Commentary
**Currency Management**

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# Currency Market Commentary

**Aaron Hurd**
Senior Portfolio Manager, Currency

## Summary of Views

| | Short/Medium Term Outlook | Strategic Outlook | Comment |
|---|---|---|---|
| **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 will likely prevent meaningful near term appreciation. Despite our constructive medium-term outlook on the global recovery we still value long JPY as a hedge to short-term equity market risk with long term upside potential. |
| **GBP** | ∧ | — | The UK economy is under increasing pressure from the global slowdown, Brexit-related supply constraints, stubbornly high Covid cases, fiscal tightening, and rising inflation which may force the BOE to tighten prematurely. However, GBP is already cheap. We expect local and global supply shocks to ease next year and high UK inflation to normalize while excess household savings helps offset fiscal tightening. GBP looks attractive over the medium-term. |
| **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 limit SEK appreciation as global yields rise, but we see ample room for appreciation vs. low yielders such as EUR and CHF. |
| **NOK** | ∧ | ∧ | A steady post-Covid growth recovery, strong oil prices, the recently started monetary policy tightening cycle, 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. We expect the RBNZ to begin raising rates as soon as October 5. Recent lockdowns under NZ's zero-tolerance policy for Covid cases may delay gains and spur further profit taking, but medium-term we see the pandemic headwinds gradually waning. |
| **CAD** | ∨ | — | CAD rallied back in September on higher yields, declining Covid cases, higher yields, and some help from the resilient US dollar. After leading the G10 year to date, we take profit on CAD and shift to a short position after that rally, preferring cheaper and potentially faster-recovering pro-risk currencies. However, we still see CAD strength against more defensive EUR, CHF, and USD once the current period of higher equity market volatility passes. |
| **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. Thus, we have a positive forecast for AUD but prefer longs in other commodity-sensitive currencies over the near-term. |
| **USD** | ∨ | ∨ | Concerns over global growth, global monetary tightening and persistent inflation are causing higher global yields and jittery equity markets. This is a strong backdrop for the USD as the reserve currency. 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 is likely to drive USD back down toward fair value. We sell into strength. |
| **EUR** | ∨ | ∨ | We remain negative on 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. |
| **CHF** | ∨ | ∨ | We are negative on 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. |

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

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## Detailed Currency Views

### Macro Environment

Currency markets are caught in the crosswinds of slower growth, higher yields/inflation and higher equity market volatility with USD as the clear beneficiary of these forces. Softer growth and shaky equity markets tend to benefit the traditional safe haven currencies such as the US dollar, Japanese yen, and Swiss franc (and to some extent the euro) at the expense of more risk-sensitive, procyclical currencies such as the Norwegian krone and Australian, New Zealand and Canadian dollars. However, during September, rising yields in those procyclical currencies relative to the defensive currencies and strong energy prices offset much of the impact of slower growth. As a result, the traditionally defensive franc and yen failed to rally as much as one would expect in a period of greater equity market volatility, and procyclical NOK and CAD were the second- and third-strongest currencies in G10. Because the US dollar tends to perform well in times of equity market weakness and has among the highest yields in G10, it was supported by both defensive and yield-seeking flows. It's no surprise that USD finished as the top-performing currency for the month.

Over Q4, we expect the lingering negative growth impacts of Covid, including related supply-side bottlenecks, waning fiscal support and persistently high inflation to continue. In this environment, we'd expect to see continued support for USD and a more mixed picture for other G10 currencies depending on the relative moves in yields, the degree of equity market volatility and the specific ability of each country to weather the ongoing impacts of Covid-19. To anticipate the impact of changes in the yield curve on currency in Q4 look beyond the simple notion that higher yields are good for a currency and lower yields are bad. That relationship exists, but more important going forward will be the degree to which changes in the yield curve are a sign of health or dysfunction.

Are yields rising because the central bank is likely to be forced to raise rates materially despite significant growth challenges? Do rates remain low despite resilient growth and continually rising inflation, i.e., is the central bank risking an inflationary spiral despite having room to raise rates? Investors clearly worried about the first case in the UK and GBP during September. An expected steady reduction in fiscal stimulus, acute supply pressures and Brexit-related labor shortages have damaged UK growth expectations. The accelerating rate of inflation and comments from the Bank of England (BOE) that it may consider raising interest rates even before completely winding down QE indicates that it may risk a deeper economic slowdown in an attempt to contain inflation. As a result, GBP suffered despite high and rising rate expectations. We'll touch on the country-specific balance between rates and currencies in our detailed currency sections below, where relevant.

