Insights
Currency & Cash

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Currency Market Commentary

Aaron R Hurd, FRM
Senior Portfolio Manager

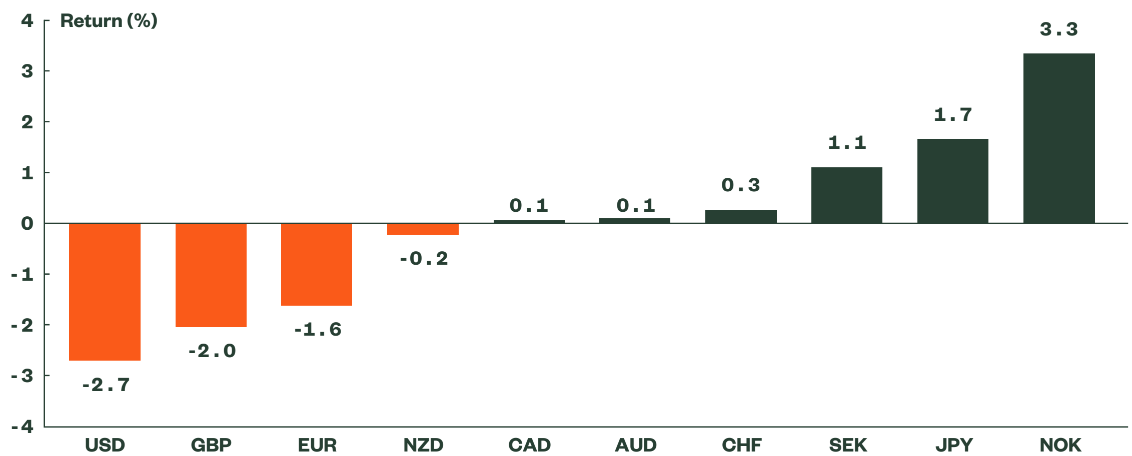
Summary of Views

Ongoing disinflation and a dovish shift in the US Federal Reserve (Fed) outlook validated the monetary policy pivot and soft-landing theme that has dominated since late October. Accordingly, market trends from November carried through December, sending yields and the US dollar lower, and equity markets higher.

The Bank of England (BoE) and European Central Bank (ECB) policy statements were more cautious than the US Fed's, but investors priced in nearly as many rate cuts as in the US due to accelerating disinflation and stagnant growth. Consequently, the euro and the British pound suffered. On the positive side, the risk-sensitive and historically cheap Scandinavian currencies enjoyed a strong bounce alongside a surprise Norges Bank policy rate increase and broadly improved investor sentiment.

The low-yielding Japanese yen and, to a lesser extent, the Swiss franc also appreciated as global yield differentials moved in their favor.

Figure 1
December 2023 Currency Return vs. G10 Average



Source Line: Source: Bloomberg and State Street Global Advisors, as of 31 December 2023. **Past performance is not a reliable indicator of future performance.**

Our outlook has changed little over December. In the long term, we see a decline in the US dollar, as the US is expected to lose much of its interest rate and growth advantage over the next 1–3 years, leading to a sustained dollar bear market. The unsustainably high combined US fiscal and current account deficits are likely to further weigh on the dollar. We recommend medium- to long-horizon investors to position themselves for a weaker US dollar.

Figure 2
December 2023 Directional Outlook

	Tactical Outlook	Strategic Outlook
USD	↑	↓
JPY	↑	↑
EUR	—	—
GBP	—	—
CHF	↓	↓
SEK	↓	↑
AUD	↓	—
CAD	↓	—
NZD	↓	—
NOK	↓	↑

Note: All individual currency views in the table above are relative to the G-10 average.
Source: State Street Global Advisors, as of 31 December 2023.

Over the near term, the bearish dollar story appears a bit ahead of itself. Any modestly positive or negative economic surprise is likely to trigger a temporary US dollar rebound. The market is pricing almost seven Fed rate cuts by January 2025, along with double-digit US corporate earnings growth within the S&P 500 index. If the US labor markets and business conditions remain strong, as implied by high earnings expectations and tight credit spreads, then there is room for some of those rate cuts to be priced out over the next couple months to the benefit of the dollar.

