Commentary
Currency & Cash

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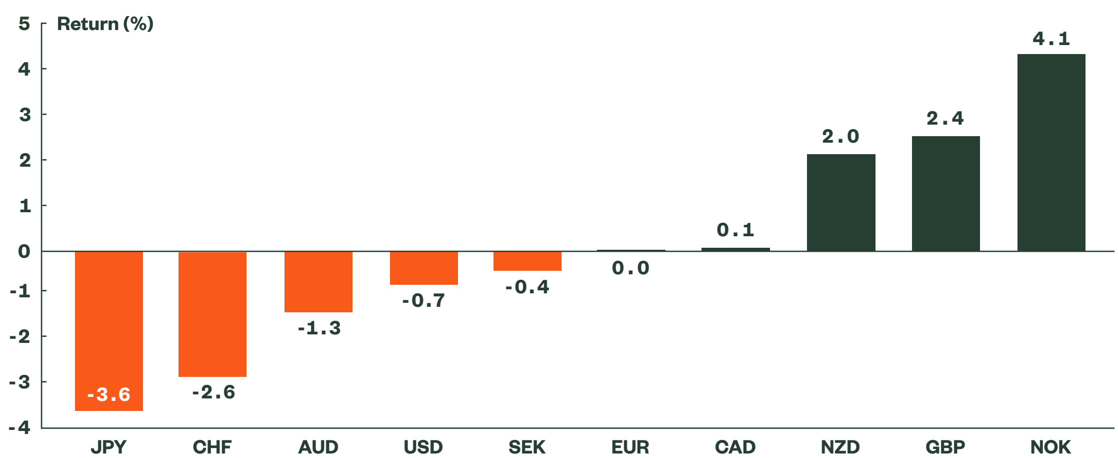
Currency Market Commentary

Aaron R Hurd, FRM
Senior Portfolio Manager

Summary of Views

In October the USD rally witnessed in September ran out of steam and reversed despite continued positive inflation surprises and rising yields. To some degree, this was likely due to selling pressure on risky assets exhausting as the defensive shift by investors had already priced in significant recession worries. In addition, a deceleration in the pace of rate hikes by the Reserve Bank of Australia and the Bank of Canada, along with a Wall Street Journal article speculating about a similar pivot by the US Fed, buoyed sentiment and helped send equities higher and the USD lower.

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



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

The GBP and the NOK were the relative winners. A change in the UK government and a move toward fiscal responsibility helped the GBP recover from the turmoil of September. Norway was the top performer alongside recovering equities and strong oil prices following a large Organization of the Petroleum Exporting Countries (OPEC)+ production cut. The NOK has been the most sensitive G-10 currency to equity markets this year.

The laggards were the JPY and the CHF. The JPY sold off on rising global yields, giving back the gains from the Ministry of Finance's late September currency intervention. The CHF trended steadily lower, partly due to improved global risk sentiment and partly due to a dovish divergence between the Swiss National Bank (SNB) and the European Central Bank (ECB).

Figure 2
October 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 October 31, 2022.

The October rebound in risk assets and risk-sensitive currencies and the weakness in the USD may continue through much or all of November, especially if November inflation decelerates. However, the move appears fragile. For now, the Fed and other central banks are likely to continue to focus on the ongoing rise in inflation and tighten policy as global growth slows. This means that we cannot rule out even higher US and global yields through Q4, in view of recurring fears of recession and a return of downside equity market volatility. While we may have seen the cycle high in the USD in late September, the risk of fresh highs is non-trivial. At the very least, the USD should be well supported against a broad basket of currencies due to higher rates, a safe-haven bid as the world's core reserve currency, and what appears so far to be a more resilient US economy.

