Insights
Currency & Cash

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Currency Market Commentary

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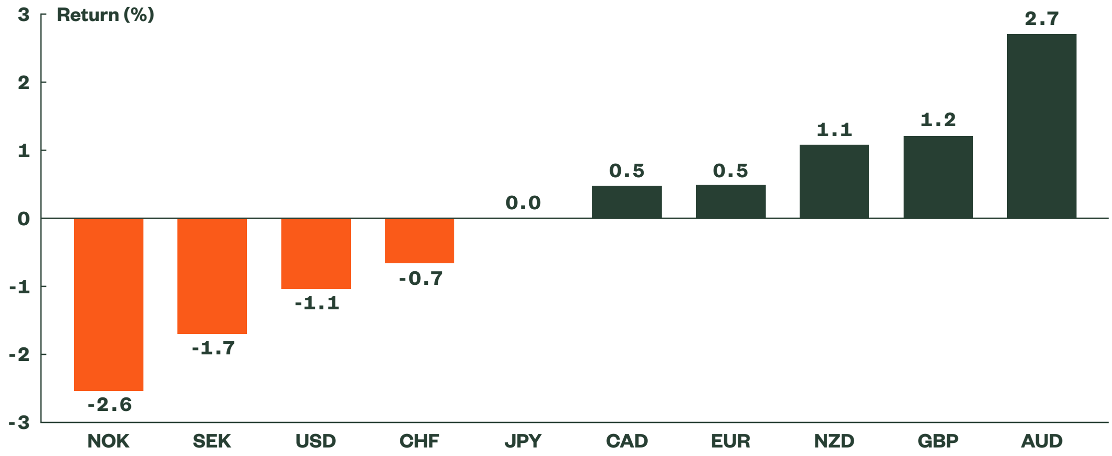
Summary of Views

Global yields fell while credit and equity markets rallied on continued signs of disinflation and a modestly improved global economic outlook. Much of the improved growth outlook was due to lower European energy prices and the faster-than-expected China's reopening as they lifted nearly all covid-19 related restrictions. The positive sentiment drove USD lower for the fourth consecutive month. While the AUD was the clear winner, the NZD also posted strong gains. Both benefited from the positive risk environment and their strong economic ties with China, with the AUD getting an extra boost from higher-than-expected inflation. The EUR and the GBP rallied on reduced risk of a deep recession and stickier core inflation, which bolstered expectations for further monetary tightening. The Scandinavian currencies lagged the G-10, which is unusual in a pro-risk, rising EUR environment. Both appear to have been dragged down by softer economic data and a relatively more hawkish European Central Bank (ECB) policy outlook, with the NOK being hit harder by oil market volatility.

Figure 1
January 2023 Currency Return vs. G-10 Average



Source : Bloomberg and State Street Global Advisors, as of 31 January 2023.

Figure 2
January 2023 Directional Outlook

	Tactical Outlook	Strategic Outlook
USD	↑	↓
EUR	↑	—
SEK	↑	↑
GBP	—	—
JPY	—	↑
CHF	—	↓
NZD	↓	—
AUD	↓	—
CAD	↓	—
NOK	↓	↑

Note: All individual currency views in the table above are relative to the G-10 average.
Source: State Street Global Advisors, as of 31 January 2023.

We see a bumpy ride for risk assets and currency through 2023 and perhaps into 2024, whereas rising risk assets, falling yields, and a falling USD are consistent with a perfect landing, a moderate growth slowdown accompanied by rapid disinflation. The problem is that if the economy runs either too hot or too cold, risk assets will suffer and the USD will bounce back.

Over the next 3–6 months, we expect greater volatility and some retracement of the USD sell-off. More pro-cyclical currencies are likely to suffer the steepest pullbacks, with the EUR caught in the middle. Longer term, the market has it right. At some point, the period of restrictive monetary policy will likely bring inflation under control and the negative impacts of that policy on growth will pass, resulting in a sustainable recovery regime. We will then see the USD trend materially lower and pro-growth currencies higher. However, it is too early to aggressively price this scenario now.

Review and Outlook by Currency

US Dollar (USD)

The USD lost 1.1% in January versus the G-10 average, adding to its large 6.4% loss in Q4. The month began with a countertrend bounce following hawkish December Fed minutes and stronger-than-expected numbers from both the ADP employment report and the Job Openings and Labor Turnover Survey (JOLTS) measure of unfilled job openings. That rally fizzled quickly after the employment report released on January 6 highlighted a slower pace of average hourly earnings growth, 4.6% YoY versus 5.0% expected. Disappointing durable goods orders, industrial production, ISM services PMI, and retail sales numbers further weighed on growth and Fed's policy expectations, pushing US yields and the USD lower. Meanwhile, equity markets have remained strong on the hopes that lower inflation would result in less aggressive monetary tightening. After 18 January, both US interest rates and the USD gained back their footing and moved sideways.

