Commentary
Currency & Cash

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Currency Market Commentary

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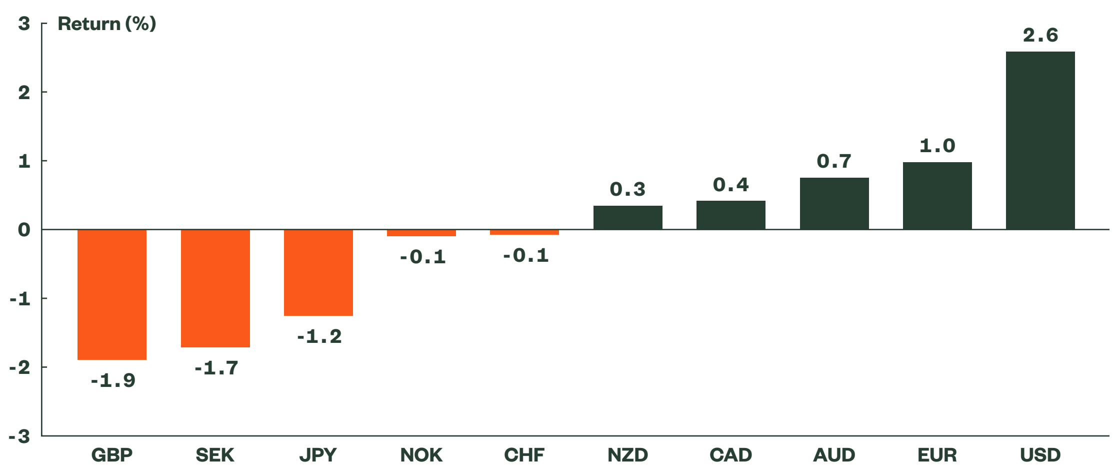
Summary of Views

Another month, the same key market drivers: the stagflationary mix of persistently high global inflation and slowing growth, complicated by the aggressive global monetary policy tightening required to tame inflation. The hope of a slowdown in policy tightening and a soft landing of the global economy that pushed global rates and the USD lower and equities higher through July ran out of steam in early-mid August. Global yields and the USD turned back higher as central bankers, led by the US Fed, continually emphasized the need for additional policy tightening. Equity markets weakened a bit after mid-month but accelerated to the downside after Fed Chair Jerome Powell's Jackson Hole speech, where he emphasized the need for a sustained period of restrictive policy that would most likely result in some pain for households and businesses.

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



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

While the USD rose, the GBP registered the worst performance in G-10 on downgraded growth outlook and further inflation surprises to the upside. The JYP and the SEK also underperformed the G-10 average by a wide margin. The former due to its sensitivity to rising global yields and the latter due to slowing economic data, weaker inflation, and its sensitivity to rising European Union (EU) recession risk. Surprisingly, the EUR finished with the second-best performance in G-10 despite the ongoing energy crisis, thanks to a late-month rally seemingly triggered by rising expectations of a 75 bp rate hike from the European Central Bank (ECB) and a better-than-expected build in natural gas inventories.

Our base case going into August was that the rally in short-end global yields and the equity markets would falter to support the USD. Now that that has happened, we see it continuing. Mr. Powell emphasized the need for a sustained period of softer demand, the goal of restrictive monetary policy, to combat inflation. Thus, a period of below-potential growth in the US is likely.

Figure 2
August 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 August 31, 2022.

Similar conditions plus the severe spike in energy prices are likely to tip the European Union and the United Kingdom (UK) into recession, while factors such as COVID-19, property sector stress, and drought are likely to keep China's growth depressed for longer than many hoped. Simultaneously, weakness in the US, the EU, the UK and China is not a recipe for calm and prosperity in risky assets. Thus, we see continued upside risks to the USD against the EUR, the GBP and currencies sensitive to global growth. The JPY and the CHF tend to hold up better during periods of slower global growth and higher equity market volatility. However, near-term strength may prove elusive as rising global yields will be a headwind, particularly for the JYP, given the Bank of Japan's commitment to zero rates and yield curve control capping 10-year yields at 0.25%.

