Commentary
Currency Management

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Currency Market Commentary

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Summary of Views

	Short/Medium Term Outlook	Strategic Outlook	Comment
AUD	—	∨	RBA expectations of ultra-low rates until 2024 and the economic drag of Covid lockdowns impair the near-term AUD outlook. But, AUD is already well off its early year highs suggesting that much of the risk is already priced and the potential for RBA QE tapering in November is positive. Thus we remain neutral over the near-term.
CAD	∧	—	Lower global yields, shaky oil markets, and surprisingly weak Q2 GDP caused pushed CAD lower in August. However, local economic and policy conditions strongly favor a resumption of strength. Strong vaccination rates and more constrained recent rise in Covid cases further the bullish case. We take advantage of recent weakness to add long CAD.
CHF	∨	∨	We are negative CHF due to ultra-low yields, low inflation, SNB intervention to limit further CHF gains, and extreme overvaluation vs. long run fair value. Any pullback in global risk sentiment, further drop in global yields, or setbacks to EU recovery may delay CHF weakness, but we look through that and remain max short the Franc.
EUR	∨	∨	We remain negative EUR due to negative interest rates, elevated long-term valuation, and weak potential growth. We see scope for a cyclical bounce in EUR later this year or next but prefer to gain exposure to an EU recovery via higher beta, higher yielding currencies with regional EU ties such as the CE3, NOK, and SEK.
GBP	—	—	Elevated levels of Covid transmission and moderating growth after the initial reopening surge limit our enthusiasm for GBP vs. the G10. However, GBP remains cheap to fair value and we see ample room for upside vs. certain currencies, notably EUR, USD, and CHF once the current wave of Covid subsides.
JPY	∧	∧	The Yen is substantially below fair value and its yields are more competitive compared to the past 10 years. JPY tends to underperform in a global recovery which we expect to reaccelerate after the current surge in Covid. Despite our constructive medium-term outlook on the global recovery we still value long JPY as a risk hedge with long-run upside potential.
NOK	∧	∧	A steady post-Covid growth recovery, strong oil prices, an expected Q3 rate hike, ample fiscal support, and a cheap valuation are positive for NOK. That said NOK is very sensitive to global growth and risk sentiment, which have increased volatility recently. We look through short-term volatility and view any bouts of NOK weakness as a buying opportunity.
NZD	∧	∨	Fast recovering labor markets, solid manufacturing PMI, and rising inflation support NZD gains. The RBNZ's bias toward tighter monetary policy bolsters our positive view. Recent lockdowns under NZ's zero tolerance policy for Covid cases may delay gains, but over the medium-term we see the pandemic headwinds gradually waning.
SEK	∧	∧	SEK remains among the cheapest G10 currencies, while both Swedish and EU growth remain on solid footing. Recent pressures from Covid and expectations for the Riksbank to maintain policy rates at 0% well into 2024 may limit SEK, but we see room for appreciation vs. low yielders such as EUR and CHF.
USD	∨	∨	Strong — albeit decelerating — growth, rising uncertainty regarding the global surge in Covid, and the potential for the Fed to taper QE more rapidly and begin rate hikes as soon as 2023 all provide near-term USD support. Over the longer-term, USD remains quite expensive to fair value and we expect its relative growth advantage to erode into 2022 as the world catches up in vaccinations. This will likely to drive USD back down toward fair value. We sell into strength.

Note: All individual currency views in the table above are relative to the G10 average.

Detailed Currency Views

Macro Environment

Through August 20, commodity and currency markets incorporated the potential negative impacts of the fourth wave of Covid that began in July. The zero-tolerance approach to Covid in China and other countries across Asia and Oceana resulted in widespread lockdowns. In turn, the lockdowns disproportionately dented growth expectations for the region and weighed on commodity prices due to China's role as an anchor for global commodity demand. Equity markets and credit spreads weathered the storm quite well as the potential for an economic slowdown also reduced expected interest rates propping up equity valuations and reducing expected funding costs. FX markets followed commodities and rates by pricing in the fourth Covid wave more explicitly. In keeping with that, we saw the usual defensive shift toward the safe-haven currencies, USD, JPY, and CHF.

