Insights
Currency & Cash

July 2023

Currency Market Commentary

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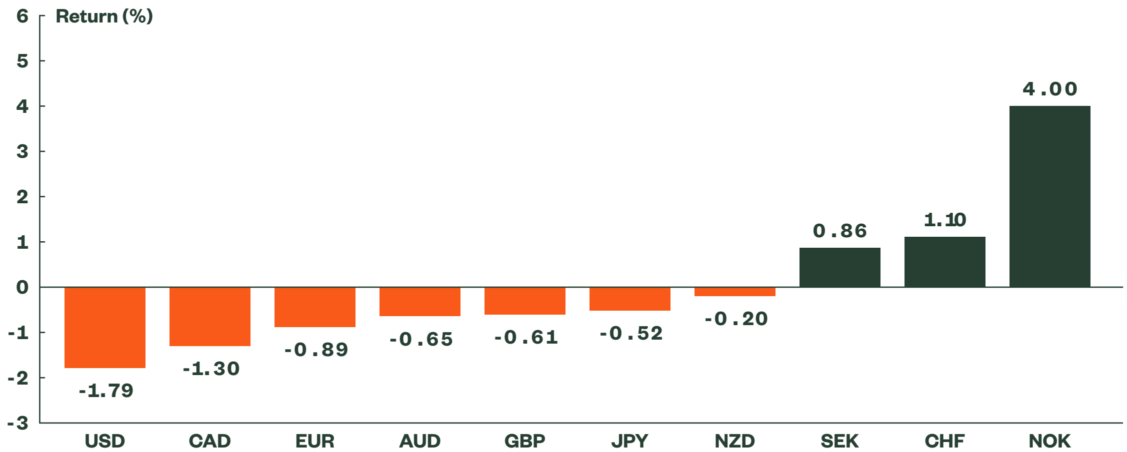
Summary of Views

Weaker-than-expected inflation in the US, the UK, and Australia, soft European Union (EU) growth data, and a dovish shift in monetary policy from the US Federal Reserve (Fed), Reserve Bank of Australia (RBA), and European Central Bank (ECB) helped to boost investor sentiment. The MSCI World Index rallied nearly 3% in local currency terms and oil bounced almost 14% during July, while the US dollar declined and dragged the Canadian dollar with it. The downside inflation and growth surprises also weighed on the British pound, the Australian dollar and the euro. The yen struggled, given its negative short-end yields even after a surprise Bank of Japan (BoJ) adjustment to the Yield Curve Control (YCC) policy that projects to allow 10-year Japanese government bond (JGB) yields to rise as high as 1.0%, a level not seen since 2011.

Figure 1
July 2023
Currency Return vs. G10 Average



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

The Norwegian krone was the big winner during the month, retracing more than half its 7.5% H1 loss following an upside surprise to Norwegian inflation and oil rally during the month. The neighboring Swedish krona also beat the G10 average thanks to its own upside inflation surprise and some likely spillover from the krone's rally, though it was unable to beat the Swiss franc. The franc once again defied broader macro patterns, registering the second strongest performance in the G10, despite having the second-lowest yields in the G10, softer-than-expected inflation, and sluggish growth. It seems to be supported as a safe alternative amid the ongoing weakness in EU economic data.

Figure 2
July 2023
Directional Outlook

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

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

There is strong momentum behind the positive move in risk assets, currently supported by disinflation and the resultant shift of major central banks toward a pause, or an outright end, to the policy tightening cycle. That risk-loving environment, if it continues, favors a weaker US dollar and yen against strength in more pro-cyclical currencies such as the Norwegian krone, the Swedish krona and the Australian dollar. The problem with this scenario is that our base-case outlook is for a period of significantly-below-potential global growth through 2024. We already see stagnation across the UK and Europe. The US is holding up surprisingly well for now, but consumers have been burning through excess pandemic savings and credit conditions continue to tighten. China is likely to get close to its 5% 2023 growth target; however, deflationary forces and a lack of private sector confidence point to a tough road ahead. China is unlikely to be an engine of global growth. On a positive note, elevated levels of fiscal stimulus, strong labor markets, and healthy private sector balance sheets are probably enough to avert a global recession. Still, we see the world in a fragile place, which will limit further upside in risky assets and result in periods of support for safe-haven currencies such as the US dollar and the Japanese yen.

