Commentary
Currency Management

June 2021

Currency Market Commentary

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Summary of Views

	Short/Medium Term Outlook	Strategic Outlook	Comment
AUD	—	∨	The recovery continues supported by strong commodity prices, loose monetary and fiscal policies, rising home prices, and employment growth. However, recent lockdowns due to the surge in Covid cases and a central bank that is unlikely to project rate increases until 2024 weight on near-term AUD prospects.
CAD	—	—	YTD growth is strong, creating a firm base for recovery and hawkish Bank of Canada policy. The recovery in the US economy and expectations of an earlier FED rate hike are likely to spill over to help support CAD vs the broader G10 universe. CAD leads the G10 year to date reflecting these positives and that reduces scope for further near-term gains.
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 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 (EUR/USD to 1.25) the recovery matures 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	∧	—	The UK vaccination program has been impressive and underpins a solid recovery while GBP remains substantially below fair value compared to EUR, CHF, and USD. Optimistic tones from the Bank of England are also supportive. We see ample medium-term upside for GBP, but the YTD GBP rally prices much of this optimism and may slow gains near-term.
JPY	∧	∧	The Yen is substantially below fair value and its yields are more competitive compared to the past 10 years. But, JPY tends to underperform in a global recovery and we expect it to remain challenged in this recovery, but our long JPY position diversifies higher beta long positions in NOK, SEK, and GBP.
NOK	∧	∧	An steady post-Covid growth recovery, strong oil prices, an expected Q3 rate hike, ample fiscal support, and a cheap valuation are positive for NOK. We expect potentially sharp downdrafts in NOK if equity market volatility increases, but we see strong gains for NOK over the medium-term.
NZD	—	∨	Fast recovering labor markets, solid manufacturing PMI, and rising inflation support NZD gains. The RBNZ opening the door to an H2 2022 rate hike is also positive. But a recent slowing in the recovery and steady fall in commodity export prices limits near-term upside.
SEK	∧	∧	SEK remains among the cheapest G10 currencies while both Swedish and EU growth accelerates. The biggest obstacle to SEK appreciation the Riksbank expectation to maintain policy rates at 0% well into 2024. This may limit SEK vs. currencies with rising short-term rate expectations, but we see room for appreciation vs. low yielders such as EUR and CHF.
USD	∨	∨	World leading growth enabled by massive fiscal stimulus and tremendous progress in Covid vaccinations support USD near-term, especially now that the FED appears willing to begin rate hikes as soon as 2023. Medium- to long-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 is likely to drive USD back down toward fair value.

Source: State Street Global Advisors, as of June 30, 2021.

Detailed Currency Views

Macro Environment

The major themes we flagged in last month's commentary intensified in June and skewed in favor of the US dollar. Specifically, diverging central bank outlooks, a slower, bumpier recovery from the pandemic, and stubbornly high inflation.

The largest market impact came from the surprisingly hawkish shift in outlook from the US Federal Reserve (Fed) on June 16th. The Fed pulled forward the date of its first expected policy rate increase while leaving the long run expected rate unchanged at 2.5%. The policy path based on the Fed DOTS projection now calls for two rate hikes in 2023 up from zero at the March meeting and seven Fed policy makers now see at least one rate hike in 2022 up from four in March. In addition, the Fed Chair Powell indicated that the committee is now talking about tapering the QE program. USD short-end yields and the US dollar moved higher in response. However, after an initial knee jerk sell-off equity markets and emerging markets handled the news well as the expected terminal policy rate of 2.5% did not change and longer dated US yields fell. There may be a number of technical reasons contributing to the drop longer dated yields, but an important possible explanation is that a more responsive Fed reduces the risk of a severe inflation overshoot which requires the Fed to move more aggressively and potentially raise rates to restrictive levels. Lower risk of a policy error is good for longer-term stability and growth. Going forward we expect the currencies backed by more proactive central banks to hold up better. We now add the US dollar to that list. This should help to support USD through Q3 however USD is already expensive to fair value and that along with other factors that we discuss in the USD section suggest that USD is likely to come under pressure once again later this year and into 2022.

