

2022 Currency outlook

FX markets became more focused on inflation and rising treasury yields in 2021, as the effects from the COVID-19 pandemic continued to linger. US dollar strength was buoyed by evolving expectations of the Fed’s response to these factors as inflation was on the rise. After cryptocurrencies’ breakout year in 2020, bitcoin and ether extended their runs in 2021 through increased institutional adoption and the rise of decentralized finance.



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Inflation, the Fed, and the US dollar

Inflation continues to be an important topic of conversation going into the New Year, as its transitory vs. persistent nature is a major discussion point in central bank policy.

Following a weak 2020, the US dollar reversed course in early 2021 as US exceptionalism and rising US treasury yields were the dominant factors in the first quarter, stoking fears that higher than expected inflation could cause the Fed to shift policies sooner than anticipated.

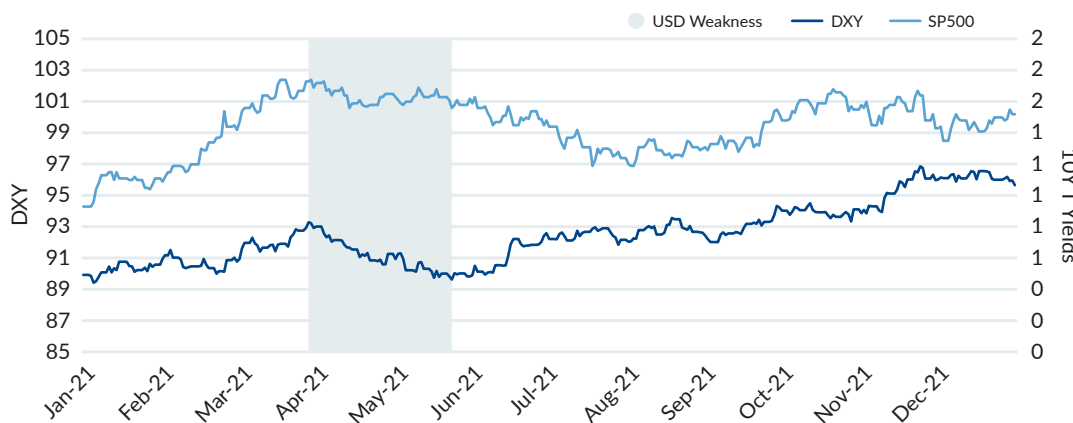
As yields leveled out and tilted lower, the US dollar followed suit and weakened temporarily before regaining strength as yields rebounded and Fed rhetoric became more hawkish. US dollar strength was supported into year-end as the Fed doubled the pace of tapering to \$30 billion a month and signaled three rate hikes in 2022 through its dot plot.

All told, the US dollar gained 6.4% in 2021 as reflected through DXY, the strongest annual performance since 2015.