After August 20 investors shifted to a more positive stance. The precise catalyst for this shift isn't clear, but it was surely rooted in the belief that the last Covid wave would ultimately prove temporary. Specifically, this latest wave's economic impact would be limited as businesses and consumers learn to function alongside the virus and monetary/fiscal support would remain sufficient to prevent a deep slowdown and promote a strong recovery once the wave passes. By month end, equity markets went to new highs, or at least near prior all-time highs. Commodities recovered and with them higher beta commodity linked FX bounced. USD and JPY gave back nearly all of their mid-month gains and CHF sank to a loss of 0.9% versus the G10 average. Not all pro-cyclical currencies managed to fully recover. Mixed data came from Canada highlighted by very disappointing Q2 GDP and worry UK growth would gradually soften after the re-opening surge prevented CAD and GBP from fully retracing their early August losses resulting in slightly negative performance for DSH during August.

We remain early in the global recovery. If we are correct that the impact of Covid will gradually wane over the next 12 to 18 months, the initial pandemic recovery this year may disappoint but a longer recovery is likely to support above average growth through 2022. We expect monetary and fiscal policy to gradually tighten but remain extremely supportive over this period. As a result, we remain broadly positioned for a global recovery, selling EUR, CHF, and USD and buying pro-cyclical currencies that remain cheap to long run fair value, CAD, NOK, NZD, and SEK. We hedge this pro-risk portfolio with a long JPY position due to its tendency to rise during times of market stress, cheap long-run valuation, and historically high relative interest rates. JPY retains its low-yield reputation but now that the rest of G10 has historically low yields, JPY yields are relatively high by historical standards.

Despite our constructive view through next year, we see growing risk of additional, temporary bouts of pessimism in the currency markets over the near-term, like the USD rally and pro-cyclical currency correction during the first few weeks of August. The risk is rising that equity markets will take a pause in the form of a normal 5% to 7% over the next couple of months. If that happens, then the move in currency markets is likely to be somewhat more dramatic than it was in August.

We see several risks that could cause an adverse move in global risk sentiment through the end of Q3 and start of Q4. The commodity and commodity-linked currencies bounced after August 20, but catalysts for a negative move remain. At month-end we learned that China's PMI for August dipped into contractionary territory led by the services component. A deeper slowdown in China resulting from lockdowns can have material spillover effects of global growth, not just via reduced demand which would hurt Asia more broadly as well as Europe, but also via continued supply chain impacts. Those supply chain impacts act like a speed limit to growth by reducing effective productive capacity and are also likely to keep inflation on the high side long enough to make markets nervous (including equity markets). We expect to see a greater drag on economic data in the developed markets. Widespread lockdowns in Australia will certainly have an impact, but we also saw a miss recently in US ADP employment data and a sharp drop in the employment component of the US ISM Manufacturing Index. Political events in the US regarding the debt ceiling and tax policy and/or elections in Germany, Canada, and Japan also represent potential catalysts for a modest increase in volatility. Altogether these risks do not sway our medium- to long-term positive view of the global expansion, but they do suggest that the road to that expansion and returns to portfolios exposed to expansion may hit a few bumps over the next few months.

US Dollar (USD)

The US Dollar gained 0.3% in August versus the G10 average. USD found support early in the month following a strong jobs report, adding 943l new jobs compared to expectations of +870k and a drop in the unemployment rate to 5.4% relative to 5.7% expected. The JOLTS job opening data reinforced the positive employment report by reaching a record over 10 million. The dollar did well in the days following the employment data until a disappointing University of Michigan consumer sentiment survey on August 13, 70.2 versus 81.2 expected, caused USD to temporarily give back its gains. Weaker consumer sentiment against the backdrop of rapidly rising Covid cases introduced doubt about the sustainability of the recovery. However, the reluctance of US authorities at the state level to reimpose lockdowns, or even mask mandates in many regions, helped calmed those worries. The US reluctance to reinitiate lockdowns and proven ability to grow during Covid surges suggest the US is likely to continue growing, albeit at a more moderate pace. However, extrapolating growth from the Q1 Covid wave is not without risk. The past waves of Covid precipitated large fiscal support packages whereas this time we see key supports such as enhanced unemployment benefits and mortgage forbearance programs rolling off. US growth may disappoint over the next one to three months.

Globally things are a bit more concerning given the lockdowns in China and across Asia. Those concerns manifested as a sharp correction in commodity markets, a slight pullback in equities, and a risk-off move in currency markets. USD moved higher, reaching a gain of over 1.5% against the G10 average by August 20. Global risk sentiment recovered from that point, as described in the macro section, sending USD back down to finish with a slight gain for the month.