The six- to 12-month outlook is more optimistic. Investors may not be as quick to buy the dip in equities and riskier currencies as they have been over the past year, but the longer-term fundamentals and supportive policy settings still favor risky assets. As global vaccination rates rise and Covid transitions from pandemic to endemic, supply-side constraints should abate, though at a slower pace that many had hoped. At the same time, monetary policy is likely to remain extremely accommodative even with some central banks winding down QE and beginning to raise rates. That easy monetary policy in addition to excess household savings and continued labor market improvement should support above-average growth through 2022 and perhaps into 2023 and is consistent with resilient risky asset prices. Therefore, we view the upheaval in September and any further volatility in Q4 as an opportunity to enter attractive positions in procyclical currencies to capture that more-positive long-term outlook. Specifically, we look past the current increased volatility and USD rally with a portfolio long NOK, SEK, NZD and GBP vs. short EUR, CHF and USD to capture the longer-term positive growth/recovery theme that should see the premium valuation of defensive currencies revert lower.

With respect to that longer-term six- to 12-month view, it is important to be mindful of the divergence in currency market valuations relative to those of equity and credit markets. Strong earnings expectations and somewhat elevated valuation levels in equities and historically tight credit spreads increase the risk that those markets move sideways for an extended period. This is likely to impact currency markets; however, currency valuations are not as optimistically priced. Pro-growth currencies such as NOK, AUD, NZD and CAD remain far below our estimates of long-run fair value while the defensive CHF and USD are expensive. Even if we enter an extended period of sideways price action in equities and credit over the next year, there is still room for pro-recovery currencies to rally. This will seem like a decoupling of currency with broader market risk sentiment, but we'd argue that the decoupling has already happened and such a move would represent currencies catching up to, or recoupling with, the optimism of equity and credit markets.

## US Dollar (USD)

The USD downtrend that began on August 20 extended into early September after a much-weaker-than-expected employment report on the 3rd, +235,000 new jobs vs. +733,000 expected. Mid-month, USD reversed course to finish the month up 1.2% vs. the G10 average. The dollar recovery was supported by an accelerating equity market correction and somewhat hawkish Fed meeting outcome on the 22nd. The tendency for USD to appreciate alongside falling global growth expectations and increased equity market volatility is well established given the dollar's defensive role as the global reserve currency. The increase in the Fed median dot projections from 0.875% to 1.0% for end 2023 and stubbornly high core PCE also helped push USD higher due to the projected yield advantage. Growth is slowing in the US with full-year Bloomberg consensus GDP estimates falling during September from 6.2% to 5.9% for 2021 and 4.3% to 4.2% for 2022 but is still well above the post-GFC average. It is likely that the US economy can easily handle QE tapering beginning late this year and a slow rate hiking cycle beginning as early as late next year without precipitating a substantial slowdown in growth.

We remain negative USD over both the tactical and strategic horizons. Our view is anchored by expensive valuation relative to our estimate of both long- and short-run fair value. Resilient growth, rising rate expectations and less consistent equity market performance helped lift USD well off its May–June lows. However, that move relative to long-run fair value and relative to short-term changes in growth, yields, terms of trade and equity market returns appears a bit overdone. The relative advantages of USD appear well priced. As investors work through the uncertainty of potential changes in the growth, inflation and monetary policy outlooks, it is hard to see sustained USD downside over the next month or two, but upside should also be limited. We prefer to position for longer-term USD depreciation, which we expect as the impacts of Covid wane through next year.

Further to our medium- to long-run bearish USD view, it is important to be cautious in extrapolating the USD effects of 2013–2015 QE tapering and initial Fed rate hike to the current policy shift. The broad Bloomberg US Dollar Index rose nearly 25% from end 2012 to end 2015, but context matters. As we entered the last Fed tightening cycle USD was well below fair value. The ECB introduced significant quantitative easing programs and negative rate policy. The yen fell precipitously on the introduction of Abenomics. Commodity markets were entering a multiyear bear market, depressing commodity-sensitive currency. And investor and central bank confidence in the EUR as a store of value remained impaired by the 2011–2012 EU debt crisis. Yes, USD rose impressively as the Fed tightened policy, but that was very much a function of deteriorating currency fundamentals outside the US. Now, we enter this Fed tightening cycle with the USD 11.6% expensive vs. the MSCI World xUS currency basket, most central banks expected to tighten policy — albeit at a slightly slower rate than the Fed — and much more resilient commodity markets. Moreover, the expected terminal rate at the end of this hiking cycle is expected to be materially lower than in 2018. In this cycle, the Fed will tighten, but currency fundamentals outside the US are improving alongside USD fundamentals; we are not seeing the same massive divergence. Therefore, it is not appropriate to use the prior QE exit and rate hiking cycle as a template to predict USD behavior in this cycle.

