Insights
Currency & Cash

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Currency Market Commentary

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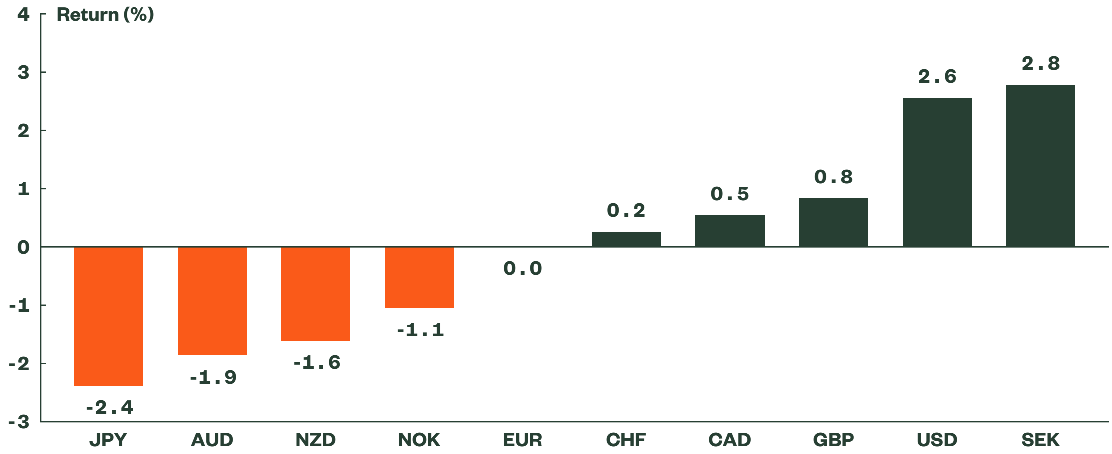
Summary of Views

The US dollar broke out of its four-month bear market as inflation, employment, retail, and global services Purchasing Mangers' Index (PMI) data surprised to the upside. The strong economic data triggered a sharp rise in yields as investors priced in tighter monetary policy to combat the greater inflation pressures. That, in turn, weighed on equity markets from both a valuation perspective and the higher probability of a monetary-policy-induced recession. The US dollar was supported by rising yields and rising risk aversion/weaker equity markets — a return to the familiar dynamics of 2022.

More cyclically sensitive commodity currencies lagged while the euro and the pound were stuck in the middle. The yen was the worst-performing currency as it is very sensitive to rising US yields, and the new governor-elect of the Bank of Japan (BoJ) promised to take a patient approach, maintaining the ultra-loose monetary policy for now.

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



Source: Bloomberg and State Street Global Advisors, as of 28 February 2023. **Past performance is not a reliable indicator of future performance.**

Figure 2
February 2023 Directional Outlook

	Tactical Outlook	Strategic Outlook
USD	▲	▼
CAD	▼	—
EUR	▲	—
GBP	▼	—
JPY	—	▲
CHF	—	▼
NOK	▼	▲
SEK	▲	▲
AUD	▼	—
NZD	—	—

Note: All individual currency views in the table above are relative to the G-10 average.
Source: State Street Global Advisors, as of 28 February 2023.

The Swedish krona broke out of its pattern over the past year to outperform following tough talk from the central bank and a significant positive inflation surprise.

February was illustrative of our primary concern for 2023: A perfect, soft landing, with inflation moving back to target and economies avoiding a hard landing, is very difficult. Markets will remain highly sensitive to incoming data, while central banks are likely to err on the side of tighter policy for longer. The result is a period of higher-than-average financial market volatility and yields — both of which tend to support the US dollar.

We see a period of significantly-below-trend growth at best and a broad global recession at worst, along with gradually improving inflation. However, the strength of the incoming data suggests that the path to normalization may take longer than many expected going into this year. We are increasingly concerned that recession risk and additional market upheaval may extend well into 2024. A long period of heightened uncertainty as well as high yields favors the US dollar at the expense of cyclically sensitive, commodity-linked currencies. The yen and the euro should do reasonably well in such an environment, although the yen requires lower US yields.

Review and Outlook by Currency

US Dollar (USD)

The US dollar broke out of its four-month downtrend with a gain of 2.6% vs. the G10 average in February. The US dollar began the month with a loss in response to the US Federal Reserve (Fed) chair Jerome Powell's reluctance to push back against the easing of financial conditions due to the strong equity markets and falling yields in his 2 February press conference. However, the US dollar popped back up after a surprising January employment report on 3 February (+517k new jobs compared to only +189k expected). The strength in the economic data and the US dollar continued throughout the month. Retail sales registered a sharp positive surprise, the services PMI moved back into expansionary territory, and core personal consumption expenditures (PCE) inflation unexpectedly rebounded back to its highest month-on-month levels since June 2022, at +0.57%. The strong rise in yields, resulting from the strong data, reignited worries of monetary-policy-induced recession risk, weighing on equity markets. This general risk sentiment further supported the dollar.

