

Currency Market Commentary

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Summary of Views

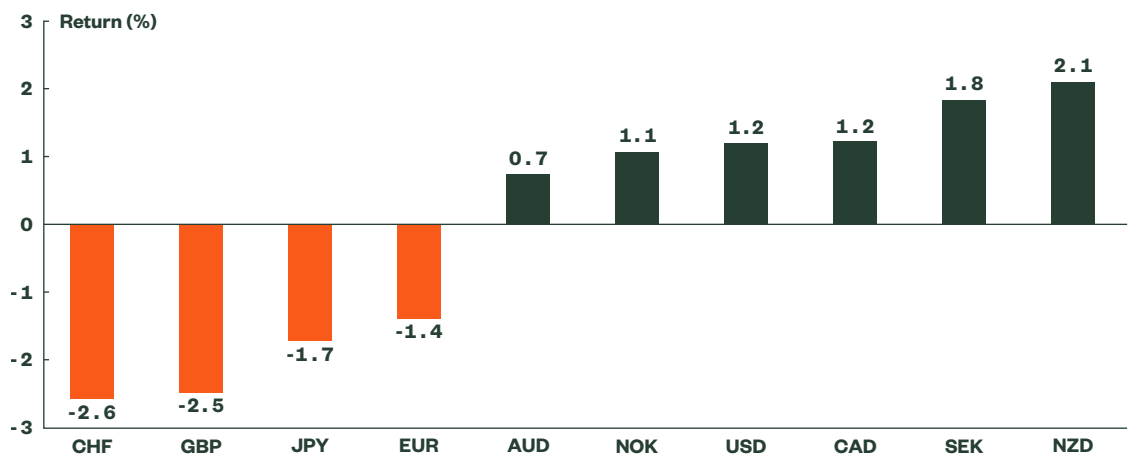
The big macro theme of the month was the higher-for-longer global policy rates led by the US, which resulted in rising yields and weaker equity markets.

As one would expect, the US dollar fared well in that environment, while the low-yielding Japanese yen suffered. However, neither registered the most extreme moves.

The British pound and the Swiss franc were the worst performers on the back of cautious central bank policy decisions and both weaker growth and inflation data. On the positive side, stronger-than-expected gross domestic product (GDP) and some stabilization in the Chinese outlook propelled the New Zealand dollar to the top spot in the G10.

The Swedish krona was a close second following a rate hike from the Riksbank and an announcement that the bank would buy an amount of krona equal to 25% of its foreign reserves.

Figure 1
September 2023
Currency Return vs.
G10 Average























Source: Bloomberg and State Street Global Advisors, as of 30 September 2023. **Past performance is not a reliable indicator of future performance.**

Despite our long-term US dollar bear market thesis, it is hard to bet against the US at the moment. The US dollar is both a defensive and high yield currency, while the US economy is holding up better than most — a very attractive trio of factors for the dollar against the backdrop of a fragile world economy.

That said, the dollar has enjoyed a steady rally since mid-July and is due a modest pullback sometime in the next 4–6 weeks. Conversely, the Norwegian krone appears oversold and due for a temporary bounce as weaker equity markets offset a positive response to higher yields and oil prices.

Figure 2
September 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 30 September 2023.

The European currencies — the euro, pound, and franc — have fallen substantially, but do not appear oversold due to dovish central banks and rising recession risk. We see little scope for a meaningful recovery in the near term. The deeply undervalued yen stands out as a positive risk hedge, but is still likely to struggle vs. the US dollar until yields finally peak and begin to move lower.

Through 2024, we expect US growth to soften to well below 1% as consumers run out of cash and tight credit conditions increasingly restrict activity. We expect the slowing in US growth to be gradual. Because of that, investors may interpret any initial deceleration in the US as a sign of a soft landing for the economy, which could send yields and the US dollar lower and equity markets higher, a pattern we have seen a few times over the past year.

Ultimately, if the US slowdown is as strong as we expect, it will threaten the soft-landing thesis and open the door to a more meaningful equity market volatility into next year, which will once again prop up the US dollar against most currencies, except the yen. A true top in the US dollar and a bottom in higher-beta currencies likely have to wait until sometime in 2024 until risky assets price in a greater degree of pessimism and/or the economic outlook outside the US bottoms and begins to recover on a relative basis.

Review and Outlook by Currency

US Dollar (USD)

The US dollar once again rallied on resilient economic data, higher yields, and weaker equity markets to finish the month with a 1.2% gain vs. the G10 average. Weak purchasing managers' index (PMI) data across the UK and Europe, as well as the Reserve Bank of Australia's (RBA's) decision to keep rates on hold, pushed the US dollar higher on 5 September.