Monetary policy news came in the form of Fed Chair Powell's speech at the Kansas City Fed's Jackson Hole symposium on August 27. He stayed true to his message from the July meeting, suggesting that the economy had likely made sufficient progress to warrant tapering of the QE program by year end. However, he also pointed out that the bar for interest rate increases was much higher than for tapering, effectively requiring max employment, and that the timing and pace of QE tapering did not imply a faster pace of rate increases. With Chair Powell's comments, we look forward to the tapering announcement as soon as the September Fed meeting. Investors seemed to take this as a dovish surprise sending US yields slightly lower and equities higher. The US Dollar sell-off from its August 20 peak accelerated. We are also watching the potential for a US government shutdown later this fall over disagreements regarding the debt ceiling. We've been through debt ceiling disputes several times over recent years and don't think it will have a major impact on the currency. However, we do see room for proposed tax hikes, likely coming sometime in September or October, to weigh on sentiment toward USD.

We remain negative USD over both the tactical and strategic horizons. The view is anchored by expensive valuation relative to our estimate of long-run fair value and continued low interest rates. We also see softening in our leading economic indicator models and see the USD rally since mid-June as a bit overdone despite the pullback from the mid-August high. Although it's too early to be picked up by our economic indicators, we see the foundations for a strong rebound in Europe and Asia once the fourth Covid wave peaks. A similar recovery may take another quarter or two in Asia because of the still relatively low vaccination rates and reliance on lockdowns as a primary tool to manage Covid. Latin America is already enjoying a more durable reduction in daily virus cases and most central banks in the region are raising rates, as are most Eastern European countries. Higher interest rates across emerging markets, the prospects of better EU growth, and historically cheap equity valuations almost everywhere versus the US, bode well for a broad rotation of capital out of the US once this Covid wave passes and global growth broadens. Such a rotation is consistent with the historical pattern of USD weakness during global recoveries. We saw an USD pattern in 2020 and expect it to resume into next year, although timing is uncertain given persistent pandemic risks.

Our negative dollar view does not mean that we reject the thesis of US exceptionalism that many investors see as a basis for longer-term USD strength. It is hard to deny the pillars of the US exceptionalism thesis. Many factors support a structurally stronger USD over the next several years. The US potential growth and monetary policy/interest rate outlooks remain attractive relative to much of the world. US demographics are healthier than in most developed countries and China while friendlier immigration policies under the Biden administration could also help labor force growth. The US remains well positioned to lead in a global economy driven by innovation and the development of intellectual property. We may also see some technology enabled re-shoring of manufacturing. We respect these positive long-run factors and think that they will result in the mildest USD bear market since currencies were floated in the early 1970s. The USD typically moves 15% to 20% below fair value at the trough of a bear market, but we think USD will only fall back to and maybe slightly through fair value in this cycle. That still implies a broad 8% to 10% fall in USD.

Euro (EUR)

The euro moved sideways for the month, finishing with a minor loss of 0.2% versus the G10 average. EUR began the month on the soft side before reaching its low after a disappointing ZEW expectations survey, which plummeted from 61.2 in July to 42.7 in August. Weaker consumer sentiment in the US on August 13 helped stem EUR selling and send the currency higher. As the month progressed and the global Covid situation destabilized commodity and equity markets, EUR began to rise. The generally more well contained Covid outbreaks in the EU, the absence of new lockdowns, and the somewhat defensive nature of the EUR given its healthy current account surplus all supported this recovery in EUR. However, like USD, CHF, and JPY, once investors shifted back toward a more optimistic mindset after August 20th, EUR fell back to end August down slightly.

Looking ahead, we are bearish EUR over both the tactical and strategic horizon. All three of our long-term signals, valuation, interest rate carry, and long-term growth, suggest a short EUR position. EUR is quite expensive compared to GBP, NOK, SEK, CAD, and JPY and only fairly valued versus USD, AUD, and NZD. The EU is trapped in a negative interest rate regime and hindered by an anemic potential growth outlook, which is a function of low productivity growth and poor demographics. That is not a good backdrop for currency strength. One bright spot is the ongoing recovery as the EU economies reopen, which shifted our leading economic indicator into positive territory. However, that lone strong signal relative to negative reading on all our other measures leaves the EUR ranked at the bottom of the G10 universe.

