material, this is compared to 425 bps of increases by the Fed over the same period of time. Some European policymakers are saying that the ECB is only halfway through the tightening cycle. These comments are more aggressive than the consensus expectations that the terminal rate will reach 3% next year, which is evidenced by recent adjustments in the OIS curve. Markets are currently pricing in 50-bp hikes in both February and March. The question remains whether this series of additional hikes in 2023, coupled with a planned reduction in bond holdings, will be enough to satisfy the ECB's more hawkish members.

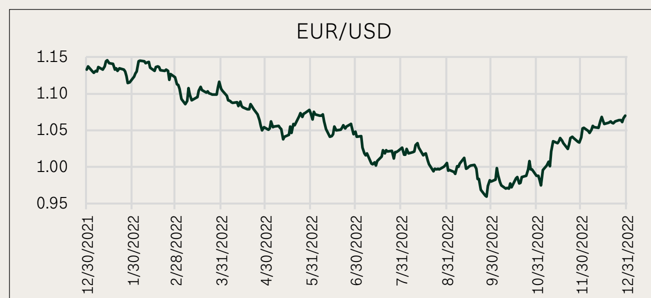
The narrative is forming that the ECB is going to have to continue to raise rates in the face of slowing European economic growth. The ECB still holds the view that the risk of doing too little to bring inflation back down outweighs the risk of exacerbating the current slowdown. Eurozone inflation, driven by higher food and energy costs, peaked in October at 10.6%. Core inflation, which excludes food and energy costs, remains sticky as well. Inflation is forecasted to be above the ECB's 2% target in three years, justifying a more hawkish approach. Ultimately, the expectation for higher rates traditionally supports the underlying currency, a positive for the Euro.

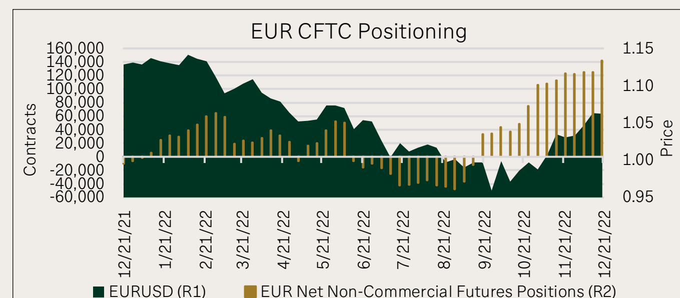
Technical Commentary: The Euro rebounded this quarter after trading below parity in the back half of the third quarter. A hawkish ECB keeps the Euro supported as markets prepare for continued outsized rate hikes from the ECB in the beginning of 2023. The ECB has delivered 250 bps of rate hikes this year, its fastest on record, while European governments have provided €200bn of support to the economy. Markets are anticipating a shallow recession next year, a consequence of higher borrowing costs and the Russia-Ukraine war, which has kept gas prices sharply elevated in the winter months. EUR/USD trades above all major moving averages, and common monthly price action shows oversold conditions. One standard deviation move in EUR/USD provides a range of [1.02/1.12].

Current Indicators

CFTC Trader Commitments (Noncommercial Contracts)				
Date	Long	Short	Net	Signal
12/20/2022	249,149	106,877	142,272	EUR Strength
Prev Week Chng	12,734	(4,823)	17,557	EUR Strength

1-Month Risk Reversal (EUR Calls vs. EUR Puts)				
Date	1M 25D Call	1M 25D Put	1M 25D RR	Signal
12/30/2022	8.462	8.962	(0.500)	EUR Weakness





Key Events Calendar

Country	Central Bank Meeting	GDP	Trade Balance	Consumer Price Index	Employment Data
Eurozone	2/2/2023	1/31/2023	1/13/2023	1/18/2023	1/9/2023

Source: Bloomberg, as of December 31, 2022.

GBP/USD

Taking an alternate route

The Bank of England (BOE) followed the ECB and Fed by raising rates by 50 bps in mid-December, bringing the U.K. base rate to 3.5%. Having raised rates by 325 bps over 2022, the BOE rate at 3.5% sits squarely between the ECB at 2.5% and the Fed at 4.5%. December BOE had their ninth consecutive meeting where they raised rates, bringing the base rate to its highest level in 14 years. However, juxtaposed to the Fed and the ECB, the BOE looks almost dovish. It was revealed in the December meeting minutes that two members of the Monetary Policy Committee, which sets policy rates, voted against any hike at all. This split in voting on the nine-member committee has painted the latest BOE move as a dovish hike.

While inflation is public enemy No. 1 in the eyes of the ECB and the Fed, falling household disposable incomes and depressed living standards have put a U.K. economic recovery as the top priority for the BOE in determining monetary policy in the new year. As economists expect the U.K. to be stuck in a recession for most of 2023, the BOE seems especially concerned about overtightening and will look for signs of cooling in the red-hot U.K. labor market. A slowing of inflationary pressure, emanating from elevated private sector pay in 2023, may mean that the base rate reaches its peak terminal rate at a lower level than originally forecasted. Current expectations are for the base rate to peak at 4.25% before midyear.

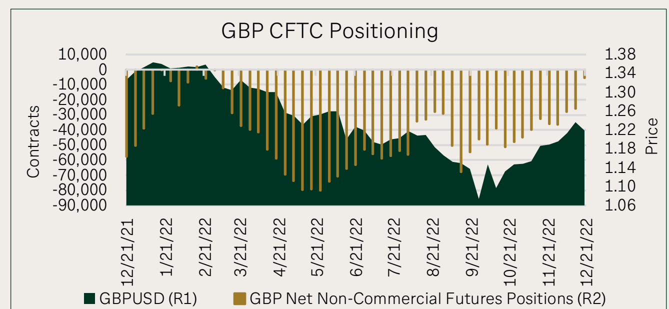
The BOE will tread lightly as monetary and fiscal policy are brought back in line following September's mini-budget debacle, which led to former Prime Minister Liz Truss being ousted in mid-October after only 44 days in office. Political and economic turmoil made the Pound one of the worst performing G10 currencies, falling over 10% versus the U.S. Dollar throughout the year. 2022 was the worst year for the Pound since Brexit in 2016. Among the G10, only the Swedish Krona and Japanese Yen performed worse than the Pound in 2022. Although the Pound has rebounded in the last quarter of the year, Pound gains in 2023 may be limited as the BOE diverges from other major central banks, accepting the risk of sustained inflation in exchange for the hopes of an economic recovery.

