Insights
Currency & Cash

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Currency Market Commentary: December 2022

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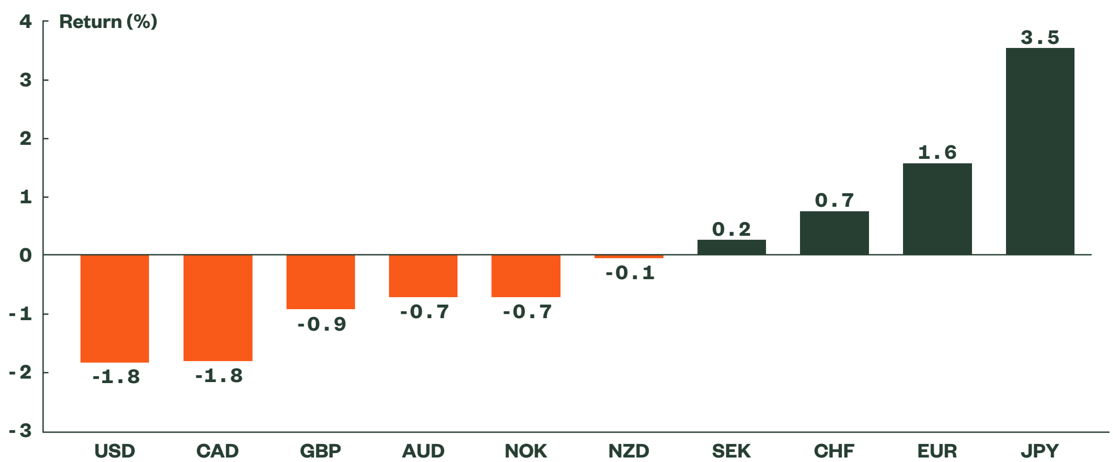
Summary of Views

December saw macro consolidation in currency markets as monetary policy tightened and inflation continued to show signs of moderation. However, there were a few notable moves in response to country-specific events. In response to the surprise relaxation of yield curve control (YCC) by the Bank of Japan (BoJ), the JPY witnessed a 3.5% gain against the G-10 on 20 December. The EUR also posted a strong month with falling natural gas prices boosting the 2023 growth outlook and a more hawkish-than-expected European Central Bank (ECB) indicating to "raise interest rates at a 50 bp pace for a period of time". On the downside, the USD did not perform well, entirely due to a fall of 1.9% versus the G-10 on 1 December. Aside from that, the USD was nearly unchanged. The CAD lost almost as much in sympathy with the USD weakness, but weaker oil prices and a less hawkish Bank of Canada outlook also likely weighed on the currency.

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



Source: Bloomberg and State Street Global Advisors, as of December 31, 2022.

The recent slowing of US inflation represents an important regime shift. We have likely seen the high in the USD and will see around 20% downside over the next 3–5 years. But it seems premature to expect the currency to reverse into a sustained downtrend over the next couple of months. The Fed has yet to reach peak rates, and the timing of rate cuts, currently priced in Q3 2023, is suspect, but the top of the rate cycle is in sight, which removes a major positive USD factor. However, the high absolute level of interest rates and recession risk are likely to keep investor sentiment on the edge and equity volatility high, helping to boost safe-haven USD demand from time to time and limit the scope for weakness, at least through Q1.

Figure 2
December 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 of December 31, 2022.

More cyclically sensitive currencies such as the AUD, the NOK, the SEK, and to some extent, the GBP are likely to struggle the most during this period. Earlier-than-expected re-opening of China from the zero-Covid lockdown may help support the AUD and oil-sensitive currencies. The JPY has rallied a little too far, too fast on short covering, leading to a negative short-term signal in our framework. That said, it continues to stand out as an attractive currency through H1 2023 as it benefits from peak US rates, risks of further monetary tightening from the BoJ, and less sensitivity to bouts of global recession risk. Our models also see upside potential in the EUR on the improved growth outlook, tighter monetary policy, and the potential for inflows into cheap European equity markets in anticipation of a return to growth later this year.

Review and Outlook by Currency

US Dollar (USD)

The USD lost 1.8% versus the G-10 average, adding to its 3.8% loss in November. The actual price action was more resilient than the suggested total monthly loss. The negative momentum during late November, a weak ISM manufacturing report, and a soft personal consumption expenditure (PCE) price deflator sent the USD down 1.9% on 1 December. For the rest of the month, the currency was flat and mostly stuck in a range except for a volatile period on the 13th and the 14th. On 13 December, another downside surprise in the core consumer price index (CPI) sent the USD sharply lower before a 0.5% Fed policy rate increase. A more hawkish-than-expected policy projection prompted a quick reversal of the post-CPI losses. Seventeen of the nineteen Fed policy makers projected an end-of-year 2023 policy rate of 5.1% whereas none of the members projected a rate above 5% in the September forecast. This notable shift, along with Fed Chair Powell's focus on core services and ex-shelter inflation — the portion of CPI that is most sensitive to wages — suggests that the US monetary policy could remain at restrictive levels for longer than the markets expect — markets currently price monetary easing in H2 2023. The Fed's bias toward higher rates for longer is likely to offset lower-than-expected inflation, leaving the USD stable after 1 December.

