Commentary
Currency & Cash

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Currency Market Commentary

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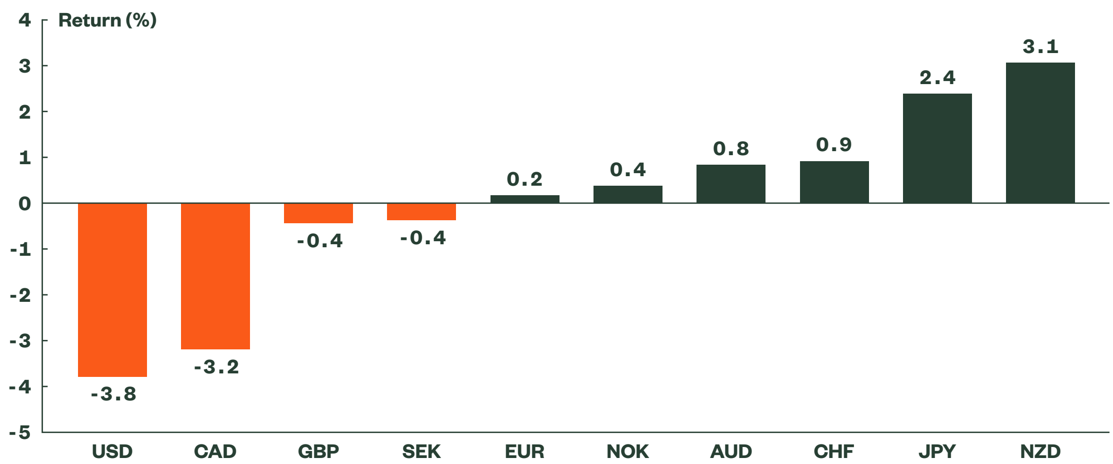
Summary of Views

A decidedly risk-on tone swept the markets in November as investors extrapolated the recent slowing of US inflation data to the consequent slowing of the Fed's tightening of monetary policy. Early-stage plans in China to ease COVID-related restrictions alongside slightly better-than-expected growth data further calmed recession fears. The result was strength in equity markets, tighter credit spreads, resilient commodity prices and a major sell off in the US dollar (USD). The heavily shorted and beaten down Japanese yen was one of the big winners alongside the New Zealand dollar (NZD), which was supported by its increasingly vigilant central bank and prospects of China fully reopening in 2023. The Canadian dollar (CAD) lagged the broader G10 thanks to its high correlation with the USD and a dovish central bank shift.

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



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

The recent slowing of US inflation represents an important regime shift. We have likely seen the high in USD and see as much as a 20% downside over the next 3–5 years. But it seems premature to expect the USD to reverse into a sustained downtrend at this point. We do not expect a rapid reversal of rate hikes and economic slowdown that depressed risky assets and lifted the USD. Peak central bank policy tightening may be in sight, but policy is still tightening and will likely remain restrictive through 2023. That is great to contain inflation but only because it is likely to significantly slow economic activity and keep recession risks elevated.

High rates and weak growth do not usually define a great environment for risky assets and a sustained USD downtrend. We expect further periods of heightened equity and rates market volatility, which should lead to coincident periods of USD strength at least over the next 2–3 months. We also respect the risk that if the US economy were to hold up better than expected, and so far it has, then we may have to endure another shift higher in central bank policy rates and some rebound in the USD. The change relative to much of the USD rally over the past 18 months is that currency markets are likely to become more rangebound and relative fundamentals should gradually become more important as we get closer to peak rates and inflation.

Figure 2
November 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 November 30, 2022.

Review and Outlook by Currency

US Dollar

The USD lost 3.8% vs. the G10 average in November. The entire loss happened by 11 November after which the USD moved sideways rest of the month. At the very start of the month, the USD rallied and equities sold off in response to the 2 November Fed rate increase of 0.75% and hawkish comments from Fed Chair Jerome Powell asserting that rates would have to rise further and remain high longer than previously thought. That rally was short lived as equity market sentiment turned positive and the USD fell after China announced plans to moderate its Zero-COVID policy.