Technical Commentary: The Pound closed above the topside pivot point of the 1.1500 level, which opened the retest of 1.2000 after a tumultuous period that included an extraordinarily short tenure for Truss. New Prime Minister Rishi Sunak quickly steadied the ship, reversing tax policy that had previously weighed on the Pound. After rallying from 1.0350 to 1.2446 in roughly two months, the Pound has retreated to the 1.2050 level but remains in a steady upward trend channel and is now trading relatively sideways near the 200-day Simple Moving Average (SMA) at ~1.2060. The topside appears temporarily capped at the 1.2500 level through the turn of the year. A close above the 1.2500 level targets previous support (now resistance) from February through April 2022 at 1.2975 and prior support/resistance at ~1.3300. Downside support is at the ~1.1600 level, which is where the 100-day Simple Moving Average rests.

Current Indicators

CFTC Trader Commitments (Noncommercial Contracts)				
Date	Long	Short	Net	Signal
12/20/2022	35,284	40,887	(5,603)	GBP Weakness
Prev Week Chng	3,276	(16,860)	20,136	GBP Strength

1-Month Risk Reversal (GBP Calls vs. GBP Puts)				
Date	1M 25D Call	1M 25D Put	1M 25D RR	Signal
12/30/2022	10.361	11.639	(1.278)	GBP Weakness



Key Events Calendar

Country	Central Bank Meeting	GDP	Trade Balance	Consumer Price Index	Employment Data
United Kingdom	2/2/2023	2/9/2023	1/12/2023	1/17/2023	1/16/2023

Source: Bloomberg, as of December 31, 2022.

USD/CAD

Signaling a lane change

The Bank of Canada (BOC) raised borrowing costs by 400 bps between March and December 2022, landing the benchmark overnight rate at 4.25% at year-end. The BOC delivered a 50-bp hike in early December, leading other major central banks, which mirrored the move. The BOC's action repeated the 50-bp increase in October, which was a step down from a 75-bp hike in September, and a surprise 100-bp move in July. Expectations for a 25-bp hike at the January meeting are guided by better-than-expected economic data and underlying price pressures that have been slow to recede. The BOC is expected to ratchet down the size of the base rate increases in 2023 in the same manner that rate increases were stepped up in 2022.

Even if the BOC has entered a phase of fine-tuning its monetary policy, BOC Governor Tiff Macklem was clear that the greater risk would be to not raise interest rates enough to sufficiently restrict financial conditions and restore price stability. Canadian inflation peaked at a 40-year high of 8.1% in June year over year (YOY) but cooled to 6.8% YOY in November. Although an improvement, this level is still well above the BOC's 2% inflation target. Canadian home prices fell for a ninth straight month to end the year. Increased borrowing costs have left many Canadian buyers priced out of the market, with both buyers and sellers now content to wait out the winter months. On a positive note, October and November GDP gains show that the Canadian economy is holding up better than expected. A "technical" Canadian recession, signaled by a contraction of GDP growth in the first two quarters of 2023, is expected to be shallow.

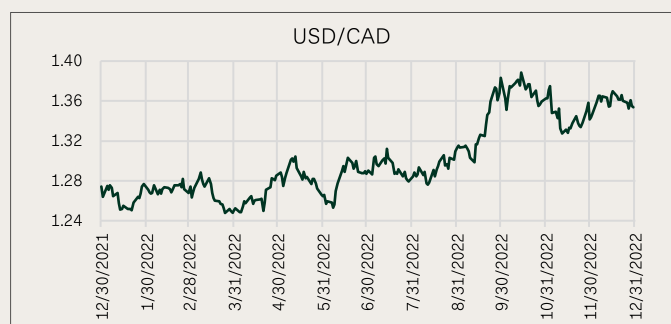
Ultimately, the Canadian Dollar should be supported by a central bank that looks comfortable to err on the side of going too far in raising borrowing costs. It is important to note that the BOC is beginning to shift its mindset from how much to raise rates to whether to raise rates. Market participants should prepare for a potential pause in the rate cycle based on incoming data over the first quarter of the new year. Commodity-based currencies such as the Canadian Dollar could also benefit from the unwinding of China's zero-COVID rules, which could help speed a Chinese economic recovery and an increased demand for raw materials. Oil prices will be supported by potential Russian output cuts in response to a price cap imposed by the G7 on Russian exports and colder-than-normal weather across much of North America at year-end.

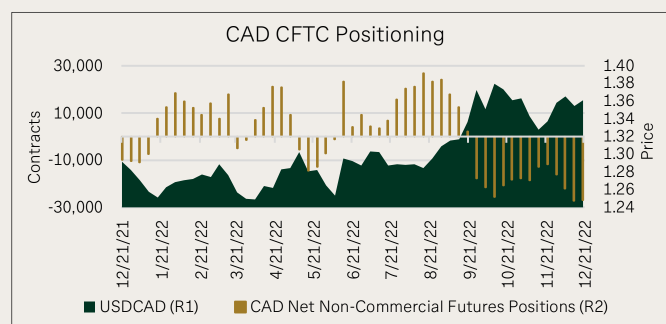
Technical Commentary: The Canadian Dollar was one of the worst performing currencies against its G10 peers over the last quarter, largely due to a decline in commodity prices and a slowdown in the BOC's aggressive monetary policy tightening path. A dovish tilt from the BOC in the fourth quarter has stoked fears of monetary policy divergence between the BOC and the Fed, as the Fed remains more hawkish. Near-term focus will remain data driven, especially on the rate-sensitive housing sector, as the BOC has indicated higher rates are to come. A double bottom at 1.3275/80 provides immediate support for a move lower, while 1.3700 provides resistance.