The USD is historically expensive and we continue to see the currency moderately lower in 2023 and as much as 15%-20% lower over the next 3–5 years as we eventually move to more normal levels of inflation, lower monetary policy rates, and enter the next global recovery cycle. However,, for now, those conditions have yet to materialize, suggesting that the recent USD move may be a bit too much too soon. The currency has most likely peaked for this cycle, but that does not mean we will see a steady and rapid reversal from uptrend to downtrend. Rather, we might see a messy topping process for the USD over the next few months. The Fed is set to continue its policy tightening into 2023 and keep rates at restrictively high levels. High enough to tame inflation via a material economic slowdown with an elevated risk of outright recession. This suggests more pain and stress on equity markets and risky assets more generally, which supports the USD. Overall, we see strong evidence that the USD will not go down without a fight and is likely to bounce back at least partially over the coming months before trending lower.

Euro (EUR)

The EUR appreciated 1.6% relative to the G-10 average on improved yields and economic prospects. However, the improvement in growth prospects was from very weak growth expectations to less weak expectations. The likelihood of a recession remains very high. Manufacturing and services purchasing managers' index (PMI) remained in contractionary territory. October retail sales fell 1.8% month-on-month and industrial production dropped 2% on the month. Meanwhile, the European Central Bank (ECB) increased policy rates by 0.5% and indicated that it would keep tightening at that pace despite the increasingly obvious slide into recession. We do not believe that these factors can be a reason for currency appreciation; however, these outcomes were better relative to the expectations. As already expected, the tough action from the ECB is likely to further curtail economic activity. Higher rates directly support the EUR and the ECB vigilance is likely to prevent an even more distressing outcome if inflation expectations become unanchored.

For the reasons stated above, we have become more positive on the EUR over the near term. Low drawdowns of natural gas stockpiles reduce the chances of a severe and prolonged recession extending through winter 2023–2024. The cheap valuation of the EUR and European equities supports greater net capital inflows into the region over the course of the year, even if long-run GDP and earnings growth prospects remain relatively poor. Our models are already flagging improved relative European equity performance as a positive for the currency. As we mentioned above, actual data and consensus estimates remain weak, but our economic surprise indicator turned positive on the EUR over the last month, indicating that those expectations may be too pessimistic. Finally, the EUR is less sensitive to our base case of a bumpy landing for the global economy and ongoing equity market volatility, which will likely help the EUR maintain some support even if we see a sharper-than-expected global economic slowdown.

British Pound (GBP)

The GBP lost 0.9% relative to the G-10. The currency held up well during the first half of the month due to resilient-than-expected economic data and was likely helped by the spillover of the EUR strength. October's GDP came in at 0.5% MoM compared to 0.4% expected, manufacturing production surprised at +0.7% versus -0.1% expected, and the economy created 107k new jobs in November compared to 42k expected. The positive tone did not last. The GBP began to trend lower after the Bank of England (BoE) meeting on the 15th. The BoE raised rates by 0.5%, but with a split vote, with two members voting for no change and one voting for a 0.75% increase. The tentative message from the BoE stood in sharp contrast to the hawkish outlook of the Fed and the ECB and later to the BoJ pushing the GBP lower.

Our models remain slightly negative on the GBP over the near term. The pound is well off its panic low from September, but the weak economic outlook, cautious BoE policy tightening, and lingering (large) current account deficit suggest that the rebound has gone a bit too far, too fast. Longer term, the GBP remains quite weak by our estimates, about 14% below fair value relative to the MSCI World currency basket and 20% cheaper versus the USD. However, until the economic outlook improves, rates rise further (or inflation falls meaningfully), and we see some improvement in the current account deficit, it is hard to see the GBP moving back up toward longer-term fair value.

Japanese Yen (JPY)

The JPY was the big winner, up 3.5% against the G-10 average due to a one-day 3.5% gain on 20 December in response to the surprise relaxation of yield curve control (YCC) by the BoJ. Prior to the 20th, the BoJ limited 10-year JGB yields to +/- 0.25%, around zero. That band was widened to 0.5%. In isolation, the move was not particularly large, but it raises the possibility that further monetary tightening, in the form of an even wider band on JGBs and perhaps the end of negative policy rates, may happen in 2023. We have flagged the risk of this in our prior notes, but were quite surprised by the timing, given Governor Haruhiko Kuroda's insistence that the policy would remain in place until there were clear signs of self-sustaining inflation. Core inflation and cash wages have risen, but the pace of wage increases has failed to keep up with inflation, suggesting that the current CPI surge may prove temporary. Nevertheless, the action taken in December suggests a greater skepticism of the negative rate and YCC policy in PM Fumio Kishida's government, which raises the chance of further actions over the course of 2023 lending material support to the JPY.