The US remains one of the highest yielding and highest growth economies in the G10. A more substantial slowdown in economic activity would better justify more than seven rate cuts, but it could also threaten the earnings outlook, leading to an increased volatility in equity market and a safe-haven demand for the US dollar, potentially driving the dollar higher once again. Given the challenges faced by the commodity markets and G10 growth outside the US, we see downside risks for higher-beta currencies like the Australian, New Zealand and Canadian dollars, as well as the Scandinavian currencies. However, it is worth noting that both the Norwegian krone and Swedish krona are extremely cheap from a longer-term perspective. While the Japanese yen may struggle to extend its gains against the US dollar in the near term, we remain broadly positive relative to the G10 average, as global disinflation and weaker growth pressure yields lower and add uncertainty to the medium-term equity outlook.

Review and Outlook by Currency

US Dollar (USD)

The US dollar lost 2.7% in December compared to the G10 average. Early in the month, the dollar found some support after its steep 3.7% loss in November following a surprise drop in the unemployment rate to 3.7% and a tick up in average hourly earnings growth to 0.4% MoM.

However, it was not a big rebound, as the dollar was only able to gain around 0.5%, until the Fed meeting on 13 December reignited its downtrend. The US Fed held rates steady at 5.25%–5.5%, but indicated that the next move was more likely a rate cut with the Dot Plot projection of future rates showing a total of three cuts in 2024. The US dollar sold off aggressively and trended lower through the year-end, helped by softer-than-expected core personal consumption expenditure inflation released on 22 December — +0.1% MoM vs. +0.2% expected.

We have long held the view that the US dollar is likely to fall at least 10%–15% over the coming years as US yields and growth fall back toward the G10 average, while the US grapples with high fiscal and current account deficits. For investors with a horizon of two years or more, we strongly recommend short US dollar positions, just look though this highly uncertain transition period. For those with a shorter horizon, we believe the dollar will remain in a range-trading environment into the first half of 2024.

In the near-perfect soft-landing scenario, characterized by much lower yields and a resilient growth and corporate earnings outlook, the recent downtrend of the US dollar would likely persist. However, achieving perfection is challenging. The dovish Fed pivot in December adds to near-term downside pressure. Any positive or negative deviation from the perfect soft landing would result in additional intermittent US dollar rallies. We forecast US growth to slow substantially enough to introduce fears of global recession and potential stress in the outlook for corporate earnings, even if recession is avoided in the end (as we expect). In such a scenario, we expect lower yields, more volatile equity markets, and another rally for the dollar. Conversely, given the market's current pricing of seven Fed rate cuts by January 2025, even moderate resilience in US growth or inflation would likely trigger a rise in yields and once again bolster the dollar. After we get through, or are at least well into, a global slowdown, risky assets price in greater pessimism, and we see the Fed actually cutting rates, we expect a large, sustained US downtrend to begin.

Japanese Yen (JPY)

In December, the yen gained 1.7% against the G10 average, making it the second-best performer in the group. This relative strength through 6 December was supported by falling global yields and notable weakness in the Norwegian krone and euro early in the month.

Comments from the Bank of Japan (BoJ) Deputy Governor Ryozo Himino on 6 December regarding the potential for limited negative impacts of exiting negative interest rate policy (NIRP), along with further comments on possible policy paths in 2024 from BoJ Governor Kazuo Ueda the following day, were seen as signs that the BoJ may exit NIRP as soon as January. This triggered a sharp short covering rally and a near 2% one-day rally in the yen.

However, the yen moved lower in volatile trading through the end of the month. The dovish US Fed meeting mid-month created an additional surge higher in the yen, while an unexpectedly dovish BoJ meeting on 19 December, pushing back on the market's interpretations of the 6–7December comments, sent it sharply lower. Overall, the steady fall in global yields improved the relative carry on the yen and helped it to remain in positive territory for the month.

Our models maintain a positive view on the yen relative to the G10 but retain a negative view versus the US dollar, given high US interest rates and strong relative growth. First quarter may be quite volatile, but we see risks skewed toward a broad yen recovery in 2024 as yields peak and turn lower, while below-trend global growth creates an increasingly fragile environment for risky assets. The increased likelihood that the BoJ exits the Negative Interest Rate Policy by mid-year is also supportive, though the magnitude of potential BoJ rate increases is tiny compared to the scope for rate cuts across the rest of the G10. We believe foreign interest rate policy will remain the bigger driver of the yen. The clear shift in global monetary policy from tightening to a broad pause with an eye to 2024 easing creates a persistent positive backdrop for the yen over the next 6–12 months.

Euro (EUR)

The euro trended steadily lower against the G10 average during the month to finish down 1.6% for December. The month began on a sour note after the core consumer price index (CPI) fell short of expectations on 30 November — 3.6% YoY vs. 3.9% expected.

