Commentary
Currency & Cash

June 2022

Currency Market Commentary

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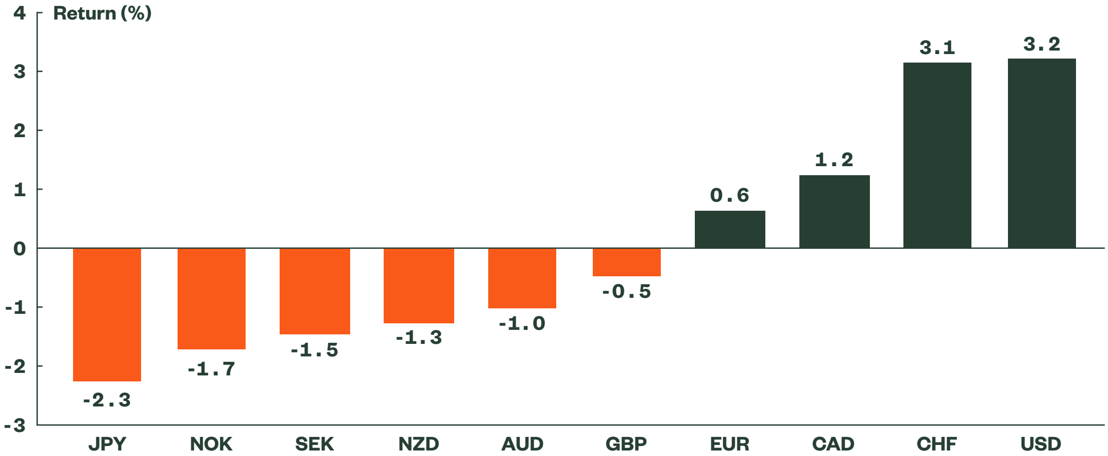
Summary of Views

Inflation and recession risks continue to drive markets. The first half of June brought an accelerated pace of policy tightening, with 50 bp monetary policy rate hikes in Canada, Australia, and even Switzerland. The US Fed led the pack, delivering 75 bp in the United States (US). Global yields and the high-yielding, safe-haven USD rocketed higher while the equity market repriced lower. A series of weak economic data prints during the second half of the month took the attention away from rising yields toward rising recession risk. Global yields and commodity prices fell sharply, but the USD held on to most of its gains given its tendency to perform well as global economic risks rise.

Figure 1
June 2022 Currency Return vs. G-10 Average



Source: Bloomberg and State Street Global Advisors, as of June 30, 2022.

We think the macro environment will be extremely challenging over the next couple of quarters. Global growth is slowing, and we expect inflation to begin to stabilize and moderate this year but remain at historically high levels. Weaker growth and high inflation will keep central banks on the defensive and introduce substantial uncertainty for investors. The big risk is that a recession may be required to tame inflation. Even if we were to avoid a recessionary scenario, it is unlikely that inflation at 40-year highs can be brought under control without a meaningful slowdown to balance supply and demand.

Cross currents from that highly uncertain economic outlook coupled with the ongoing risks of further COVID-19 lockdowns under China's zero-COVID policy and the Russia-Ukraine War portend further turbulence in financial markets. In such an environment, the USD is likely to remain well supported against more cyclically sensitive currencies. Beyond that, it is difficult to identify high conviction positions in currency markets, as evidenced by the unusually large number of neutral signals in our tactical outlook.