The second major theme, a slower global recovery, also intensified in June as the Delta variant of Sars-Cov-2, the one that was first discovered in India, began to spread rapidly in many countries. By month-end Australia was back in widespread lockdowns, the number of new daily cases in the UK rose back above 20k despite high vaccination rates, and several other countries especially in Asia and Latin America saw pronounced surges. The US, Canada, and continental Europe fared well. Nevertheless, the pace of global recovery will be longer and bumpier than many had hoped, and persistent global supply frictions should keep inflation stubbornly high. In this environment the relative pace of recovery across countries will continue to be an important driver of currency returns. Right now, that favors USD. In June the rise off the Delta variant outside the United States relative the continued fall in case rates in the US favor USD. Later this year and into 2022 we expect to see a shift in leadership which is likely to impact currency differently, across Europe through the summer and into next year, and Asia Pacific and broader emerging market universe later the year and very much in 2022.

Supply chain and labor market bottlenecks not only slow the pace of growth but introduce higher inflation and higher inflation volatility. To the extent that investors and policy makers regard these price disruptions as temporary the impact is likely to be small. But, the consequences of a more permanent shift in inflation that requires a material increase in real policy rates is likely to be extremely disruptive given current valuations and high global debt levels. Even if the probability of a structural shift higher in inflation is low, it cannot be ignored due to its potentially serious impact. The difficulty in forecasting medium to long run inflation means that investors are very likely to assign some reasonable chance to the risk of structurally higher inflation. Greater inflation pressure likely amplifies the important of central bank policy divergence as a driver of currency. More responsive central banks reduce risks of runaway inflation but the pace of tightening and difficulty in resolving supply side constraints are likely to keep inflation front of mind for investors. We must also be careful to watch out for central banks that are forced to tighten policy much earlier than warranted by growth and employment conditions due to inflation concerns. This is more of a problem for emerging markets, but in such cases the damage to the currency outlook from reduced growth may offset the benefits to the currency from higher rates. Either way, inflation is likely to continue to be an important factor for currency markets going forward.

US Dollar (USD)

The US dollar gained 2.6% versus the G10 average in June, the best performance in the group. Almost the entire gain happened in the two days following the Fed surprise, the 16th through the 18th. Outside of those two days USD only gained 0.15% on the month. The story is quite straightforward. Currency is particularly sensitive to shifts in short-term rates and the Fed shift toward a 2023 increase in policy rates was positive for short end yields and by extension USD. Covid dynamics also helped to underpin a positive USD story. While the Delta variant resulted in Covid surges across the globe the number of US cases continued to their lowest level since the early days of the outbreak in March 2020. Economic data verified a steady pace of recovery albeit not at the breakneck pace many had hoped for earlier this year. Nonfarm employment once again disappointed at 559k new jobs compared to 675k expected. May retail sales also disappointed at -1.3% MoM versus -0.8% expected, however the shift from goods consumption to services as consumer mobility increases likely explains much of the decline. Core inflation once again surprised higher at +0.7% MoM, +3.8% YoY. The US recovery is robust and supply side constraints are keeping inflation at an elevated level. YoY base effects should turn negative over H2, but the strong MoM inflation numbers point to continued strength in CPI. This validates the recent Fed shift and should help to support USD over the near-term as it did in June. Overall, a slower but robust recovery and higher risk of an earlier Fed rate hike should be USD supportive over coming months.

We retain a longer-term negative USD position despite the USD positive shift in Fed expectations.

USD remains overvalued, more than 9% above fair value versus an MSCI World xUS basket of currencies. That suggests much of the US advantage is already priced. While recent trends in US relative growth and inflation favor US assets and USD over the near-term, the rest of the world is likely to catch up later this year and especially in 2022. If that happens as we expect, then it should favor a weaker dollar. In addition, USD tends to suffer during broad global recoveries. The rest of the world catches up in vaccinations and recovery suggests a broadening, more synchronized global recovery into 2022. US capital flows are also a risk as US equities remain historically expensive relative to foreign equities. Our expected shift in growth leadership increases potential for relative upside surprises in earnings growth outside the US. Greater risk of higher corporate taxes in the US later this year further increase the chance for equity market outflows which tend to weigh on the dollar. For these reasons the shift in Fed stance this past month and surges in Covid in many locations outside the US are likely to delay the resumption of a USD downtrend, but ultimately we do not think it eliminates USD downside potential into next year.

This 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 while we may see some technology enabled re-shoring of manufacturing. We respect these positive long run factors and think that they result in the mildest USD bear market since currencies were floated in the early 1970's. Whereas the USD typically moves 15% to 20% below fair value at the trough of a bear market we think USD only falls back to and maybe slightly through fair value in this cycle. However, that still implies a broad 8% to 10% fall in USD.