In light of this accelerating disinflation, ECB members Francois Villeroy de Galhau and Isabel Schnabel suggested that the rate hiking cycle was likely over. We also saw softer-than-expected retail sales data released on 6 December and a downside surprise in the final third quarter gross domestic price (GDP) — 0% QoQ vs. +0.1% expected, which kept the euro on the defensive through mid-month.

On 14 December, the ECB convened and maintained deposit rates at 4%. Despite ECB President Christine Lagarde striking a more hawkish tone than the US Fed Chair Jerome Powell, and indicating that rate cuts were not discussed at the meeting, this did little to help the euro, which continued to fall on weaker-than-expected Purchasing Managers' Index (PMI) data the next day.

We maintain a neutral view on the euro against the G10 average and a negative view against the US dollar and the Japanese yen. While the ECB may not have discussed rate cuts at its December meeting, rapid disinflation and near recessionary conditions suggest a strong case for rate cuts over the course of 2024. This challenging environment is likely to weigh on the euro due to the combination of high European Union recession risk and a softening ECB policy outlook.

However, our models are not negative relative to the G10 average. Heightened global uncertainty and equity volatility over the next few months may help support the euro against higher-beta currencies, as will the ongoing weakness in commodity markets. Conversely, against the US dollar and other less cyclically sensitive currencies, we expect the euro to struggle, as they benefit more from global uncertainty than the euro.

British Pound (GBP)

The British pound declined 2% against the G10 average in December and managed a paltry 0.7% gain versus the US dollar, despite its broad-based weakness. Early in the month, the pound remained relatively quiet, with a slight decline as the US dollar bounced on better-than-expected US employment data.

However, soft UK wage growth announced on 12 December and weaker-than-expected October GDP (-0.3% MoM vs. -0.1% expected) announced the following day added to the downward pressure on the pound. The BoE met on 14 December, voting 6–3 to keep policy rates on hold — six votes to keep rates steady and three to increase by 0.25%. The tone was notably more hawkish than the Fed's the prior day, not only because there were three votes for further tightening, but also because the minutes warned of further rate increases if inflation pressures persist.

Despite that hawkish sentiment and a positive surprise in December and composite PMI data the next day, the pound continued to weaken as investors focused on the near-stagnant growth environment and accelerating pace of disinflation. In line with this theme, the November CPI report released on 20 December indicated a surprisingly large decline in core CPI (5.1% YoY vs. 5.6% expected). The pound sold off to hit its low for the month before settling into a range around those depressed levels through year-end.

Our factor models remain neutral to slightly negative on the pound versus the G10 average, but are quite negative against the yen and the US dollar. We see risks to the pound skewed lower as the economy stagnates, inflation and wages are finally accelerating lower, and the UK economy faces the constraints of high fiscal and current account deficits.

However, we see similar average risks across most G10 economies and currencies, resulting in a relatively neutral tactical outlook for the pound. In addition, the UK's economic stagnation is proving to be surprisingly stable, meaning the risk of falling off a cliff into recession has proven limited. We can see this via the rebound of services and composite PMI back into expansionary territory and the relatively stable home prices, while the recent sharp drop in longer-term yields helps alleviate some pressure from mortgage refinancing.

In contrast, our long-term valuation model has a more positive pound outlook. It is particularly cheap against the US dollar and the Swiss franc. Nevertheless, it is important to temper upside expectations, as low productivity growth and high inflation are pushing fair value lower. The fair value of the pound against the US dollar has fallen from 1.55 to 1.42 since May 2022. Based on breakeven inflation expectations and recent trend productivity differentials, fair value will trend down to at least the mid-1.30s over the next few years. Despite this trend, the pound, currently trading in the mid-1.20s, remains materially cheap, even if fair value trends down as expected.

Swiss Franc (CHF)

The Swiss franc languished in negative territory against the G10 average for most of the month until a sharp rally on 27–28 December pushed it up more than 1% to finish the month with a 0.3% gain.

The fundamental backdrop for the franc was mixed. The sharp fall in global yields and the ongoing weak EU economic data were consistent with a stronger franc. Offsetting that was the typically negative impulse of positive risk sentiment and rising global equity markets.

The Swiss National Bank (SNB) met on 14 December and had little impact on the currency, maintaining steady policy with a warning that the fight against inflation was not over. However, on a more dovish note, the bank removed language suggesting it was biased to support the franc through market intervention, selling foreign reserves and buying the franc. The extreme jump on 27–28 December appears related to year-end technical flows, as there was no material news supporting the move.