We see continued upside pressure for the US dollar as the strong consumer, hot inflation, and impressive employment data push the Fed to raise rates further and keep them at elevated levels for longer. That tighter policy is aimed at controlling inflation by dampening demand, which significantly increases recession risk later this year and into 2024.

Periods of high US yields and recession risk tend to be dollar-supportive. In the longer term, we stick with a decidedly bearish US dollar view. The US dollar is historically expensive, and we see a broad decline of as much as 15% over the next 3–5 years as we eventually move to more normal levels of inflation and lower monetary policy rates, and enter the next global recovery cycle. As we saw with the 10+% move down in the dollar over the October–January period, the turn lower in the US dollar can come quickly. That move proved premature, but at some point, over the next year or so, we expect the market to be able to more confidently (and correctly) anticipate economic and policy normalization, pushing the US dollar durably lower.

Euro (EUR)

The euro had an uneventful month as it finished flat relative to the G10 average. The European Central Bank (ECB) delivered a 0.5% rate hike on 2 February to take the deposit rate to 2.5% and signaled another 0.5% hike to come at its March meeting, after which hikes would become more data-dependent. Markets were not impressed partly because the stellar US employment data the following day dominated currency markets. A strong rebound in services PMIs across the European Union (EU) and the ZEW survey on 21 February also failed to move the euro, though the latter prompted a modest increase in market expectations for higher ECB policy rates.

We are positive on the euro in the near term on an improving (but still weak) economic outlook, powered by lower-than-expected energy prices and a decent fiscal outlook. Meanwhile, the stubbornly high inflation is likely to keep the ECB on a tightening path. As a result of that — more resilient growth outlook and tighter ECB policy — we see scope for capital inflows into both equity and fixed income markets. The euro is also likely to benefit from its relatively low correlation to global equity volatility and risk sentiment, which makes it less sensitive to the ongoing fear that global monetary tightening will trigger a recession.

British Pound (GBP)

The British pound surged late in the month to finish with a gain of 0.8% relative to the G10 average. The pound quickly fell to its intra-month low, down 1%, by 3 February in response to a dovish 0.5% rate hike from the Bank of England (BoE) and a stellar US employment data. Two BoE board members voted for no change, while Governor Bailey noted that the central bank sees early signs of a turn in inflation. From there, the currency moved sideways at depressed levels on conflicting data. Better-than-expected Q4 gross domestic product (GDP) growth and a strong jobs report (+102k new jobs in January compared to +15k expected) were positive for the pound.

But that positive impact was offset by the weaker-than-expected inflation data on 15 February. The pound finally gained some traction following an upside surprise in retail sales on 17 February, and a few days later by the surge in services PMI to 53.3 from the prior reading of 48.7. At the end of the month, news of a negotiated deal to rework the Northern Ireland Trade Protocol sent the pound up once again to finish the month with a gain.

Our models remain slightly negative on the pound over the near term and close to neutral in the medium term. A return of fiscal responsibility and modestly improved economic outlook justify the pound remaining well off its panic low from September, but the weak economic outlook, a cautious BoE policy tightening, and a lingering (large) current account deficit suggest some weakness, or at least near-limited upside from here. The new Northern Ireland protocol, if adopted by the parliament, is a positive in that it provides evidence that it is possible to successfully negotiate with the EU to ease the strains of Brexit. However, we do not view it as a game-changer for the pound at this point because it does not impact broader EU–UK Brexit-related trade issues, but only trade between Northern Ireland and the rest of the UK.

In the long term, the pound remains quite cheap by our estimates — about 12% below its fair value relative to an MSCI World currency basket and 17% cheap vs. the US dollar. However, until the economic outlook improves, real interest rates rise, and we see some improvement in the current account deficit, it is hard to see the pound moving back up toward its longer-term fair value.

Japanese Yen (JPY)

The Japanese yen was the worst-performing G10 currency in February, down 2.4% vs. the G10 average, and down nearly 5% vs. the US dollar. The story was rather simple. The yen is the lowest-yielding currency in the G10 and the nomination of Kazuo Ueda as the next Bank of Japan (BoJ) governor reduced expectations of a rapid change in monetary policy. As a result, the yen fell steadily in response to the large, steady rise in global yields. By month-end, the US dollar three-month yield advantage vs. the yen was near 5.3%, its highest level on a monthly closing basis since 2000.