Our short-term models remain negative on the JPY due to the size of its recent rally relative to still very low interest rates and weak growth in Japan. Our outlook beyond the very short term is more positive. As we approach peak global inflation and yields, we expect to see medium-term strength in the currency. Unlike most other G-10 currencies, if falling yields are triggered by a global recession, the JPY can hold up well due to its safe-haven qualities. Finally, the BoJ surprise in December makes it much more difficult for investors to heavily sell the JPY even if US and global yields rise further, as those investors would suffer if there were further policy tightening.

We do not expect another BoJ policy action prior to the spring round of wage negotiations and Kuroda's departure in April. However, we may have a strong idea of his successor by February, which could once again increase expectations of monetary tightening. Putting all the pieces together, we see room for a near-term correction lower in the JPY, but a long JPY position remains one of our preferred ways to position for the gradual transition from the USD bull to bear market over the next 6–12 months.

Swiss Franc (CHF)

The CHF trended higher to gain 0.7% versus the G-10 average. Swiss economic activity remained strong relative to the G-10 with manufacturing PMI in expansionary territory at 53.9. However, we are beginning to see signs of slowing with October retail sales falling 2.3% MoM and core inflation limping along at +0.1% MoM. The Swiss National Bank (SNB) and the CHF were unphased by signs of slowing raising interest rates by 0.5% to 1.0% while a steady fall in foreign exchange reserves in H2 2023 suggests ongoing intervention to buy the franc — intervention to buy CHF supports the value of the franc and limits imported price inflation.

As per our models, the CHF is the least attractive currency in the G-10.The currency strength in addition to higher interest rates has helped to prevent the runaway inflation we have seen in other countries but has not been restrictive enough to seriously risk recession. Thus, economic data has been strong but consensus already reflects that expected strength. And relative to those optimistic expectations, data has been somewhat disappointing, especially inflation data. Going into next year, we expect global inflation, and EU's regional inflation to slow, which removes some of the impetus for a stronger CHF and tighter monetary policy. While the SNB needs to continue to talk tough and modestly tighten policy in order to prevent additional inflation pressures, we expect that they will signal that they are nearing the limit of that tightening cycle. Overall, the softening of data versus expectations and likely need to shift monetary policy in a dovish direction over the next few months suggests downside risk for the CHF.

Canadian Dollar (CAD)

The CAD once again followed the USD lower to finish down 1.8% versus the G-10 average. The USD weakness plus falling oil prices and a tentative Bank of Canada (BOC) sent the CAD steadily lower through mid-month. On 7 December, the BoC stated that it was "considering whether the policy interest rate needs to rise further", pushing the CAD lower. The currency gradually recovered about a third of its early month loss in the second half of December as oil prices recovered and inflation data released on 21 December surprised to the upside.

Our models shifted negative on the CAD during the month on weaker commodity price. The rapid reopening in China will likely improve the commodity outlook, but that will likely take some time as the uncertain pace of recovery in China and headwinds from slowing GDP growth weigh on commodity demand. As the BOC hinted after their October meeting, extremely high home prices and elevated levels of consumer debt in Canada should make the economy and inflation sensitive to policy rate hikes compared to the US.

This suggests greater medium-term vulnerabilities to the Canadian economy and the CAD and a further divergence between the BoC and the Fed monetary policy in favor of relatively tighter US policy. This should keep the CAD depressed versus the USD over the near term. Beyond that, we see greater scope for the CAD appreciation versus the USD, especially as Chinese growth recovers. However, our expectation of broad USD weakness later this year and into 2024 suggests that the CAD will likely underperform most other G-10 currencies, given the CAD's high correlation to the USD.

Norwegian Krone (NOK)

The NOK fell 0.7% versus the G-10 average. The month started on a negative note for the currency with Brent crude oil prices down over 10%. Just as oil was reaching its low, the November core CPI came in at -0.1% versus +0.2% expected. The weaker inflation data did not cause a repricing of the expected 0.25% interest rate increase at the Norges Bank meeting on the 15th; however, it did increase worry that going forward the bank could take a more cautious stance on monetary policy. Indeed, the Norges Bank raised rates by 25 bp as expected and issued a tepid forecast that the policy may be raised again in Q1 2023. This kept the NOK on the weaker side for the remainder of the month even as oil prices recovered much of their early December loss.