Review and Outlook by Currency

US Dollar (USD)

The US dollar was the worst-performing G10 currency in July, down 1.8% relative to the group average, though that is much better than the mid-month decline of nearly 3.5%. The dollar's weakness began after a slightly weaker-than-expected employment report on 6 July and accelerated a few days later as both consumer and producer price inflation came in under expectations. The soft data reduced the anticipated Fed policy tightening beyond the rate increase in July. That sent US two-year yields down 35 bp between 6 and 13 July and the US dollar down 3.94%. The US dollar recovered during the second half of the month as attention turned to weaker growth in the EU and downside surprises in UK and Australian inflation. The Fed delivered the expected 0.25% rate increase and pointed toward a pause in tightening on 26 July. That would have been negative for the US dollar but had little impact as the ECB also delivered a dovish message the next day and expectations were muted for the Bank of Japan meeting later in the week.

We have long held the view that the US dollar is likely to fall at least 10%–15% over the coming years but is currently in a noisy transition period from a bull to a bear market. We confidently believe that the next big, sustained move in the dollar is lower, but it appears a bit early for that now. US growth and yields are among the best in the G10 and the equity rally since October of last year looks ripe for a correction at some point leading to safe-haven demand for the US dollar (very difficult to time).

As the cumulative impact of monetary tightening works its way through the economy and excess household pandemic savings decline, we expect a material economic slowdown with risk of a mild recession into 2024. That negative risk likely reduces the dollar's yield support but replaces it with safe-haven support as investors seek safe assets amid recession fear and resurgent volatility in risky assets. Once we get through, or are at least well into, a global slowdown and see the Fed actually begin to ease monetary policy, investors are likely to look forward to an eventual recovery catalyzing a more sustainable and large US dollar downtrend.

Euro (EUR)

The euro outperformed the US dollar but traded down 0.9% against the G10 average. The sharp fall in the US dollar early in the month was mostly to the benefit of oversold commodity-sensitive currencies, particularly the Norwegian krone. The euro did not participate as it is a safer commodity-importing currency. But, even more importantly, the string of negative EU data surprises in the manufacturing purchasing managers' index (PMI), the services PMI, industrial production, and retail sales continued through the first half of the month. The single currency enjoyed a rebound mid-month, paring some of its losses, but that was more a result of a temporary correction lower in riskier currencies after the massive rally from 6 July to 13 July than an outright euro strength. The euro turned lower following comments by ECB member Klaas Knot on 18 July that downplayed the chance of further rate hikes after the July meeting, a message that was also delivered by ECB president Christine Lagarde after the meeting on 27 July.

We are neutral to slightly negative on the euro in response to the steady stream of weaker economic data surprises and the more dovish ECB policy outlook. Any return of pessimism and equity volatility over the next few months would likely support the euro vs. higher-beta currencies, but a broad euro upside appears unlikely in the near future. ECB policy rates are middling relative to the rest of the G10, providing only limited yield support for the euro, while the risk of recession is rising as the ECB tightens monetary policy, adding headwinds to an EU economy that is already flatlining.

