Insights
Currency & Cash

June 2023

Currency Market Commentary

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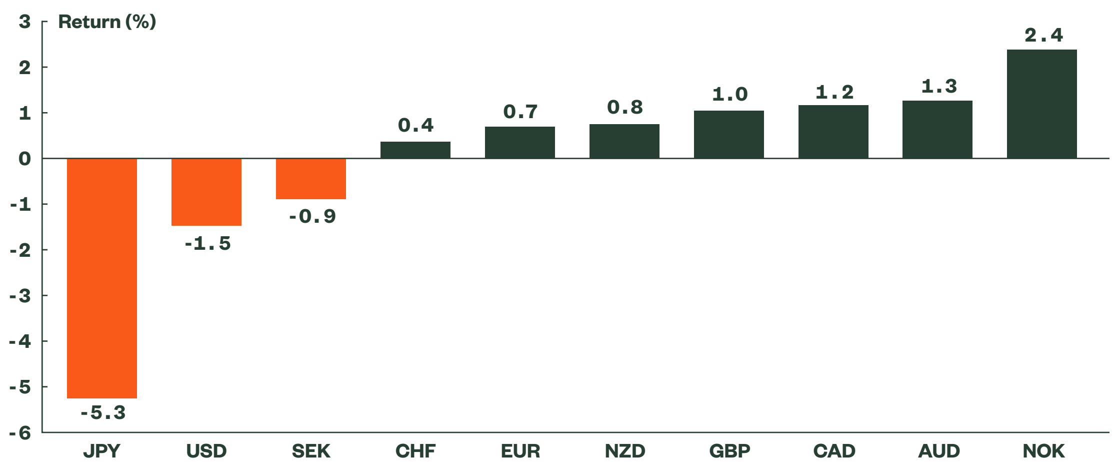
Summary of Views

Investors appear to have reinterpreted the current environment as one of a healthy mid- to late-cycle expansion marked by solid growth alongside rising interest rates, which are well justified by that growth. Accordingly, the MSCI World ex-USA gained 3.46% in local terms, and US equities did even better, with the S&P 500 up an impressive 6.47%. Credit spreads tightened and the Bloomberg Commodity Index was up 3.59%, all while the average G10 two-year yield rose 48 basis points (bp) on expectations of higher monetary policy rates for longer.

Figure 1
June 2023
Currency Return
vs. G10 Average



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

Figure 2
June 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 June 2023.

The more cyclically and equity-sensitive currencies of Norway, Australia, Canada, New Zealand, and the UK all outperformed, while the defensive Japanese yen and US dollar underperformed. Call it goldilocks, an immaculate disinflation, nirvana, or your favorite superlative — everything seems great if you do not think about the risks posed by unhealthy levels of inflation, high post-pandemic government debt ratios, and the most dramatic monetary tightening cycle in 40+ years. Also, growth across Europe and the UK is already stagnant; personal spending in the US is stagnating after its Q1 surge; Chinese growth continues to disappoint; and ultra-high debt levels limit the future fiscal impulse.

The pro-risk trade certainly has momentum. That optimism may well continue through July and beyond until one of the risks bites. Our base case is that eventually we may see a more pronounced stagnation across the world through 2024 with increased recession risk as central banks continue to tighten more than expected. We would call for a material recession as a base case, but household and corporate balance sheets look much healthier than they typically do before a major recession.

Given the risks outlined above, we favor higher-yielding defensive currencies over a six-month horizon. The US dollar stands tallest in this regard. The Japanese yen does not meet the high yield criteria and could continue to weaken in the near term, but, over H2 and into next year, we see substantial room for appreciation once growth rolls over and global interest rate expectations begin to fall. The pro-cyclical currencies that performed so well in June will struggle to sustain gains in an environment of high economic risk, although they may not have significant downside, either because they are historically on the cheap side of fair value, or because there could be, in our view, stagnation rather than a serious recession.

Review and Outlook by Currency

US Dollar (USD)

The US dollar lost 2.7% against the G10 average by 16 June as equity markets trended higher and relative monetary policy surprises favored a lower dollar. Surprise policy rate increases by the Bank of Canada (BoC) and Reserve Bank of Australia (RBA) contrasted with the stable near-term US Federal Reserve (Fed) expectations following downside surprises in the revised Q1 unit labor costs and May average hourly earnings, and the jump higher in the unemployment rate from 3.4% to 3.7%. As expected, the Fed held rates steady at its 14 June meeting, but did manage a modestly hawkish surprise by increasing its projected rate path to include an additional 0.5% of rate increases this year. Fed Chair Jerome Powell also noted that the first rate cut may not happen for another two years. The more hawkish-than-expected outcome, a temporary correction in equity markets, and the better-than-expected data during the second half of the month helped the dollar recover to finish the month down only 1.5% vs. the G10 average — new homes sales, durable goods orders, home prices, consumer sentiment, and Q1 revised gross domestic data (GDP), all surprised to the upside.