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 while we may see some technology enabled reshoring 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 15–20% 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 10% fall in USD from current levels.

## Euro (EUR)

The euro lost 0.6% vs. the G10 average in September. The month began quietly with EUR trading in a tight range of +/-10 basis points relative to the G10 average. The ECB meeting on the 9th tilted slightly dovish, sending the currency slightly lower, about 0.2%. At first glance, it appeared that the ECB took a more optimistic, hawkish tone. Emergency PEPP asset purchases were reduced from the accelerated pace adopted during the prior wave of Covid, and GDP and inflation estimates for 2021 were increased by 0.4% to 5% and 0.3% to 2.2% respectively. However, by end 2023 inflation is expected to fall back to 1.5%, far below the 2% target. Those estimates imply that monetary policy will remain extremely loose for the foreseeable future. During the press conference, ECB President Christine Lagarde also struck a more dovish tone, downplaying the reduction in current PEPP purchases and pointing to the high levels of unemployed workers. With ECB rate expectations well anchored, the rise in US and global yields after the Fed meeting on the 22nd sent EUR down nearly 0.4% vs. the G10 average in two days and pushed EURUSD through support at 1.16.

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 vs. 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 of 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 vs. the US dollar over the six- to 12-month horizon. The EU vaccination program has caught up to, and in many countries surpassed, the US. 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 on EUR, but we expect that as the recovery reasserts itself after the current Covid surge, we are 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 vs. 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 1.22–1.25 at some point in 2022, though in such a case it is still likely to underperform cheaper, more cyclical higher-yielding currencies.

## British Pound (GBP)

The pound had a difficult month, losing 0.8% against the G10 average, the worst performance in the group. Prior to the sharp drawdown in equity markets mid-month, GBP had been trading quietly. After the 16th, GBP appeared to follow equity markets quite closely, selling off as equity markets surged lower from the 17th to the 22nd, recovering for a few days, then falling sharply into month end. As a risk-sensitive currency, the GBP gyrations in equity markets are important, but there were also some other important concerns driving GBP during that time. Rising inflation and indications from the BOE at its policy meeting on the 23rd that it would consider rate increases even before fully unwinding QE destabilized the currency. At first, GBP reacted positively to the prospect of higher rates, a typical knee-jerk reaction. Then investors turned negative on concerns that the BOE may be forced into hiking rates prematurely into a rapidly slowing growth environment in order to combat inflation. This was an important factor in GBP weakness toward month end.

In addition to global inflation pressures from supply chain bottlenecks, the UK also faces additional bottlenecks due to Brexit-related limits on immigration, which are contributing to labor shortages as well as trade frictions from more onerous customs protocols. These Brexit-related factors both lower potential growth/productivity and increase inflationary pressures. Raising policy rates against that backdrop could be painful. On top of those concerns, the UK is also steadily removing pandemic-related fiscal and employment support programs which may further drag on growth.

Despite these concerns, we shifted to a long GBP position, reflecting the fact that GBP has already fallen to levels more consistent with its softening economic outlook. The pound may retest recent lows and may set modestly lower lows, but it appears to have overreacted to recent developments, and risks are tilted more to the upside over the medium term.

Specifically, we see inflation and growth risks as difficult but manageable. Inflation spiked to 3.1% YoY, but that was driven by a narrow subset of prices, mostly transportation and hospitality, suggesting it is more likely to be transitory than permanent. Our leading-economic-indicator model shows that while UK growth has softened from its immediate post re-opening spike, the pace of decline is slowing relative to the G10 average. Concerns over a longer-lived impairment to structural/potential growth from Brexit issues are valid. To the extent that Brexit is aimed at reduced immigration to preserve jobs for local workers, it is a form of protectionism, which tends to lower potential growth. This justifies a weaker GBP, but GBP is already near 15% cheap to our estimates of fair value vs. USD and 10% cheap to EUR. And cyclically the picture is more optimistic. The current acute labor shortages will likely ease over time as the government allows some additional immigration and/or local workers shift in to fill shortages. The UK and GBP will also benefit if global supply chain bottlenecks resolve themselves over the next year, as we expect.