British Pound (GBP)

The British pound lost 0.6% against the G10 average in July. Sterling began the month resiliently supported by hawkish comments on 7 July from Bank of England's (BoE) Catherine Mann regarding risks that inflation may become imbedded in the UK. On 11 July, strong wage gains in the employment report — +6.9% YoY — added support. That strength was short-lived, with the soft US inflation data triggering a sharp fall in both US and global yields. Two-year UK government bond yields fell nearly 20 bp on 12 July, dragging the British pound down 0.73% on the day relative to the G10 average. A softer-than-expected UK Consumer Price Index (CPI) print accelerated the pound's decline, sparking a one-day sell-off of 0.99% in the currency on 19 July. From there, a modest recovery in yields on hopes that the BoE would ultimately have to raise rates to a G10-leading 5.87% in this cycle helped the pound to recover some of its losses into the month-end.

We shift to a tactically negative view on the British pound in response to decelerating economic data and the poor UK equity market performance. It was helpful to see a downside surprise in the CPI data, but core inflation remains at a very uncomfortable 6.9% YoY, with tighter monetary policy expected. That is not healthy for an economy that has stagnated since November 2022. We expect the BoE to raise rates at the next meeting in early August, and raise rates at least to 5.5% by autumn. That said, the BoE is prone to caution in this cycle and the modest downturn in inflation, coupled with softer growth data, even in the resilient services sector, may result in some hesitation to tighten policy as much as expected.

Dovish central bank surprises have been quickly punished by currency investors in recent months. This is a non-trivial near-term risk to the pound. Of course, the increasing probability of a recession later this year or in 2024 is also a major headwind for the currency and a forceful tightening of monetary policy would increase that risk.

Our long-run valuation model suggests that the pound is cheap. However, low productivity growth and high inflation are pushing fair value lower. Relative to the US dollar, the fair value has fallen from 1.55 to 1.41 since May 2022. Breakeven inflation expectations and recent trend productivity differentials suggest that fair value will trend down to near 1.30 over the next few years and 1.20 over the next decade — a tough outlook for the BoE and the British pound.

Japanese Yen (JPY)

The yen outperformed the G10 average for most of the month before dipping into negative territory on 31 July to finish down 0.5%. Lower yields in the US, the UK, Australia, and the EU during the first half of the month were a material positive for the yen. As yields rebounded and risky assets continued to rally later in the month, it gave back most of the gains from early July but remained positive for the month. On 27 July, the BoJ effectively lifted the YCC target to allow ten-year Japanese government bond (JGB) yields to rise as high as 1% from the current cap of 0.5%. The initial reaction was yen-positive until markets refocused on the negative short-term policy rates and the notion that easing of the YCC cap may take pressure off the BoJ to end negative interest rate policy anytime soon. As a consequence, the yen sold off sharply at month-end to finish down 0.5% for July.

We are neutral to slightly positive on the yen for the next few months but see room for additional downside in early August as we expect higher yields outside of Japan and positive global risk sentiment to keep the yen under pressure. However, risks are skewed toward a yen recovery later this year and through 2024.

First, we see the global economy slowing later this year and into 2024, reviving a safe-haven bid for the yen. Second, we see an improving yield differential into 2024, with an economic slowdown, in our view, and ongoing global disinflation leading to rate cuts across the G10. Finally, in Japan, rising core inflation and more persistent wage growth point to an eventual move to positive BoJ policy rates. The timing of these factors is an issue that requires patience and tolerance for additional near-term losses in long yen positions. The global monetary tightening cycle is not over yet. The BoJ will err on the side of maintaining loose monetary policy for too long given its battle with deflation for most of the past 30 years. Nevertheless, the yen is very cheap, and markets could price these changes abruptly. It makes sense to have a long yen bias now.

Canadian Dollar (CAD)

The Canadian dollar followed the US dollar closely throughout the month to finish with a loss of 1.3% vs. the G10 average. The Canadian dollar moved lower against the US dollar following the surprisingly strong US ADP employment report on 6 July but reversed back higher on the next day as Canadian employment surprised to the upside — +59.9k new jobs vs. +20k expected — and US official employment data came in on the soft side. Relative to the broader G10, the better Canadian growth data and strong oil markets had little impact on the Canadian dollar. Instead, both the Canadian dollar and Canadian yields tracked the US dollar and US yields lower into the mid-month. As the US dollar turned higher on a rebound in yields and weaker growth and inflation data outside of North America, the Canadian dollar also recovered about half its early-month losses. The 0.25% rate increase form the Bank of Canada (BoC) also helped the Canadian dollar to recover, although the impact was limited after BoC Governor Tiff Macklem indicated that the policy tightening cycle was likely nearing its end.