Current Indicators

CFTC Trader Commitments (Noncommercial Contracts)				
Date	Long	Short	Net	Signal
12/20/2022	39,705	66,666	(26,961)	CAD Weakness
Prev Week Chng	7,985	7,698	287	CAD Strength

1-Month Risk Reversal (USD Calls / CAD Puts vs. USD Puts / CAD Calls)				
Date	1M 25D Call	1M 25D Put	1M 25D RR	Signal
12/30/2022	8.461	7.724	0.737	CAD Weakness





Key Events Calendar

Country	Central Bank Meeting	GDP	Trade Balance	Consumer Price Index	Employment Data
Canada	1/25/2023	2/28/2023	1/5/2023	1/17/2023	1/6/2023

Source: Bloomberg, as of December 31, 2022.

USD/JPY

Flashing the high beams

The Bank of Japan (BOJ) has been the last of the major central banks to stick to an ultra-loose monetary policy. The BOJ has had a negative interest rate for the past six years. This unwillingness to raise rates to match the rest of the G10 central banks has directly translated to Yen weakness throughout the first three quarters of the year. The U.S. Dollar-Yen exchange rate touched 150 in mid-October, a level not seen since 1990. Overall, the Yen has been among the weakest of the G10 currencies versus the U.S. Dollar, losing about 14% of its value since the beginning of the year.

Most important to note, the BOJ surprised investors with a change to its long-standing yield curve control measures in December. In mid-December, the BOJ said it would let 10-year yields fluctuate by plus or minus 0.50% from its target of 0%. The previous band was half that at 0.25%. While this was not a major adjustment and there was no change to the overnight interest rate at negative 0.10%, investors can't help but look at this move as a possible sign of a pivot in BOJ monetary policy. BOJ Governor Haruhiko Kuroda has denied that this move signals any adjustment to monetary policy and has reiterated that this action was meant to make the current dovish monetary policy more sustainable by improving bond market functioning. These actions by the BOJ caught investors off guard, as most expected a change in BOJ policy to come when leadership changes in April. This preemptive move by the BOJ may have been spurred on by core inflation in Japan that has been above the BOJ's 2% target since the spring, hitting a 40-year high of 3.6% in October. Making policy decisions even more challenging is the fact that wage growth in Japan has failed to keep up with inflation.

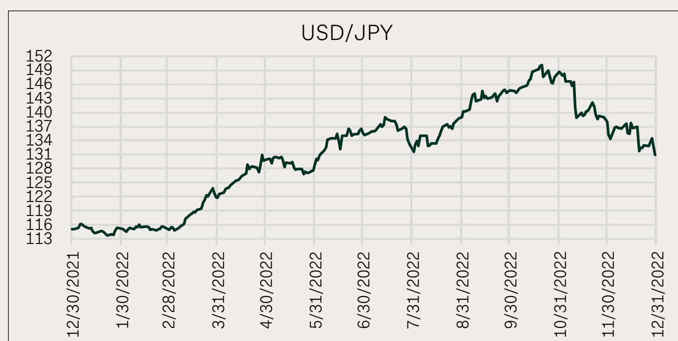
Ultimately, the Yen has been supported by this surprise move at year-end to widen the bond yield target band. This puts investors on high alert for further surprises from the BOJ in 2023. The BOJ will welcome any Yen strength, cutting down on the need for further BOJ intervention to support the Yen. A weak Yen, while beneficial for Japanese exporters, has inflated raw material prices for local companies, weakening earnings. Higher import costs were a direct cause of a contraction in GDP in the third quarter of 2022.

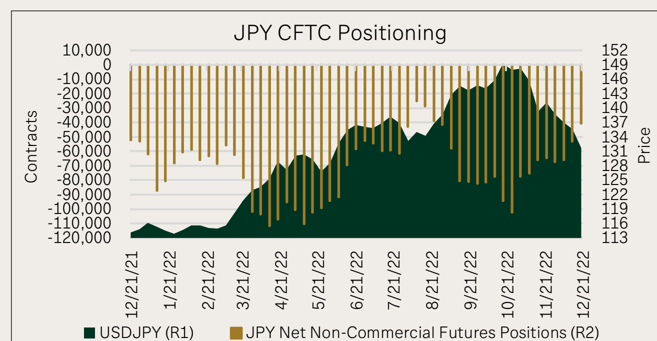
Technical Commentary: The Yen found its footing against the dollar after the BOJ intervened directly to stem losses near 146 Yen per Dollar, and again after the BOJ surprised markets by changing its yield curve control for 10-year JGBs. The Yen was one of the outperformers in the fourth quarter, gaining more than 10% against the Dollar; however, major moving averages are now indicating overbought conditions. A change in BOJ leadership in early 2023 has markets wary of a larger shift in monetary policy. However, with a weak growth outlook for the year, we may see verbal and monetary intervention in the markets instead to cap topside moves. The 100-day SMA (136.19) provides a topside target ahead of a move to 140.00.

Current Indicators

CFTC Trader Commitments (Noncommercial Contracts)				
Date	Long	Short	Net	Signal
12/20/2022	33,686	74,567	(40,881)	JPY Weakness
Prev Week Chng	11,396	(911)	12,307	JPY Strength

1-Month Risk Reversal (USD Calls vs. USD Puts)				
Date	1M 25D Call	1M 25D Put	1M 25D RR	Signal
12/30/2022	13.590	15.340	(1.750)	JPY Strength





Key Events Calendar

Country	Central Bank Meeting	GDP	Trade Balance	Consumer Price Index	Employment Data
Japan	1/18/2023	2/13/2023	1/18/2023	1/19/2023	1/30/2023

Source: Bloomberg, as of December 31, 2022.

AUD/USD

Happy in the middle lane

Starting in May 2022, the Reserve Bank of Australia (RBA) increased the base borrowing rate by 300 bps from zero. The RBA considered a pause in rate increases at the December 6 meeting, but instead opted for a 25-bp rate increase, bringing the base rate to 3.1%. RBA minutes showed that three options were discussed at the December meeting: a rate increase of 25 or 50 bps, or no change at all. This was the first time since the RBA began raising rates in May that a pause was discussed. Markets are expecting two additional 25-bp increases in 2023, which would bring the terminal base rate to 3.6%. The RBA is the closest of all the major central banks to nearing the end of its tightening cycle and was the first to break stride with its central bank peers by downshifting to a 25-bp hike in October.