We have long held the view that the US dollar is likely to fall at least 10%–15% over the coming years, but the currency is currently in a noisy transition period from a bull to a bear market. In the near term, the resilience of the US economy and the stickiness of inflation should support short-end US yields and the US dollar as we saw in May and June. 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 the risk of a 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, the 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 US dollar downtrend.

Euro (EUR)

After a sluggish start to the month, the euro appreciated 0.7% relative to the G10 average during June. The first week of the month brought downside surprises in the core Consumer Price Index (CPI; 5.3% vs. 5.5% expected), disappointing retail sales, and the downwardly revised Q1 GDP data (from +0.1% to -0.1% QoQ). That was not a large revision, but it garnered extra attention because it is the second consecutive quarter of negative growth, a technical recession. That disappointing data, along with surprise rate hikes in Australia and Canada and buoyant equity markets, weighed on the euro in favor of more cyclically sensitive currencies through the first half of the month, though it did outperform the US dollar. The tide turned positive for the euro following the European Central Bank (ECB) meeting on 15 June. In addition to a 0.25% increase in the deposit rate and confirmation that all (bond) asset purchase program reinvestments would end in July, ECB President Christine Lagarde pointed to further tightening at the July meeting. The euro trended higher through the month-end despite a weaker-than-expected services Purchasing Managers' Index (PMI), which had been the one area of consistent strength during this period of stagnation.

We have shifted to neutral on the euro following the string of weaker economic data surprises. Further ECB tightening should help prevent significant weakness, and, any return of pessimism or equity volatility would likely support the euro vs. higher-beta currencies. But the euro upside appears unlikely in the near future. The 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 a European Union economy that has already posted two quarters of negative growth.

British Pound (GBP)

The British pound gained 1.0% relative to the G10 average in June. It is the top performer in the G10 for Q2 and year-to-date (YTD), up 4.0% and 7.3%, respectively. After a quiet start to the month, the employment report on 13 June surprised with 250k new jobs over the past three months — compared to 150k expected — and a 3M/3M average wage increase of 7.2% YoY vs. 6.9% expected. Investors priced in an additional 0.83% of tightening from the Bank of England (BoE), bringing the estimated terminal policy rate to a G10-leading 6.19% by February 2024, which helped to push the pound up about 1.2% between 13 and 20 June. Thereon, the currency moved sideways, still supported by high yields, but was held back by the somewhat cautious 0.25% rate increase by the BoE at its meeting on 22 June.

We are neutral on the British pound but see serious risks ahead. For now, high UK yields and the positive global risk sentiment are supportive of the currency. However, the BoE is in a tough spot. Recent data showing both core CPI and wage growth above 7% points to the risk of a wage-price spiral, necessitating tighter monetary policy. However, that greatly increases the chances of a meaningful recession as credit tightens, mortgages reset to the new higher rates, excess household savings from the pandemic run out, and the broader economy faces longer-term impairment to potential growth from Brexit.

At some point, we expect investor focus to shift from the high rates to recession fear, sending the currency lower. The BoE may remain cautious in the face of that economic risk, which it seems prone to do. But that may damage monetary policy credibility, which could hurt the pound even more than a recession. Our long-run valuation model is picking up on this low productivity growth and high inflation, pushing fair value lower. Relative to the US dollar, the fair value has fallen from 1.55 to 1.43 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 was the worst-performing G10 currency in June, down 5.3%. It has been the closest proxy of a pure rates trade in the G10 universe, with rising relative yields outside of Japan resulting in a weaker yen. Thus, the surge in global yields explains the steady downtrend in June. Bank of Japan (BoJ) Governor Kazuo Ueda maintained his patient tone, suggesting that Japanese monetary policy is unlikely to be tightened nearly as rapidly as the rest of the G10. Although core CPI reached 4.3% YoY, we see a risk that the BoJ may increase the upper band on allowable ten-year government bond yields in Q3, maybe as early as the July meeting. Another potential support for the yen would be a return of economic pessimism and equity market volatility. However, for now, the global soft-landing scenario dominates and the positive equity market momentum remains strong, suggesting further yen weakness in the near term.