On 10 November, core CPI came in at 0.3% MoM compared with 0.5% expected, a second consecutive monthly downside surprise. Yields and the USD fell sharply while equity markets accelerated higher. But after a couple of days the USD stalled and moved sideways for the remainder of the month caught between opposing forces. On the positive side, a chorus of hawkish Fed speakers and positive data surprises including a surge in core retail sales, +0.7 MoM vs. 0.3% expected, and strong durable goods orders supported the dollar. On the negative side, falling yields and generally positive equity market sentiment weighed on the currency. Those opposing forces left the USD without a clear direction after 11 November.

The USD is expensive versus its historical value and we continue to see it moderating 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. But for now, those conditions have yet to materialize, suggesting that the recent USD move may be a case of bit too much too soon. The USD likely peaked for this cycle, but that does not mean we see a reversal from uptrend to downtrend. Rather we see a messy topping process for the USD over the next few months. The Fed is set to continue to tighten policy into 2023 and keep rates at restrictively high levels. This suggests more pain and stress on equity markets and risk assets in general, which tends to support the USD. It is not our base case, but we must also recognize the risk that the surprising resilience in the US consumer and labor markets may keep inflation afloat for a few months longer than expected and prompt the Fed to once again shift to a tighter path, resulting in a more meaningful dollar rebound. 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.

Euro

The euro (EUR) was up 0.2% vs. the G10 average in November. The EUR rose nearly 1% by mid-month relative to the G10 on China's easing of COVID-19 restrictions, a 20%+ drop in natural gas prices between 3 and 11 November, and better-than-expected German industrial production data. That rally reversed mid-month as natural gas prices rose back up to prior month-end levels and investors began to re-focus on downside risks to EU growth. Late in the month, hawkish comments from ECB Governing Council member Klaas Knot and ECB President Christine Lagarde failed to help support the EUR, perhaps because they coincided with slightly weaker-than-expected November CPI.

We are neutral EUR relative to the G10 over the near term but see room for renewed weakness versus the USD. The EU economy continues to face elevated downside risks. If we were to see a harsh winter that drains natural gas reserves, it will be difficult to rebuild the reserves next year given the shutdown of Russian gas supplies. In that scenario, prices are likely to spike again and remain high through the 2023–2024 winter, severely straining economic activity. The support for the EUR from rising yields is also highly uncertain. The ECB is tightening and is stating the right things about beating inflation, which should be marginally EUR positive. However, the gradual slowing of economic activity may ultimately limit the degree of policy tightening.

British Pound

The pound's (GBP) rally back above 1.20 versus the USD, a 3.4% gain, created the appearance of strength, but that was because the USD fell against everything. Relative to the G10 average, the GBP underperformed, losing 0.4% in November. The Bank of England's (BOE) 0.75% rate hike was at the upper end of expectations, but BOE Governor Andrew Bailey cast a shadow on expectations with comments that the terminal rate will be lower than what markets currently expect. By 4 November, the GBP fell almost 2.5% versus the G10. Mid-month the tide turned more positive on higher-than-expected wage gains, 5.7% YoY vs. 5.5% expected.

On 17 November Chancellor Jeremy Hunt released the autumn budget statement, which outlined a planned fiscal consolidation of £55 billion. That met investor expectations for a renewed commitment to fiscal responsibility without significantly damaging near-term growth expectations as the planned tax increases are gradual. In the days that followed, the GBP continued to rally and eventually retrace most of its early month loss.

Our models shifted from slightly positive to slightly negative GBP over the near term. The GBP 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. Long term GBP remains quite weak by our estimates, about 17% below fair value relative to the MSCI World currency basket and 23% cheap 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 its longer-term fair value.