Figure 2
June 2022 Directional Outlook

	Tactical Outlook	Strategic Outlook
USD	↑	↓
EUR	—	—
GBP	—	—
JPY	↑	↑
CHF	—	↓
CAD	—	—
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 at 30 June 2022

Review and Outlook by Currency

US Dollar (USD)

The USD gained 3.2% in June, finishing Q2 with a massive 7.2% gain versus the G-10 average. The entire June rally occurred during the first half of the month. Strong employment data, +390k new jobs relative to 318k expected, and a fresh 40-year high in consumer price index (CPI) at 8.6% year-over-year (YoY) prompted a repricing of the Fed's rate-tightening expectations. This sent the USD steadily higher alongside US yields and triggered steep losses in equity markets. As anticipated, the Fed delivered a 0.75% rate increase at its meeting on 15 June and signaled the potential for another 75 bp move in July. However, the market reaction was short-lived as investors had largely anticipated the move. Instead, during the second half of the month, yields and commodity prices fell as recession fears rose. A series of disappointing data, including of retail sales, regional manufacturing surveys, housing starts, and purchasing managers' index (PMI), suggested that the Fed was tightening into an already slowing economy. The USD stabilized and traded sideways for the second half of the month, caught between the negative impact of lower yields and the positive impact of rising recession risk.

The currency is highly overvalued from a long-run perspective, almost 22% expensive relative to the currency basket in the MSCI World ex USA Index, a level that has tended to precede a significant multi-year depreciation. At these valuation levels, the USD is clearly at risk over the longer term. Our 3–5 year USD outlook remains firmly negative. But for now, it is difficult to see the USD falling while the US rates continue to rise, global growth slows, and uncertainty from the Russia-Ukraine War and supply chain disruptions from COVID-19 remain elevated. Until the macro environment stabilizes, the currency is likely to continue to find support and may reach marginally higher highs despite its already elevated valuation.

Euro (EUR)

The EUR underperformed the USD by more than 2.5% but outperformed by 0.6% versus the G-10 average. Its gains were steady during the first three weeks, pushing it up 1.4% relative to the G-10 average by the 22nd, a broad-based strength that was easy to miss given the headline reports of the currency's weakness against the USD. The European Central Bank (ECB) held policy rates unchanged and ended its asset purchase program as expected on the 9th while signaling a gradual, flexible rate-hiking path beginning in July. This was far less aggressive than most G-10 central banks but had little impact on the EUR because markets will continue to price an aggressive tightening path through year end. Despite the ECB's measured tone, the overnight indexed swap (OIS) market was pricing an additional 25 bp of rate increases for 2022 on 10 June compared to the day before the meeting.

The EUR likely benefitted from its usual stability during periods of rising risk aversion and recession risk. Manufacturing and consumer sentiment surveys showed weakness, as did April retail sales; however, this was largely in line with softness in global data and was not a significant driver of the currency.

We maintain a moderate but increasingly negative view on the EUR over the coming months. Underneath its resilience during June, downside risks grew. Russia has shut off about 60% of natural gas supplies, making it nearly impossible for Europe to restock its inventories before the winter season. Entrenched fighting in Ukraine increases the chance of Russia completely shutting down the supply. This threatens a deep recession in the EU, one that will hit the core German economy most acutely. In the days following the ECB meeting, Italian debt spreads temporarily widened to more than 240bps relative to German bunds. This fragmentation, or differential yield moves across individual eurozone countries, represents another tail risk to regional growth, limiting ECB flexibility. The ECB responded with a promise to provide a backstop to prevent excessive widening of peripheral debt spreads, but details were scant. There is a risk that the final ECB plan may not be aggressive enough to placate markets.

Longer term, once the uncertainty over Ukraine, Russian gas supplies, and recession risk subside (which could take very long given current fighting), we see room to have a more constructive discussion on the EUR. For now, we expect that these growing downside risks to European growth will weigh heavily on the EUR in the coming months.

British Pound (GBP)

The GBP lost 0.5% relative to the G-10 average and 3.7% versus the USD due to slower growth, high inflation, and a persistently cautious central bank. As high inflation eroded real consumer purchasing power, UK retail sales fell in six of the past seven months. The preliminary June composite PMI fell to 52.4, still in expansionary territory but well below its 58.2 level that it reached just two months ago. Core CPI fell back from 6.2% YoY in April to 5.9% in May, but is still at extreme levels. Facing high inflation and weaker growth, the Bank of England (BoE) maintained its slow, steady pace with a 25 bp rate increase in June. However, the BoE also promised to act more aggressively on inflation if needed. This pushed the GBP temporarily back into positive territory mid-month before recession fears sent it back down toward the month end. Prime Minister Boris Johnson survived a no-confidence vote, but his position looks increasingly tenuous. This is not a major issue for the GBP because a general election is unlikely and a new replacement from the conservative party, if it comes to that, would not likely change policy in a meaningful way. Markets and the GBP may cheer a new premier, who might be able to govern more effectively, backed by broader support within the party.