Euro (EUR)

The euro lost 0.5% against the G10 average on the month in largely directionless, sideways trading. EUR is caught between the dovish ECB and hopes for a rapid acceleration in economic activity as its eurozone economies reopen. In contrast to the more hawkish central banks of Canada, Norway, New Zealand, and the US the ECB stuck to its extremely dovish stance seeing no need to adjust QE or rates policy in the foreseeable future. After the policy meeting on the 10th ECB President Christine Lagarde commented that it was premature to even discuss adjustments to policy. With YoY core CPI stuck around 1% there is certainly little pressure for tighter policy, although pressure may grow later this year as recent month on month inflation has picked up notably. Growth also appears to be accelerating sharply with the German IFO sentiment index back to late 2018 levels and the Markit composite PMI hitting a 15-year high. Hard economic data does not yet show the rebound due to reporting delays. The June data releases for retail sales, employment, and industrial production were all from April.

Looking ahead, we are bearish EUR over both the tactical and strategic horizon. All three of our long-term signals, interest rate carry, valuation, 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. More importantly, we do not have high hopes for change because of high debt levels, persistently high levels of regulation, resistance to reform, and potential misallocation of capital due to the ECB's large QE program. As a result, our long-term potential growth model ranks the EUR at the bottom of the G10 universe.

While we are negative on EUR against the G10, we recognize the risk that EUR could surge versus the US dollar as its economy reopens and US growth peaks. The EU vaccination program is catching up to the US and UK. Growth is increasing supported by 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 as mentioned above and may help to raise longer-term potential growth depending on the effectiveness of the investment programs. 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 matures, we are more likely to see a steadier rotation toward cyclical and higher yielding sectors of the equity market favoring 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 in the second half of the year or H1 2022. This call is a bit less aggressive than in prior commentaries in which we saw the potential for a move as high as 1.27% and saw the chance that could happen during Q3. We believe the relative strength of the US recovery and more responsive Fed policy approach modestly reduces and delays any potential for a EUR/USD rebound.

British Pound (GBP)

GBP held up well in June losing only 0.2% versus the G10 average, mostly due to a 2.8% underperformance against USD. Events were broadly mixed. The Delta variant has become the most common variant in the UK and is responsible for a steady rise in daily cases. On June 14th Prime Minister Boris Johnson delayed the plan to lift all restrictions until July 19th from the original end June date. The impact was muted as it mostly prohibited large gatherings such as concerts, most day to day activity is already unrestricted. Economic data is strong but decelerating after the initial reopening surge. Retail sales for May fell 1.4% compared to +1.5% expected. Markit composite PMI stabilized at high levels, 62.2, but that is down slightly from May's 62.9. Employment was also slightly below expectations with a 3M/3M change of 113k, near the average during the pre-pandemic 2017-2019 period. The unemployment rate is now only 0.9% above its December 2019 pre-pandemic level. Inflation is picking up with both April and May inflation printed +0.6% MoM pointing to further gains in the YoY number which remains low at 2.1%.

The Bank of England met on June 24th voting to keep policy settings unchanged noting that, "the Committee does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably." That statement sounds dovish but is really outlining a data dependent policy path. Rising inflation and a solid growth outlook suggest that the BOE could tighten in late 2022 or early 2023 expected prior to the BOE meeting. As a result, GBP was little changed.

The long-term GBP story seems straightforward to us and it is positive. The currency is cheap to fair value and now that Covid and Brexit stresses are receding there is plenty of upside in terms of growth, inflation, and monetary policy expectations. In addition, we see the potential for capital flows into the lagging UK equity market may further help to accelerate GBP gains. We hold a tactical long position. For strategic investors/hedgers we also encourage long GBP positions and/or higher than average hedge ratios on most foreign currencies. 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 as this is our central long run forecast. The pound's gains Q1 were a good example of the need for long-term investors to look through short-term uncertainty.

Japanese Yen (JPY)

The Yen gained 1.1% against the G10 average in June. JPY continues to be driven by external factors. This month it was the Fed surprise which initially drove equities lower and the Yen sharply higher alongside, but trailing, USD gains. After that knee-jerk reaction equity markets recovered, and JPY fell gave back most of its gains until it began to track higher into month end. That late month appreciation is difficult to tie to a specific driver. Most likely it was due to weakness in non-US equity markets amidst rising concerns over the increased spread of the Delta variant. Lower US 10-year yields may have also helped support the currency. Japan lifted its third state of emergency on June 20th, but it is far too soon to see benefits from that in hard economic data. Even as growth picks up, we expect little impact on the Yen because with core CPI still in deflationary territory, -0.3% YoY, there is a long way to go before the BOJ will react. The global recovery may be hitting its share of roadblocks, but it remains intact while an increasing number of central banks are preparing for an eventual tightening of policy. It will be difficult for the defensive, low-yielding JPY to sustain a rally in such an environment.