Review and Outlook by Currency

US Dollar (USD)

The USD lost 0.7% versus the G-10 average. After a stellar September, the currency sold off in the first few days of October as equity markets bounced back, ISM manufacturing Purchasing Managers' Index (PMI) came in weaker-than-expected, and two-year yields fell nearly 19 bp by 4 October. The surprise 2 million barrel/day production cut by OPEC+ on 5 October triggered a correction lower in equity markets and a bounce back in the currency and US yields, as higher energy prices threatened higher inflation and lower growth. Another strong US employment report on 7 October with unemployment falling from 3.7% to 3.5% bolstered the USD, which continued to trend higher until the Consumer Price Index (CPI) release on 13 October.

The CPI data once again surprised to the upside, core +0.6% MoM relative to 0.5% expected. Yields jumped and the USD inched higher in response, but equity markets failed to follow suit. The S&P 500 surged nearly 2.5% on the day, suggesting that pessimism was, at least over the near term, fully priced. The next day, the USD took the cue from equity markets and began to sell-off. That sell-off accelerated as investors began to look through the anticipated 75 bp rate hike in early November to an eventual pivot to a slower pace of hikes and a pause. However, the USD retraced more than half of its loss after disappointing tech earnings and a major sell-off in both Asian equity markets and the Chinese yuan.

The USD is historically expensive and near term overbought. Aside from 1985, we estimate that the currency is near its most expensive level in the past 50 years. Over the next 3–5 years, we will see ample downside to the USD (15%–20%) as we eventually move to more normal levels of inflation, lower monetary policy rates, and enter the next global recovery cycle. However, the USD may stay well supported over the coming months.

It is difficult to predict the exact timing of the USD peak. We need to see a peak in interest rates, a credible decline in inflation, and some reliable sense of the trough in growth, especially outside of the US. We are getting closer to peak rates but cannot rule out another surge as inflation proves stubborn and the Fed remains focused on the inflation component of its mandate. Reduced supply chain bottlenecks, improved input/output prices, and declines in used car and home prices indicate that inflation may top soon. But we are yet to see it in broad CPI and Personal Consumption Expenditures price index (PCE) inflation indices. On the growth front, the extent of the global economic slowdown and fall back in equity markets remain highly uncertain due to geopolitical risks, the energy price shock, weak Chinese growth, and the ongoing drag from tighter monetary policy. We could see a sustainable downturn in the USD by late Q4 or early Q1 if inflation and rate monetary policy expectations moderate. However, if inflation proves more resilient and/or the expected growth slowdown is more severe, the turn may not happen until well into 2023.

We urge caution in assuming that this USD move represents a permanent, structural move higher. We also urge caution in trying to time the turn too carefully. We can see the growing stress of the strong USD on global financial and economic conditions as well as on the large US current account deficit. We take this as clear evidence that the USD is at unsustainable levels. While we suspect it is slightly early for the USD turn right now, we are much closer to the peak and the eventual downturn could be very quick. As we said last month, we see great benefits for long-term investors to build short USD positions.

Euro (EUR)

The EUR lost 0.01% versus the G-10 average. The EUR was choppy in the beginning of the month with a jump on 4 October in sympathy with a broad rally in equity markets. That quickly evaporated as equities turned lower and the 6 October release German factory orders and construction PMI disappointed. It wasn't until mid-month that the EUR sustained a rally against the G-10 following a comment on 17 October from Martins Kazaks that there was no reason for the European Central Bank (ECB) to pause rate hikes after December. The EUR rally persisted until the ECB meeting on 27 October, at which they delivered a strong 0.75% rate hike. The problem for the EUR was ECB President Lagarde's comments during the press conference that they had already made substantial progress in withdrawing monetary policy accommodation. This spooked investors who worried that the ECB may pivot to a more cautious pace going forward. The EUR sold off into the month end to finish flat.