The size and timing of future hikes will be determined by incoming data and the outlook for inflation and employment. A large number of Australian households are on fixed-rate mortgages and have been unaffected by increases in the base borrowing rate to date. This is set to change in 2023 as 30% of borrowers on fixed-rate mortgages will see their repayments jump by more than 40% when their current loans expire. This resetting of rates will put Australian household finances firmly in the crosshairs in 2023. On a positive note, Australian unemployment is at a 48-year low, and wage growth has remained benign. The decreased threat of wage-push inflation will give the RBA a bit more breathing room than the Fed when setting monetary policy in 2023.

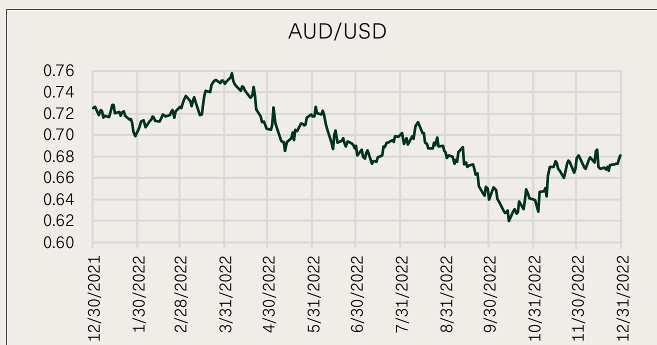
Global growth in 2023 (or lack thereof) will also play an important role in determining the path of the Aussie Dollar. The currency should find support from rising prices for commodity exports and optimism around improved trading conditions with China given the recent lifting of COVID restrictions. Furthermore, as a higher-yielding, higher-risk currency, the Aussie Dollar has historically been positively correlated with global equities.

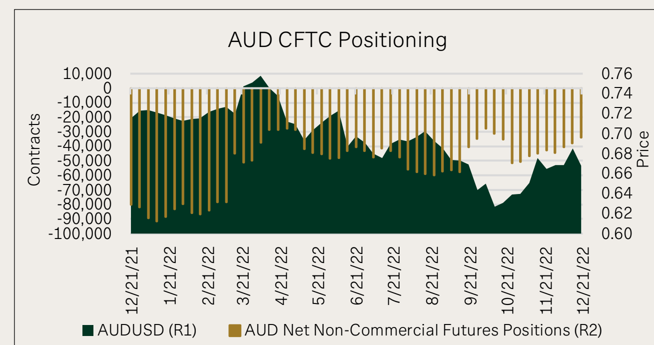
Technical Commentary: The AUD/USD This pair trades comfortably in an upward trend channel after gaining approximately 6% against the Dollar in the fourth quarter. The RBA slowed its hiking cycle this quarter, delivering a rate increase of 25 bps versus previous 50-bp increases earlier in the year. It appears that they will be able to end their hiking cycle early, as inflation and supply chain pressures continue to ease. International Monetary Market data shows the market is still positioned significantly short Aussie, risking a substantial rally fueled by short covering on a Dollar pullback or better regional data. The 200-day SMA at 0.6867 provides a topside target ahead of the psychologically important 0.70 level.

Current Indicators

CFTC Trader Commitments (Noncommercial Contracts)				
Date	Long	Short	Net	Signal
12/20/2022	31,779	65,894	(34,115)	AUD Weakness
Prev Week Chng	(4,046)	(7,768)	3,722	AUD Strength

1-Month Risk Reversal (AUD Calls vs. AUD Puts)				
Date	1M 25D Call	1M 25D Put	1M 25D RR	Signal
12/30/2022	12.700	13.750	(1.050)	AUD Weakness





Key Events Calendar

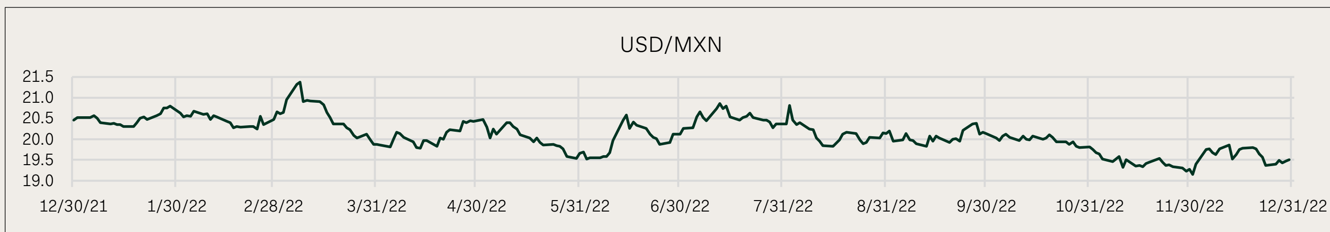
Country	Central Bank Meeting	GDP	Trade Balance	Consumer Price Index	Employment Data
Australia	2/6/2023	2/28/2023	1/11/2023	1/24/2023	1/18/2023

Source: Bloomberg, as of December 31, 2022.

Other Select Currency Pairs

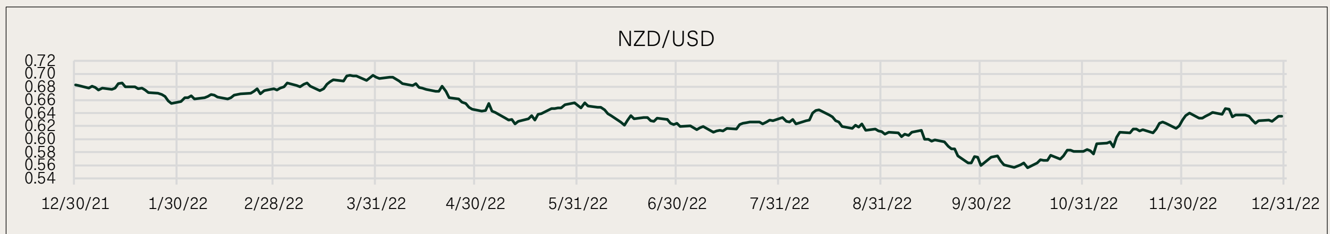
USD/MXN

The Bank of Mexico (Banxico) delivered a 50-bp hike on December 15, bringing the benchmark rate to 10.5%. As domestic activity remains below potential output, the high rates in Mexico are mostly to minimize spillover of external shocks on prices and safeguard financial stability from tightening global conditions. Banxico also adjusted one-year inflation expectations to close to 5.2%, well above the neutral rate estimated at 1.8%–3.4%. While relatively range bound throughout 2022 (trading between 20.50 and 19.50), the Mexican Peso (MXN) briefly strengthened to ~19.15 on December 1 on broad risk-on sentiment following news of China's reopening. Looking ahead to 2023, Mexican investments and exports should benefit from U.S. demand and companies moving their supply chains, but activity will fall if the U.S. experiences a recession. Additionally, the Peso could see pressure if the dispute on nationalist energy policies is not resolved and the U.S. places tariffs on Mexican products.