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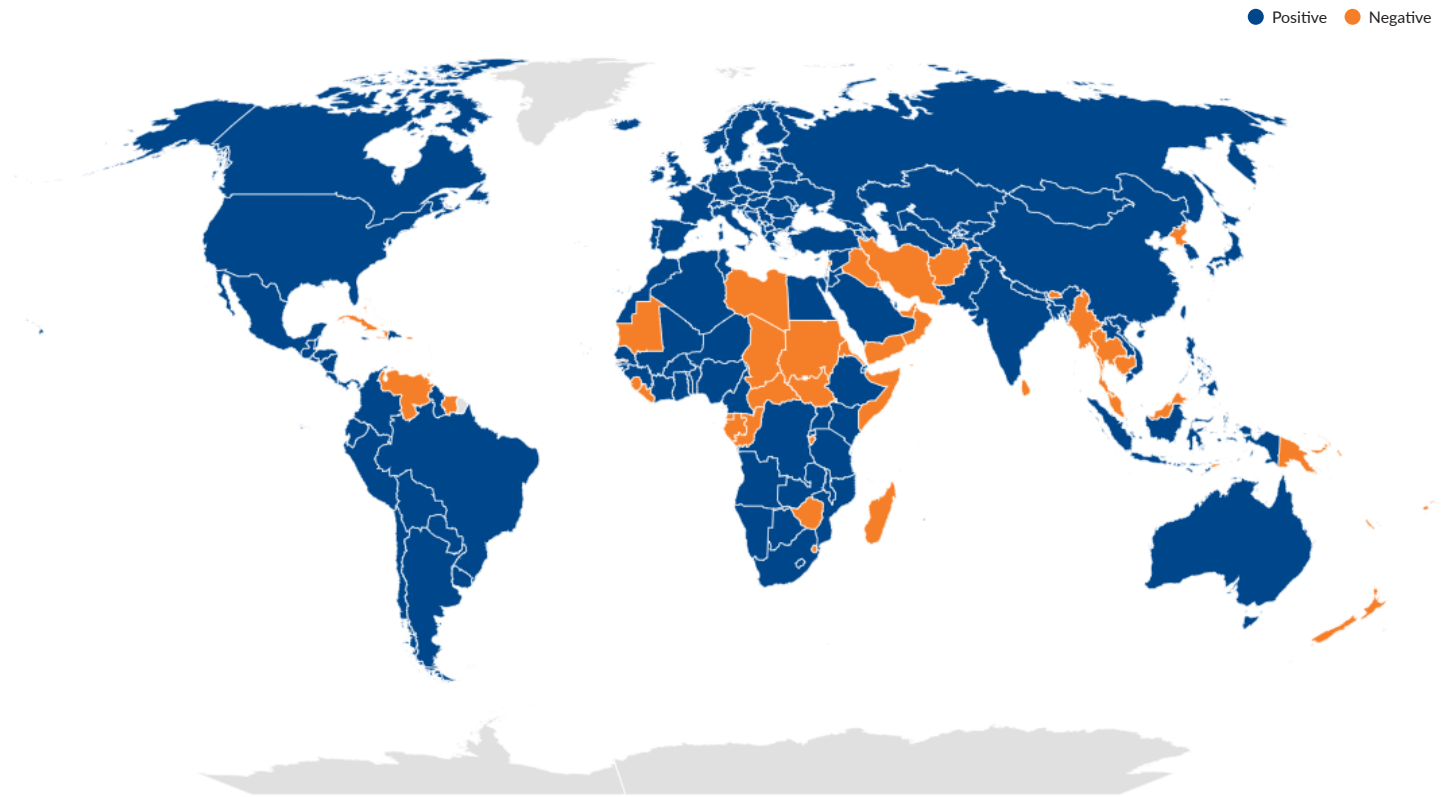
CHART 1: DXY VS YIELDS



Source: Bloomberg, January 2021 to December 2021. Past performance is not necessarily indicative of future results. Actual results may materially differ.

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CHART 2: GDP YOY | DECEMBER 2021



Source: <https://tradingeconomics.com/country-list/gdp-annual-growth-rate?continent=world> as of January 6, 2022.

The first year of the pandemic compressed growth on a worldwide basis as countries shut down in hopes of stemming the spread of COVID. However, as vaccine distribution and more comprehensive policies helped manage the Delta wave across the globe in 2021, economies began to recover as government shutdowns lifted and businesses reopened.

The rise in GDP worldwide is evident when looking at the number of countries with positive year-over-year growth as of the end of 2021.

While strong economic growth often increases inflationary pressures in typical environments, the effect has been magnified through the lens of the pandemic. COVID has disrupted supply chains around the world, causing shortages, backlogs, and global delays while at the same time, demand has risen as consumer needs (technology, for example) have become increasingly critical as a significant portion of the workforce has been working remotely. This combination of product shortages and strong consumer demand has led to higher prices, and the question looming for 2022 is whether the supply chain disruptions will fade over time or if there is an element of permanence involved. Effective vaccinations

and treatments, along with sensible government policies, may help ease pressures, although potential new COVID variants will remain an area of concern.

Additionally, the Fed response has become more hawkish in nature, with the US leading the developed world towards quantitative tightening. Rising interest rates are generally supportive of the US dollar, as higher yields attract investors abroad seeking higher returns on bonds and interest-rate products.

US treasury yields have spiked going into the New Year, eclipsing the highs from March of last year. The sustainability of inflation in 2022 will dictate whether the Fed continues on its current path, which has a direct effect on the US dollar. With uncertainty surrounding inflation and COVID, plus growing tensions with Russia and China, the safe-haven characteristics of the US dollar continue to provide a base of stability.

With rate hikes in the US expected to outpace its G10 counterparts, wider interest rate differentials between the US and other developed regions are a logical consequence. As noted in our previous paper, the [US Hedging Advantage](#), US investors have enjoyed a carry benefit when hedging away the currency risk within their international exposures. Prior to the pandemic and the global convergence of interest rates in response to COVID, carry benefited US investors by over 2%.