While our central case is negative EUR against the G10, we recognize the risk that EUR could surge versus the US Dollar as its economy reopens and US relative growth peaks. The EU vaccination program has mostly caught up to the US and UK. Growth may slow alongside global growth for now, due to the recent Covid surge, but should continue to find support from a return of the consumer backed by historically high household savings rates over the past year. The EU is now disbursing fiscal support from the Next Generation EU fund, which will provide additional tailwinds and the resulting investment may help to raise longer-term potential growth. At very least the EU appears unlikely to repeat its mistake of forcing excessive fiscal contraction after the 2008–2009 Global Financial Crisis, which should help it achieve a much more robust cyclical recovery. Low interest rates are a drag, but we expect that as the recovery reasserts itself after the current Covid surge, we will be more likely to see a steadier rotation toward cyclical and higher yielding sectors of the equity market. This favors some rotation out of US equities into European equities. Such a rotation would help to push EUR higher versus USD. We saw this during late 2020 and think it may well resume as we get closer to a sustained post-pandemic recovery. To put a number to it, we could see EUR/USD up toward 1.25 at some point late this year or in 2022.

British Pound (GBP)

The Pound was the third worst performing currency in the G10, down 0.8% versus the average. GBP began the month nearly unchanged before trending steadily lower from the 10th through month end. Consistent with that trend, there was not one specific catalyst responsible for the Pound's weakness but rather a series of concerns throughout the month. After a strong economic surge following the reopening of the economy, data is beginning to soften. Industrial production for June, released on August 12, fell 0.7% relative to expected growth of 0.3%. The employment numbers were healthy on the August 17, but investors also have concerns that employment may suffer going forward, as government support in place during the pandemic winds down. CPI was unchanged month-on-month for July, compared to +0.2% expected. This reduces pressure on the Bank of England to tighten policy next year. Covid cases came down from their June/July highs but remain elevated. A sharp drop in July core retail sales, -2.4% MoM versus expectations of +0.1%, suggest that those elevated Covid case counts are impacting the recovery. Finally, on the 23rd we learned that August composite PMI dropped back from 59.2 in July to 55.3, led by a much weaker services component. Again, a sign that the sustained high level of Covid cases is constraining economic activity. Altogether the gradual series of disappointing economic reports and still uncomfortably high number of Covid cases provided more than enough of a catalyst for GBP to trend lower.

We shifted from a tactical short to a neutral GBP position with a negative bias in August, reflecting the fact that GBP has already fallen to levels more consistent with its softening economic outlook. It is important to note that while we are negative to neutral GBP versus the G10 average, we see scope for GBP strength versus EUR, USD, and CHF. For strategic investors/hedgers, we encourage long GBP positions and/or higher than average hedge ratios on most foreign currencies. The long-term GBP story is positive in our view. The currency is cheap to fair value, and there is plenty of upside in terms of growth, inflation, and monetary policy expectations once we more fully merge from the pandemic. In addition, we see the potential for capital flows into the lagging UK equity market may further help to accelerate GBP gains. With a long horizon it is better to ensure that you are in the market with a positive GBP position once the recovery takes hold and GBP reverts to fair value. The pound's gains in Q1 were a good example of the need for long-term, strategic investors to look through short-term uncertainty.

Japanese Yen (JPY)

The Yen followed global risk sentiment and yields throughout the month to finish nearly unchanged, +0.1% against the G10 average. The month began on quietly, as it did for most currencies, before the rising Covid concerns and commodity market correction sent the Yen sharply higher to a peak gain of nearly 1.8% versus the G10 by mid-month. Recovering global risk sentiment during the final 10 days of the month saw all those mid-month gains fall away. This is the same externally-driven pattern of Yen behavior that we describe nearly every month. A dramatic increase in Covid cases and continued weak inflation point to a continuation of ultra-loose Bank of Japan monetary policy. Unless we see developments that might impact domestic policy, we expect JPY to continue to be driven by external global risk sentiment and yields.

We also see little chance that the upcoming Japanese elections will impact JPY in a meaningful way, although we do think that if there is an impact it is more likely to be Yen positive. Prime Minister Suga, who has struggled with record-high Covid cases and correspondingly low approval ratings, has announced that he will not seek re-election as leader of the LDP in September, signaling the end of his tenure. If the new leader is a less enthusiastic supporter of Abenomics, then JPY could rally. The important point is that election uncertainty in Japan tends to strengthen JPY where in other higher risk countries such as Brazil it tends to weaken the currency. But, at this point, likely successors to Suga also appear likely to strongly support Abenomics, so this is unlikely to cause a sustained move in JPY.