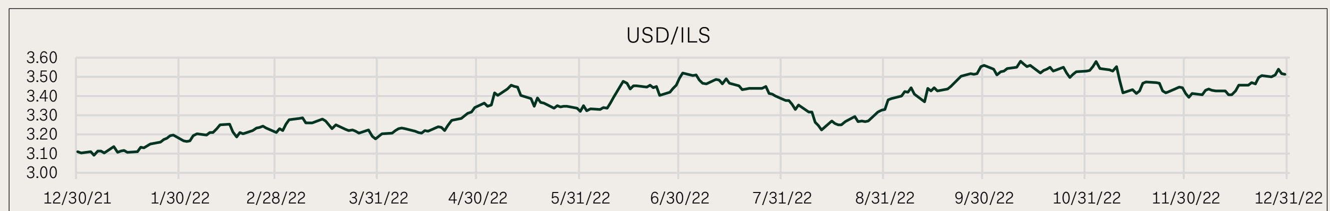
NZD/USD

The Reserve Bank of New Zealand (RBNZ) increased its benchmark rate by 75 bps on November 22 to 4.25%. This is the first time the RBNZ has raised rates by more than half a point since introducing the official cash rate in 1999. It also sharply revised its projected peak for the benchmark rate, which it now expects to reach 5.5% next year before it decreases. It also predicted a steep rise in unemployment next year and for the economy to dip into a shallow recession. In 2022, the New Zealand Dollar (NZD) aligned with its traditional high-beta status — underperforming at times of market distress (~20% decline versus USD from January to mid-October when the S&P 500 lost nearly 25%) and recovering ~15% since mid-October along with the sharp rebound in risk appetite. Looking ahead to 2023, NZD will need external factors for support, as domestic drivers are dimming. In particular, a weaker economy and softer inflation outlook could lead the RBNZ to underwhelm, implying deteriorating yields and growth appeal for the currency.



USD/ILS

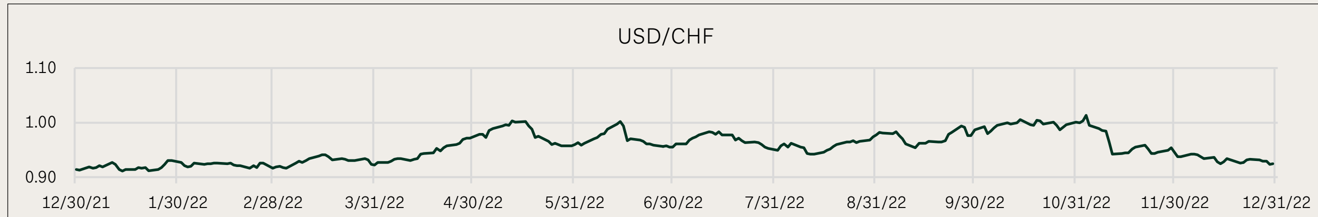
The Bank of Israel (BOI) raised rates for the sixth time in a row on November 21, delivering a 50-bp hike and bringing the target rate to 3.25%. Since the BOI started to lift the benchmark rate from an all-time low of 0.1% in April, it has accelerated the pace of hikes in recent months in a move to get inflation back within the government's 1%–3% target range. Unlike past hikes, this move was met with sharp criticism by business groups, who said it would harm them and the economy, as the cost of credit had become unbearably high. On December 25, the BOI approved the banking license and control permit for the country's second digital bank, Esh Bank Israel Ltd., in an effort to boost competition in the highly concentrated banking sector dominated by five banks. Esh follows on the heels of the first fully digital bank, One Zero Digital Bank, the nation's first new bank in more than 40 years.



Source: Bloomberg, as of December 31, 2022.

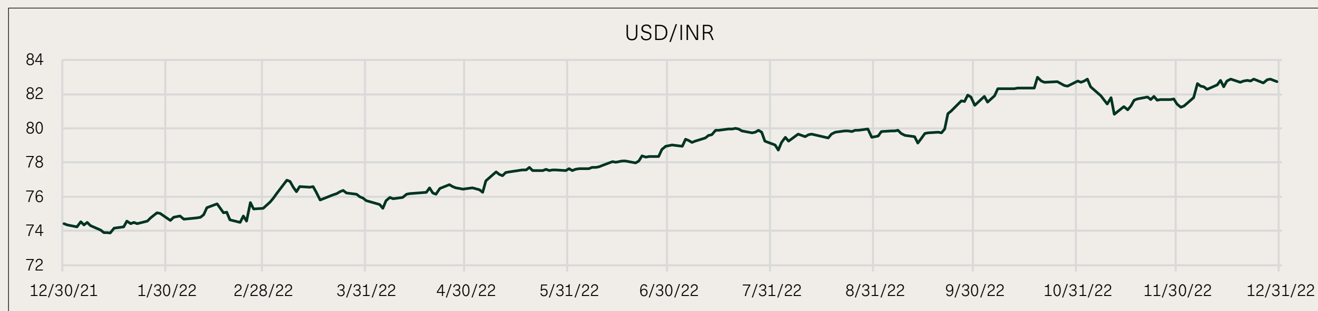
USD/CHF

The Swiss National Bank (SNB) raised interest rates for the third time in 2022 with an additional 50-bp increase on December 15 to counter the spread of inflation. This brought the Swiss policy rate to 1%, with an additional 0.25% hike expected in March 2023 per the CHF OIS curve. 2022 witnessed a risk-on environment that resulted in CHF weakening below parity with the U.S. Dollar in May, June and October. CHF weakness was largely on the back of the SNB's slower reaction to raising interest rates, the COVID policy in China keeping the world's second-largest economy in lockdown and the uncertainty in Europe following the Russian invasion of Ukraine, boosting prices for energy and goods across the continent. Market analysts expect USD/CHF to grind lower in 2023 as the Swiss Franc benefits from tighter SNB policy and the threat of China's reopening boosts global inflation. The result would be a risk-off environment that places traders on the defensive in early 2023, supporting the Swiss Franc as traders look to safe haven currencies for protection.