Review and Outlook by Currency

US Dollar (USD)

The USD gained 2.6% versus the G-10 average and nearly 4.5% versus the GBP. The month began on a weak note as investors clung to the idea that the Fed pivoted toward a more cautious pace of tightening at its July meeting. That was despite a parade of Fed officials making statements to the contrary, a stellar employment report on 5 August, +528k new jobs versus +250k expected, and better-than-expected core durable good and factory orders for July. A lower-than-expected core CPI print on 10 August, 0.3% MoM compared to 0.5% expected, was in line with the thesis of an easier path to monetary policy and sent the USD to its low for the month. After that, the rates and currency markets began to focus more on the hawkish Fed rhetoric, improved economic data and the potential stimulative impact of easing financial conditions resulting from the recent equity and credit market rallies. US yields and the USD began to recover. Chair Powell's hawkish speech at Jackson hole on 26 August amplified those rallies and pushed equity markets materially lower and the USD to new highs into month end.

The USD is historically expensive and near term overbought. Over the next 3–5 years, we will continue to see ample downside to the USD (15-20%) as we eventually move to acceptable levels of inflation, lower monetary policy rates, and enter the next global recovery cycle. However, these conditions are distant and higher rates and rising recession are likely to support the USD over the coming months.

We saw ample risk that the USD would rally back toward its cycle highs from July. It is there. All other things equal further gains should be more difficult given the extreme levels. But all other things are not equal. The energy crisis has continued in the EU and the UK, further increasing recession risk. Disappointing growth in China, a weak Chinese policy response to reverse the slowdown, and slower goods demand from Western economies are likely to weigh heavily on Asian growth prospects over the next 3–6 months. Meanwhile, we are seeing surprising resilience in US activity and even an improvement in survey-based PMI data. We now must consider that a heightened risk of a reacceleration in US growth will likely have to be met with an even tighter monetary policy. Thus, both rates and relative growth may be in favor of the US and the USD. At best this extends the period of USD strength for several months, but it could also lead to a higher peak for the USD for this cycle.

Euro (EUR)

The EUR impressed in August by outperforming the average G-10 currency by 1%, though it underperformed the USD by 1.6%. For most of the month it languished in a negative range held back by poor growth prospects, lower than average yields, and ongoing concerns over energy prices. Following the hawkish speech from Fed Chair Powell, the EUR fell back to parity versus the USD but bounced significantly versus the broader G-10, gaining nearly 2% in the final days of the month. The speed of that broad positive move suggests a quick round of profit taking on crowded EUR short positions. The primary catalyst appears to be a bit of a safe-haven bid as equities plummeted and there was an increase in expectations of a 75 bp rate hike from the ECB at its September meeting following the higher-than-expected CPI print at month end. News flow pointing to the better-than-expected buildup of EU natural gas supplies to 80% capacity may have also helped support the late month rally.

Going forward, we remain moderately bearish on the EUR. The build in gas reserves for the winter is a clear positive and should reduce the need for sudden, dramatic rationing later this year that could have threatened to shut down entire industries via rolling natural gas blackouts. However, this provides little solace. Even with storage at 100%, a complete shutdown of Russian supplies remains a high risk and will keep prices at extreme levels. Higher storage levels will smooth some of the pain, but they are insufficient to prevent sustained shortages through 2023 if Russia completely shuts off supplies. This is likely to drive the EU into recession over the coming quarters. At the current levels, the EUR already reflects a healthy recession risk premium and the prospect of faster ECB rate hikes should help alleviate some short-term pressure on the currency. However, any relief from monetary tightening may be muted. The ECB is in a tough spot due to the economic slowdown and higher downside tail risks to economic activity. That is likely to limit its ability to raise interest rates by enough to support the currency over the medium term.