Our short-term models remain negative on the yen due to the size of its recent rally relative to the still very low interest rates and lack of evidence that Japanese inflation will be self-sustaining. As we approach peak global inflation and yields, we expect to see medium-term strength in the yen. And in the case of a global hard landing (recession), the yen can hold up well vs. most G10 currencies due to its safe-haven qualities.

The nomination of the pragmatic Kazuo Ueda may reduce the chance of a quick change in BoJ policy, but inflation continues to prove sticky, and we think the BoJ under Governor Ueda would likely act at some point. This possibility of BoJ action should help to limit the risk that we see in the kind of runaway yen depreciation at times in 2022. Altogether, we see room for a continued correction lower in the yen, but a long yen exposure remains one of our preferred ways to position for the gradual transition from the US dollar bull to bear market over the next 6–12 months.

Canadian Dollar (CAD)

The Canadian dollar rose 0.5% vs. the G10 in February, helped by strong domestic data and the strength of the US dollar. Like the US, the Canadian employment report came in well above expectations — +150k new jobs in January vs. +15k expected — while the manufacturing PMI rebounded back to expansionary territory at 51.0. The Canadian dollar responded positively but was unable to keep pace with the US dollar as a weaker-than-expected Consumer Price Index (CPI) (5.9% vs. 6.1% expected), continued housing market pressures, choppy-to-weaker oil prices, and soft December retail sales all weighed on Canada's economic outlook. Against the broader G10, the Canadian dollar was able to hold its gains through the month, helped in part by the broad strength in the US dollar. The Canadian dollar tends to outperform the G10 average during periods of US dollar strength, given their close economic and financial ties.

Our models are negative on the Canadian dollar on weaker commodity price trends. The reopening in China will likely improve the commodity outlook, but that will likely take some time as the uncertain pace of recovery in China and headwinds from slowing ex-China global GDP growth weigh on commodity demand. We also see greater near-term vulnerabilities in the Canadian economy from extremely high home prices and elevated levels of consumer debt, which should make the economy and inflation sensitive to tight monetary policy compared to the US.

In the longer term, we see greater scope for appreciation of the Canadian dollar vs. the US dollar, especially as Chinese growth recovers. But in line with our expectation of a broad US dollar weakness later this year and into 2024, we think the Canadian dollar will likely underperform most other G10 currencies once we enter a period of normalization in global inflation, monetary policy, and growth (given the Canadian dollar's high correlation to the US dollar).

Swiss Franc (CHF)

The Swiss franc performed well throughout February, though it weakened late in the month on rising relative global yields, to finish up only 0.2% vs. the G10 average. The Swiss franc appreciated significantly through 8 February. It is difficult to identify a specific cause of the franc strength. Local Swiss data was soft early in the month, with manufacturing PMI coming in below 50, signaling contraction. Thus, it appears that the franc outperformance early in February was not as much a story of Swiss strength as it was about weakness in currencies other than the US dollar.

The same pattern repeated itself in the middle of the month following the strong US inflation and retail sales prints. Later in the month, following the broad, positive surprises in services PMIs across Europe, the UK, and US, the rise in global yields accelerated and the franc turned weaker, limiting its gain for the month.

The franc may continue to outperform higher-beta currencies such as the Australian dollar, the Norwegian krone, and the New Zealand dollar during this period of heightened uncertainty. However, we see the franc as vulnerable against the euro and the dollar. In our view, it is expensive relative to the recent rise in global yields. While the Swiss National Bank (SNB) needs to continue to talk tough and is likely to raise rates by 0.5% in March in order to prevent additional inflation pressures, we expect that it will ultimately signal an end to the tightening cycle earlier than the ECB.

Weaker-than-expected PMI data and retail activity, expected fiscal contraction, and the surprise stagnation in Q4 GDP (0% QoQ) will likely hasten that dovish SNB shift. In the longer term, we are also quite negative on the franc as it is materially overvalued relative to our fair value estimates, and is likely to remain one of the lowest-yielding currencies in G10. Once we get through this period of high inflation and recession risk, and into a period of calmer global recovery, the franc is likely to underperform for an extended period.

Norwegian Krone (NOK)

The krone fell 1.1% vs. the G10 average in February. The krone was closely aligned with oil markets during the first half of the month, falling sharply in the early days of the month before partially regaining lost ground, leaving the krone down modestly by mid-month. The krone moved sideways through the second half of the month, with equity market weakness likely weighing on the krone, while a late-month rebound in oil helped to offset equity weakness to provide support. Local economic data also had little impact on the currency as a disappointing Q4 GDP growth was largely offset by better-than-expected January retail sales and a positive surprise in the CPI print.

