Insights
Currency & Cash

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Currency Market Commentary

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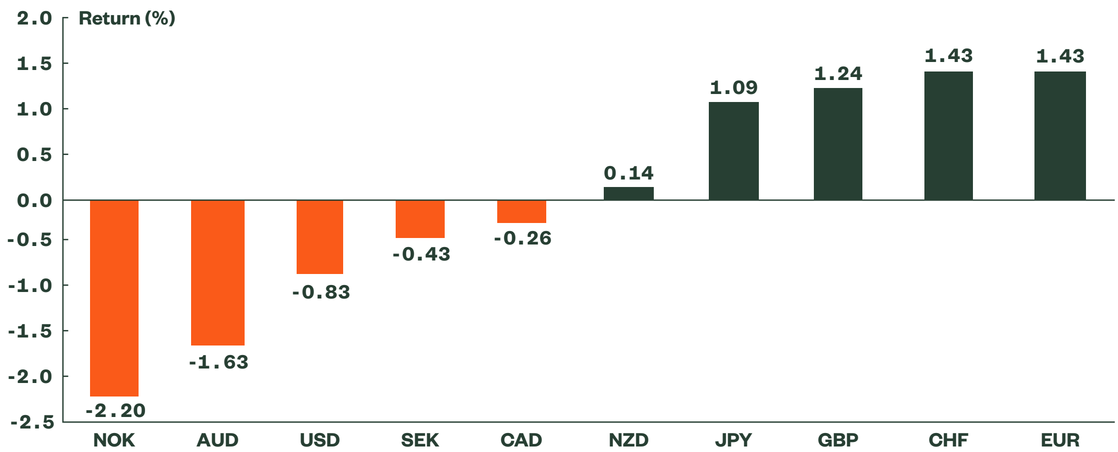
Summary of Views

The failure of Silicon Valley Bank (SVB) on 10 March shook financial markets. US 2-year yields fell more than 1.0% in a matter of days, while equities moved sharply lower and credit spreads wider. Liquidity support from central banks, particularly the US Federal Reserve (Fed), and lower yields helped allay concerns of further near-term bank failures, allowing equity and credit markets to almost fully recover. However, something broke and it durably changed the complexion of currency markets by re-focusing market drivers on changes in relative growth, inflation, and monetary policy outlooks.

Figure 1
March 2023 Currency Return vs. G-10 Average



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

Figure 2
March 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 March 2023.

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The yen strengthened on lower relative global yields and reclaimed its traditional role as the preeminent safe haven currency from the US dollar. The euro and British pound were higher in response to stubbornly high core inflation and better-than-expected growth, both of which suggest tighter monetary policy even if the US Federal Reserve (Fed) pauses. In contrast, reduced growth, inflation, and monetary policy expectations in Norway, the US, and Australia pushed the Norwegian krone, the US dollar, and the Australian dollar lower.

The odds strongly favor a near-term end to the Fed tightening cycle and greater downside risk to US growth resulting from tighter credit conditions. This skews our medium- to long-term expectations for the US dollar lower, though we see room for a short-term bounce in short-end US yields and the US dollar before both resume a downward trajectory.

Our outlook on the yen has strengthened as it provides protection against a hard economic landing and benefits from lower US yields. The euro looks increasingly positive, thanks to a somewhat healthier banking sector, improved growth, and the high likelihood that the European Central Bank (ECB) might continue to raise interest rates even after the Fed stops. The events of March also skew the risks for the credit and equity markets lower, which support the US dollar. As a result, we expect more cyclical and risk-sensitive currencies with central banks at or closer to peak tightening — such as the New Zealand dollar, the Australian dollar , and the Norwegian krone — to continue to struggle even against the US dollar.

Review and Outlook by Currency

US Dollar (USD)

The US dollar fell 0.80% vs. the G10 average in March. The month began with a strong surge following the Fed Chair Jerome Powell's 7 March testimony to Congress, in which he hinted at the possibility of a 0.5% rate increase at the upcoming policy meeting and a higher than previously expected peak Fed funds rate. This made sense following the strong inflation, employment, and consumer spending data in January and February. But, just a couple of days later, the failure of SVB and Signature Bank radically changed market expectations for the economy and the Fed monetary policy. Rate hikes caused something to break, and that break threatened an ongoing, rapid outflow of banking deposits, threatening further bank failures. US interest rates, the US dollar, and equity markets all fell precipitously. Actions by the Fed, the US Treasury, and the Federal Deposit Insurance Corporation (FDIC) to cover uninsured depositors and provide substantial liquidity calmed fears of another imminent bank failure, but increased stress on deposits. Greater scrutiny of bank capital adequacy is likely to restrict lending over the coming quarters and result in a faster deceleration in economic activity and inflation, and increases the risk of a painful recession. The US dollar weakness reflects these concerns.