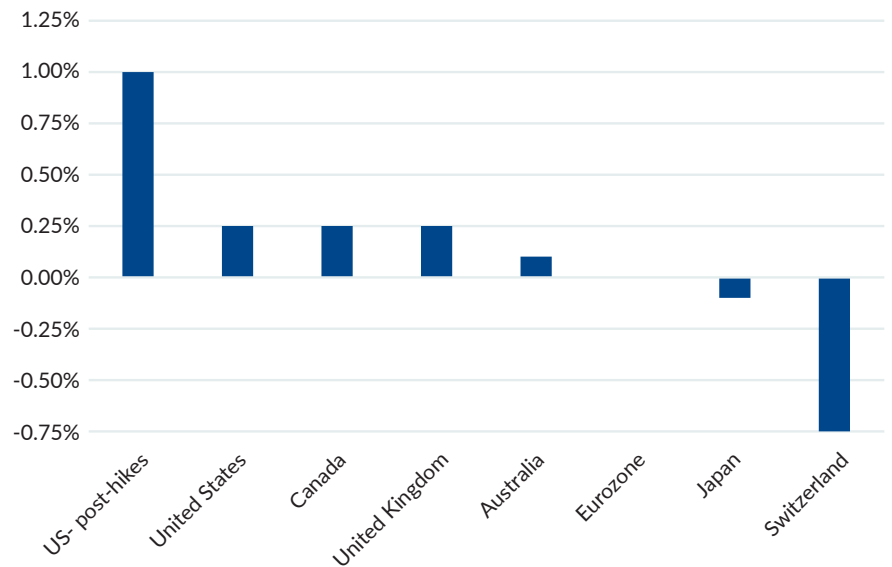
While the US has maintained higher rates than most developed nations over the pandemic, its faster exit velocity from quantitative easing promotes wider interest rate differentials and consequently, a US hedging advantage.

Cryptocurrencies

In last year's outlook, we noted the mainstream prominence that digital currencies attained within news outlets and the investing community at large. 2021 continued the rise in both investment returns and participation rate, with bitcoin and ether appreciating 60% and 400%, respectively, after soaring 305% and 475% in 2020. With decentralized finance gaining significant attention lately, Ethereum has been the main beneficiary in the space as most DeFi applications run on its blockchain.

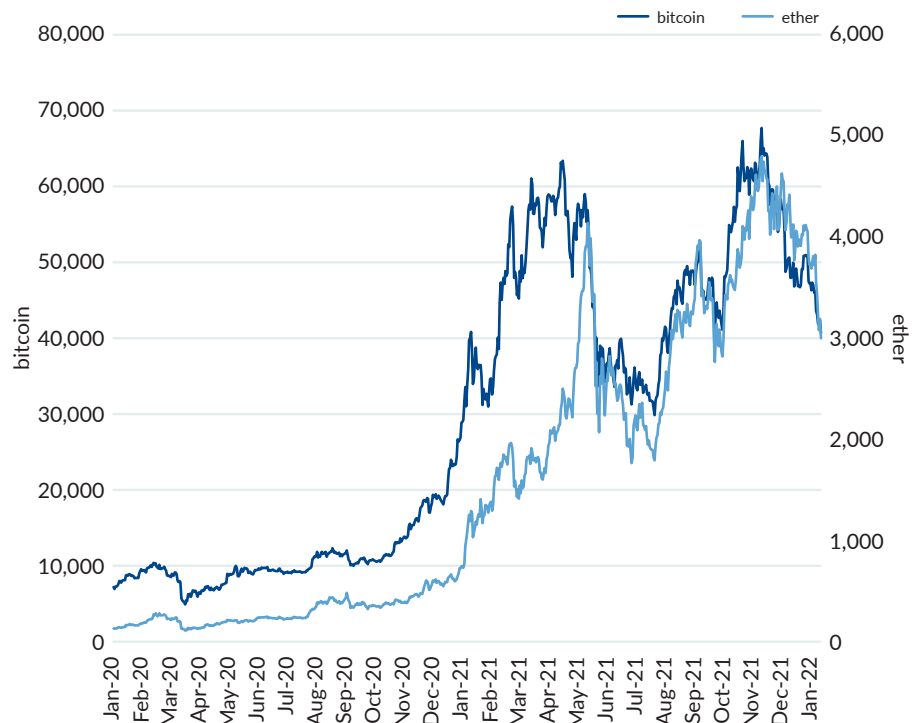
As returns have accumulated, the number of institutional investors allocating to digital currencies has grown. In the venture capital space, \$30 billion was invested into crypto-related investments in 2021, almost four times the previous high for any one year.¹ In 2022, more capital is anticipated to find its way into cryptocurrencies, with 7 out of 10 institutional investors projected to invest in digital assets in the future.²

CHART 3: CENTRAL BANK RATES



Source: Bloomberg, as of December 31, 2021. Includes 3 rate hikes of 25bps each in 2022.