That rally stalled, quickly sending the dollar into a range until the positive surprise in core consumer price index (CPI) on 13 September (+0.3% MoM vs. 0.2% expected) set the dollar back on a gradual trend higher.

On 20 September, the US Federal Reserve (Fed) held policy rates steady but revised its expected path of interest rates through 2024–25 materially higher, accelerating the uptrend in both the US dollar and US yields, and triggering a sell-off in equity markets.

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 — a protracted range-trading environment.

The next big US dollar sell-off does not appear imminent. The world is in a fragile place, while the US grows above trend and offers high yields, and the US dollar tends to provide a good hedge for risky assets if we slide into recession.

This is a strong basis of support for the US dollar. However, while those positive factors should prevent material dollar weakness, they are largely priced in, which also limits further upside. In fact, if US growth gradually slows to below trend over the next 3–6 months, investors are likely to react positively at first in hopes of a soft-landing, sending yields and the US dollar lower and equity markets higher.

Eventually, by early 2024, we suspect US growth to slow substantially, igniting fears of a global recession and poor corporate earnings. In that case, we expect lower yields and lower, more volatile equity markets. In that environment, the dollar likely strengthens once again. The positive impact of the US dollar's safe-haven appeal in a time of falling equity markets historically dominates the negative dollar impact of lower yields.

In short, the US dollar is overvalued on a long-term basis, but is likely to remain well supported in a range over coming months. Once we get through, or are at least well into, a global slowdown, see risky assets price in greater pessimism, and see the Fed bias shift toward easier monetary policy, we expect a large, sustained US dollar downtrend.

Canadian Dollar (CAD)

The Canadian dollar was up 1.2% against the G10 average and nearly unchanged against the US dollar during September.

The month began on a weak note following a downside surprise in the June GDP (1.1% YoY vs. 1.4% expected), and a tick lower in the August manufacturing PMI.

On 6 September, the Bank of Canada left the policy rate unchanged at 5%, in line with expectations, but comments in the monetary policy statement that the economy “entered a period of weaker growth” weighed on the currency.

The tide turned positive for the Canadian dollar following a better-than-expected employment report on 8 September, a strong rally in oil prices, and a higher-than-expected Canadian inflation report on 19 September.

The Canadian dollar gained vs. both the G10 and the US dollar through the middle of the month. Strength vs. the G10 average continued through month-end, but the Canadian dollar's gains against the US dollar reversed following the hawkish Fed meeting on 20 September.

Our models are neutral on the Canadian dollar, with improved oil prices offsetting modest softening in economic data and sluggish relative Canadian equity market performance.

Like the US, the Canadian labor market is tight, and consumption, while softening, is holding up better than one might expect, given the high levels of household debt and the 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 the Canadian dollar may likely underperform the US dollar in an adverse global economic scenario.

In the long term, the Canadian dollar looks more attractive as it is 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.

Euro (EUR)

The euro trended steadily lower to end September down 1.4% against the G10 average.

For the first half of the month, the downtrend was gradual on weaker-than-expected manufacturing and services PMI data, poor retail sales and a downward revision to Q2 GDP from +0.3% QoQ to 0.1%.

The EU economy appears to be sinking into at least a shallow recession. On 14 September, the European Central Bank (ECB) raised policy rates from 0.25%, but did so alongside a downgrade of both inflation and growth forecasts and a statement considering the new 4% policy rate as maybe sufficient to tame inflation, if held at that level for some time.

This signals that the policy tightening cycle may have over-steepened the euro's trend lower through the remainder of the month, particularly after the relatively hawkish US Fed statement and policy projections on 20 September.

We maintain a neutral to slightly negative view on the euro in response to the steady stream of weaker economic data surprises, the stubborn inflation and a dovish shift in the ECB outlook. Further pessimism and equity volatility over the next few months may help support the euro vs. higher-beta currencies, but a broad euro strength appears unlikely in the near future.

We must also pay closer attention to the Italian fiscal deficit and the potential for rising peripheral spreads. On 28 September, Italy put forward a new budget projecting a deficit of 5.3% of GDP, compared to prior estimates of 4.5%.

With debt/GDP near 145%, Italian bond spreads to safer German Bunds widened. We do not see an imminent repeat of the 2012 EU debt crisis, but, with the ECB having ended its quantitative easing (QE) program, private markets may require a higher risk premium to purchase Italian bonds and those of other highly indebted EU countries. In the past, that has pressured the euro lower.

British Pound (GBP)

The British pound fell 2.5% relative to the G10 average in September. The path was similar to that of the euro, a modest move lower during the first half of the month, followed by a steep drop in the second half.

There were few economic data releases early in the month, though continued deterioration in the employment report on 12 September followed by a weaker-than-expected July GDP released on

13 September provided a mildly negative backdrop. The pound also appeared to weaken in sympathy with the euro following the more-dovish-than-expected ECB statement on 14 September. The losses accelerated on 20 September following a large downside surprise in core CPI and Fed projections of higher US policy rates for longer.