Like the EUR, we are neutral on the GBP with a negative bias. Economic risks from a potential slowing of the UK's growth, current account deficit, fiscal drag, and eroding consumer purchasing power from elevated inflation are negative for the GBP. The BoE's hesitancy in tightening policy, despite its near 40-year high in inflation, also weighs on the outlook. Despite these challenges, we remain near neutral over the tactical horizon. The UK's data has slowed, and the drop in services PMI coupled with poor consumer confidence may foreshadow greater problems ahead. Overall, the UK is not slowing more than most economies and labor markets are holding up well. Longer term, we see greater room for sustained GBP appreciation powered by its cheap valuation versus long-run fair value, an eventual recovery in fundamentals, rising policy rates, and our expectations for broad long-run USD weakness. When this long-term recovery will begin is difficult to predict. For the foreseeable future, risks of a more significant global slowdown and intensifying stagflation risks in the UK may delay any long-run recovery in the GBP, even as late as H2 2023 or beyond.

Japanese Yen (JPY)

The JPY was the worst-performing G-10 currency, down 2.3% versus the average. The currency is driven by external factors, rates and global risk sentiment, rather than domestic data. That may change late this year or next, but for now the rebound in inflation is in its early stages, and negative real growth in cash wages suggests that it may not be sustainable. A change in Bank of Japan's ultra-easy monetary policy looks very unlikely this year. In relation to external factors, the JPY behaved as you would expect until the final week. As global yields surged early in the month, the JPY sold-off vigorously. As recession fears rose and equity markets accelerated lower, the currency rebounded in line with its usual safe-haven behavior. That lasted until the bounce in equities between the 16th and the 20th, sending the JPY back to its lows. After that, the currency's behavior was hard to explain.

In late June, the equity markets stalled and global yields fell significantly, yet the JPY was not able to materially recover. This could mean that the market has shifted to be more bearish and if we see a rebound in yields, it could quickly fall to a fresh low this year. Or the JPY investors are already pricing an expected recovery in yields such that the JPY remains in its current range even if yields move back to the June highs. It's probably a bit of both. Because we see rates moving higher after the steep late June rally, the probability of the JPY moving to new lows, the USD and the JPY up to and through 140.0, appears higher than a month ago. Long term, the JPY looks very cheap and is now near its 30-year low on a real effective exchange rate basis. The weakness in the currency appears to be a rational response to underlying cyclical fundamentals. Once the inflation/growth/monetary policy cycle turns, the JPY will have ample room to appreciate; 2023 is shaping up to be a very strong year for the currency.

Swiss Franc (CHF)

The Swiss National Bank (SNB) tightened policy much more aggressively than expected. The CHF jumped higher to finish the month with a 3.1% gain relative to the G-10. Markets expected a 25 bp rate increase in June with some chances of a 50 bp rate increase; the SNB's 50 bp was a modest positive surprise. The SNB also declared that the CHF was no longer highly overvalued and that they stood ready to intervene by buying CHFs to prevent excessive weakness. This is a major regime shift for a central bank that has been steadily selling CHF for the past decade.