We hold a negative view on the franc over both the tactical and strategic horizons. It is the most expensive G10 currency per our estimates of long-run fair value; growth data remains soft; inflation remains stable within target ranges; and, aside from the yen, the franc has the lowest yields in the G10. The monetary policy outlook is also likely to continue to shift in the first quarter.

The SNB's statement no longer expresses a bias toward franc-supportive intervention, suggesting that it views the franc at elevated levels. And that was before the sharp appreciation at month-end brought the real trade-weighted franc to more than 30-year highs. If its strength continues into the first quarter, it could easily induce the SNB to intervene to weaken the franc. Such a shift is likely to provide a catalyst for the highly overvalued franc to begin a reversion back down toward our estimate of its longer-term fair value, although we also likely need to see stabilization and early signs of recovery in the EU economy.

Swedish Krona (SEK)

The krona appreciated 1.1% vs. the G10 average in December. The gains were steady, alongside the generally positive global risk environment and an uptrend in equity markets. Riksbank's buying of krona likely helped to provide a positive tailwind as well.

Conversely, local fundamental data was mixed and not supportive of the steady gains. On 5 December, composite PMI improved slightly but remained in contractionary territory, below 50. On 14 November , core CPI data came in well below expectations, at 5.4% YoY vs. 5.9% expected. However, the dovish market reaction to the US Fed and ECB policy announcements seem to have shielded the krona from a negative reaction. Spillover from the surprise rate hike in neighboring Norway probably helped provide support as well. Late in the month, the krona abruptly gave back more than half its gains on no discernable news. Perhaps this was due to profit-taking after a stellar two-month run or other technical factors going into year-end.

Our short-term value model is strongly negative on the currency, as it estimates that the recent strength in the krona is not justified by economic data. The ongoing Riksbank reserves hedging program and potential for further near-term resilience in equity market sentiment may limit downside over the near term, but those positive factors appear limited going forward.

The krona-buying program is likely to end in January-February, and the potential for a period of consolidation and higher equity market volatility appears likely in first quarter following the amazing gains since October. Eventually, though maybe not in the next several months, Swedish and global inflation will be under control and the economy will begin a more durable recovery. Once that happens, the historically cheap krona has substantial room to enjoy a broad-based appreciation back toward its long-run fair value on a sustained basis.

Australian Dollar (AUD)

The Australian dollar saw a modest 0.1% rise relative to the G10 average in December, as the currency traded within a narrow range. The month began on a negative note following the Reserve Bank of Australia (RBA) meeting on 5 December, where the bank held policy rates steady at 4.35%, but noted that it forecast wage gains to slow, a development consistent with reduced inflation and less pressure for future rate hikes.

However, the combination of a strong employment report on 13 December — more than 61,500 new jobs compared to 11,500 expected — and the dovish US Fed meeting, shifted the Australian dollar into a more positive track by the end of the month. Weaker commodity prices likely weighed on the dollar, but stronger equity markets and iron ore prices likely muted the impact.

Our models continue to see medium-term risks tilted to the downside for the Australian dollar on weak commodity prices, sluggish economic growth, underperformance of Australian equity markets, and the overall fragility of the global growth outlook heading into 2024. On a more positive note, we do not expect the RBA to ease monetary policy as rapidly as in the EU or North America in 2024, and, given its subdued performance, the currency does not appear as overbought as other commodity-sensitive currencies, such as the Norwegian krone. Additionally, we anticipate a small uptick for the Australian dollar on improvement in Chinese growth following the recent fiscal and monetary stimulus.

In the long term, the outlook for the Australian dollar is mixed. It is cheap against the US dollar, the British pound, the euro, and the Swiss franc, with potential for appreciation, but it is relatively expensive against the yen and the Scandinavian currencies. The Chinese story presents a less positive outlook, as we see a structural downtrend in Chinese growth as well as a rotation toward domestic consumption and higher-value-added industries, which may gradually reduce the growth rate of Australian commodity export demand.

Canadian Dollar (CAD)

The Canadian dollar remained within a tight range throughout December, ending the month with a 0.1% gain against the G10 average. However, the Canadian dollar faced conflicting fundamentals. Commodity prices have been soft, and both manufacturing and services PMIs are well into recession territory. GDP growth has been 0% MoM for each of the last three months and home prices continue to trend lower.