We are modestly positive on the EUR relative to the G-10 over the near term, but we also see room for some additional underperformance relative to the USD. We expect volatility in equity markets to persist and commodity prices to remain on the weaker side as investors grapple with a weaker demand outlook and rising recession risk. Thus, much of the positive EUR view is not due to the EU's strength on an absolute basis, but rather because we see greater downside risks in cyclically sensitive and commodity-linked currencies, similar to the dynamic we saw in September. The ECB will also be key to the EUR outlook over Q4. With fiscal stimulus ramping up to offset the drag from high energy prices, the impending recession in the EU should be shallower. However, core inflation should also prove stickier. If the ECB responds with a more vigilant stance to contain that inflation, then the EUR is likely to hold up well. Conversely, if we see a harsh winter straining energy supplies and the ECB taking a more cautious approach favoring growth over inflation, then we could see the EUR moving broadly lower and breaking back down toward 0.95 versus the USD.

British Pound (GBP)

The GBP was the second-best performing currency in G-10, up 2.4% versus the G-10 average in volatile trade. The decision by Liz Truss to reverse the planned tax cut of the 45% top personal rate pushed the GBP higher at the start of October until she reiterated her commitment to the remaining tax cuts, sending the currency back down in the following days. That weakness continued as the Bank of England (BoE) Governor Bailey warned investors that the BoE's gilt market support was temporary and would expire on 14 October. Mid-month, the GBP surged on news that Tory MPs were planning a sweeping reversal of Truss's tax cuts, followed by the replacement of Chancellor Kwasi Kwarteng, with a more fiscally conservative Jeremy Hunt. The GBP rose further on news that Chancellor Hunt was planning to reverse nearly all the tax cuts. However, like the early-month surge, the mid-month GBP rally quickly evaporated on concerns over UK recession risk and political uncertainty as Truss resigned. Rishi Sunak, who was quickly installed as the new Prime Minister, focused on a path of fiscal austerity/responsibility, sending the GBP back to its highs to finish the month.

Our models continue to point to GBP strength largely due to a short-term oversold condition, even after the October rally. However, it is difficult for the models to fully appreciate the rapidly changing policy outlook. The abrupt shift to austerity should prevent the panic selling in the GBP that we saw in late September. That said, it does point to a deeper, longer recession which, while it may be good to reign in the current account deficit, will be painful and raises the risk that the BoE will adopt a more cautious approach to monetary policy. These conditions are not positive for the GBP. Therefore, we are significantly more cautious on the currency compared to our model signal.

Japanese Yen (JPY)

The JPY was the worst-performing G-10 currency, down 3.6% versus the average. The month began on a quiet note with choppy equity markets and lower US yields lending some support to the currency. The JPY has been primarily driven by widening yield differentials as the Bank of Japan (BOJ) keeps rates pinned near zero while the rest of the world hikes. Broader risk sentiment has also helped explain short-term fluctuations in the currency, with the JPY benefitting against higher-risk non-USD foreign exchange such as the NOK, the SEK, the AUD, and the NZD during equity market selloffs. After the quiet start, things turned more negative. The worst-case scenario for the JPY has been rising yields and equity markets. This is exactly what we saw after early October and explains the currency's underperformance. However, the downtrend was interrupted by a sharp, but temporary, move higher in the JPY on 21 October, suggesting another round of BOJ intervention in the currency markets (on behalf of the Ministry of Finance) after the JPY rose above 151. Without this intervention, the JPY may well have underperformed by an even wider margin.

Going forward, our models have a positive view on the JPY versus the G-10 average, but a negative view versus the USD. Further intervention by the Ministry of Finance remains a JPY-positive risk. However, we do not think that Japanese authorities will attempt to reverse the trend lower in the JPY or even set a floor on the currency. The ongoing divergence between ultra-loose monetary policy in Japan and historically aggressive monetary tightening outside of Japan is a powerful negative force, too powerful to overcome through intervention alone. As a result, we expect that Japanese authorities will continue to use intervention to slow the pace of depreciation by introducing some two-way price risk and discouraging short-term speculation. Beyond that near-term dynamic, the JPY is extraordinarily cheap and we think that we are approaching the high in global yields. Once we set that peak in interest rates and inflation begins to moderate, the JPY can begin to recover on a more sustainable basis. We see the potential for the JPY to be the first currency to turn higher versus the USD as yields peak because it also has safe-haven qualities and should not be severely impacted if global growth slows more than expected.