We are patiently and stubbornly positive on the yen. We expect higher yields outside of Japan and the positive global risk sentiment to keep the yen under pressure, but as it weakens risks are increasingly skewed toward a yen recovery later this year and through 2024.

We believe this for a few reasons. First, we see the global economy slowing later this year and into 2024, reviving a safe-haven bid for the currency and reducing yields outside of Japan. Second, persistent and rising core inflation suggests a modest tightening of BoJ monetary policy this year. Finally, in June government officials began to warn markets of excessive yen depreciation, foreshadowing an intervention that could come in the near term if the downtrend continues. The timing of these three 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 decades-long battle with deflation. And the government may not be as quick to intervene to buy the yen as it was last fall because the stronger domestic economy and lower energy import prices reduce the pain of a weak currency. 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 gained 1.2% against the G10 average in June. Rising oil and equity prices pushed the Canadian dollar higher in the opening days of the month prior to the Bank of Canada (BoC) meeting on 7 June, where it surprised markets with a 0.25% rate hike, the first since January. Going into the meeting, only 8 out of 37 economists surveyed by Bloomberg expected a rate hike. This move set the stage for the Canadian dollar to rally steadily through the month relative to the US dollar despite disappointing employment data on 9 June. Against the broader G10, the Canadian dollar oscillated in line with the US dollar. It struggled to keep pace in the first half of the month as the US dollar struggled, then posted strong gains from 16–23 June, alongside the mid-month correction in equity markets and rebound in the US dollar.

Our models are negative on the Canadian dollar as a result of weaker commodity price trends and poor relative local equity market performance, though the signal is improving on the back of better economic data. Like the US, the Canadian labor market is tight, and the consumer is holding up better than one might expect, considering the high levels of household debt and rapid rise in interest rates over the past year. 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. 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 gained 0.4% vs. the G10 average during the month. It was a tale of two halves for the franc in June. Through mid-month, the currency trended lower as surprise rate increases from the RBA and the BoC highlighted the relatively low policy rates in Switzerland, while positive risk sentiment, weak Swiss manufacturing PMI, and rising equity markets favored higher-yielding currencies. The mid-month correction in equity markets and some anticipation that the Swiss National Bank (SNB) may have to tighten policy by 0.5% at its 22 June meeting helped the franc to recover. The SNB only delivered a 0.25% rate increase, but the franc continued to trend higher after SNB President Thomas Jordan pointed to additional rate increases this year and reiterated the important role of intervention to support franc strength.

We are negative on the franc over both the tactical and strategic horizons. It is the most expensive G10 currency in our estimates of long-run fair value. Growth data continues to soften, inflation appears to be 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. Inflation is improving but domestic services inflation remains stubbornly high and labor markets are very tight. SNB President Jordan has been clear that inflation above 2% risks becoming imbedded. The SNB is likely to continue to raise interest rates and intervene to prevent any notable franc weakness.

Norwegian Krone (NOK)

The krone led the G10 with a 2.4% gain in June but still lost 7% in H1, second only to the yen's 9.3% H1 loss. June's gain appears to be a short-term rebound from oversold levels, prompted by the positive acceleration of global equity markets. The krone rallied to an intra-month high (up 3% by 14 June in sympathy with rising equity markets) before stagnating and falling slightly into month-end. Local economic data was mixed and did not provide a clear catalyst for the currency. Manufacturing PMI fell back into contraction and the April mainland GDP (published in June) showed a surprise contraction of 0.4% MoM vs. expectations for 0.1% growth, while retail sales beat expectations. The clearest positive fundamental catalyst for the krone was the unexpected rise in May core inflation of 0.7% relative to estimates of +0.4%.

The Norges Bank surprised markets by increasing policy rates by 0.5% to 3.75% at their meeting on 23 June and indicated a new, higher terminal rate of 4.25%, citing inflation risks, strong wage growth, and the weak currency. The krone initially bounced on the news but failed to sustain the rally. A 4.25% terminal rate is barely above ECB terminal rate expectations, is about 1% below that of the Fed and BoC, and is almost 2% below market expectations for the BoE terminal rate. That is not enough yield support to trigger sustained investor interest in a higher-beta currency like the krone.