Japanese Yen

After losing 3.6% in October, the yen bounced back to gain 2.4% versus the G10 in November. Approximately 2% of that gain happened in only two days alongside a 0.25% drop in the US two-year yields after the downside surprise in US core inflation on 10 November. This is very much in keeping with the year-to-date behavior of the JPY, which has been largely determined by interest rate differentials. While interest rates have been the primary driver, comments regarding the undesirable impact of the yen's rapid weakening this year from Governor Haruhiko Kuroda helped amplify the yen rebound. After 11 November, price action was subdued with a bit of yen weakness after an unexpected decline in Q3 GDP, later offset by a steady downtrend in US yields. JPY effectively ended the month at the same level as on 11 November relative to the G10 average.

Our short-term models have flipped from positive to negative on 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 yen. And unlike most other G10 currencies if falling yields are triggered by a global recession, the yen can hold up well due to its safe haven qualities. This makes long JPY one of our preferred ways to position for the gradual transition from the USD bull to the USD bear market over the next 6–12 months.

One important factor to watch will be the potential for a shift in monetary policy after Governor Kuroda's retirement in spring 2023. To date, the improvement in core inflation has been accompanied by increasingly negative growth in real cash wages, which suggests Japan has yet to achieve self-sustaining inflation and should not tighten monetary policy. However, core inflation and nominal cash wage growth are picking up. If that trend continues, then a discussion on shifting away from Japan's ultra-easy monetary policy next year is likely to be appropriate, which would further strengthen our medium-term yen forecast.

Canadian Dollar

The Canadian Dollar (CAD) had a difficult month trending down 3.2% against the G10 average though it was still able to outperform the USD by 0.6%. A decent portion of the CAD's struggles was likely due to broad USD weakness and the high correlation between the CAD and the USD — a correlation which makes sense given the tight links between the two economies. However, Canadian specific factors also appear to have weighed on the currency. The CAD began the month under a shadow after the Bank of Canada (BoC) pivoted to a slower pace of rate hikes at its 26 October meeting. Employment data was strong but September retail sales were weaker than expected, oil prices trended lower for most of the month, and core inflation failed to surprise to the upside, limiting the pressure on the BoC to reaccelerate policy tightening.

We see modest upside potential for the CAD versus the G10 over the very near term as we see room for the USD to rebound from its November losses and the CAD is likely to remain highly correlated to the USD. The view versus the USD is slightly more challenging. As the BOC hinted after its 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 for the Canadian economy and the CAD and a further divergence between the BoC and the Fed's monetary policy in favor of relatively tighter US policy. This should keep CAD depressed versus the USD over the near term.

Swiss Franc

Like the yen, the franc (CFH) recovered a portion of its October loss moving up 0.9% relative to the G10 average in November and the entire move happened during the days around the lower-than-expected US CPI surprise, from November 8 to 14. There was no clear economic data or political news that contributed to the move. Unlike the yen, we must pay more attention to domestic economic factors, especially monetary policy, after the Swiss National Bank (SNB) increased its policy rates from -0.75% to +0.5% and backed away from a long-standing policy of intervening to weaken the currency. News on the domestic front was mixed. Switzerland boasts the strongest PMI growth alongside a strong industrial output in the G10. It appears to be at the lowest risk of a hard landing from tighter monetary policy. At the same time, core CPI for October came in at a disappointing 1.8% YoY relative to 2% expected. That reinforces the somewhat dovish shift in messaging from the SNB at its September meeting, a CHF negative.

The CHF ranks as the least attractive currency in the G10 per our models. The currency's strength and higher interest rates have helped to prevent the runaway inflation that we have witnessed in other countries but have 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 to slow, which removes some of the impetus for a stronger franc 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 the central bank to signal that it is nearing the limit of that tightening cycle. Overall, the softening of data vs. expectations and likely need to shift monetary policy in a dovish direction over the next few months suggest downside risks for the CHF.

Norwegian Krone

The krone (NOK) was stuck between good news, higher-than-expected inflation and higher equity prices, and bad news, lower oil price and a dovish central bank decision, resulting in a subdued 0.4% gain versus the G10 average in November. The Norges Bank delivered a 0.25% rate hike relative to 0.5% expected at its 2 November meeting, pointing to risks of lower growth and a fall in energy and transport prices. This was disappointing to markets — however, the negative impact on the NOK was offset when core inflation surprised to the upside, 5.9% YoY compared to 5.5% expected, keeping hopes alive that the Norges Bank would have to continue to tighten policy. The NOK has also been very sensitive to oil and equity prices. Those factors also washed out as equities posted a strong month but oil prices fell. The net result was intra-month volatility but little overall movement in the NOK for November.