We have long held the view that the US dollar is likely to fall at least 10%–15% over the coming years. Prior to March, we argued that the transition from the US dollar bull market of the past several years to that of a bear market will be bumpy and could take the better part of a year. The weaker economic and inflation outlook following the banking crisis in March quickens the likely onset of that US dollar bear market. However, it is not a straightforward path.

Slower growth and banking stress may impact the US to a greater extent, but tight monetary policy is a global issue. This puts global corporate earnings, and by extension credit and equity markets, at greater risk. In a time of general financial market stress, the US dollar, as the primary reserve currency, is still likely to be attractive vs. more cyclically sensitive currencies such as the Australian dollar, the Norwegian krone, the New Zealand dollar and, to a lesser extent, the Canadian dollar. We see room for a temporary rebound in both short-end US yields and the US dollar after the extreme weakness in March. Beyond that, we focus our bearish US dollar view against longs in safer currencies such as the euro and the yen, which are also likely backed by further tightening in monetary policy.

Euro (EUR)

The euro enjoyed a strong month, leading the G10 with a 1.4% gain. The euro strengthened early in the month in response to a strong February core Consumer Price Index (CPI; +5.6% YoY vs. +5.3% expected). It continued to perform well during the initial US regional banking sector shock. However, the euro gave back its early month gains as fears mounted regarding Credit Suisse, which had been struggling over the past few years. However, a quick resolution — the sale of Credit Suisse to UBS — with substantial support from the Swiss National Bank (SNB) helped to alleviate the fear of contagion across European Union (EU) banks. Investors also appeared to pay more attention to the healthier balance sheets and liquidity buffers of European banks, opening the door for the euro to respond to positive news. And positive news came quickly with a 0.5% ECB rate hike on 16 March (an indication that more hikes were likely), a surge in the services Purchasing Managers' Index (PMI), and March core inflation data. As a result, the euro trended higher throughout the second half of the month.

We are positive on the euro in the near term on an improving (but still weak) economic outlook powered by lower-than-expected energy prices and decent fiscal spending. Meanwhile, stubbornly high core inflation is likely to keep the ECB on a tightening path, while the Fed and a number of other G10 central banks have stopped, or will soon stop, tightening policy. The euro is also likely to benefit from its relatively low correlation to global equity volatility and risk sentiment, which makes it less sensitive to the ongoing fear that global monetary tightening will trigger a recession.

British Pound (GBP)

The British pound impressed during March, being up 1.2% relative to the G10 average. Historically, any sign of banking stress and heightened equity market volatility weigh on the pound. Instead, the pound rallied, thanks in large part to the relatively strong capital and liquidity positions of UK banks, limited spillover from the US regional bank crisis, and stronger-than-expected inflation and growth data, which distinguished the UK outlook from the deteriorating outlook for the US. The manufacturing sector remains in contraction, but the services PMI, construction PMI, and retail sales all surprised higher. At the same time, core inflation unexpectedly jumped to 6.2% YoY vs. 5.7% expected, and the unemployment rate came in at 3.7% vs. 3.8% expected. Against widespread calls for a prolonged UK recession, including the Bank of England's (BoE) own gross domestic product (GDP) forecast, these data points paint a less dire picture to the benefit of the pound.

We are tactically neutral on the pound as better-than-expected growth and stubborn inflation suggest another BoE rate hike, or at least a prolonged pause at current levels. However, that positive impetus is offset by the pound's sensitivity to the fragile global economic outlook as well as the continued risk of downside volatility in equity and credit markets. We would expect the pound to underperform the yen and the euro, and remain rangebound vs. the US dollar. But it is likely to outperform more cyclically sensitive and commodity-linked currencies, such as the Norwegian krone, the Australian dollar, and the New Zealand dollar. In the long term, the outlook is more positive. The pound remains quite cheap by our estimates, about 12% below fair value relative to an MSCI World currency basket and 17% cheap vs. the dollar.

Japanese Yen (JPY)

The Japanese yen reclaimed its historical role as the preeminent safe-haven currency after rising sharply during the mid-month banking crisis. That was not enough for the yen to outpace the euro, the franc, and the pound, which were bolstered by a combination of stronger growth and inflation supporting a tighter relative monetary policy outlook. The improvement in risk sentiment and rebound in credit and equity markets during the final week of March also dragged the yen down from its intramonth high up over 3% to finish March with a 1.1% gain vs. the G10 average.