In contrast, the next day, the Bank of England opted to take the cautious route and keep policy rates unchanged, though the accompanying statement did point to risks of further rate hikes if inflation persists. Markets were unimpressed with the forward-looking commitment to raise rates if needed and the pound fell over 1% through month-end.

Our factor models continue to point to a neutral to slightly negative near-term pound outlook driven by weakness in relative economic growth, partly offset by recent equity market outperformance. However, we see risks to the pound increasingly skewed lower as the economy teeters on the brink of recession, inflation and wages remain uncomfortably high, and the central bank turns away from further rate increases.

Our long-run valuation model suggests that the pound is cheap, particularly against the US dollar and the Swiss franc. But it is important to temper upside expectations as 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 1.42 since May 2022. Breakeven inflation expectations and recent trend productivity differentials suggest that fair value will trend down to at least the mid-1.30s over the next few years. Currently in the low 1.20s, the pound is still materially cheap even if fair value drops to the 1.30s.

Japanese Yen (JPY)

The yen was slightly lower, but mostly traded in a choppy range until the hawkish Fed meeting on 20 September sent it down to finish the month at a 1.7% loss vs. the G10 average.

Early in the month, the yen moved higher in response to an interview by Bank of Japan (BoJ) Governor Kazuo Ueda, where he hinted that negative interest rate policy (NIRP) could be changed if growth and inflation continue to beat expectations.

That support was quickly offset by a disappointing cash wage report on 7 September, (a mere +1.3% YoY growth compared to expectations of +2.4%) that left real cash wage growth at -2.5% YoY.

The sharp rise in US yields following the upside surprise in US core CPI and hawkish Fed projections on 20 September sent the yen lower before it rebounded back to flat for the month in anticipation of the BoJ meeting on 21 September.

That meeting was a disappointment. Rather than building on his earlier comments regarding the end of NIRP, Governor Ueda delivered a dovish message emphasizing the need for patience.

Inflation has been consistently above target since September 2022, but recent weakness in global growth and the disappointing pace of wage gains threaten the ability of inflation to sustain at or above target in the long run.

We are neutral to slightly positive on the yen for the next few months but see room for additional near-term downside vs. the US dollar as global interest rates remain at high levels with positive upward momentum.

Later this year and into 2024, risks are skewed toward a yen recovery as yields peak and turn lower, while below-trend global growth creates an increasingly fragile environment for risky assets.

The uncertain timing of this turn in global yields and growth is an issue that requires patience and tolerance for additional near-term losses in long yen positions.

One growing yen-positive risk is the chance for government intervention to support the currency. We do not think it will be as quick to intervene as it was in 2022 because lower import prices and stronger growth reduce the pain of yen weakness. But, if the yen rises above 150 and toward 155+ vs. the US dollar, the risk of intervention to limit/slow further yen losses will increase. It makes sense to have a long yen bias at least against non-US dollar currencies now, even though it may take some time before it begins to materially strengthen.

Swiss Franc (CHF)

The franc was the worst-performing G10 currency in September — down 2.6% vs. the G10 average and 3.8% vs. the US dollar.

Following a weak retail sales report released on 31 August, 1 September brought a weaker-than-expected manufacturing CPI at 39.9, vs. expectations of 40.5, both well below 50, signifying economic contraction.

Core CPI — also released on 1 September — was in line with expectations but showed a continued deceleration to 1.5% YoY, well within the Swiss National Bank's (SNB's) target range.

On 4 September, Q2 GDP disappointed at 0% QoQ. The Swiss economy stagnated in Q2 and is nearing recession, while inflation trends lower and threaten to fall below the SNB's target range if they persist.

Accordingly, the SNB surprised markets at its meeting on 21 September by holding the policy rate unchanged at 1.75%. The combination of weaker economic data and the shift in SNB monetary policy to hold rates steady weighed heavily on the franc throughout the month. The uptrend in global yields and hawkish stance of the US Fed added to the downward pressure.

We are negative on the franc over both the tactical and strategic horizons. It is the most expensive G10 currency as 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.

We expect the Swiss National Bank (SNB) to hold rates for at least a couple of quarters before shifting to an easing bias. And, importantly, SNB foreign reserve data suggests that it is no longer aggressively intervening to maintain franc strength via its active currency market intervention policy.

However, despite the weaker local economic situation and a potential dovish SNB pivot, our pessimistic view on the franc may require patience as the rising risk of EU recession and the fragile global macro environment may provide some near-term support, at least vs. the euro and the British pound.

Any meaningful increase in investor fear regarding Italian, or broader EU, debt levels would also provide added franc support.