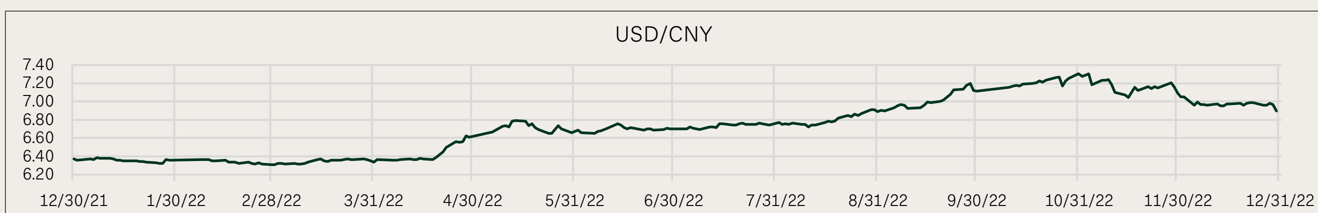
USD/INR

The Reserve Bank of India (RBI) hiked interest rates 35 bps on December 6 bringing the benchmark rate to 6.25% as the RBI seeks to control inflation along with the rest of the globe. The Indian Rupee (INR) has led the Asian emerging currency markets as the worst performer of 2022, declining as much as 10.2% versus the U.S. Dollar due to the relatively weaker economic recovery outlook compared to its Asian peers. The Rupee gained against the U.S. Dollar at the tail end of December after better-than-expected U.S. inflation data led to U.S. Dollar weakness and increased capital inflows to India. The Indian economy's growth differentials will likely improve in the coming months as both India's current account deficit and oil prices come under check. The near-term issues that could hamper USD/INR in 2023 would be continued Fed rate hikes starting in February or further cuts to the country's economic growth outlook.



USD/CNY

COVID has had a meaningful impact on the Chinese economy in 2022 as China's zero-tolerance COVID policy hampered its economic growth and forced many of its largest urban centers into ongoing lockdowns over the past three years. In December, growth in Chinese factory output decelerated to 5% from the previous month's 6.3%, and with most major economies raising interest rates, Chinese imports and exports fell on weakened global demand. After USD/CNY slid to 14-year lows in September following the Fed's 75-bp rate hike, the PBOC intervened in currency markets to stem the losses and bring the Yuan below the psychological 7.00 USD/CNY level. On December 27, however, the Yuan reference rate was fixed 0.19% higher than the previous trading day as China sought to increase demand. In 2023, China will be tasked with supporting growth. By doing away with its zero-COVID policy in January, China expects its economic growth and trade to spike dramatically as the economy gets back on track, potentially bringing with it increased inflationary pressures for the global economy.



Source: Bloomberg, as of December 31, 2022.