Long term, the EUR outlook is more positive, particularly versus the USD. The currency is already near 20% cheap to the USD while the ECB is likely to maintain positive policy rates for several years, EU unemployment is at record lows, consumer balance sheets are reasonable, and we appreciate the potential for attractive long-term investments in areas such as digitization, green technology and semiconductors.

British Pound (GBP)

The GBP was the worst performer in August down 1.9% versus the G-10 average. The month began on a negative note with the Bank of England (BoE) raising rates policy rates by 0.5% at its meeting on 4 August and predicting continued high inflation and recession into 2023. A negative 0.1% QoQ GDP print for Q2 and negative June industrial and manufacturing production numbers validated the recession thesis while another upside surprise in core inflation, 6.2% YoY vs. 5.9% expected, validated the BOE's expectation of continued price pressures. On a more positive note, manufacturing and services PMIs remained poised to expand, albeit at a slower pace, and employment growth remained positive with unemployment at generational lows. But even those positive data points did little to support the GBP as they also pointed to greater difficulty in controlling inflation and the potential need for the BOE to tighten more dramatically which may deepen the expected recession. The bottom line is that high inflation and low growth are both individually bad for a currency, the pound faces both and it does so with the overhang of large current account and fiscal deficits.

Our model shifted to a positive stance on the GBP, but that is almost entirely due to a strong positive signal from our ultra-short-term fair value model. The economic news has been negative, but the recent GBP sell off has been extreme and our model is signaling that the risk of a short-term bounce is high, even if that is only driven by temporary profit taking on the large stock of short positions in the market. Liz Truss winning the election as new Prime Minister brings with it the risk of tax cuts and fiscal expansion that may force the BoE to accelerate rate hikes and cause a deeper recession; hence the 1.3% increase in 2yr Gilt yields in August. At some point, yields may rise enough to help support the GBP, but for now the prospects of fiscal stimulus into a period of stagflation is a significant drag on the GBP. Longer term, the outlook is mixed. Once inflation normalizes and the economic slowdown is behind us, the GBP has ample room to appreciate relative to the expensive USD and the CHF. However, it is likely to underperform the deeply undervalued NOK and SEK, which also tended to outperform the GBP during healthier economic environments.

Japanese Yen (JPY)

The sharp JPY short covering rally that began in late July continued into early August alongside falling global yields. As yields began to recover, the JPY once again trended steadily lower to finish August with a 1.2% loss against the G-10 average. In line with recent behavior, global yields and risk sentiment dominated the JPY with little impact from domestic factors as the Bank of Japan remained committed to negative rates and yield curve control policy capping 10yr JGB yields at 0.25%. In fact, contrasting the clear hawkish messages from the ECB and the Fed at the Kansas City Fed's symposium in Jackson Hole, the BOJ reiterated its commitment to leaving policy unchanged at ultra-easy levels.

We shifted to a tactically negative stance on the JPY in August. As global short end rates retest or in some cases set new 2022 highs, the currency is likely to remain under pressure. However, as equity and commodity markets turn lower, the JPY should begin to find greater support especially against currencies other than the USD. Sustained strength versus the USD may have to wait a while as rising global recession risk helps to support the USD and the market does not appear completely done repricing the Fed's policy rate expectations higher. But July provided a good example of the potential for significant JPY gains as we head into next year. At some point later this year or early next, slowing global growth and expectations of Fed rate cuts, even 9–12 months out, will likely make way for a broadly stronger JPY.

Swiss Franc (CHF)

The CHF lost 0.1% versus the G-10 average. It is finding support as a safe-haven relative to the EUR and the GBP as the European energy shock and broader strains of high inflation steadily continued to depress the regional economic outlook. At the same time, the sharp jump in German Bund and UK Gilt yields relative to Swiss yields during the second half of the month helped to offset some of the economic fears, limiting the currency's performance. The Swiss National Bank (SNB) played an important role as it moved toward positive interest rates and backed away from its long-held view that the CHF is overvalued. Falling sight deposits during the first half of the month indicated that the SNB may have been reducing reserves and buying the CHF. However, in the second half of the month sight deposits ticked back up suggesting intervention to sell the CHF. Such behavior is consistent with both the SNB's stated opinion that they do not want to see excessive strength or weakness in the currency and the actual CHF exchange rate movements during the month, higher during the first half then weaker late in the month.