Our models have shifted from negative to neutral on the Canadian dollar as a result of improved commodity prices and the ongoing positive economic data surprises, which offset relative weak local equity market signals. Like the US, the Canadian labor market is tight, and the consumer is holding up better than one might expect given the high levels of household debt and rapid rise in interest rates over the past year.

The Canadian dollar's high correlation to the US dollar also makes it more attractive than other more cyclical currencies such as the Norwegian krone and the Australian dollar in a global hard-landing scenario, though it might likely underperform the US dollar in an adverse global economic scenario. In the longer term, the Canadian dollar looks cheap in our estimates of fair value relative to the euro, the franc, and the US dollar, and 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.

Swiss Franc (CHF)

The franc rose steadily to finish up 1.1% relative to the G10 average and a strong 2.9% vs. the US dollar. The move higher is hard to explain with fundamentals. Swiss economic data continues to soften; core inflation rolled over and is back below 2% YoY; and Swiss yields remain the second-lowest in the G10. The apparent causes of the ongoing franc strength were the steady and relatively faster deterioration in EU economic data and reduced expectations for further ECB rate increases. The franc historically outperforms during periods of economic stress in the EU. We also have yet to see clear signs that the Swiss National Bank (SNB) is acting to curtail franc strength via its active currency market intervention policy.

We are negative 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 continues to soften; inflation is rolling over; and, aside from the yen, the franc has the lowest yields in the G10. Despite those negative forces, our pessimistic view on the franc will require patience. As we mention above, the recent deceleration in EU growth is a near-term support and the SNB has not yet shifted to a more dovish or even neutral posture. Once it does, there is ample scope for the franc to move lower.

Norwegian Krone (NOK)

The krone built on a G10-leading 2.4% gain in June with a stellar 4% gain in July, vs. the G10 average. The combined two-month move leaves the currency down 3.5% year-to-date (YTD) relative to the G10, up from its 9.0% YTD loss at the end of May. A near 14% rise in oil prices provided a steady tailwind for the krone throughout July. A jump in core inflation to 7% YoY vs. 6.6% expected increased pressure for further Norges Bank policy tightening and pushed the krone higher. The downside inflation surprises and more dovish central bank expectations in the US, the UK, Australia, and the EU further highlighted the relative attractiveness of the krone.

We shift from negative to neutral on the krone due to the strength in oil prices, better-than-expected economic data, and hopes for further monetary tightening. We continue to see risks due to the krone's high beta to equity market risk during this highly uncertain macro environment. In the long term, the story is more positive. The krone is historically cheap relative to our estimates of fair value and is supported by steady potential growth.

Swedish Krona (SEK)

The krona gained 0.9% against the G10 average in July. Like Norway, Sweden's core inflation surprised to the upside at 8.1% YoY as opposed to the expected 7.9%. This surprise bolstered expectations for further monetary tightening and stood in contrast to the more dovish expectations for monetary policy in much of the rest of the G10. The krona responded positively. However, growth data points to a continued recession and the recent deterioration of EU growth likely introduces additional headwinds. As a result, the krona was unable to keep pace with the neighboring Norwegian krone.

We are tactically neutral on the krona. Last month, we identified the krona as being short-term oversold and susceptible to a bounce. Now that bounce has occurred, we need to see a meaningful increase in expected policy rates and/or signs of economic recovery for a sustained recovery in the krona. We see neither. At the same time, we do not see large downside risks to the currency. The Riksbank is likely to keep pace with or tighten more than the ECB over the next several months and the cheap krona already reflects the ongoing recession risk in Sweden. Eventually, though maybe not in the next 6–9 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 appreciate back toward its long-run fair value on a sustained basis.