We remain tactically neutral on the CHF with a positive bias. In addition to the hawkish SNB regime shift, heightened downside risk to the eurozone's growth and ongoing global recession risks also favor a stronger CHF, particularly relative to the EUR and the GBP. Over the very short run, we are cautious chasing the CHF higher because it rarely strengthens more than 6% relative to the EUR without a 2%–3% correction lower. In this case, it has already appreciated by nearly 5.5%. Longer term, the outlook is decidedly negative. The SNB declared that the CHF is no longer expensive versus the long-run fair value. Our models suggest that it remains quite expensive, though far less overvalued than it was 3–5 years ago. Swiss yields and inflation are likely to remain among the three lowest in the G-10 in future. A stronger CHF now is a logical trade during this period of high inflation and global economic slowdown (stagflation). However, looking through the business cycle, the CHF is unlikely to hold these gains as the economy and inflation recover to longer term trend levels.

Canadian Dollar (CAD)

The CAD was bolstered by strong domestic data, tighter monetary policy and positive spillover effects of the strong USD to gain 1.2% versus the G-10 average. Given the close economic ties with the US, the CAD tends to outperform other commodity-sensitive currencies when the USD is strong. May manufacturing PMI rose from 56.2 to 56.8, bucking the global softening trend, while May employment data and April retail sales both surprised higher. Common core inflation jumped to 3.9% YoY relative to expectations for a small increase to 3.4%. This validated the Bank of Canada's decision to raise rates by 50 bp, to 1.5%, and further underpinned market expectations for another 1.9% of rate hikes by year end. Intra-month, the CAD, as a pro-cyclical, commodity-sensitive currency, did fluctuate with broader global risk sentiment. However, the positive economic and monetary policy factors were more than enough to keep it in positive territory throughout.

Medium term, our CAD view remains positive due to rising yields, continued positive inflation surprises, and a strong domestic economy. However, short term, the recent rally looks ripe for a correction due to the steep drop in commodity prices and rising global recession risk. This limits our enthusiasm for further gains over the near term. As the Bank of Canada continues to tighten, we will have to confront the potential impact of higher yields on elevated household debt levels and extremely elevated home prices, but we are not there yet. From the perspective of long-run valuation (a 3–5 year horizon), the CAD is cheap and has potential for sustained long-run appreciation versus the USD and the CHF, but it is expensive versus the GBP, the JPY, and the Scandinavian currencies, and may underperform.

Norwegian Krone (NOK)

The NOK lost 1.7% versus the G-10 average, making it the worst-performing G-10 currency in Q2, down 4.3%. The story is straightforward. The NOK is highly sensitive to equity market sentiment and oil prices. June, like Q2, was marked by a substantial downside in equity markets and oil prices. The currency fell as it typically does in such environments. Local economic data has been on the disappointing side as well. Mainland GDP for April was at -0.5% month-over-month (MoM) versus +0.5% expected. That weakness carried over to May as manufacturing PMI gapped down from 60.6 in April to 54.9 and retail sales fell 0.9% MoM. The Norges Bank continued to gradually increase policy rates with a 25 bp hike to 1.25%, but it is under little pressure to materially accelerate the pace of tightening.

Our models have shifted negative on the NOK over the short run due to lower oil prices and weaker-than-expected economic data. We also see ongoing downside volatility in equity markets given the tenuous global macro outlook, which will likely cause the same behavior in the NOK. Over the medium term, the outlook is a bit more positive. Oil price downside is likely limited even in a recession due to US and Organization of the Petroleum Exporting Countries (OPEC) supply constraints and geopolitical risks to Russian supply. However, the benefits of high oil profits will likely be partly diluted by the Norges Bank's daily selling of the NOK. Over the long run, the NOK is historically cheap relative to our estimates of long-run fair value and is supported by steady potential growth. We expect strong gains eventually but reiterate that the currency faces a tough near-term environment.