Our models have shifted negative on the NOK over the near term due to weak/volatile oil prices. Outside of the models, our concern regarding a steeper-than-desired global economic slowdown and further equity market weakness keep us cautious on the NOK outlook over the next few months due to the krone's high correlation with equity markets. Over the long run, the currency is historically cheap relative to our estimates of long-run fair value and is supported by steady potential growth. Thus, eventually, we expect strong gains but reiterate that the NOK faces a tough near-term environment. Timing the shift to a more bullish NOK stance can be tricky. One important factor to watch will be the speed of China's recovery and increased oil demand after the current wave of covid infections, likely from March 2023.

Swedish Krona (SEK)

The SEK gained 0.2% versus the G-10 in December. The month began with a strong rally alongside the EUR after a resilient composite PMI and better-than-expected October GDP, +0.7% MoM compared to -1.3% expected. That all changed on the 14th after November core consumer price index with a fixed income rate (CPIF) inflation came in at only 0.2% MoM relative to +0.4% expected, reducing expectations of further monetary tightening. The expectations contrasted with the hawkish surprises on the following day by both the ECB and the Fed. The SEK slid to give back most of its early month gains and finish the month near unchanged.

We are close to neutral with a small positive bias on the SEK over the near term. Economic data has been mixed, generally positive but below expectations with a deteriorating outlook while the improving outlook for the EUR and EU's growth is a positive, given Sweden's close economic and financial ties to the region. Long term, our outlook is much more positive. According to our fair value estimates, the SEK remains among the cheapest currencies in the G-10. However, we will likely have to see growth bottom out and be able to look forward to an economic recovery in the region as well as a stronger EUR in order to unlock that value. Even then, if the ECB continues on a more restrictive monetary policy path compared to the Riksbank, it will likely delay and reduce the scope for a medium-term SEK recovery.

Australian Dollar (AUD)

The AUD fell 0.7% versus the G-10 average in December. The AUD tracked global equity market sell-off through the 6th before rallying back and then falling steeply from the 14th through the 20th. Outside of that broad risk sentiment effect, AUD specific news was mixed. The Reserve Bank of Australia (RBA) raised rates by 0.25% and indicated that there is likely more to come. This had little impact on the currency as it was also coupled with warnings from Governor Philip Lowe that the full impact of rate hikes have yet to be felt in the housing market and global growth was slowing. Economic data was also mixed. The current account disappointed at -AUD2.3 bn against expectations of +AUD6 bn; however, employment surprised higher with +64k new jobs for November compared to +19k expected. China's reopening can help the Australian economy via higher export volumes and prices as well as the potential for greater inbound travel. The AUD diverged from weak equity markets to rally into the month end following the announcement that China would lift travel restrictions.

Our tactical view on the AUD deteriorated considerably over the month and is now the second most negative model signal in G-10. The China reopening may help alleviate some of the negativity as it shows up in the data, but weak/choppy commodity prices, slowing consumer activity, the weaker current account balance, and relatively dovish RBA monetary policy stance present meaningful headwinds for the AUD over the near term. Longer term, the AUD outlook is mixed. It is cheap versus the USD and the EUR and has room to appreciate. However, it is expensive against the GBP, the JPY, and the Scandinavian currencies.

New Zealand Dollar (NZD)

The NZD was nearly unchanged, -0.1% relative to the G-10 average. The currency's surge in late November following the hawkish central bank policy outcome spilled over into the first half of December, sending the currency it more than 1.5% higher versus the G-10 by mid-month. A surprisingly strong Q3 GDP print, +2.0% QoQ compared to 0.9% expected, highlighted the degree to which the New Zealand economy is overheating and in need of further monetary tightening. However, by mid-month, after a near 6% rally from end October, the rally ran out of steam as global sentiment turned negative pushing equity markets lower. Attention also turned to the newly issued hawkish monetary policy projections of the ECB and the Fed, which shifted focus from the Reserve Bank of New Zealand's (RBNZ) hawkish statement in November. The NZD fell alongside equities until the news of China lifting foreign travel restrictions from early January gave it some support into the month end.

Going forward, we are neutral to slightly positive on the NZD. The vigilance of the RBNZ, considering the latest wage data, growth impulse, and rapid move by China to exit zero-Covid policy, is a positive driver of the NZD. However, the story remains mixed. The economy is slowing and will likely have to enter a recession in order to contain inflation. China may be moving away from zero-Covid policy, but near term the transition will be quite disruptive. Finally, we expect further equity market volatility to weigh on the NZD as the global economy slows under the weight of restrictive monetary policy. Overall, we believe that the NZD is unlikely to trend significantly higher in January after the strong rally of the past 2–3 months.

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