Over the tactical horizon we retain a maximum long JPY position for two reasons. First, and most importantly, JPY provides diversification against adverse events as it tends to rise during global shocks, periods of falling yields, and equity market corrections. We may lose on the long JPY position during a recovery as we have over the past year, but using long Yen as a hedge allows us to take even more aggressive long positions in higher beta currencies such as NOK, SEK, and NZD which we think are likely to more than offset any losses on long Yen. Second, Japanese yields are higher than EUR and CHF yields across the curve and short-end yields are historically high versus most of the rest of G10. This implies that Yen weakness is likely be milder compared to prior global recovery periods in which JPY was the clear, low-yielding currency used to fund interest-rate carry trades. The yield gap is even more attractive in real terms because of the very low Japanese inflation rate. Thus, over the tactical horizon we may lose money in absolute terms on a long JPY position during this recovery, but the diversification and likely limits to those losses versus other low yielding currencies make it a worthwhile position.

Over the longer-term horizon, we have more direct positive Yen view. The Yen is quite cheap to long-run fair value relative to most G10 currencies, except for NOK, SEK, and GBP. This suggests that long-run forces are tilted toward a stronger JPY. Projecting ahead into late 2022 and 2023 the business cycle is more likely to support gains in JPY. We may be in the early stages of a dramatic global recovery, but by mid-2022 investors will turn their attention to the reversion of growth back to sub-par long-run averages. In fact, depending on the drag from high global debt levels, the potential misallocation of capital due to ultra-easy policy, and the degree to which governments efficiently allocate fiscal spending, global long-run potential growth may even be lower than the already weak level prior to the pandemic. That future period of a mature and decelerating expansion is more consistent with outright Yen appreciation given its cheap valuation. The major risk to this view is a longer recovery period and greater than expected productivity gains outside Japan, on the back of government financed development programs and higher levels of private investment.

Canadian Dollar (CAD)

CAD was the worst performing currency in the G10 this month, -0.94% versus the average, but it remains the top performer year to date. During most of August CAD followed oil markets, especially during the steep mid-month drop in oil prices following the IEA's downgrade of the Chinese oil-demand outlook on the 13th. Like most commodity-linked currencies, CAD bounced back strongly as oil prices recovered from their August 20 low. Unlike most other commodity linked currencies, the Canadian dollar rebound was brief. Oil and other commodity oil-linked currencies such as NOK trended higher from August 20 through month end, as risk sentiment turned positive. CAD's rebound lasted only until the 24th before it turned lower once again. This lack of follow through was most likely due to CAD's strong year to date performance in the face of decelerating growth. That was the case on August 31 after disappointing Q2 GDP (-1.1% versus +2.5%) expected sent CAD lower on the day.

The key question going forward is whether the disappointing Q2 GDP foreshadows a more substantial slowing of Canadian growth and undermines the bullish fundamental picture that has propelled CAD to be the top performing developed market currency this year.

Our indicators suggest this will not be the case. We remain long CAD over the short- to medium-term horizon. Q2 was weak, but June retail sales and June monthly GDP were more optimistic. Canada is struggling with the fourth wave of Covid as is most of the world. But the overall increase in case rates during this wave is low compared to many other countries; Canadian vaccination rates are relatively high which should mitigate the number of severe cases; and the vaccinations in Canada are more recent so the efficacy of the shots has probably not waned as much. Trade is strong, the border with the US has reopened for vaccinated travelers, and fiscal and monetary policy remain generous enough to ward off a more serious contraction.

We expect further softening in the near-term across the globe, and that impacts Canada as well. Global supply chain constraints will continue to be a drag, particularly on the manufacturing industry, and that has worsened with the lockdowns in Asia. We are constructive on oil, but as we saw in August the Covid surge will dent demand growth expectations, creating near-term headwinds. Overall, the Canadian recovery and very gradual path toward monetary tightening remains intact over the 3- to 6-month horizon. Ultimately this should limit CAD losses and encourage a return to earlier 2021 highs as we head into next year.

From a longer-term hedging perspective, the story is mixed. CAD is slightly expensive versus the G10 average but average valuation masks major differences across currencies. CAD is cheap versus USD, AUD, and EUR and extremely cheap versus CHF, while it is expensive versus JPY, GBP, NOK, and SEK. Therefore, we recommend that Canadian based currency hedgers adopt above-average hedge ratios on USD, AUD, CHF, and EUR and lower than average hedge ratios on JPY, GBP, NOK, and SEK.