CHART 4: BITCOIN ETHER



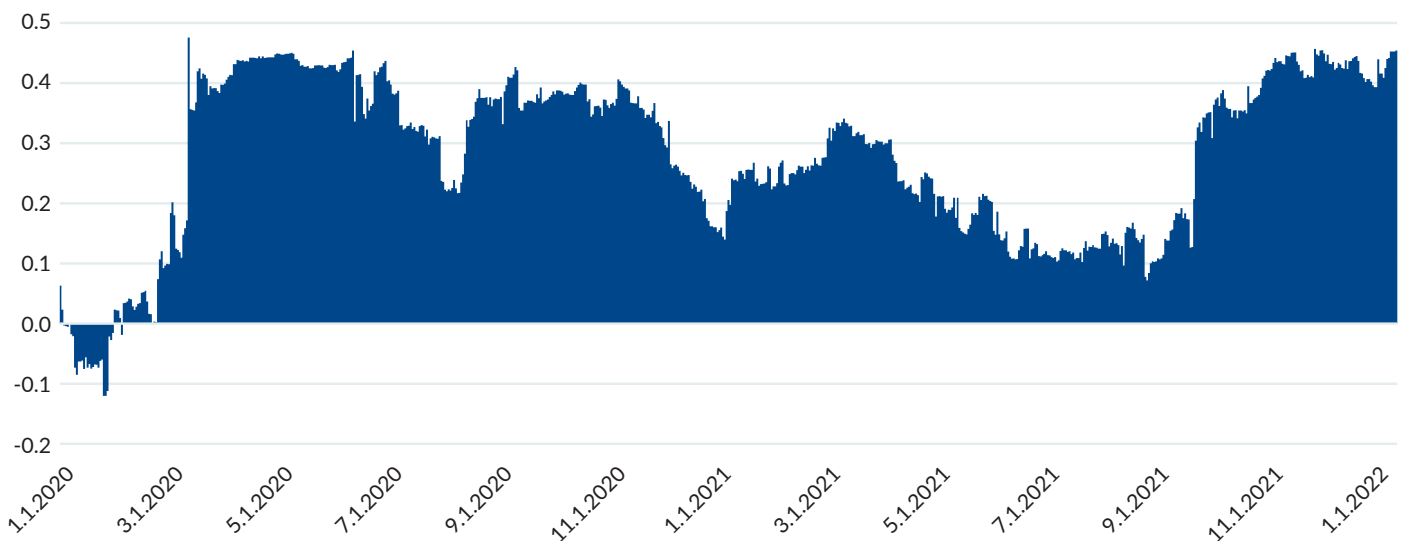
Source: Bloomberg, as of January 10, 2022. Past performance is not necessarily indicative of future results. Actual results may materially differ.

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As institutions consider investment into digital assets, it is important to understand the portfolio contribution towards risk as well as return. The most significant barrier of adoption for new investors is price volatility.³ The speculative nature of cryptos have led to precipitous drawdowns against the wave of gains. Twice in the last two years, both bitcoin and ether have experienced drawdowns of over 50%, with the current drop from the end of last year approaching 40% (as of January 10, 2022).

While the uncorrelated nature of cryptocurrencies to other assets is considered an appealing attribute of digital assets, the return profile over this pandemic period has shown otherwise. Since the onset of COVID in March of 2020, bitcoin has maintained a positive correlation to the S&P 500, with the former essentially behaving as a risk asset. Although the eye-popping gains of cryptocurrencies can be alluring, a total portfolio assessment can reveal whether risk is being diversified or accentuated by allocating digital assets into the portfolio.

CHART 5: 3M ROLLING CORRELATION | BITCOIN VS. S&P 500



Source: Bloomberg, as of January 10, 2022. Past performance is not necessarily indicative of future results. Actual results may materially differ.

Conclusion

As inflationary pressures continue to mount across the current market environment, the Fed response and the pandemic’s progression will be major factors influencing the direction of the US dollar. As interest rate differentials widen between regions due to diverging central bank policies, US-based investors hedging foreign exposures will experience a carry advantage while managing their currency risk.

We will be monitoring the sensitivity of currency movements towards inflation and central bank activity. While current conditions support US dollar strength, the degree to which central bank policy is already priced in is a matter of debate. As the landscape can shift quickly, with unforeseen events on the horizon as we have seen over the past few years, we recommend that institutions have a currency hedging policy in place, refreshed periodically, to strategically manage international exposures over fluctuating FX markets and changing portfolio priorities.

We, at Mesirow Currency Management, wish you a healthy and successful 2022.

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1. Source: <https://www.bloomberg.com/news/articles/2021-12-19/ftx-moonpay-axie-lead-crypto-firms-attracting-record-30-billion-in-2021?srnd=markets-vp>

2. Source: <https://www.fidelitydigitalassets.com/articles/digital-asset-survey-2021>

3. Source: https://www.fidelitydigitalassets.com/bin-public/060_www_fidelity_com/documents/FDAS/2021-digital-asset-study.pdf

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