Swiss Franc (CHF)

The CHF trended steadily lower through most of October, finishing the month down 2.6% versus the G-10. Rising relative global yields and buoyant equity markets likely weighed on the currency. At the same time, the lack of major new negative news regarding the EU's growth and improved energy prices, thanks in part to a warm October, likely helped ease some of the safe-haven demand for the CHF. The local economy remains resilient with manufacturing PMI at a healthy 54.9 and retail sales growing 1% MoM in September following 1.2% in August. Still, the economy does not appear to be able to generate self-sustaining inflation. Real wage growth remains negative while both headline and core CPI has only increased by a cumulative 0.1% over the past three months, a 0.4% annualized rate. For this reason, the cautious tone of the Swiss National Bank (SNB) at their September meeting is likely to continue and limit policy rate increases.

We have shifted from slightly positive to neutral on the CHF over the near term. We expect the currency to be supported by high levels of equity volatility, high EU recession risk, the ongoing geopolitical risk from the Russia-Ukraine War, and the lack of SNB's intervention to prevent the currency's strength. However, the CHF has already appreciated significantly in response to these factors and is expensive versus our estimates of its long-run fair value. Moreover, the tone of the SNB action was relatively cautious, consistent with what we see as a weak inflation outlook. We expect the CHF to remain the second-lowest yielding currency in the G-10, and the SNB warned that at some point it will stand ready to resume direct market intervention to sell the CHF. Once the spike in regional political and recession risk settles, the CHF has plenty of room to move lower toward its long-run fair value, though that may take several quarters.

Canadian Dollar (CAD)

The CAD traded in a tight range, finishing up 0.1% versus the G-10 average and 0.8% against the USD. The currency was sluggish to begin the month and reacted little to the OPEC+ production cut and rise in oil prices. The employment report on 7 October was tepid, with +21.1k new jobs after three consecutive months of losses totaling 113k. However, the unemployment rate decreased from 5.4% to 5.2%, prompting the CAD to strengthen modestly as investors seemed to focus on the potential for the tight labor market to keep the Bank of Canada (BOC) on course to further tighten policy. Other economic data was mixed to weaker. More backward-looking data, an 11.9% rise in August building permits and a positive surprise in August retail sales, looked good. However, more forward-looking data such as the BOC Business Outlook for Future Sales dropped near the March 2020 lows and manufacturing PMI remained below 50, signaling a contraction.

The CPI surprised to the upside, with common core at +6% YoY relative to the 5.6% expected. The CAD rose in response but failed to hold the gains into the month end after a dovish BOC surprise on 26 October. The BOC increased rates by 50 bp versus expectations of a 75 bp hike. According to Bloomberg reports, the BOC also expressed concern regarding the impact of higher policy rates on heavily indebted households. They also revised down growth forecasts, predicting stagnation into next year with a greater chance of recession.

Going forward, we see further downside for the CAD in response to soft, range-bound commodity prices and steadily deteriorating employment, home prices, and manufacturing PMI. The recent divergence between the expected monetary tightening path of the BOC and the Fed is also likely to be a drag on the currency. 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.

Norwegian Krone (NOK)

The NOK jumped 4.1% versus the G-10 average, almost completely erasing its 4.5% loss in September, though it only retraced about 50% of its September loss versus the USD. The rebound was caused primarily by three things. First, the OPEC+ production cut announcement on 5 October boosted oil prices to the currency's benefit. Second, core inflation surprised to the upside at +1% MoM compared to +0.7% expected. And, finally, unemployment, industrial production, and retail sales data suggested resilient economic growth although retail sales and PMI data slowed. Stronger equity markets also provided a good tailwind for the NOK as it has had the highest beta to equities in the G-10 year to date and over recent years.

Our models shifted in September to a negative tactical NOK view on weaker relative growth, softer oil prices, a weaker monetary policy outlook, and rising global risk aversion. The positive economic surprises in October and rising oil prices moderated that signal but it remains slightly negative. 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, we expect strong gains eventually but reiterate that the NOK faces a tough near-term environment.