That said, we remain long Yen over the tactical and strategic horizons and see room for appreciation versus USD, EUR, and CHF. On the surface this appears at odds with our commentary above. We are calling for a general improvement in global conditions which according to our framework should result in a weaker Yen, in fact our outright JPY return forecast is negative versus the G10 average. Yet we are long. Why?

Over the tactical horizon the long position is attributable to two factors. First, and most importantly, JPY provides diversification against adverse events as it tends to rise during global shocks and equity market corrections. We may lose on the long JPY position during this recovery, 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 GBP which we think are likely to more than offset any losses on long Yen. Secondly, 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 mild 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 a more explicitly 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, or earlier, 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 government's 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 lofty 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 traded in a very tight range during the month to finish with a small gain of 0.2% against the G10 average. The lack of volatility in CAD appears to be the result of two factors. Firstly, CAD proved less sensitive to the Fed surprise than most currencies. Good news out of the US has direct positive spillover effects on the Canadian economy helping to anchor CAD to USD. The Canadian Dollar did underperform the US dollar as one would expect after the hawkish Fed surprise, but that anchoring effect also helped CAD to outperform other G10 currencies thereby keeping it very stable against the G10 average. Secondly, there was little news that impacted the medium to long run Canadian outlook. Economic data was on the weak side but that was largely expected due to the significant spike in Covid cases from April into early May. May employment fell 68k jobs relative to -25k expected while April retail sales ex autos fell sharply, -7.2% MoM. Going forward the outlook is more positive. The vaccination rate is steadily rising and is now on par with Europe at about 35%. As the economy more fully reopens growth should rebound nicely. The Bank of Canada (BoC) expressed similar confidence in the outlook at its meeting on the 9th. Policy was unchanged but the BoC retained its hawkish outlook noting that it sees potential for a rate hike in H2 2022, in line with current BoC expectations. With lower sensitivity to the Fed surprise and little news to challenge the medium-term recovery and monetary policy outlook, CAD was quiet on the month.

Similarly, our CAD forecast was little changed. We retain a small long CAD bias though at a reduced level as we favor the GBP and SEK on their improved economic outlooks. A stronger than expected recovery as Canada reopens would likely refocus our attention on CAD upside. But at this point the expected Canadian recovery and continued strong oil prices appear to be well priced by CAD at current levels. As a result, we limit the size of our long position. From a longer-term hedging perspective, the story is mixed. CAD is slightly expensive versus the G10 average but that average valuation measure masks major differences across currencies. CAD is cheap versus USD, AUD, and EUR and extremely cheap vs CHF while it is expensive vs 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 down 0.2% versus the G10 average for the month. The first half of the month brought steady CHF strength. It outperformed all G10 currencies except for the Norwegian Krone. The downtrend in global yields since March and the dovish ECB outcome alongside the strong Swiss current account surplus and lack of portfolio outflows likely supported the Franc. The spike in short end rates after the Fed surprise disrupted the early month strength sending CHF lower to finish near flat for the month. Unlike JPY, the Franc did not benefit from the two-day equity market correction following the Fed meeting despite its traditional behavior as a defensive currency. However, this makes sense compared to recent history. CHF has been quite sensitive to global interest rates but far less sensitive to equity market fluctuations. Interestingly, the market has recently priced in a 0.25% policy rate hike from the Swiss National Bank by end 2023 compared to only 0.10% for the ECB. This may be helping to keep EUR/CHF depressed despite the pickup in EU economic activity.

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, after the recent rally CHF is approximately 23% expensive to its long run fair value vs 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. The net result will be pressure for a weak CHF during the recovery.