Our models are negative on the krone in the near term on 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 keeps us cautious in our krone outlook over the next few months. The krone has had the highest downside correlation with equity markets in the G10 over recent years. In the long term, the krone 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 krone faces a tough near-term environment.

Swedish Krona (SEK)

The Swedish krona enjoyed a strong rally, leading the G10 with a 2.8% gain vs. the average. After a slow start to the month, the Riksbank delivered a hawkish 0.5% rate hike and pointed to the likelihood of additional rate increases this spring. Importantly, it also specifically mentioned the desire to see a stronger krona. That hawkish tone and the resulting krona rally were further amplified by a large positive surprise in the core Consumer Price Index with a Fixed Interest Rate (CPIF) inflation (+0.4% MoM in January vs. –0.2% expected).

Our models have a small positive bias toward the krona in the near term as it has already priced in a fair amount of bad news, and local equity markets have performed well. The shift in the Riksbank rhetoric is also positive. That said, we see persistent downside risks. The manufacturing PMI remains in contraction territory, January retail sales growth was negative, and high levels of household debt make the Swedish economy very sensitive to tighter monetary policy. The hawkish Riksbank shift is welcome but suspect.

The Riksbank talk of higher rates is muted by its own projection of a peak rate at 3.33% in the monetary policy report, only 0.33% above current levels. It spoke of the desire for a stronger currency but admitted that it does not plan specific actions to push the currency higher.

In the longer term, the outlook is much more positive. The Swedish krona remains among the cheapest currencies in the G10 according to our fair value estimates. Eventually Swedish and global inflation will be under control and the Swedish and regional economies will begin a more durable recovery. Once that happens, the krona has substantial room to appreciate on a sustained basis.

Australian Dollar (AUD)

The Australian dollar lost 1.9% in February relative to the G10 average. The macro environment was a headwind as the initial enthusiasm regarding the China reopening from COVID-19 lockdowns waned, weaker equity markets weighed on risk-sensitive currencies (such as the Australian dollar), and stronger-than-expected economic data moved interest rates in favor of the US dollar and euro.

The Australian services PMI remained in contractionary territory, while the services PMI in the US, UK, and EU unexpectedly bounced back into growth territory. The Reserve Bank of Australia (RBA) delivered a 0.25% rate increase and pointed to the need for more increases, but it has been on a more cautious path than the ECB and the Fed. Importantly, weaker-than-expected employment and wage data cast doubt on expectations for further RBA policy tightening. The Australian dollar downtrend steepened into the month-end after the lackluster Australian services PMI print on 20 February which came in at 48.6, signaling continued contraction of services activity.

Weak/choppy commodity prices, slowing consumer activity, tepid wage growth, rising equity market risk, and a more cautious RBA present meaningful headwinds for the Australian dollar in the near term. Investors appeared less excited about the China reopening in February, but we think the improved Chinese growth may help to limit the Australian dollar downside as it begins to show up in the data.

Though we do not think the China reopening will be enough to warrant outright strength in the Australian dollar, in the longer term, the Australian dollar outlook is mixed. It is cheap vs. the US dollar and the Swiss franc and has room to appreciate, but is expensive against the British pound, the yen, and the Scandinavian currencies.

New Zealand Dollar (NZD)

The New Zealand dollar was down 1.6% vs. the G10 average in February. It trended steadily lower throughout the month following the upside surprise in the US employment data on 3 February. Economic data remains at stressed levels but improved on the margin, with a tick-up in consumer confidence, credit card spending, and business confidence.

The Reserve Bank of New Zealand (RBNZ) delivered additional monetary tightening, raising the cash rate by 0.5% to 4.75%, and signaled that more rates increase would likely be necessary to tame inflation. However, the New Zealand dollar failed to respond to the improved local conditions due to equity market weakness and an even stronger positive impulse in EU, UK and US economic data.

We are neutral on the New Zealand dollar in the near term. Signs of stabilization in economic data, albeit at depressed levels, the China reopening, and high yields should help support the New Zealand dollar. However, that positive impulse is likely to be offset by a fragile global risk sentiment and equity markets as investors grapple with ever tighter monetary policy and rising global recession risk.

In the longer term, our New Zealand dollar outlook is also mixed. It is cheap vs. the US dollar and the franc and has room to appreciate, but is fairly valued vs. the Canadian dollar and the euro, and expensive against the Australian dollar, the pound, the yen, and the Scandinavian currencies.

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* Pensions & Investments Research Center, as of December 31, 2021.
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