Swedish Krona (SEK)

The SEK lost 0.4% in October relative to the G-10 average. The dovish outlook from the Riksbank at its September meeting was largely supported by weaker economic data in October. August manufacturing PMI slipped below 50, signaling a contraction, both August and September retail sales fell MoM, and August industrial orders dropped 4.2%. Inflation remains well above target, but MoM core inflation came in at 0.7% MoM, below the 0.8% expected. More importantly, annual wages for non-manual workers are running at 3% compared to annual core inflation of over 7%. That implies a significant fall in real incomes that is likely to continue to slow domestic demand. Despite weaker data and soft monetary policy outlook, the SEK only experienced a small loss. It has been relatively sensitive to equity markets and global risks sentiment and the rise in equity prices likely helped stem losses from the disappointing economic data.

We continue to have a negative tactical view on weaker economic data and our expectation is that global risk aversion and equity volatility will return from time to time in this highly uncertain environment. The ongoing SEK sales to replenish Sweden's foreign exchange reserves are also likely to weigh on the currency over the coming months. Long term, the currency remains among the cheapest currencies in the G-10 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 (AUD)

The AUD lost 1.3% versus the G-10 average. The AUD began to fall early in the month following a surprise decision by the Reserve Bank of Australia (RBA) on 3 October to raise policy rate by only 0.25% against expectations of a 0.5% increase despite inflation remaining well above the target. Negative sentiment toward China after the US announced severe restrictions on key semiconductor technology exports also likely weighed on the currency during the first half of the month. Mid-month, the currency began to slowly recover some of its losses as global risk sentiment improved and equity markets rose. A surprisingly strong employment report on 25 October, 1.8% QoQ versus 1.5% expected, also helped the AUD recover from its lows as the markets questioned the RBA's ability to maintain its new, cautious pace of tightening. However, the inflation surprise was not enough to offset the impact of the dovish monetary policy shift and expected weakness in China, bringing the AUD to flat or positive territory for the month.

Our tactical AUD view remains negative. It is hard to dispute the resilience of economic data in Australia, but the trend is weaker and the global softening of economic data suggests further softness. The cumulative impact of RBA interest rate increases should also begin to weigh more heavily on economic activity and home prices as mortgage rates reset higher. On top of this, softness in commodity prices and continued weakness in the near-term Chinese growth outlook are serious headwinds for the AUD. However, these negative factors point to the RBA sticking with its more cautious, slow approach to policy tightening while the Fed and other central banks continue to tighten at a historically rapid pace. Thus, the balance of risks points to near-term challenges for the currency, likely keeping 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 2.0% versus the G-10 average. Unlike the RBA, the Reserve Bank of New Zealand (RBNZ) met expectations with a 0.5% policy rate increase on 5 October. This helped the NZD remain better supported than the AUD during the start of the month as equity markets and general risk sentiment remained volatile. On 17 October, the Q3 CPI surprised to the upside at 2.2% QoQ, far above consensus expectations of 1.5% and above the RBNZ's forecast of 1.6%. The positive surprise underscored the need for a continued policy tightening and strengthened the contrast with the RBA's dovish pivot. In response, the NZD trended higher into month end also helped by the recovery in global risk sentiment and equity markets.

We remain tactically negative on the NZD. Higher policy rates and very tight labor markets may be positive contrary to our negative view. However, there are several headwinds. Interest rates remain below those in the US and Canada making it a good, but not the best source of carry. New Zealand has a large current account deficit which is penalized during periods of economic and market uncertainty. And commodity prices are likely to remain soft/range-bound until global growth, or at least Chinese growth, begins to rebound. We do not see that happening in Q4. Relative to long-run valuations, the NZD appears attractive against the USD and the CHF but is not as cheap as the other commodity currencies, such as the NOK, the AUD, and the CAD.

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United States: State Street Global Advisors, 1 Iron Street, Boston, MA 02210-1641.
T: +1 617 786 3000.

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