Swiss Franc (CHF)

The Franc was the second weakest currency in the G10 for the month, -0.87% versus the average. CHF moved lower early in the month giving back most of its large July gain. A steady rise in sight deposits early in August suggest that much of the early month Franc weakness was due to central bank intervention to stem the gains from July. It worked. After the IEA's downgrade of Chinese oil demand kicked off a bout of global risk aversion mid-month, CHF rallied back alongside the other traditional safe-haven currencies, USD and JPY. That rally proved short lived as a subsequent return of positive risk sentiment after August 20 sent CHF steadily lower into month-end.

The Swiss National Bank's (SNB's) negative rate and currency intervention policy is not under pressure to change with inflation at low levels. The SNB is likely to maintain its ultra-loose policy due to chronically low inflation and its assessment that the currency is substantially overvalued. As a result, we expect CHF to continue to be driven by external growth, inflation, and central bank interventions rather than domestic economic conditions.

We continue to hold a large short-CHF position over both tactical and strategic horizons. Our strategic negative view is driven almost entirely by the Franc's extreme overvaluation and ultra-low yields. By our estimates, CHF is more than 21% expensive to its long-run fair value versus an MSCI World currency basket. Over the tactical horizon, very low inflation, an overvalued currency, and weak growth point to continued currency intervention and negative interest rates. As domestic and EU growth pick up, capital outflows are likely to accelerate (eventually) as investors look for growth and higher yield opportunities, much like they did during the 2017 EU growth spurt. We expect low global yields and the ongoing surge in the Delta variant to delay the recovery process and CHF weakness. However, currency intervention is likely to continue to limit CHF gains even in adverse scenarios. And, once we get through this surge, or at least gain confidence that its end is in sight, the net result will likely be pressure for a weak CHF during the subsequent recovery.

Norwegian Krone (NOK)

The Krone was surprisingly resilient to oil market volatility en route to a 1.8% gain relative to the G10 average in August. A strong rise in July manufacturing PMI to 63.3 from 60.8 in June and an increase in core CPI to 0.6% month-on-month helped support NOK through the first three weeks of the month as oil prices fell. Once oil and equity markets rebounded after the 20th, NOK followed with a steady move higher into month end.

The economic story is strong in Norway, but not without risk. Late in the month we got a very poor July retail number, -3.1% month-on-month versus-0.4% expected, but the currency shrugged it off in favor of the broader prospects for medium-term recovery and tighter monetary policy. In fact, the day of the release, August 27, was the Krone's second strongest day of the month. It will be important to watch consumer sentiment and retail activity going forward. By end August the seven-day average of new daily Covid cases surpassed its prior March peak. Mobility is quite high after the first three phases of easing lockdown restrictions, but the fourth phase has yet to be implemented. Private gatherings are limited to 20 people while some restrictions in areas such as international travel and restaurants/bars remain. The psychological impact of the surge on consumers and lingering restrictions could slow the recovery. However, at this point the central bank is still most likely to be among the first in the developed markets to raise interest rates this year on the back of strong inflation, resilient oil prices, and solid manufacturing activity. As a result, we retain a strong positive view on NOK over both the tactical and strategic horizons.

As we point out each month, a long NOK position is not without interim volatility risk. We cannot ignore the Krone's extreme volatility during 2020 and its frequent hypersensitivity to equity market corrections, as we recently witnessed in late February and again on a couple of occasions since mid-June. Norway's underlying fundamentals and the Krone's cheap valuation may portend strong returns, but they do come at a greater level of risk. And, even if the vaccination process continues to accelerate globally, we are learning that vaccination will not offer perfect insurance against further Covid disruptions. We suspect equity markets which are at or near all-time highs are likely to experience a correction or two along the way. This higher volatility and the Krone's high beta to global risk sentiment limits the size of our position. Over the strategic horizon, we can look through the short-term risks and are more positive in our view. We recommend Norwegian based investors set strategic hedge ratios on foreign currency at a high level, while most foreign investors leave NOK almost completely unhedged.