Over the near term, we are neutral to slightly positive on the CHF as it tends to weather global fragilities well given its large positive net foreign asset position. Switzerland is also showing greater economic resilience, which is likely to keep the SNB on course to tighten further. At the same time, we see limited CHF upside as it is likely to remain one of the lower yielding currencies globally, and the SNB has clearly indicated that it prefers not to see excessive appreciation. Longer term, the outlook is decidedly negative. The SNB may have declared that CHF is no longer expensive versus the long-run fair value, but our models suggest that it remains quite expensive, though far less so compared with what it was 3–5 years ago. Therefore, a flat to 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 those gains once the global economy and inflation recover to longer term trend growth levels.

Canadian Dollar (CAD)

The CAD lost 2.2% relative to the USD but managed a small 0.4% gain versus the G-10 average in August. During the first half of the month the softer outlook for the US economy and reduced monetary tightening expectations in both the US and Canada weighed on the CAD despite rising oil prices. The mid-month turn higher in USD and global yields, including Canadian yields, and pushed the CAD back into positive territory against the broader G-10. However, the CAD was unable to keep pace with the USD. On 16 August, a much higher-than-expected common core CPI print, +5.5% versus 4.7% expected, also likely helped the CAD to outperform most other G-10 currencies during the second half of the month.

We are neutral on the CAD over the near term. Economic data is softening as seen in a second consecutive negative employment print in early August, weaker business sentiment, and a steady deterioration in housing markets. Offsetting those negative factors are the need for the Bank of Canada to continue to keep pace with the Fed's aggressive policy tightening path, the recent improvement in US economic data, and the fact that the Canadian economy is running above reasonable estimates of full employment. These positives should help prevent significant losses in the CAD relative to the broad G-10. Thus, we are neutral on the CAD versus the G-10 for now, though we can easily see further weakness versus the USD over the near term. From the perspective of long-run valuation (a 3–5 year horizon), the CAD is cheap and has potential for sustained appreciation versus the USD and the CHF, but it is expensive versus the GBP, the JPY, and the Scandinavian currencies and against which it may (eventually) underperform.

Norwegian Krone (NOK)

The NOK was near flat in August, -0.1% versus the G-10 average. After a quiet start to the month, higher-than-expected CPI, core +1.5% MoM relative to +0.8% expected, increased expectations for a 50 bp rate increase at the Norges Bank meeting on 18 August and pushed the NOK higher. That gain was short-lived as a mid-month dip in oil prices prompted the NOK to fall back. From there, the currency recovered steadily alongside a recovery in oil prices and a 50bp rate hike from the Norges Bank, which also indicated further tightening was likely in September. By 24 August, the NOK was up nearly 1.7% against the G-10 until the hawkish comments from the Fed and the ECB on the 26th sent equities, oil prices, and the NOK sharply lower. Norges Bank's announcement of planned sales of 3.5bn NOK per day in September to move windfall energy sector revenue into the offshore wealth fund added to downside pressure on NOK to finish the month.

Our models have once again turned positive on the NOK on resilient commodity prices and local economic data, though retail sales for July came in on the weak side. However, we see this positive signal as highly risky in this environment marked by rising risk of a deeper, broader global economic slowdown due to restrictive monetary policy, the EU energy crisis, and weak Chinese growth outlook. This is likely to keep equity and oil markets on the volatile side which tends to pressure the NOK lower, or at very least makes it quite difficult for NOK to rally. 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. Thus, we expect strong gains eventually but reiterate that the NOK faces a tough near-term environment.