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 emerge from the pandemic. In addition, we see the potential for capital flows into the lagging UK equity market to further help 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 Q1 were a good example of the need for long-term, strategic investors to look past short-term uncertainty.

## Japanese Yen (JPY)

The yen followed global risk sentiment and yields throughout the month to finish down 0.3% against the G10 average. During the first few weeks of the month, JPY took its cues from global equity markets, rallying steadily while equity markets fell. By the 21st, the yen was the top-performing currency in G10, up over 1.1% vs. the average and more than 0.7% vs. USD. Up until that point, global rates were stuck in tight ranges, exerting little impact on currencies. After the Fed meeting on the 22nd, global yields moved steadily higher except for yields in Japan and Switzerland. This favored higher-yielding currencies vs. CHF and JPY. JPY gave back all its earlier gains to finish slightly down for the month.

Fumio Kishida, former LDP Policy Research Council chairman, was elected president of the LDP on September 28 and is set to become prime minister on October 4. The change is largely neutral, perhaps slightly negative for JPY. Soon-to-be PM Kishida has indicated support for current Bank of Japan monetary policy and promises a large fiscal spending package by the end of the year, on the order of 6% of GDP (though actual spending may come in lower). He's largely aligned with the approach of Abenomics but differs on the third arrow, deregulation. PM Kishida is more focused on income redistribution. He also values fiscal consolidation, but he has shied away from further VAT increases. The form of a redistribution plan, the amount of support in parliament, the funding sources and its impact on the yen are entirely uncertain and likely to take a while to develop.

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. Secondly, Japanese yields are higher than EUR and CHF yields across the curve, and short-end yields are historically high vs. 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 vs. other low-yielding currencies make it a worthwhile position.

Over the longer-term horizon, we have more a 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 late 2022, investors will turn their attention to the reversion of growth to subpar 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 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)

The Canadian dollar was on track to be the worst-performing currency in the G10 for the month until a sharp turnaround after the 22nd lifted it to be the second-best-performing currency in G10 during the month, up 1% vs. the average. The month began with good economic news. Manufacturing PMI increased from 56.2 in July to 57.2 in August, and August employment surprised higher at +90,200 new jobs compared to 68,200 expected. The Bank of Canada meeting on the 8th was a nonevent. It kept policy rates at 0.25% and purchases under the QE program at 2 billion per week while expressing confidence that the economy and inflation would continue to recover into next year despite drag from the recent fourth wave of Covid. That neutral-to-positive news flow did little to stop the recent downtrend in the currency amid an environment of weaker equity markets. CAD sentiment sharply reversed to the upside in line with rising yields and oil prices after the US Federal Reserve policy meeting on the 22nd. By month end, CAD had regained its lead as the top-performing G10 currency year to date.

We closed our tactical long CAD position in September and shifted to a short position due to a deterioration in our leading-economic-indicator model. As we mentioned above, employment and manufacturing data in Canada is holding up well as the country slowly recovers from the fourth wave of Covid. The problem is that the pace of recovery is decelerating compared to most other G10 economies; it is too gradual. We see scope for further appreciation vs. EUR, CHF and USD but expect CAD returns to lag most other G10 currencies. From a longer-term hedging perspective, the story is mixed. CAD is slightly expensive vs. the G10 average, but that average valuation measure masks major differences across currencies. CAD is cheap vs. 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 fell 0.6% vs. the G10 average for the month. Prior to the equity sell-off on the 17th, CHF trended lower, continuing a steady depreciation that began in late August. News was light during this period. The Swiss National Bank's (SNB's) Zurbruegg reminded markets on the 12th that the SNB would not follow other central banks as they tightened policy, for fear that the overvalued franc would rise further. This was also made explicitly clear at the official SNB meeting on the 23rd, at which it once again stressed that long-run inflation expectations remain well below target and CHF remains "highly valued." The expected monetary policy divergence, with many other central banks tightening policy while the SNB stands pat, is negative for the franc. Once equity market volatility spiked higher mid-month, CHF began to follow its well-worn pattern, rising during times of stress. However, as with JPY, after an initial move higher during the equity market correction from the 17th to the 22nd, the post-Fed rise in yields relative to CHF weighed on the currency and eroded those gains despite equity markets falling back near their lows by month end.