Our models are picking up on the crosscurrents in the underlying drivers of the NOK and remain neutral over the near term. 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 NOK is historically cheap relative to our estimates of its long run fair value, supported by steady potential growth. Thus, we expect strong gains eventually but reiterate that the NOK faces a tough near-term environment.

Swedish Krona

The krona (SEK) lost 0.4% in November relative to the G10 average. With equity markets higher, the EUR on the strong side, better-than-expected services PMI, the 0.75% Riksbank rate hike, much higher-than-expected inflation and US yields falling, we would have expected better performance from the SEK. However, manufacturing PMI is under pressure, retail sales have been in decline, and home prices are nearly 14% off their highs. More importantly, based on these negative impulses, the Riksbank did not materially raise its longer-term policy rate forecast despite hiking rates by 75 bp. On balance the negative factors and dovish Riksbank outlook overpowered the SEK positive factors listed above to push the currency slightly lower.

We are close to neutral with a small positive bias on weaker-than-expected 2023 growth, a cautious Riksbank and our expectation that global risk aversion and equity volatility will return from time to time in this highly uncertain environment. Long term SEK remains among the cheapest currencies in the G10 according to our fair value estimates. 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.

Australian Dollar

The Australian Dollar (AUD) rose 0.80% on the month versus the G10 average in sideways trade. The AUD rose during the first half of the month in response to news of China easing COVID-19 restrictions, rising iron ore prices and the general risk positive market move following the downside surprise in US CPI. Mid-month news of a rapid increase in COVID-19 cases in China began to weigh on the currency despite a better-than-expected employment report. The AUD came under further pressure later in the month due to disappointing October retail sales, -0.2% MoM versus +0.5% expected. By 28 November the AUD was nearly unchanged versus the G10 average before jumping back to +0.8% in the final days alongside a surge in equity markets.

Our tactical AUD view is neutral with a slightly positive bias. The Australian economy has been resilient but weakness is beginning to appear in the housing market and retail sales. The cumulative impact of the Reserve Bank of Australia's (RBA) interest rate increases should also begin to gradually weigh more heavily on economic activity. Signs that China is moving away from its zero-COVID are a clear positive for the AUD, but the impact of an improved Chinese growth outlook is likely to be limited in the near term. Re-opening from COVID lockdowns will be a complicated task and we expect that to happen only gradually through H1 2023. Near term we are also concerned with the RBA's cautious approach to policy tightening, while the Fed and other central banks continue to tighten at a faster pace. 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

The New Zealand Dollar (NZD) led the G10 with a 3.1% gain in November. Like the AUD, the positive news out of China early in the month and the generally risk positive mood (higher equity markets) helped support the currency. However, the NZD outperformed by a wider margin and held its gains throughout the month due to the rising risk of a wage-price spiral and the Reserve Bank of New Zealand's (RBNZ) strong response to that risk. Q3 inflation is running at 7.2% per year and on 1 November we learned that wage growth is running at 7.95% per year making New Zealand one of the only countries globally to enjoy positive real wage growth. Of course, with that comes the risk of a wage-price spiral that makes inflation very hard to contain. The RBNZ raised rates by 0.75% on 22 November and signaled further tightening to keep inflation under control. In response, the NZD extended its rally into the month end.

Going forward we are neutral to slightly positive NZD. The vigilance of the RBNZ, considering the latest wage data and early-stage plans in China to relax its COVID measures, is an important 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's path to reopening will be bumpy and we expect it will take the better part of H1 2023. 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 from here after the strong rally of the past 6–8 weeks.

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* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as of September 30, 2022 and includes approximately $55.12 billion USD 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. Please note all AUM is unaudited.

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