Insights
Currency & Cash

August 2023

Currency Market Commentary

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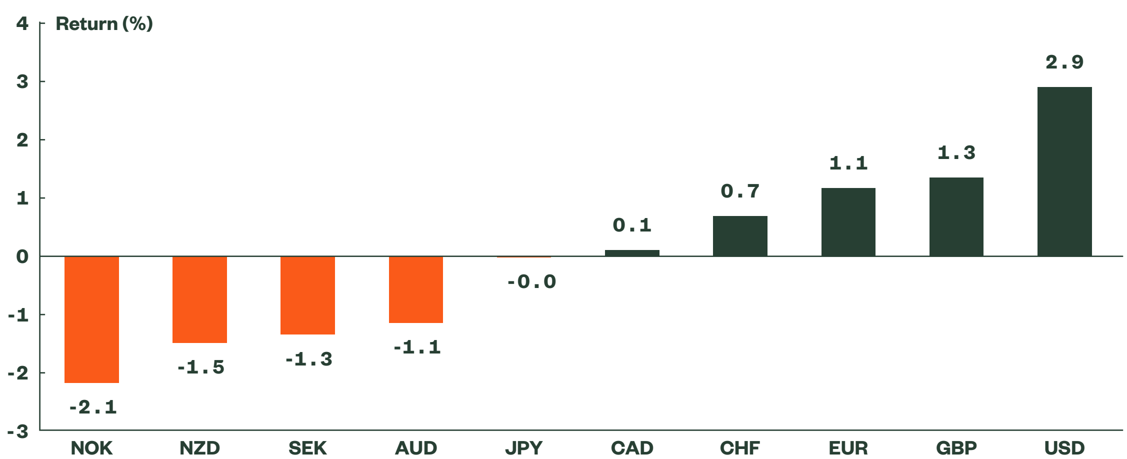
Summary of Views

In August, markets focused on the relative strength of the US economy relative to the flagging data in the UK, the European Union (EU), and China. The resilient US data and concerns of a more vigilant US Federal Reserve (Fed) sent US 10-year yields up to new cycle highs, pushing equity prices lower. FX markets followed their usual pattern, with the safe-haven US dollar leading the upside and the equity-risk-sensitive Norwegian krone posting the worst performance in the G10, with the Swedish krona not far behind.

The Australian and New Zealand dollars suffered from the risk-off mood, weak domestic data, and the ongoing disappointment in the Chinese growth outlook. As they usually do, the euro and the Swiss franc held up better during the equity correction despite the ongoing softness in local economic data. The Canadian dollar and the Japanese yen notably underperformed the US dollar but were stuck in the middle of the broader G10. Canada was insulated from the softening global risk sentiment by its reasonably high yields and proximity to the resilient US economy. The yen found itself stuck between the negative impulse from rising global yields and the positive safe-haven impulse from weaker equity markets.

Figure 1
August 2023 Currency Return vs. G10 Average



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

Despite our longer-term bear market thesis, it is hard to argue against the US dollar at the moment. The US dollar is both a defensive and high-yielding 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. This is especially true, heading into September, which typically brings higher levels of equity market volatility.

In the near term, currency market performance is likely to look similar to that in August, with more cyclically sensitive currencies underperforming. There are a couple of exceptions relative to August. The British pound looks increasingly vulnerable as economic data surprises turn negative, and, while we expect the Norwegian krone to have difficulty in the face of higher equity volatility, it looks increasingly oversold relative to strong oil prices.

Figure 2
August 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 August 2023.

Beyond September, we expect US growth to soften to well below 1% for 2024 as consumers run out of cash and tight credit conditions increasingly restrict economic 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, sending yields and the US dollar back down 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. For a true top in the US dollar and a bottom in the higher-beta currencies, we may likely have to wait until sometime in 2024.

Review and Outlook by Currency

US Dollar (USD)

The US dollar shrugged off a credit downgrade, softer-than-expected employment data, and continued deceleration in the core consumer price index (CPI) to lead the G10 with a 2.9% gain vs. the G10 average in August.

The primary drivers were the strong relative US growth — as seen in better-than-expected retail sales and core durable goods orders — and concerns that the Fed will keep monetary policy tight amid above-trend growth. This sent US 10-year yields to new cycle highs, spooking equity markets. The US dollar benefited from both.

Fed Chair Jerome Powell's speech at the Kansas City Fed symposium on the 25 August did not reveal as hawkish a tilt as feared after the minutes of the July Fed meeting were released on 16 August. Powell's status quo speech, along with a notable reduction in job openings in the Job Openings and Labor Turnover Survey (JOLTS) report on 29 August, caused the US dollar and the US yields to ease slightly into month-end, but they held most of their August gains.

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, offers high yields, and the US dollar tends to provide a good hedge for risky assets in the event of a recession. This is a strong basis of support for the US dollar.

However, those positive factors are largely priced in, making it unlikely that we may see a sustained uptrend in the US dollar. 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 US dollar lower and equity markets higher.