Norwegian Krone (NOK)

The Krone fell 0.7% versus the G10 average during the month. NOK tracked oil higher during the first half of the month despite weak April industrial production, -0.1% MoM, and a significant disappointment in May core inflation, -0.4% MoM versus +0.1% expected. Those early month gains reversed sharply as NOK fell more than 2% in the two days following the hawkish Fed surprise. This is another example of the Krone's very high sensitivity to equity market losses; a risk we have highlighted consistently in these notes. The Norges Bank meeting on the 17th and reaffirmation of their expected September rate hike did little to stop the pain. The quick recovery in oil and equity markets after the 18th did stop the pain and NOK recovered almost all its month to date loss by the 25th before following oil prices lower into month end.

The Krone has had a strong year, but it remains very cheap to long run fair value. The Norges Bank has penciled in a rate hike as early as September backed by Norway's solid growth outlook. Oil prices appear well supported by the global recovery and supply restraint. Overall, NOK fits the profile of an attractive global economic recovery currency very well given its cyclical sensitivity and commodity market exposure. We are positive on NOK and hold a tactical long position.

That long 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 in 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, equity markets 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 0.5% relative to the G10 average and was unchanged versus EUR. Sweden's recovery is well under way with the May Markit composite PMI reaching a new 15-year high at 70.2 and retail sales rising 2.3%, up from a contraction of 1.4% in April. However, modest inflation, a very dovish Riksbank, and recent softness in EUR are hindering further Krona appreciation. The May inflation report released on the 10th showed a small 0.1% MoM increase and 1.2% YoY increase. This is well below the Riksbank's 2% target and we expect they will continue to project the 0% policy rate into 2024. SEK began to slide lower in the days following the inflation data. The hawkish Fed surprise and two day pull back in global equities hit SEK hard in the middle of the month sending it down nearly 1.4% versus the G10 average. Like equity markets and the neighboring Norwegian Krone, SEK recovered until he 24th, but was unable to erase the entire mid-month loss as it was slightly lower during the final week of June. This late month weakness may have been partly due to political uncertainty. Prime Minister Stefan Lofven lost a confidence vote and called on the parliamentary speaker to form a new government. We don't see this as a major risk to broad economic policy or SEK, but heightened political uncertainty is not helpful to the currency.

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 and into 2022. On a less positive note the Riksbank also indicated that have little appetite to raise policy rates from zero into at least 2024. This 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. Also, long SEK versus EUR and CHF also 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)

AUD fell 0.4% against the G10 average in June. After a quiet start to the month the hawkish Fed surprise pushed AUD into negative territory. AUD bounced back after that initial selloff, but it was cut short by rising Covid cases and a series of lockdowns which sent AUD to new lows by month end. Entering July nearly the entire country, or at least all major population centers, were in lockdown. Only about 7% of the population has been fully vaccinated putting the population at significant risk of the new, fast spreading Delta variant. Things are improving with near 25% of the population having received at least one shot, but that is not enough to prevent lockdowns well into July. However, the acceleration of the vaccination program is likely sufficient to preserve the positive economic outlook for H2 overall. As a result, the impact of lockdowns on AUD, monetary policy, and fiscal policy should be muted.

Outside of the mid-month volatility caused by the Fed and the latest surge in Covid, the economic data continues to look optimistic. Australian terms of trade finished the month at new 12-year highs thanks in large part to strong iron ore prices. May employment gained 113k new jobs compared to expectations for only +30k and much of the surprise came from the 97.5k new full-time positions. June PMI softened a touch from 58.0 to 56.7, but that remains consistent with strong growth. The only clear disappointment in the data was a 0.1% MoM gain in May retail sales compared to +0.4% expected. Overall, the data was strong enough to prevent a serious reaction from the RBA at its upcoming July meeting. Expectations are for the RBA to hold fast to its prediction that policy rates will remain at historic lows until 2024 but to be open to tapering bond purchases under its QE program later this year. Many investors and forecasters remain skeptical of the RBA's willingness to taper so any move in that direction is likely to be marginally positive.

We remain neutral to slightly positive on AUD over the tactical horizon. The story is not as positive as in prior months given the Covid surge. But with increased vaccination and Australia's track record of controlling spread through lockdowns we do not see this surge as derailing the broader recovery. While economic data remains strong in absolute terms the pace of recovery is decelerating compared to other countries such as the US, UK, and EU. It is hard to see Australian growth accelerating meaningfully until global travel and immigration resume. 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. In fact, tensions continue to rise. The firm commitment by the RBA to keep yields at 0.1% over the three-year horizon is also weighing on our AUD forecast due to the pickup in rate hike expectations in countries such as the US, Canada, New Zealand, and Norway. In the end AUD appears stuck near current levels. The positive impact of its healthy long-term outlook and strong commodity prices are offset by the negative impact of its lower relative interest rate outlook and decelerating growth relative to the broader G10 universe.