The USD is historically expensive and we continue to see it moderately lower in 2023 and as much as 15%–20% lower over the next 3–5 years as we eventually move to more normal levels of inflation, lower monetary policy rates, and enter the next global recovery cycle. For now, these conditions have yet to materialize, suggesting that the recent USD move may be a bit too much, too soon. The USD has most likely reached its peak for this cycle, but that doesn't mean we will see a steady and rapid reversal from uptrend to downtrend. Rather, we anticipate a messy topping process for the USD over the next few months. The Fed is set to continue tightening policy and keep the interest rates at restrictively high levels in 2023. Importantly, the USD may find support if the 2023 economic outcome surprises either to the upside or downside. Upside surprises imply tighter monetary policy and a higher risk of 2024 recession in which yields will rise and equities will fall, pushing the USD higher — this is a slightly less dramatic replay of 2022. A downside surprise will likely result policy rate cuts and falling yields, but also in disappointing earnings and equity market stress, which tends to support the currency.

Euro (EUR)

The EUR moved sideways but finished at the top of its range, appreciating by 0.5% relative to the G-10 average. The broader narrative surrounding the EUR remains positive, as falling energy prices reduce the risk of a severe recession and sticky core inflation is likely to keep the ECB's policy tightening at 0.50% for at least the next two meetings. Data was largely consistent with that narrative. After a modest pullback in the EUR as the USD surged, December core CPI surprised to the upside on 6 January. The inflation report prompted hawkish comments from the ECB's Robert Holzmann, stating that the ECB will remain aggressive until core inflation turns, despite the fact that lower energy prices dragged down headline CPI. In response, the EUR moved higher into mid-month until it was hit by a Bloomberg report on the 17, suggesting that the ECB may only increase its rate by 0.25% at the upcoming February meeting. However, the resulting sell-off was short-lived as a sharp bounce in ZEW business expectations and a pushback from ECB President Christine Lagarde helped it to recover over the following week.

Our tactical models remain positive on the EUR as monetary policy tightens and the economic outlook improves as energy prices fall. Lower energy prices increase consumer purchasing power, reduce import costs, relieve fiscal pressure, and make it easier for businesses to plan investment. Stronger relative equity market performance, reflective of increased capital inflows, is also positive for the currency. In the near term, we see some risks, especially against the USD. The EUR is facing resistance around 1.10, which is in line with our view that the USD is temporarily oversold. Higher ECB policy rates have been positive for the EUR, but with core inflation yet to peak, there is a risk that the ECB will be forced to move to a restrictive territory which could further reignite fears of a deeper recession. Finally, there is the risk of the Russia-Ukraine war intensifies to uncomfortable levels as we approach spring may re-introduce some negative risk premium. These near-term risk factors do not suggest a return to 2022 lows but may cause a retracement of recent gains.

British Pound (GBP)

The GBP gained 1.2% relative to the G-10 average, largely due to a strong surge after a positive core CPI surprise on the 18. The broader narrative of an improved economic outlook supported by falling energy prices helped the GBP. However, it is important to understand the GBP gain as a response to a modest relative improvement in an otherwise weak outlook. This is evident in the poor December retail sales report, which fell by 1.0% MoM compared to expectations for a 0.5% gain. In addition, the rolling 3-month GDP report has been negative for four months in a row and industrial production has declined for eight consecutive months. The UK is likely in a recession that will last for some time, albeit maybe a shallower recession than markets feared 1–2 months ago. As a result, we also expect the Bank of England to remain more cautious in tightening monetary policy than the ECB or the Fed, thereby weighing on the GBP.

Our models remain slightly negative on the GBP over the near term and close to neutral in the medium term. A return to fiscal responsibility and a modestly improved economic outlook justify the currency remaining well off its panic low from September but the weak economic outlook, cautious BoE policy tightening, and lingering (large) current account deficit suggest some weakness, or at the very least near limited upside from here. According to our estimates, in the long term, the GBP should remain cheap, about 12% below fair value relative to an MSCI World currency basket and 17% 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 (JPY)

The JPY was unchanged against the G-10 average. From a macro perspective, the JPY was stuck between two offsetting forces: the positive impact of falling global yields, which supports the currency by reducing its negative carry, and improving risk sentiment (rising equity markets), which attracts money to carry trades and depresses the JPY. Aside from the mixed macro forces, most intra month volatility for the JPY was caused by Bank of Japan's (BoJ) monetary policy. Following the easing of Yield Curve Control policy (YCC) in December, an increase in the allowable top band of 10-year Japanese Government Bond (JGB) yields to 0.5%, investors began selling the JGBs. This forced an unusually large intervention from the BoJ to defend that 0.5% limit in the form of a dramatic increase in bond purchases, aka quantitative easing. The stress and potential monetary easing effects of those bond purchases induced speculation that the BoJ would further raise the JGB band at their meeting on 18 January and pushed the JPY sharply higher. Instead, the BoJ held policy steady, reconfirming their commitment to YCC and negative interest rates. The JPY quickly fell by 2% to give back all the pre-meeting gains.