We remain negative on the krone due to shaky economic data, middling yields, weak equity markets, rangebound oil prices, and risks due to its 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 traded in negative territory all month to finish June down 0.9% against the G10 average. Manufacturing PMI continues to fall, reaching 40.6, well into contractionary territory, and its lowest level since the peak of the pandemic scare in March 2020. Services PMI is also hovering around 50, signaling stagnation. Both Bloomberg consensus and the Riksbank's GDP estimates for this year are for a contraction of 0.5%, providing little incentive to buy the currency. The Riksbank raised the policy rate by 0.25% to 3.75% on 28 June in response to another upside surprise in core consumer price index with a fixed interest rate (CPIF) inflation. It also spoke out against excessive krona weakness and raised the possibility of hedging up to 25% of its FX reserves in late Q3 to early Q4. This would effectively constitute a currency intervention to support the krona. However, with Sweden stuck in a stagflation at best, and an inflationary recession at worst, the small rate increase and potential for intervention months from now did little to support the currency.

In the very near term, the krona appears oversold and we see signs of peak pessimism. Economic data has been weak, but it is beginning to surprise relative to expectations. Perhaps, the best thing we can say about the krona is that the weakness in Sweden's fundamentals is already well priced by the weak currency, which is near record lows against the euro and the US dollar. Tactically, we see some scope for a temporary bounce, but caution that a sustained rally looks unlikely in the face of negative real yields, high inflation, and negative growth. The krona could easily set new lows for the year in Q3. Eventually, though maybe not in the next 6–12 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 finished June as the second-best performer in the G10 (up 1.3% relative to the average), but that outcome obscures a steady downtrend during the second half of the month. The Australian dollar went from strength to strength during the first half of June to reach a high of +3.3% against the G10 by 19 June. The Melbourne Institute's May inflation estimate came in at +0.9% MoM relative to +0.2% in April; the RBA surprised markets on 6 June with a hawkish 0.25% rate hike; 14 June brought another stellar employment report (+75.9k new jobs vs. 17.5k expected); and all of this positive news came against a backdrop of improving global risk sentiment.

The second half of the month was a different story. Investors were disappointed that the RBA minutes released on 19 June did not explicitly discuss further policy tightening, sending the Australian dollar lower. Following that, China delivered a disappointingly small 0.1% cut to key rates and did not announce any of the hoped-for fiscal stimulus measures. On 28 June, the official monthly CPI number reinforced the more dovish interpretation of the RBA minutes, with a downside surprise of 5.6% YoY vs. 6.1% expected. The Australian dollar downtrend continued, ultimately giving back more than half of its early June gains by month-end even as equity markets rallied to finish the month at their highs.

We continue to see downside risks to the Australian dollar. Weak/choppy commodity prices, flat-to-negative real wage growth, and rising equity market risk, in our view, in H2 more than offset the RBA's pivot back to monetary tightening, though we do not see significant near-term downside either. We think the market was a bit harsh in its reading of the minutes, which seemed consistent with another 1–2 rate increases by early Q4, even if they were not explicitly mentioned. We see continued stiff headwinds for China but expect that it will announce targeted fiscal stimulus later in July and August, which could help provide some relief to China bears and support for the Australian dollar. In the longer term, the Australian dollar outlook is mixed. It is cheap vs. the US dollar and the franc, and has room to appreciate, but is expensive against the British pound, the yen, and the Scandinavian currencies.

New Zealand Dollar (NZD)

The New Zealand dollar gained 0.8% vs. the G10 average in choppy trade in June. The positive equity market and general preference for higher-yielding currencies helped provide support, keeping the currency in positive territory during the month. However, following two quarters of negative GDP growth and gradually falling inflation, the Reserve Bank of New Zealand (RBNZ) is likely done tightening policy, while the other major central banks have more work to do. This makes the New Zealand dollar less attractive despite having (for now) the highest short-term interest rates in the G10. Highlighting the importance of this divergence with the RBNZ, the New Zealand dollar fell almost 0.9% on 28 June as Fed Chair Powell spoke of the potential need for two additional rate increases. The ongoing disappointments in Chinese growth and the lack of meaningful stimulus in June also weighed on the New Zealand dollar.

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 GDP — more than offset any benefit of high yields, particularly now that the RBNZ has signaled a pause. We expect the tepid Chinese growth outlook and higher expected yields in other G10 countries, notably the US and UK, 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 fairly valued vs. the Canadian dollar and the euro, and is expensive against the Australian dollar, the pound, the yen, and the Scandinavian currencies.

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Marketing communication

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