Swedish Krona (SEK)

The SEK fell 1.7% against the G-10 average, the second-worst performance in the group. After a quiet start, the currency began to fall after Consumer Price Index with fixed interest rate (CPIF) inflation came in lower-than-expected at -0.2% MoM for July. Following that inflation print a string of disappointing data including a near 3% MoM fall in home prices in July and a third straight monthly decline in retail sales perpetuated the SEK downtrend. On 24 August, Riksbank Deputy Governor Martin Floden noted that the SEK was way too weak and suggested that the Riksbank would likely tighten policy at a faster pace than the ECB. The SEK was slightly higher on the day, but markets largely ignored the hawkish comments given the ongoing weakness in Swedish economic data and rising concerns about EU recession risk.

Going into August, our models favored the SEK over the near term, thanks to resilient economic data, but data turned negative in August. Ongoing SEK sales to replenish Sweden's foreign exchange reserves are also likely to weigh on the currency over the coming months. We expect gradual, SEK supportive, monetary tightening from the Riksbank. However, the extent of that tightening is at risk given the slowing in economic activity both in Sweden and the EU. Long term, the SEK will remain among the cheapest currencies in the G-10 according to our fair value estimates. However, we will have to see growth bottom out and look forward to an economic recovery in the region as well as a stronger EUR in order to unlock that value.

Australian Dollar (AUD)

The AUD registered a 0.7% gain in August. It began on a weak note after the Reserve Bank of Australia (RBA) raised interest rates by 50 bp as expected on 2 August but disappointed markets with a dovish tone that stressed their goal to combat inflation while also keeping the economy on an even keel. This was a clear dovish tilt recognizing the slowing global and domestic growth outlook. Mid-month, the AUD bounced higher on broad USD weakness following the lower-than-expected US CPI print, before disappointing employment data and weak consumer confidence pushed it back into negative territory. The currency enjoyed a final surge during 16–25 August on rising commodity prices and yields despite rising risk aversion and lower global equity prices. In the final days of the month, the AUD gave back some of its gains after the hawkish comments from the Fed and the ECB drove commodities and equities lower.

Elevated commodity prices, despite the recent sell-off, along with the high level of employment and retail activity and steady tightening of monetary policy indicate a higher Australian dollar. However, the turn softer in domestic activity, Chinese growth, commodity prices, and rising risk aversion weigh on 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 once we can see through the current global economic slowdown to the next recovery cycle.

New Zealand Dollar (NZD)

The NZD gained 0.3% versus the G-10 average. It followed a very similar pattern to the AUD during the first half of the month. It fell after the employment report was released on 2 August, which was worse than the expectations — flat QoQ employment growth compared to +0.4% expected and a tick higher in the unemployment rate from 3.2% to 3.3%. The currency rallied strongly mid-month following the disappointing US CPI data as well as a nice recovery in New Zealand's manufacturing PMI for July before falling back to flat for the month following the Reserve Bank of New Zealand (RBNZ) policy meeting on 17 August. The RBNZ delivered its fourth consecutive 50 bp rate increase and indicated a peak rate north of 4%. However, the NZD responded negatively. Investors appear to have looked beyond the tightening policy to focus on slower growth and the prospect that New Zealand was much closer to the peak of its policy tightening cycle than other central banks. RBNZ Governor Adrian Orr validated these concerns on 26 August, hinting that the cycle may be closer to an end and suggesting that the country is at its peak inflation level while current policy settings are weighing on retail activity.

We are neutral to slightly negative on the NZD due to weaker economic growth, weak commodity prices and the ongoing fragility in global risk sentiment. Approaching peak rates with slowing domestic economic growth alongside a weaker Chinese outlook and persistent global recession risk is no time to buy the NZD. That said, New Zealand is further along in its economic slowdown and rate cycle compared to other commodity-sensitive currencies such as the AUD, the CAD and the NOK. The market has been reacting to that and pushing the NZD steadily lower against the other commodity-sensitive currencies for several months. As a result of that underperformance, the NZD is looking increasingly oversold and could outperform once global macro uncertainty dies down and New Zealand's growth finds a base. Relative to long-run valuations, the currency appears attractive against the USD and the CHF but is not as cheap as the other commodity currencies.

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