Eventually, we suspect US growth will slow enough, as the rest of the world remains slow, that investors will worry about recession risks and poor corporate earnings. In that case, we expect lower yields and lower equity markets, which will send the dollar temporarily higher once again. The positive impact of the US dollar's safe-haven appeal historically dominates the negative 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 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.

Canadian Dollar (CAD)

The Canadian dollar moved sideways in choppy trade during August to finish the month with a 0.1% gain relative to the G10 average. The dollar sold off early in the month following a disappointing Canadian employment report (-6.4k new jobs vs. expectations for +25k), and a weaker-than-expected Ivey Manufacturing PMI report. The surge higher in the US dollar following a stronger-than-expected producer price index (PPI) report on 11 August aided the Canadian dollar, helping it recover and erase its post-employment report losses. From there, the Canadian dollar moved sideways in a very tight range through month-end, with US dollar strength on the back of decent US economic data likely helping the Canadian dollar outperform other risk-sensitive currencies to finish nearly flat vs. the G10 average.

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 the consumer 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, though we see early signs of softening domestic demand.

Its 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 likely underperforms the US dollar in an adverse global economic scenario.

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

Euro (EUR)

The euro steadily underperformed the US dollar this month, but gained 1.1% against the G10 average. Overall, EU economic data continued to disappoint, with June retail sales coming in at -0.3% MoM compared to +0.2% expected, and previously resilient services purchasing managers' index (PMI) joining manufacturing PMI in the contractionary territory. Meanwhile, stronger-than-expected core CPI inflation for August constrained the European Central Bank (ECB) from easing policy to support growth.

On 25 August, ECB President Lagarde pledged to keep rates sufficiently high for a long enough period to tame inflation. If it were not for the higher sensitivity of the Antipodean and Scandinavian currencies to weaker equity markets and disappointing Chinese data driving them lower, the euro would likely have fallen vs. the broader G10 as it did vs. the US dollar.

We maintain a neutral to slightly negative view on the euro in response to the steady stream of weaker economic data surprises and rising stagflation risk. Any return of pessimism and equity volatility over the next few months would likely support the euro vs. higher-beta currencies as we saw in August, but 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, creating greater headwinds to an EU economy that is already flatlining.

British Pound (GBP)

The British pound gained 1.3% against the G10 average in August, lagging only the US dollar. The pound began to trend higher following the Bank of England (BoE) policy rate increase from 5.0% to 5.25% on 4 August. Stronger-than-expected June gross domestic product (GDP) growth (+0.5% vs. +0.2%) and a solid July construction PMI over the next week provided further support. Around mid-month, a strong employment report — +97k new jobs relative to -12k expected — and another positive core CPI surprise sent the pound sharply higher.

At that point, the data, however, turned negative, pushing the currency lower into month-end. July retail sales dropped 1.2% vs. an expected fall of 0.6%, and services PMI fell into contractionary territory for the first time since January, dragging the composite PMI with it. The pound was able to hold on to about 2/3rd of its earlier August gains through month-end, but the downward trajectory in preliminary Q3 growth data threatened a return of recession/stagflation fears.

Our view of the British pound is increasingly negative in response to the decelerating economic data, persistently high inflation, and poor UK equity market performance. We expect the BoE to raise rates again at its September meeting and probably at least one more time by year-end. But that may provide little support for the pound as tighter monetary policy further damages an economy already teetering close to recession. As much as the BoE acknowledges the rising recession risk, the BoE may spark market fears that it has become too cautious in tightening policy enough to tame inflation.

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 the lower 1.30s over the next few years. The pound is still cheap at those levels, but the BoE and the pound face a tough outlook over the next few quarters.

Japanese Yen (JPY)

The yen was unchanged against the G10 average in August. After a quick bounce early in the month following the US debt rating downgrade, higher US yields weighed on the yen. Faltering risk sentiment pushed equity and commodity prices, helping to elevate the yen over the more cyclically sensitive currencies, but not enough to prevent losses against the US dollar, the euro, the Swiss franc, and the British pound.

Local economic data was strong. Q2 GDP grew at a 6% annualized rate and national core CPI rose from 4.2% to 4.3% YoY in July. However, those positive data surprises had little impact on the currency given the Bank of Japan's (BoJ's) cautious approach to monetary policy. We expect the yen to continue to be driven more by global yields and risk sentiment than local economic developments.

We are neutral to slightly positive on the yen for the next few months, but see room for additional near-term downside as global interest rates remain at high levels. 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 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, as the yen approaches 150 vs. the US dollar, intervention risk is rising, which will likely help to limit/slow further yen losses. It makes sense to have a long yen bias now, even though it may take some time before it begins to strengthen.

Swiss Franc (CHF)

The Swiss franc rose steadily through 29 August before selling off in the last couple of days of the month to finish with a gain of 0.7% relative to the G10 average. The move higher is hard to explain with fundamentals. Swiss economic data continues to soften, core inflation is trending lower and is back to 1.7% YoY for July from a peak of 2.4% earlier this year, and Swiss yields remain the second lowest in the G10. The apparent cause of the ongoing Swiss strength is the rising stagflation risk in the EU and the muddled expectations for further ECB rate increases. The franc historically outperforms during periods of economic stress in the EU.