Norwegian Krone (NOK)

The krone bounced back from a 2.1% loss in August to post a 1.1% gain in September vs. the G10 average.

The steady rise in oil prices was a clear positive throughout the month. However, the much-weaker-than-expected inflation data (core CPI fell 0.6% MoM in August compared to an expected drop of 0.3%) and weak equity markets weighed on the krone through the first half of the month.

On 21 September, the Norges Bank raised rates from 4% to 4.25% and indicated that another rate hike was likely in December, while oil prices accelerated higher. The positive combination of hawkish monetary policy and higher oil prices finally pushed the krone into positive territory for the month despite the deepening equity market sell-off.

Our models are increasingly positive on the krone in the near term. It appears oversold relative to the recent strength in oil prices and the tighter monetary policy outlook.

However, our current positive bias is only over the near term. We continue to see medium-term risks due to slower growth data and 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 was the second-best performing currency in the G10, up 1.8% vs. the G10 average, thanks entirely to a robust rally following the Riksbank meeting on 21 September, which kicked off seven days of consecutive gains.

Prior to that meeting, the krona was languishing in negative territory for the month. Weaker-than-expected manufacturing and services PMIs, a downside surprise to inflation, and gradual weakening in labor markets all fed the weak krona narrative that had dominated for most of the year.

The Riksbank changed the story with a 0.25% rate increase, hints of another in coming months, and, most importantly, a plan to hedge 25% of its foreign exchange reserves.

Hedging 25% of its foreign exchange reserves effectively means the bank will buy krona and sell reserves to the tune of about USD 8 billion and EUR 2 billion. This will be a substantial ongoing source of support for the krona, and pushed the currency higher into month-end.

In August, we shifted from a neutral to a modestly negative view on the krona in response to a weaker economic outlook and poor local equity market performance. Our models retain that negative bias.

However, we see increased risks that the krona may outperform model expectations as the ECB appears to be shifting to a more dovish policy stance before the Riksbank and the Riksbank will steadily buy krona as it hedges its exchange reserves.

This does not mean we expect meaningful, broad krona strength. It just means that performance may not be as bad as the models suggest. 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 gained 0.7% vs. the G10 average in September. A weaker-than-expected Chinese services PMI print on 4 September and the RBA decision to keep rates on hold, though expected, sent the Australian dollar 0.5% lower to start the month.

From there, more aggressive measures from China to support the yuan, improved energy prices, and a strong Australian labor market report helped the dollar to trend higher through mid-month.

The hawkish US Fed outlook published on 20 September triggered an equity market sell-off and halted the Australian dollar's rally. It gave back nearly half its month-to-date gains and entered a choppy range through the last week of the month.

Though better than expected, Chinese PMI data on 29 September helped the Australian dollar to finish on a strong note.

We continue to see risks in the Australian dollar tilted to the downside on our expectation of rising risks to global growth and equity market performance into 2024. We see signs of stabilization in Chinese growth data and sense some fatigue after a surge in investor fears regarding China. This opens the door for a temporary recovery to the benefit of the Australian dollar.

However, China is unlikely to provide meaningful medium-term support for global growth, including Australia. The drag on Chinese growth from its flagging property sector, high levels of local government debt, and the lack of consumer and business confidence are likely to take years to resolve.

Domestically, consumers and businesses are holding up reasonably well, and strong immigration is helping to support growth without triggering higher inflation. But we expect high levels of household debt and the drag from monetary tightening to keep the economy and the Australian dollar on the sluggish side.

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 was the best-performing G10 currency for the month, up 2.1% vs. the G10 average. Like the Australian dollar, the New Zealand dollar is very sensitive to Chinese growth and currency outlook.

Accordingly, the New Zealand dollar struggled early in the month following weak Chinese service sector data. Strong actions by Chinese authorities in reducing the FX reserve ratio and setting the official yuan fixing well above prevailing market levels helped to support the yuan and by extension the New Zealand dollar, which rallied alongside the Australian dollar through mid-month.

Domestically, a strong upside surprise in Q2 GDP on 20 September (+0.9% QoQ vs. +0.4% expected) provided additional support for the New Zealand dollar to hold its rally through month-end despite the hawkish US Fed surprise and equity market sell-off. And, like the Australian dollar, the New Zealand dollar enjoyed a strong bounce on the last day of the month following the better-than-expected Chinese PMI data.

Despite the September rally, we remain pessimistic on the New Zealand dollar in the near term. Recession risk and the weak external balance — the current account is -8.1% of GDP — more than offset any benefit of high yields, particularly now that the Reserve Bank of New Zealand has likely ended its tightening cycle. Any further relief from the pessimistic Chinese growth theme is likely to prove temporary. 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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Marketing communication

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