There were clear signs that the Bank of Canada's (BoC) tight monetary policy is weighing on the economy. However, the labor markets continued to surprise with job creations and wage growth. Additionally, core CPI also surprised to the upside and appears to be stuck in the mid-3% range, while it is trending decisively lower in most other major G10 economies. This underpins a more aggressive, more hawkish BoC policy stance and supports the currency despite a clear weakness in economic activity. The result has been a more range-bound Canadian dollar over recent weeks.

The Canadian dollar remains one of the lowest-ranked currencies in our short- and medium-term models. The rapid deceleration in growth, coupled with weak commodity prices, suggests potential further weakness for the Canadian dollar. Resilient inflation and labor markets are likely to give way to the weaker economic conditions over the next several months, potentially leading to an earlier or more rapid monetary easing cycle in Canada relative to the US and other countries. This risk appears to be underappreciated in the current market pricing and suggests scope for Canadian dollar weakness.

In the long-term, beyond the current cyclical challenges, the Canadian dollar looks more attractive. It is cheap in our estimates of fair value relative to the euro, the Swiss franc, and the US dollar. Furthermore, its long-term potential growth is poised to improve on an aggressive increase in immigration and substantial plans to invest in sectors such as green energy technology.

New Zealand Dollar (NZD)

The New Zealand dollar fell 0.2% versus the G10 average in December, which was a decent performance given its 2.5% gain in November. The dollar mostly followed global forces and the neighboring Australian dollar throughout the month.

Similar to the Australian dollar, the New Zealand dollar trended lower for the first half of the month, hitting its low on 14 December following a negative surprise in the third quarter GDP, which showed a -0.3% QoQ versus the expected +0.2%. However, this downdraft quickly reversed on the surge in global risk sentiment in response to the dovish shift in the US Fed monetary policy outlook, allowing the New Zealand dollar to regain most of its losses by the end of the month.

Our outlook for the New Zealand dollar in the near term is increasingly pessimistic. Slowing growth, poor commodity prices, and the weak external balance — the current account is -7.5% of GDP — more than offset any benefit of high yields. Our short-term value model suggests that the New Zealand dollar is significantly overbought. Unlike the krone, the New Zealand dollar's overbought condition is not due to a strong rally in the currency. Rather, our model suggests that the New Zealand dollar should have fallen in response to weaker fundamental conditions, but has not.

In the long term, our outlook for the New Zealand dollar outlook is mixed. Our estimates of long-run fair value suggest that it is cheap versus the US dollar and the Swiss franc, and has ample room to appreciate, but is expensive against the yen and Scandinavian currencies.

Norwegian Krone (NOK)

The krone was the big winner in the G10, up 3.3% relative to the group average and 6% against the US dollar. Despite these stellar gains, the krone's return vs. the G10 average for fourth quarter remained flat at 0%, for the fourth quarter. Therein lies one reason for the krone's strong return in the month. It entered the month oversold after falling in October–November despite strong equity market performance.

The first half of the month was lackluster for the krone on negative industrial production, weak oil prices, and a downside surprise in core inflation. However, the Norges Bank surprised markets with a policy rate hike from 4.25% to 4.5% on 14 December, which starkly contrasted the more dovish tilts of the US Fed, ECB, BoE, and SNB.

The November core CPI data — 5.8% YoY — may have undershot expectations of 5.9%, but 5.8% is still a very high level and not consistent with the Norges Bank policy rate of only 4.25%. The krone shot higher and continued to gradually appreciate through month-end. At month-end, the Norges Bank announced a sharp reduction in krone sales from NOK 1400 million per day in December to NOK 350 million per day in January, adding a final positive shock to help the currency finish the month at its high.

The more vigilant central bank and reduced krone sales are clear positives. However, our short- and medium-term models remain negative on the krone due to weak oil prices and disappointing growth data. Even the relative tightening of the monetary policy outlook has had limited impact beyond the near term. The market-implied three-month government bond yields one year from now fell 0.67% during December compared to a fall of only 0.47% in the US. Markets clearly anticipate lower inflation and an eventual, and significant easing of monetary policy over the next year.

Our short-term value model suggests that the recent krone strength has substantially outpaced its fundamentals. Going forward, we also think it prudent to be cautious on the global risk sentiment and its impact on the krone. We expect a general slowing of global growth led by the US, which will likely increase recession fear and result in periods of greater equity market volatility and subdued oil prices, both of which are consistent with a weaker krone, or at least limited upside. In the long term, the outlook is positive. The krone is historically cheap relative to our estimates of fair value and is supported by steady potential growth.

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