Swedish Krona (SEK)

The Krona lost 0.2% against the G10 average in August. SEK is sensitive to EUR performance and the EU economic outlook given its close ties to the region. EUR weakness early in the month, following a worse-than-expected ZEW expectations survey, appears to have spilled over to SEK, dragging it lower. During the mid-month commodity and equity market correction the Krona largely moved sideways, supported by EUR strength and a milder-than-average increase in Sweden's Covid case count. However, SEK retraced most of its early-month losses during the late-month cyclical recovery. Local economic data failed to provide clear direction. July composite PMI rose from 66.9 in June to 68.0, led by a surge in the services sector. This improvement is consistent with the subdued increase in local Covid case rates and a more optimistic consumer. However, the consumer outlook remains muddled by the 1.2% month-on-month drop in July retail sales, which was quite disappointing compared to expectations of a 0.5% rise. Inflation also remains low, with July core CPIF coming in a 0% month-on-month for a second month. This left year-on-year inflation stuck at 0.5%. We expect the ongoing recovery and base effects to bring inflation back above 1% year-on-year, but that is far from a level that will pressure the central bank, the Riksbank, to tighten policy.

Despite some mixed economic data recently, we retain a significant long SEK position over the tactical and strategic horizons. Starting from a stronger base compared to its regional neighbors (apart from NOK) we are seeing a solid economic recovery as Covid recedes. This will benefit SEK over time and is likely to put upward pressure on inflation later this year into 2022. The Riksbank outlook to keep rates at zero through 2023 is likely to limit SEK gains against higher-yielding, equally-cyclical G10 currencies. But our positive tactical SEK view is strongest versus EUR and CHF, both of which are backed by even more dovish central banks. Long SEK versus EUR and CHF provides 50–70 basis points of positive interest-rate carry, even if the Riksbank holds rates at zero. Over the strategic horizon, we focus on SEK's extreme undervaluation as the primary driver. We recommend that long-term global investors significantly reduce SEK hedge ratios while Swedish investors adopt high hedge ratios on foreign currency.

Australian Dollar (AUD)

The Australian Dollar lost 0.3% versus the G10 average during the month, suggesting that much of the Covid-related downgrade in near-term economic activity was priced into the currency during the mid-June through end-July downtrend. As a result, AUD rallied modestly through the first couple weeks of the month, despite the ongoing surge in local Covid cases, resulting lockdowns and choppier commodity prices. The early-month resilience in AUD was supported by the central bank, the Reserve Bank of Australia (RBA). RBA Governor Lowe noted that "the experience to date has been that once virus outbreaks are contained; the economy bounces back quickly. The economy is benefiting from significant additional policy support and the vaccination program will also assist with the recovery." Consistent with this optimistic assessment of the temporary nature of Covid shocks, the monetary policy outlook was unchanged. The RBA looks toward QE tapering to begin as early as September and rates to remain at historic lows until 2024. July services PMI, released the same day as the RBA meeting, plummeted from 56.8 to 44.2 in June. Having sold AUD consistently over the prior six weeks, investors shrugged off the poor PMI data, choosing instead to focus more on the upbeat message from the RBA that Covid impacts are likely to be temporary.

The middle of the month was more challenging as commodity markets fell, equities wobbled, and the continued increase in daily Covid cases cast some doubt on the RBA's more upbeat assessment. Local economic data continued to be as drag as well. Both NAB and Westpac consumer confidence fell into negative territory, July retail sales fell a worse-than-expected 2.7% month-on-month, and July building approvals fell 8.6% month-on-month. After the 20th, global sentiment reversed lifting almost all commodity-sensitive currencies including AUD, which pared most of its losses from its mid-month swoon. Some brighter signs in the economic data also helped justify a more positive, or at least less negative, medium-term Australian growth outlook, thereby supporting the late-month AUD recovery. The July employment report on the 18th showed a gain of 2.2K jobs compared to an expected loss of 43.1K and the unemployment rate dropped from 5.0% to 4.6%. A resilient jobs market indicates that incomes will be on solid footing once the current wave of Covid passes. Ongoing home price appreciation (+5.5% month-on-month in August) should also support a longer-term recovery via its positive impact on household wealth.

During August, we moved from slightly positive AUD to neutral over a tactical horizon, on weakening leading economic indicators. Upside/downside risks to AUD appear well balanced over the near-term. Vaccination rates are accelerating but it will be another 2–3 months before they reach a level where lockdowns can be significantly reduced without risk of overwhelming the medical system. During that time economic growth is likely to remain subdued. This also introduces risk that the RBA may delay QE tapering. From the perspective of the currency, much of this near-term economic risk was already priced in during the June-July sell-off. Longer-term stable employment and well-supported household savings and wealth should ultimately serve as a strong foundation for recovery. In addition, we are now hearing talk of re-opening the borders to travel and immigration over the coming months, a big missing piece of the Australian recovery to date. Easing of China's restrictions on Australian imports such as coal, wine, and barley would also be helpful, but that doesn't appear likely in the near-term. Overall, the near-term economic stresses and uncertainty are balanced by the more optimistic prospects for a sustained longer-term recovery. We expect AUD to trade in a range until the forces play out and the market gains more clarity.