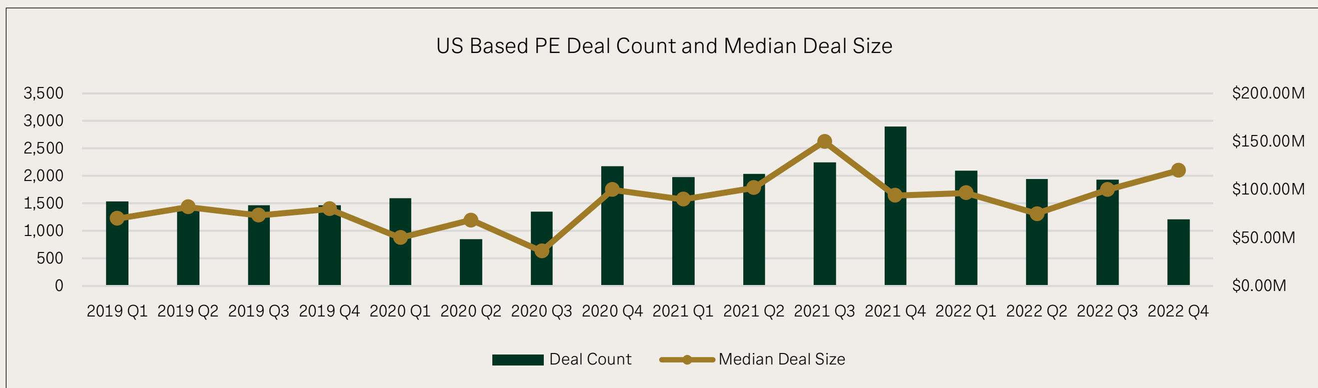
Private equity and venture capital

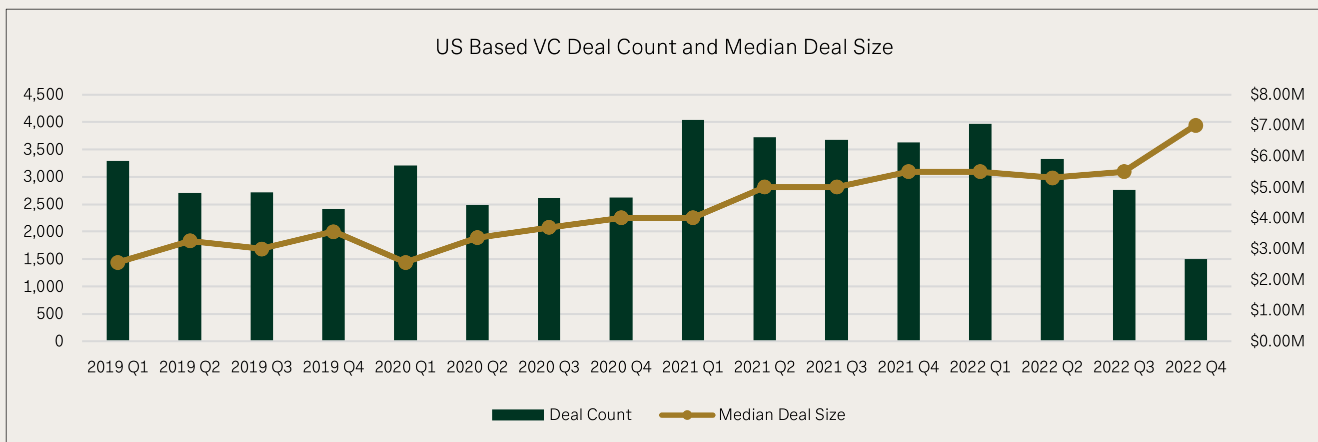
On the back of global rate hikes and fears of a possible recession in 2023, many in the private equity and venture capital (PE/VC) investment community have become more cautious as we close 2022. Public equity and bond markets have been very volatile for the bulk of 2022 as the investment world digests staggering inflation, tightening central bank policies from across the globe, and the numerous challenges presented in the previous pages of this report. In the first half of the year, private companies continued to see record valuations, and numerous funds continued raising based on 2021 deal velocity. Growth opportunities seemed abundant, and participants in this space were accustomed to deals being completed very quickly. One of the primary fears in the private market seemed to be FOMO (fear of missing out) on the next top fund or company. In the second half of the year, there was a substantial downtick in overall market activity as valuations fell from record highs and continued to trend lower with both buyers and sellers now eyeing the cost of liquidity and continued market stress.

Fundraising has become more difficult, but capital remains ready to be deployed. The rapid deal velocity seen in 2021 and early 2022 has been replaced by patience, and the FOMO has tempered for both investors and funds. Many LPs have experienced the "denominator effect" as their public equity market positions have been under pressure and allocations to bonds have also been impacted by rapidly rising interest rates. The allowable allocation, in percentage terms, to PE/VC investments might be at or near its limit, which may introduce some new considerations for managers and investors alike.

Well-established funds with loyal LP bases continue to raise capital, albeit at a slower pace. Fund managers with strong track records should continue to receive their expected allocations, but the scrutiny of lesser known or new managers will force some to reconsider their timing and lower their expectations. This approach to manager selection may lead to fewer new funds and fund managers, larger fund sizes for the established managers, and less pressure from LPs to get the funds invested quickly. While this can be viewed as a negative, substantial benefits can arise from challenging times. We believe funds with solid due diligence practices and consistent, sustainable returns will receive the allocation and there may be a greater allotment of capital to back shining stars. In addition, many market participants see the current slowdown as a healthy and necessary reset with potentially lower investment entry points that may prove to be more profitable in the long term.

Overall, a slowdown in PE/VC will bring a reset and reversion to the mean but will not likely break the long-term uptrend. The total volume of deals during Q4 2022 may tell an imperfect story as median deal sizes for both PE and VC continued to increase. Deal count numbers also reached their lowest level in more than two years for both PE and VC during Q4 2022.



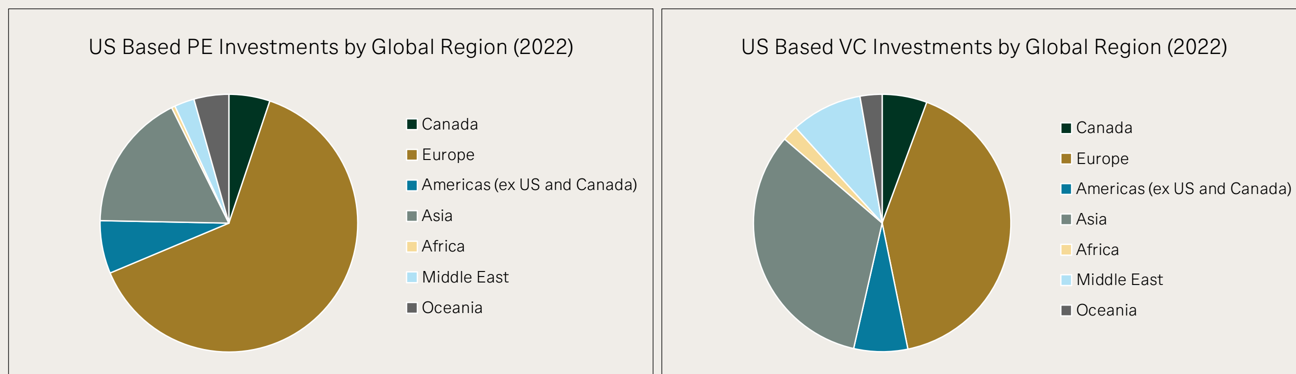


Source: Pitchbook, as of December 31, 2022

In addition to challenges for fund managers seeking investment from LPs, the cost of capital and an increasingly difficult investment and credit environment may also force portfolio companies to adjust their growth goals. Private companies are not immune to the challenges facing public companies but can be nimble in the face of a changing environment. They must remain resilient — as a new trend of reset and normalization emerges, many founders will be well positioned for a healthy and sustainable 2023 that is consistent with a longer-term growth target. The criteria have merely changed as prudent risk management is now center stage with liquidity more difficult to come by. The cost of money has gone up and portfolio companies are expected to preserve existing positions and maximize any new opportunities. In this more cautious landscape, good companies with sound and stable business practices may thrive and may outperform. Despite these changes in expectations, buyers and sellers have not yet come to a consensus on valuations. Many founders are still expecting elevated prices reflective of the recent past, and investors are expecting lower prices based on the potential contraction ahead. Until this bid/ask spread converges, investment timelines are likely to remain elongated.

Firms have increased their scrutiny of investments and are now prioritizing companies with lower risk and recurring revenue. Moreover, market participants are focusing more heavily on business fundamentals and transitioning away from solely viewing investments as having unlimited growth potential. In our view, overspending and overfunding will be eliminated, and a return to strong business practices and due diligence will support a more resilient ecosystem where the long-term upward trajectory remains intact. The past three years have broken records, but momentum cannot keep up with deal activity, and a slower, more measured decision-making process may prove to be more sustainable for all market participants. This trend shift has set a new precedent wherein portfolio companies must present a sustainable business plan, and not just an innovative idea or thesis, to receive funds.