Our short-term models remain negative on the JPY due to the size of its recent rally relative to still very low interest rates and the lack of evidence that inflation in Japan will be self-sustaining. Beyond the very short term, our outlook is more positive. As we approach peak global inflation and yields, we are hoping to see medium-term strength in the currency. Because of its safe-haven qualities, the JPY can withstand a global hard landing (recession). Finally, even though the BoJ held policy steady in January, they may further raise the top band of the YCC yield target, exit negative interest rate policy, or both, after the change in leadership at the BoJ in April. Even with a change in leadership, we think that the BoJ will wait to see the outcome of the spring wage negotiations to assess the likelihood of further inflation pressure. Altogether, we see room for a near-term correction lower in JPY, but a long JPY exposure remains one of our preferred ways to position for the gradual transition from the USD bull to bear market over the next 6–12 months.

Swiss Franc (CHF)

The CHF lost 0.7% versus the G-10 average, completely offsetting its 0.7% gain in December. It traded lower for the majority of the month, driven by the divergence of monetary policy and weaker economic surprises relative to the EU. The EU's growth is weak, but when compared to dismal expectations in Q4 data, it is on the stronger side. Switzerland has been one of the strongest economies in the G-10 and continued resilience was expected. However, actual data has been disappointing with negative November and December retail sales growth and a sharp drop in January manufacturing PMI below 50, denoting contraction. The Swiss core CPI ticked higher to 2%, but the month-on-month numbers have been a lackluster 0.1%, though some of the recent slowdown in prices is likely seasonal. Markets have priced increased divergence between the ECB and the Swiss National Bank (SNB) monetary policy as a result of diverging EU-Swiss growth and inflation impulse. This is clear in the CHF price action. The weakest day for CHF was 11 January, following hawkish ECB comments and the strongest day was the 7, following a Bloomberg news report of a possible 0.25% ECB hike instead of the expected 0.5% in February.

Our models remain negative on the CHF, as we expect weak economic data and the broad slowdown in global inflation to weigh on it over time. While the SNB needs to continue to talk tough and modestly tighten policy in order to prevent additional inflation pressures, we expect that they will signal that they are nearing the limit of that tightening cycle earlier than the ECB. In the longer term, the currency is materially overvalued relative to our fair value estimates and is likely to remain one of the lowest yielding currencies in G-10. It may near remain near recent levels while the market anticipates the next SNB meeting. However, we see ample scope for weakness over the long run.

Canadian Dollar (CAD)

The CAD rose by 0.5% versus the G-10. Similar to the price action in December, the CAD simply followed the USD, largely disregarding local Canadian fundamentals. Despite a steep drop in oil prices, the sharp rally in the USD in the first few days of the month pushed the CAD higher. The USD and the CAD rally reversed quickly on 6 January, ignoring a stellar Canadian jobs report, +104k new jobs compared to +5k expected, and a drop in the unemployment rate from 5.2% to 5%. Rather than appreciating, the CAD depreciated alongside the USD which was dragged down by weaker-than-expected US wage growth. Both the USD and the CAD continued lower through mid-month before stabilizing. The Bank of Canada (BoC) met on 25 January, delivering a 0.25% rate increase and signaling a pause in policy tightening. The markets initially reacted negatively, pushing the CAD lower. However, it quickly recovered after the BoC's Tiff Macklem sounded more hawkish in explaining the policy pause at the press conference. This hawkishness combined with rising oil prices lifted the currency back into positive territory by month end.

Our models are negative on the CAD on weaker commodity price trends. China's reopening will likely improve the commodity outlook but that will likely take some time as the uncertain pace of recovery in China and headwinds from the slowing global GDP ex-China growth weigh on commodity demand. We also see greater vulnerabilities in the Canada's economy due to extreme high home prices and elevated levels of consumer debt, which should make the economy and inflation sensitive to policy rate hikes compared to the US. Beyond that, we see greater scope for CAD appreciation versus the USD, as China's growth recovers. However, our expectation of broad USD weakness later this year and into 2024 suggests that the CAD will likely underperform most other G-10 currencies (given CAD's high correlation to the USD).