Australian Dollar (AUD)

The Australian dollar struggled throughout July, ending down 0.6% against the G10 average. The RBA held rates steady at its meeting on 4 July, setting a slightly negative tone for the currency, though comments that inflation risks were skewed to the upside helped prevent a sharp negative reaction. Soft retail spending and business confidence, as well as concerns over Chinese growth, helped push the Australian dollar lower till 11 July. The downside surprise in US Consumer Price Index (CPI) on 12 July triggered a sharp jump in the Australian dollar, which lasted a couple of days alongside strong rallies in most global high-beta, cyclically-sensitive currencies before it tracked back down to its lows. The Australian dollar enjoyed another temporary jump in response to better-than-expected labor market data on 19 July until a downside surprise in inflation on 25 July triggered a sell-off. Promises of Chinese stimulus following the Politburo meeting late in the month lacked detail and failed to provide meaningful support.

We continue to see downside risks for the Australian dollar, though stronger commodity prices helped to improve our forecast. The pivot from monetary tightening back to a pause, coupled with sluggish growth data, and the downside surprise to inflation are tough hurdles for the Australian dollar to overcome in the near term. Rising risks to global growth and equity market performance in H2 and into 2024, in our view, linger as another important risk on the horizon. China is unlikely to provide meaningful support for global growth or the Australian dollar, but we do expect the promises of fiscal and monetary stimulus to materialize and at least help to limit downside in commodity prices and the Australian dollar. In the longer term, the Australian dollar outlook is mixed. It is cheap vs. the US dollar, the British pound, the euro, and the Swiss franc, and has room to appreciate, but is expensive against the yen and the Scandinavian currencies.

New Zealand Dollar (NZD)

The New Zealand dollar lost 0.20% vs. the G10 average in choppy trading during July. The month began with a rally, with the New Zealand dollar gaining 1% against the G10 by 5 July on little to no news; from there it struggled. The Reserve Bank of New Zealand (RBNZ) met on 11 July keeping rates on hold at 5.5%. They noted that rates would likely have to remain high for an extended period but removed any warning of further rate increases. This was taken as dovish, sending the New Zealand dollar down over 0.6%. The sharp US dollar sell-off following the downside US inflation report on 12 July provided a temporary lift before the New Zealand dollar turned back lower on the dovish monetary outlook in New Zealand and steady fall in local two-year rates, down more than 40 bp from 7 July to the 18 July.

The stronger-than-expected Q2 inflation report — 1.1% QoQ vs. 0.9% expected — released on 18 July helped to halt the fall in local yields but did not stop the fall in the New Zealand dollar. Inflation may have beat expectations but was down from a 1.7% QoQ pace in Q1, reinforcing the idea that the RBNZ would be able to maintain current policy settings. The downside surprise in Australian inflation on 19 July and sell-off in the Australian dollar also may have contributed to the ongoing New Zealand dollar weakness as the two currencies are highly correlated. During the final week of the month, the New Zealand dollar recovered to near flat on the hopes of more Chinese economic stimulus and the somewhat dovish ECB and Fed policy meetings.

We are pessimistic on the New Zealand dollar in the near term. Rising recession risk and the weak external balance — the current account is –8.1% of gross domestic product — more than offset any benefit of high yields, particularly now that the RBNZ has likely ended its tightening cycle. We expect the tepid Chinese growth outlook and risks of slower global growth into 2024 to be additional headwinds for the currency. In the longer term, our New Zealand dollar outlook is mixed. Our estimates of long-run fair value suggest that it is cheap vs. the US dollar and the Swiss franc, and has room to appreciate, but is expensive against the yen and the Scandinavian currencies.

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* Pensions & Investments Research Center, as of December 31, 2022.
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