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. We expect another policy rate increase from the Swiss National Bank (SNB) in September, but think that will be accompanied by more neutral comments and may mark the end of the tightening cycle.

SNB foreign reserve data suggests that it is no longer aggressively intervening to maintain franc strength via its active currency market intervention policy. Such a dovish shift could encourage the highly overvalued franc to correct lower.

However, despite the weaker local economic situation and potential dovish Swiss National Bank (SNB) pivot, our pessimistic view on the franc may require patience as the rising risk of EU stagflation and the fragile global macro environment may continue to provide some near-term support.

Norwegian Krone (NOK)

The krone was the worst-performing G10 currency in August after being down 2.1% against the G10 average. Early in the month, rising oil prices and a very brief sell-off in the US dollar following the 4 August US payrolls report helped the krone hold largely in positive territory despite weaker equity markets.

After 8 August, oil prices reversed to fall almost 5% by mid-month, equity markets accelerated to the downside, and Norwegian inflation came in lower-than-expected, sending the krone down more than 3% from its high. The Norges Bank raised policy rates by 25 bp to 4% on 17 August and signaled further hikes, but it did little to support the currency. Oil and equity prices recovered late in the month, but the krone did not recover due to the disappointing Q2 GDP growth and retail sales alongside the Norges Bank announcement that it would increase daily FX purchases for September.

We shift from neutral to slightly positive on the krone as it appears oversold relative to the recent strength in oil prices, late August recovery in equity markets, and hopes of further monetary tightening. The modest increase in daily FX purchases — the sale of krone to move oil industry tax receipts to the offshore wealth fund — was taken as a negative by markets, but is arguably a positive as gains from higher oil prices are much larger than the value of those sales.

This makes sense because the FX sales are a portion of oil tax receipts, which are themselves only a portion of total oil profits. Our current small positive bias is only over the near term. We continue to see medium-term risks due to the recent slowdown in 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 followed global equity markets through most of the month to end August 1.3% lower against the G10 average. The krona began the month with a quick drop on 3 August alongside equity markets, sparked by risk aversion following Fitch's US credit downgrade. It bounced back quickly over the next two days after positive surprises in both Swedish manufacturing and services PMIs and the soft US employment report.

Similar to the krone, the krona, which is typically sensitive to risk assets, followed equity markets lower through mid-month. Weaker-than-expected headline inflation data reinforced that sell-off. Unlike the krone, the krona recovered alongside risk sentiment and equity markets during the final week of the month helped by better-than-expected Swedish Q2 GDP growth and retail sales data.

In August, we shifted from neutral to modestly negative on the krona on a weaker economic outlook and poor local equity market performance. Q2 GDP growth surprised to the upside vs. expectations, but it was still -0.8%. Recession risk is high. The Riksbank is likely to keep pace with or tighten more than the ECB over the next several months given the stickiness of core inflation, which sounds positive on the surface, but will put further pressure on the economy and weigh on the krona's outlook. 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 appreciate back toward its long-run fair value on a sustained basis.

Australian Dollar (AUD)

The Australian dollar dropped 1.1% against the G10 average for the month. The negative return in August is easy to understand for many reasons.

The Reserve Bank of Australia disappointed market expectations by holding the policy rate steady at 4.1% at its meeting on 1 August. Concerns over the impact of a steady stream of disappointing economic news out of China — Australia's largest trading partner — have weighed on the currency. At the same time, local economic data has been soft. Manufacturing and services PMIs data both point to contraction, while employment data surprised to the downside, with a loss of 14.6k jobs in July — not to mention weaker equity markets, as we saw in August, tend to depress the typically high-beta Australian dollar.

We continue to see risks in the Australian dollar tilted to the downside as we expect rising risks to global growth and equity market performance later this year and into 2024. China is unlikely to provide meaningful support for global growth, and for Australia. That said, there are some positive signs that suggest the strong Australian dollar downtrend over the past couple of months may slow for a time, even reverse slightly. Home prices have started to trend higher again. July retail sales showed some life.

Employment disappointed for July, but the unemployment rate is just barely off the 45-year lows, while wage growth remains elevated. Externally, commodity prices have rallied recently and pessimism regarding the growth challenges in China appears to be reaching a local crescendo. 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 1.50% vs. the G10 average in August, the second worst performance in the G10. The worsening Chinese growth outlook weighed on New Zealand's external demand outlook. Unlike Australia, New Zealand does not benefit from the recent rise in energy prices. On the contrary, milk powder prices, an important export, are near a 5-year low. This is a tough situation for a country with an uncomfortably large current account deficit. Manufacturing and services sectors both look to be under pressure, while sticky inflation limits the Reserve Bank of New Zealand from easing policy to support slowing growth. The labor market is probably the brightest sector of the economy and should help to put a floor under household consumption, but the overall economic outlook remains tenuous at best.

We are pessimistic on the New Zealand dollar over the near term. Rising 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 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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Marketing communication

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