From a foreign allocation perspective for private equity, Europe, the U.K. and Canada remain preeminent investment destinations. On the venture capital side, funds also continue to invest in Europe, the U.K. and Canada, but a large portion of total deals and volume have gone to India and China. A weaker dollar at the tail end of 2022 has reignited interest in hedging currency exposures, where these conversations may have been previously tabled due to the dollar rally seen in Q2 and Q3 2022. Fund risk managers are again assessing current and future exposures, as currency fluctuations make it increasingly difficult to maximize or forecast returns.



Source: Pitchbook, as of December 31, 2022

Tech and life sciences

The latter half of 2022 has ushered in a time of reset and normalization in the innovation sector and market after more than 10 years of consistent growth and multiple years of easy access to an abundance of capital. While there is still substantial capital to be deployed to this space, the distribution will not be as widespread as it has been in the past two to three years. Private companies with good business plans and ideas will continue to be funded despite higher overall borrowing costs and a tighter credit environment, but the growth-at-all-costs mentality is no longer the model for the broader investment community.

Prior to the pandemic, many large public companies expanded their office footprint, and during the pandemic, they overestimated their needs, with people and inventory management being done with little consideration for the long-term. Now that some of the demand has cooled and company leaders are concerned about future pressures and costs, many of these firms are shedding excess weight and focusing on safety of capital and the soundness of their business plan. The resulting wave of layoffs, slower return to the office in the tech sector and cost cutting done by large public companies has reverberated through the broader economy, impacting many aspects of tech hubs. Smaller companies and startups have consistently used short-term consultants rather than hiring full-time employees to keep costs down, but they may find a vast, local talent pool that warrants a longer-term approach.

The recent economic expansion brought record growth in the innovation sector and substantial new capital to investments, but some market participants may have focused too much on growth instead of long-term viability. This growth and expansion bias compounded risky behaviors, which drove higher valuations for firms operating on ideas alone. Expedited deals and quick funding of these ideas may have bolstered founders with unproven track records. Companies that are seeking new funding may need to lower their expectations, and those that are seeking an eventual exit may need to remain private for longer as buyers and markets wait for valuation spreads to narrow. New startups and company leaders seeking additional support for their existing company should focus on the goal of running a good, sound business and should set realistic goals so they can be in a position for funding when the next round comes.

Like private tech companies that observed a notable slowdown in funding versus previous years, there has been a similar trend change in the life science space during the last three quarters of 2022. Although both tech and life science companies saw substantial investment support during the pandemic years of 2020 and 2021, the record levels from those years are reverting to a more reasonable level consistent with the longer-term growth trend. The sustainability of investment to the life science sector is very much intact, but the forces driving the record levels and pace from the previous years will not likely continue.

While there is plenty of capital to be deployed to the life science space through venture investment or M&A, a higher emphasis will certainly be placed on due diligence. A patient approach to investments will prevail as market participants cautiously reallocate funds. Broad, rapid investment to ideas was the norm for the past few years in many sectors of the market, but the growth of those investments may not be achievable at the elevated valuations of those years. Much like tech, later stage life science companies are now more hesitant to go public as valuation spreads remain wide. While early-stage life science companies are still eager to grow and will continue to focus on their much-needed research, the importance of prudently managing cash flows and their balance sheet will be more important than ever, as the time between funding rounds may be extended.

Many life science and tech companies have continued to expand globally over the past year. This trend is not a new phenomenon for these sectors, but the recent uptick might be related to Dollar strength in the first three quarters of 2022 and the resulting relative cost in foreign investment with USD funding compared to prior years. While this Dollar strength has certainly bolstered foreign investment and reduced certain outflows, many larger firms in both sectors that have operations and sales overseas and present overall earnings in USD have seen a partial decrease in revenue.

Heading into 2023, investors remain optimistic on innovation and count on long-term value creation, even if the sectors were a bit overheated at the beginning of 2022. Indeed, as valuation spreads narrow in 2023, we believe founders, companies and investors are well-poised to meet more realistic expectations, and there will be an overall flight to quality. While past performance does not guarantee future results, some of the best vintage years occur at the sunset of historic years marked by record levels of activity, and companies that continue to raise capital in this new, more stringent climate will lead the path forward with a consolidation of talent and funding. Tech and life science companies may also find that as they set proper expectations for themselves and investors alike and as valuations become more measured, they may find it easier to live up to previously unattainable expectations. This reversion may lead to increased quality, better behavior and long-term success in the innovation sector all around, even as participants experience short-term stress during the transition.

Wineries and wine distributors

While this past year spelled the end to most COVID-related restrictions, 2022 was a year that presented its own share of issues and challenges throughout the wine industry. The global wine supply has been running somewhat short due to a succession of short harvests caused by extreme heat, spring frosts, droughts and fires. In conjunction, many domestic wineries were faced with production and bottling challenges, as numerous barrel importers had supplies stuck in the Port of Oakland for months waiting for their barrels to be released in time for harvest. Similarly, bottling schedules were disrupted due to glass shortages stemming from production disruptions in China and delays in receiving corks, capsules and other production equipment. On average, wine tasting fees are going up due to the increased cost of labor, insurance and production and as part of an overall strategy to attract more serious customers and potential wine club members. Looking ahead, domestic wine producers will continue to see compression in margins, as rising labor costs along with increased packaging and production costs impact the market.

It was a great year for M&A in the wine industry due to consolidation and increased interest from foreign buyers and private equity, although 2023 will be a very challenging year with the current cost of debt and elevated valuations. The strong U.S. Dollar could continue to make European imports attractive for U.S.-based wineries and wine importers. A common theme among both wine importers and wineries with large barrel budgets was the ability to take advantage of historically low EUR/USD levels and hedge their future Euro payables well into 2023. Winery owners and wine distributors expect to keep a close eye on their margins and FX hedging programs in the months ahead, as 2023 may prove to be a more challenging year in the overall economy.

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