We have turned tactically positive on the yen, making it the only currency with a positive model forecast for both the tactical and strategic horizon. Strong labor markets and better-than-expected wage increases keep the prospect of further monetary tightening by the Bank of Japan (BoJ) on the table for later this year. This is in contrast to expectations for policy easing across most of the G10 by end-2023. Lower global yields in response to rising recession risk directly benefit the yen via narrowing interest rate differentials, which encourage the repatriation of capital back to Japan. Recession risk also indirectly benefits the yen as it suggests additional downside risks to equity and credit markets, leading to safe-haven demand for the yen. Over a long-term horizon, the yen remains significantly below our estimates of long-run fair value, suggesting 10%–20% upside over the next 1–3 years even after the strong rally from last year's lows.

Canadian Dollar (CAD)

The Canadian dollar largely followed risk assets during March, falling steadily through most of the month before rebounding with equity markets in the final week to finish with a modest 0.3% loss vs. the G10 average. We expect the Canadian dollar to struggle alongside the US dollar given the greater US recession risk and the strong links between the Canadian and US economies. However, Canadian banks at this point look to be in a healthier position and Canadian economic data continue to show surprising resilience. The Bank of Canada (BoC) held rates steady at 4.5% on 8 March as it waits to assess the impact of the cumulative policy tightening over the past year. Better-than-expected January retail sales and GDP, another positive surprise in employment, and a strong manufacturing PMI all point to the risk that the BoC may have to hike rates again, or at least hold rates at the current level longer than the Fed.

Our models are negative on the Canadian dollar on weaker commodity price trends, poor relative local equity market performance, and expectations of a deeper economic slowdown. That said, the relative economic outlook may prove overly pessimistic. As described above, growth data have been surprisingly resilient despite the dramatic increase in policy rates, high levels of household debt, and sharp decline in home prices. At the same time, we expect greater slowing in the US. A time of greater fragility and uncertainty in global growth, with particular weaknesses in the US, is not typically great for risky assets or the Canadian dollar, but if recent trends continue, we see risk that the Canadian dollar might outperform other commodity-linked and cyclical currencies and may hold up relatively well vs. the US dollar despite the current weak signals from our models.

Swiss Franc (CHF)

The Swiss franc was up 1.4% vs. the G10 average for the month, though that was well off its 13 March high of +2.5%. Early in the month, the franc appreciated following a stronger core CPI read (+2.4% YoY vs. +2.2% expected), which raised expectations for a 0.5% or even 0.75% rate hike by the SNB at its upcoming meeting on 24 March. The failure of SVB and Signature Bank led to an even more rapid appreciation of the franc given its tendency to outperform in times of financial stress. That safe-haven surge proved short-lived as investors focused on the long-ailing Credit Suisse, sending the franc lower mid-month. The feared Credit Suisse crisis, however, was quickly averted as the SNB engineered a weekend takeover by UBS, helping to stop the slide in the franc and allay fears that issues with Credit Suisse would spill over to EU banks. With the Credit Suisse crisis mostly resolved, the SNB went ahead with a 0.5% rate hike on 24 March in line with its primary commitment to fight inflation, while emphasizing its ability to handle banking sector risks independently from the inflation mandate.

We are neutral on the franc over the near term. The currency remains expensive in our estimates of long-run fair value and growth data continue to soften, both of which point to a lower franc. On the other hand, lower yields across the G10 improve relative Swiss interest rates to the benefit of the franc. And monetary policy incentives that have changed over the past month are likely to be franc positive. Because the sale of Credit Suisse to UBS will likely take several quarters to close, the SNB should be incentivized to lean more on a strong franc policy rather than interest rate increases to contain inflation.

Norwegian Krone (NOK)

The krone fell 2.2% vs. the G10 average in March to end Q1 with a 5.6% loss, by far the worst in the G10. The month began with a wave of negative data releases: weaker-than-expected February manufacturing PMI, a sharp decline in January industrial production, and a downside surprise in the February core CPI print (+5.9% vs. +6.3% expected). The US banking failures and equity market sell-off accelerated the sell-off in the risk-sensitive krone. Relief was hard to find. The recovery in equity markets after 13 March would likely have been positive for the krone, but a sharp 15% sell-off in Brent crude oil prices between 13 and 20 March overpowered the equity rally to push the currency even lower. Finally, a modest rebound in oil, continued recovery in equity prices, and a somewhat hawkish Norges Bank policy statement on 23 March helped the krone to recover, but it managed to regain only about a third of its losses by month end.

Our models are negative on the krone over the near term on weak/volatile oil prices and poor local equity market performance. Outside of the models, our concern regarding a steeper-than-desired global economic slowdown and further equity market volatility keep us even more cautious in our krone outlook over the next few months. The krone has had the highest downside correlation with equity markets in the G10 over recent years. However, 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. Thus, we expect strong gains eventually but reiterate that the krone faces a tough near-term environment.