Swedish Krona (SEK)

The SEK lost 1.5% against the G-10 average in choppy trade. The currency largely followed equity markets during the month, falling substantially into mid-month, then mounting a weak recovery. Local economic data was mixed. May manufacturing and services PMIs rose slightly, in stark contrast to the substantial slowing of PMI data across most G-10 countries. However, April industrial orders and May retail sales fell MoM, -2% and -0.6% respectively. Core cost-plus-incentive fee (CPIF) inflation data jumped up to 0.9% MoM for May compared to 0.7% expected, helping the currency retrace some of its losses mid-month on expectations that the Riksbank would deliver a more aggressive 50 bp rate hike at its meeting on the 30th. The Riksbank obliged with a 50 bp increase, but ultimately disappointed markets by projecting caution via its forecast that the rate-hiking cycle would largely end late this year. The SEK sold off to finish near its lows for the month.

The SEK remains among the cheapest G-10 currencies, but it is likely to remain weak near term, leaving us largely neutral over the tactical horizon. The shift in Riksbank's policy is welcome, but expected rate increases remain small compared with that of several other G-10 central banks. The ongoing uncertainty regarding the EU's growth outlook and the Russia-Ukraine War are also likely to be a material drag. We see room for a recovery once we gain even a modest amount of clarity on the war and the gap between Sweden's monetary policy and that of the US and other G-10 countries begins to contract. Neither is likely over the next 2–3 months. For now, it may be best to express a positive long-term value based SEK view versus other low-yielders such as the EUR and the CHF that also have exposure to the EU's growth and the Russia-Ukraine War risks.

Australian Dollar (AUD)

The AUD reversed a strong start to the month to finish down 1.0% relative to the G-10 average and down 4.2% versus the USD. Early in the month, strong commodity prices, hopes of a near-term economic recovery as China lifted COVID-19 restrictions, and a larger-than-expected 0.5% rate hike from the Reserve Bank of Australia (RBA) pushed the AUD higher. As global risk sentiment turned negative, both equity and commodity markets moved lower, the AUD followed. Economic data was mixed. Employment once again surprised to the upside with 60.6k new jobs compared to 25.0k expected and May retail sales came in at an impressive 0.9% MoM growth rate. Survey data was less optimistic, suggesting that Australia may not be immune to the global slowdown. Composite PMI and the National Australia Bank's business survey both fell meaningfully from April levels.

Global recession risks and ongoing equity market volatility have weighed on our tactical AUD outlook. Industrial metals prices are likely to remain under pressure. We expect this terms of trade pressure plus a natural slowdown in Australian growth from the initial surge following COVID-19 reopening to limit growth into 2023. China's relaxation of COVID-19 restrictions and the potential for an announcement of additional fiscal stimulus in July may help the currency bounce from its recent lows. However, China's zero-COVID policy remains in place and the possibility of new lockdowns is a further headwind for the AUD. Thus, the balance of risks points to near-term challenges for the AUD, which are likely to keep it under pressure before it can sustain a medium- to long-term rally.

New Zealand Dollar (NZD)

The NZD fell 1.3% versus the G-10 average due to global recession fears, falling commodity prices and weaker equity markets. The move lower was fairly steady throughout the month with a short-lived reprieve as the equity market bounced off their lows from the 16th to the 21st. Broad global risk sentiment is likely to remain a key driver of the currency over the near term. Our tactical models turned negative on the NZD in March and remained in negative territory due to deceleration in economic activity, weak domestic equity markets, and deteriorating global risk sentiment. Yields remain relatively attractive, but the relative advantage is limited as other central banks are also becoming more aggressive in tightening policy.

While we are negative on the NZD, it is important to note some underlying positive signs. New Zealand's commodity export basket was relatively stable compared to Australia and other industrial metals exporters. Local economic data remained soft but showed signs of improvement relative to pessimistic market expectations. May manufacturing PMI improved from 51.2 to 52.9. Consumer credit card spending continued to grow even though the ANZ-Roy Morgan Consumer Confidence Index is at extremely weak levels, below the panic levels seen when the pandemic broke out in early 2020. Longer term, our NZD view is mixed. Relative to long-run valuations, the NZD appears attractive against the USD and the CHF, but is not as cheap as the other commodity currencies.

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† This figure is presented as June 30, 2022 and includes approximately $66.43 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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