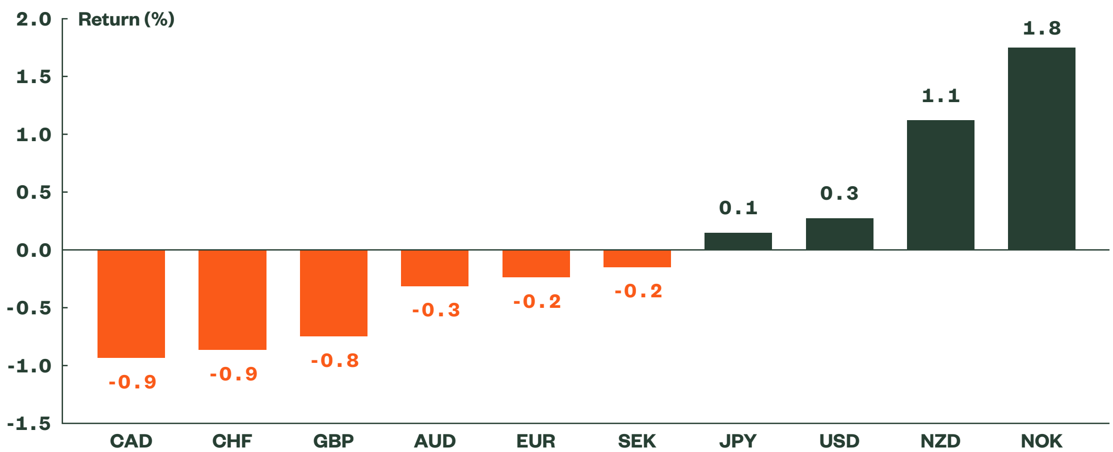
Our strategic view is also mixed. By our estimates, AUD is now nearly 5% cheap to fair value relative to an MSCI World xAU basket of currencies, a meaningful recovery compared to March 2020's 16.9% undervaluation. This average measure of valuation differs quite a lot across individual currencies. We still recommend that Australian investors maintain higher than average hedge ratios on foreign investments against the USD and fully hedge CHF positions. We estimate an AUD/USD long-term fair value of 0.790, nearly 8% above current levels. More broadly we recommend Australian investors leave positions in the cheaper GBP, CAD, JPY, and the Scandinavian currencies mostly unhedged; AUD is rather expensive relative to these currencies.

New Zealand Dollar (NZD)

NZD was more resilient than neighboring AUD with New Zealand unemployment back to its pre-pandemic level of 4%, home prices appreciating 27% year-on-year, a continued uptrend in BusinessNZ manufacturing PMI, and rising retail sales. Additionally, NZD continued to enjoy strong support from the Reserve Bank of New Zealand's (RBNZ's) shift to a tightening bias at its July meeting. These factors pushed NZD up 1.1% against the G10 average in August. That doesn't mean the month was entirely smooth. NZD is a commodity-sensitive currency and the mid-month decline in commodities weighed on it. At the same time, the RBNZ disappointed investors looking for a rate hike at its August 17 meeting, although it was clear from RBNZ comments that the bias remains for an increase in rates over the coming months.

The ongoing improvement in economic data relative to the rest of the G10 prompted us to shift from a small positive tactical bias to a larger long position. New Zealand enjoys robust local economic conditions, which will only improve once we see a broader global recovery from the pandemic and nations reopen to international travel. The greater likelihood of a monetary policy tightening and the recent QE tapering are clearly positive. We see strong upside potential against the currencies with more dovish central banks, EUR, CHF, JPY, and USD. For long-term strategic hedgers, we suggest a maximum hedge ratio on CHF and a slightly higher-than-average USD hedge ratio. In contrast, NZD remains quite expensive versus NOK, SEK, GBP, and JPY based on our estimates of fair value. We recommend New Zealand-based currency hedgers maintain very low hedge ratios against NOK, SEK, GBP, and JPY. We are near neutral versus AUD and EUR.

Figure 1
August 2021 Currency Return versus G10 Average



Source: Bloomberg and State Street Global Advisors, as of August 31, 2021.

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of June 30, 2021 and includes approximately $63.59 billion 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.

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