Swedish Krona (SEK)

The krona lost 0.40% vs. the G10 average in March. For most of the month, the krona followed the equity market weakening through 13 March before bouncing back as the acute banking fears abated. Higher-than-expected core Consumer Price Index with a Fixed Interest Rate (CPIF) inflation (+9.3% YoY vs. +8.7% expected) underscored expectations of tighter monetary policy and amplified the krona rally. During the final week of the month that rally stalled, and the krona fell slightly toward the month-end despite continued strength in the euro and equity markets. There was little news to explain the weak month-end performance. However, the krona was particularly weak on the day of the Norges Bank meeting, suggesting some profit-taking after the large 8.5% year-to-date (YTD) sell-off in the Norwegian krone may have weighed on the Swedish krona.

Our models have a small positive bias in favor of the krona over the near term as it has already priced in a fair amount of bad news and local equity markets have performed well. The hawkish shift in Riksbank rhetoric and the ongoing upside inflation surprises should benefit the krona. That said, we see persistent downside risks that make a rally from here unlikely over the near term. Manufacturing and consumer spending are quite soft, while high levels of household debt make the Swedish economy very sensitive to tighter monetary policy. In the long term, the outlook is much more positive. The krona remains among the cheapest currencies in the G10 according to our fair value estimates. Eventually Swedish and global inflation will be under control and the Swedish and regional economies will begin a more durable recovery. Once that happens, the krona has substantial room to appreciate on a sustained basis.

Australian Dollar (AUD)

The Australian dollar lost 1.6% in March relative to the G10 average. It began to decline after the Reserve Bank of Australia (RBA) meeting on 6 March. The RBA increased rates by 0.25% as expected, but foreshadowed a pause in the rate hiking cycle despite acknowledging that some further hikes would be likely. Markets immediately reduced the expectation of peak policy rate from 4.15% to 4% and began to price cuts by year end. The US bank failures and equity sell-off a few days later perpetuated the Australian dollar's decline. The initial rebound in equity markets after 13 March and better-than-expected employment report on 15 March helped to support the Australian dollar, but that was short-lived. After the resolution of the Credit Suisse crisis, the Australian dollar resumed its downward trajectory as investor attention turned toward better growth numbers and a higher likelihood of further monetary policy tightening in Europe and the UK.

Weak/choppy commodity prices, slowing consumer activity, negative real wage growth, rising equity market risk, and a more cautious RBA present meaningful headwinds for the Australian dollar over the near term. We think the Australian dollar downside may be limited once better China growth begins to show up in the data, though a stronger China will probably not be enough to warrant outright Australian dollar strength, because China growth is likely to be concentrated in domestic services rather than the more resource-intensive sectors that favor Australian exports. In the longer term, the Australian dollar outlook is mixed. It is cheap vs. the US dollar and the Swiss franc and has room to appreciate, but is expensive against the British pound, the Japanese yen, and the Scandinavian currencies.

New Zealand Dollar (NZD)

The New Zealand dollar was up 0.1% vs. the G10 average in choppy, directionless trade during March. Given the usual high beta of the New Zealand dollar to the global risk sentiment, the fact that the New Zealand dollar held up well during the banking scare and equity sell-off is impressive. Investors appeared to be unconcerned with the contagion impacting New Zealand banks. Expectations for monetary tightening were reduced as they were globally, but by a smaller margin for New Zealand, helping to provide some yield support for the New Zealand dollar. The Reserve Bank of New Zealand appears committed to fighting high inflation even at the cost of a mild recession, and the market expects an additional 0.5% of rate hikes this year, similar to the ECB and BoE. Domestic economic data did not seem to drive the New Zealand dollar during the month, but it continues to soften. February manufacturing PMI, released on 9 March, moved back into expansionary territory but Q4 GDP was much lower than expected (–0.6% QoQ compared to –0.2% expected), while consumer confidence, home prices, and commodity terms of trade continue to trend lower.

We are negative on the New Zealand dollar over the near term. High yields should help support the New Zealand dollar. However, that positive impulse is likely to be more than offset by weaker growth, a fragile global risk sentiment, and downside risks to equity markets as investors grapple with the cumulative impact of tighter monetary policy and rising global recession risk. In the longer term, our New Zealand dollar outlook is also mixed. It is cheap vs. the US dollar and the Swiss franc, and has room to appreciate, but is fairly valued vs. the Canadian dollar and the euro, and is expensive against the Australian dollar, the British pound, the Japanese yen, and the Scandinavian currencies.

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* Pensions & Investments Research Center, as of December 31, 2021.
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