Norwegian Krone (NOK)

The NOK fell by 2.6% versus the G-10 average, the worst performance in the group. The currency fell early in the month as oil prices corrected lower before regaining some ground as oil partially recovered and December core inflation surprised higher, 0.4% MoM relative to 0.3% expected. At its meeting on the 19, the Norges Bank held rates steady at 2.75% and indicated a likely rate hike in March. The market had little reaction to the news having only expected a 30% chance of a rate going into the meeting. However, given expectations for a 0.5% ECB hike in February and March, the NOK will lose its interest rate advantage over the EUR. This was likely a primary driver of the NOK underperformance despite higher equity and oil prices, both of which usually push the NOK higher.

Our models are negative on the NOK over the near term due to weak/volatile oil prices and poor local equity market performance. Outside of the models, our concern regarding a steeper-than-desired global economic slowdown and further equity market volatility keep on cautious on the NOK outlook over the next few months. The currency has had the highest downside correlation with equity markets in the G-10 over recent years. Long term, the NOK is historically cheap relative to our estimates of 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. It can be difficult to time the shift to a more bullish NOK stance. One important factor to watch will be the speed with which China recovers and increase in oil demand after the current wave of Covid-19 infections, likely March 2023 onwards.

Swedish Krona (SEK)

The SEK lost 1.7% versus the G-10, the second worst in the G-10. Falling home prices, manufacturing PMI stuck in contractionary territory, an unexpected rise in the unemployment rate from 7.3% to 7.5%, negative retail sales growth in December, and a 0.8 % fall in December GDP, all combined to overwhelm a modest positive surprise in core inflation to push the SEK lower. The Riksbank is expected to raise policy rates by 0.5% in February in line with the ECB and faster than the Fed, but the longer policy term rate outlook is more fragile given the weaker economic environment.

Our models have small positive bias on the SEK over the near term as it has already priced in a fair amount of bad news and local equity markets have performed well. That said, we do not see a ready catalyst for the currency's appreciation so long as economic data remains challenged. The potential for the EU to avoid recession or experience only a mild recession is in stark contrast to the recessionary data from Sweden. Until Swedish data stabilizes and we get a better sense of the ECB's terminal rate, it will be difficult for the SEK to rally. Long term, our outlook is much more positive. According to our fair value estimates, the SEK remains among the cheapest currencies in the G-10. Eventually, inflation will be under control and economies will begin a more durable recovery. Once that happens, the SEK has substantial room to appreciate.

Australian Dollar (AUD)

The AUD was the strongest performing currency in G-10, +2.7%, with many positive factors including rising equity prices and falling yields globally contributing to its appreciation. China's reopening also boosted regional currencies and this was amplified by rumors that China was considering easing a ban on Australian coal imports. Finally, a large positive surprise in CPI, +8.4% YoY compared to 7.7% expected, increased market expectations of further monetary policy tightening. This combination of positive factors led to a steady appreciation in the AUD through the month save for a quick, temporary correction lower as equity markets fell on 18 and 19 January.

Despite the positive factors, our models have a negative short term AUD view. China's reopening may help alleviate some of the negativity, but weak/choppy commodity prices, slowing consumer activity, and tepid wage growth suggest a more modest trajectory for Australia's economy and a more dovish-than-expected Reserve Bank of Australia monetary policy stance. These factors present meaningful headwinds for the AUD over the near term. Longer term, the AUD outlook is mixed. It is cheap versus the USD and the CHF and has room to appreciate; however, it is expensive against the GBP, the JPY, and the Scandinavian currencies.

New Zealand Dollar (NZD)

The NZD was up 1.1% on the back of generally positive global risk sentiment and the reopening of China. However, the currency was not able to keep pace with the AUD. After an aggressive monetary policy tightening, the New Zealand's economy is slowing more rapidly, with unemployment ticking higher, weaker business and consumer confidence, and a drop in credit card spending. Like Australia, Q4 inflation surprised to the upside, but the surprise was much smaller, 7.2% versus the 7.1% expected, which was below the Reserve Bank of New Zealand's (RBNZ's) expectation. As a result, the CPI failed to provide an extra lift for the NZD, though the deceleration in price pressures was a positive news for policy makers.

We believe that the NZD will be challenged after strong rally of the past 3 months, given the steady deterioration in economic activity and likely slowdown in the pace of RBNZ's policy tightening over the next few months. Our expectation of a global bumpy landing marked by periods of increased equity market volatility should also weigh on the risk sensitive NZD.
The positive impulse from China's reopening is real, but the immediately positive impact is likely already priced into the currency. Longer term, the NZD outlook is mixed. It is cheap versus the USD and the CHF and has room to appreciate, but fairly valued versus the CAD and the EUR, and expensive against the AUD, the GBP, the JPY, and the Scandinavian currencies.

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