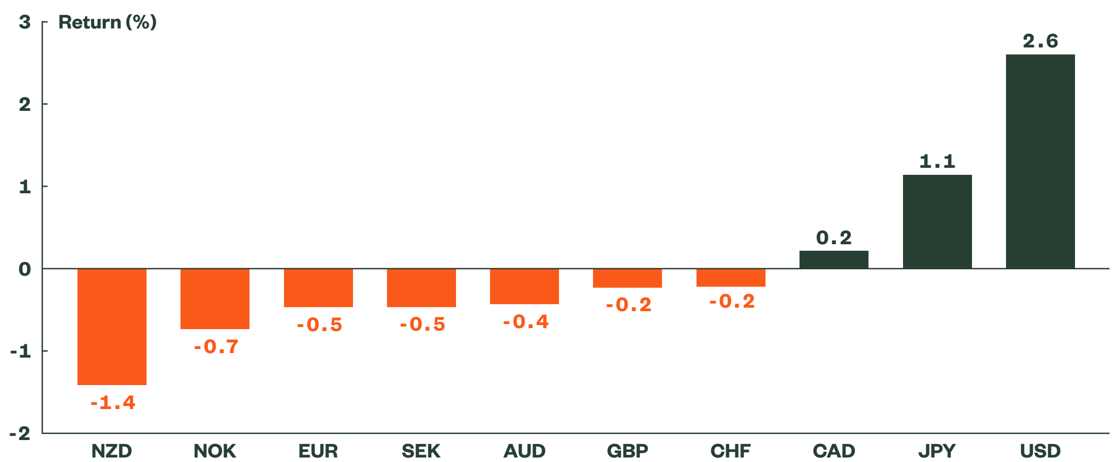
Our strategic view is also mixed. By our estimates, AUD is now about 0.7% cheap to fair value relative to an MSCI World xAU basket of currencies, a massive recovery compared to March 2020's 16.9% undervaluation. This average valuation differs quite a lot across individual currencies. We still recommend 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 0.770, about where we finished the month. However, as currencies revert to fair value they tend to overshoot. We have been modestly underhedged USD and suggest remaining in that position in anticipation of some overshooting of AUD to the expensive side. 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 lost 1.4% versus the G10 average in June. NZD had a muted response to the Fed surprise, unlike other cyclically sensitive commodity currencies, but that appears largely since it had been falling steadily from the start of the month. The weakness is likely a reflection of falling commodity terms of trade, the Citi terms of trade index for New Zealand trended lower throughout the month and has now completely retraced its January to May rally. NZD also entered the month slightly overbought after the strong reaction to the RBNZ's hawkish shift at its May meeting which added a negative bias going into June. The RBNZ remains one of the few G10 central banks most likely to increase policy rates later in 2022, but that is still at least a year away. Otherwise, economic activity remains on a strong footing. On the 16th we learned that Q1 GDP growth was revised sharply higher to 1.6% QoQ relative to +0.5% expected. More recent data such as Westpac's Q2 consumer confidence survey rose to 107.1, a level consistent with 2018–2019 pre-pandemic levels and home prices have risen 22.8% for the year ended in June. The ANZ business confidence survey dipped back into negative territory at -0.60 over the past two months, but in 2018-2019, prior to the pandemic, it was dramatically lower lingering in the -40 range and reached a trough at -60 during the peak of Covid in March 2020.

We remain close to neutral NZD over the tactical horizon with a small negative bias. New Zealand and the NZD are likely to perform well once we see a broader global recovery from the pandemic and nations reopen to international travel. The greater likelihood of a 2022 monetary policy tightening and before that a tapering of QE is clearly a positive. We see upside potential against the currencies with more dovish central banks, EUR, CHF, JPY, and to some extent USD. But, at this point it is difficult to see substantial currency appreciation against other pro-cyclical and commodity sensitive currencies given headwinds to a reacceleration of growth prior to the reopening of the border and the weakness in terms of trade which will weigh on the important export sector. For long-term strategic hedgers, we suggest a maximum hedge ratio on CHF and slightly higher than average USD hedge ratio. Oppositely, 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
June 2021 Currency Return versus G10 Average



Source: Bloomberg and State Street Global Advisors, as of June 30, 2021.

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