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 almost 20% 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. We expect low global yields and the ongoing surge in the delta variant to delay the recovery process and add to 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 continued its uptrend from August, gaining another 0.95% vs. the G10 in September. Aside from a brief pullback alongside equity markets in the middle of the month, the krone broke from its pattern over the past couple of years as the most equity-sensitive G10 currency. Instead, the prospect of a Norges Bank rate hike, which was delivered on the 23rd as expected, and strong oil prices helped to support the currency despite equity market weakness. While the policy rate increase from 0.0% to 0.25% was expected, the Norges Bank also surprised markets by tying the increase more to the goal of financial stability rather than inflation. In fact, its updated economic projections call for CPI to undershoot the 2% target through 2024. Instead it seeks to promote financial stability by constraining rising debt levels and housing prices, which are on track to rise more than 9% this year. This is an important pivot for Norwegian monetary policy and NOK, as it loosens the link between higher-frequency inflation data and policy decisions. Core CPI fell 0.6% MoM in August, bringing the YoY core inflation rate down to just 1%. If Norges Bank followed a pure inflation-targeting framework, then rate expectations would likely come down, pressuring NOK lower. Instead, the Norges Bank increased the expected policy rate path to the benefit of NOK. The bank expects another hike in December, three more 0.25% hikes in 2022, followed by two more in 2023–2024. This is a 0.25% increase in the end-2024 expected rate compared to the previous meeting.

We retain a strong positive view on NOK over both the tactical and strategic horizons because NOK remains significantly below our estimates of fair value, the central has started its hiking cycle and oil prices look well supported. Recent economic data has been lackluster and has weighed slightly on our view. Retail sales fell by more than 3% MoM in both July and August, but the spike higher in Covid case rates peaked in early September and has fallen rapidly since, which should improve consumer activity going forward.

As we point out each month, a long NOK position is not without interim volatility risk due to its lower liquidity and historically high sensitivity to equity markets. It broke that pattern of high equity sensitivity in September, but we remain cautious. The krone is likely to remain prone to periods of higher volatility and we'd need to see far more than one month of evidence to the contrary to reevaluate that risk. Unless that happens, the krone's higher volatility and high beta to global risk sentiment will continue to limit the size of our position. Over the strategic horizon, we can look past 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 was nearly unchanged vs. the G10 average in September, down 0.04%. SEK is less sensitive to global economic fluctuations and investor risk sentiment than other procyclical currencies such as NOK, AUD, NZD, CAD or GBP. But it does tend to be positively correlated to equity markets on most occasions. As a result, increased risk aversion and equity market weakness likely weighed on SEK over the quarter. More important drivers for SEK in September were likely the impact of a weaker EUR and rise in yields across much of the G10 universe. The minutes of the Riksbank meeting on September 20 indicated no desire to move rates off the current level of 0.0% for the next three years, a difficult headwind for SEK in the context of rising global yields. The close economic and financial market ties between the EU and Sweden are reflected in a relatively high correlation between EUR and SEK. EUR weakness during the month was also an important headwind for SEK.

Rising equity market volatility, a larger interest rate gap between Sweden and the G10 average and a weak EUR all point to a lower SEK, but it was unchanged. Local economic data is holding up better than in many countries, which likely helped prevent a more substantial decline in the krona. The fourth wave of Covid has been particularly mild in Sweden, helping to keep economic activity moving along with less disruption. Composite PMI for August fell back from

69.1 to 64.7 but remains at the top end of the 15-year range. August retail sales surprised higher at +0.7% MoM compared to expectations for a fall of 0.2%. The National Institute of Economic Research's economic tendency survey for September held in at 119.9, just slightly below its all-time high of 121.40.

Despite some softening in economic data recently, the economy remains on solid footing. We retain a significant long SEK position over the tactical and strategic horizons. By our estimates, SEK is the cheapest G10 currency relative to long-run fair value and we are seeing a solid economic recovery as Covid recedes. The Riksbank outlook to keep rates at zero through 2024 is likely to limit SEK gains against higher-yielding, cyclical G10 currencies. But our positive tactical SEK view is concentrated against EUR and CHF, both of which are backed by even more dovish central banks with lower policy rates. Long SEK vs. 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 gained 0.1% for the month against the G10 average. Seems lackluster, but for a risk-sensitive currency like AUD, +0.1% is impressive during a period of higher equity market volatility. That's not to say that AUD ignored global risk sentiment. It rallied strongly alongside equity markets and other procyclical currencies from August 20 through the first several trading days of September. As risk sentiment deteriorated on fears of a more prolonged global economic slowdown and uncomfortably persistent inflation, AUD fell steadily alongside equity markets from September 6 through the 22nd. Local data and policy changes had little impact through most of the month. Economic data releases mostly described activity in July–August. It was weak, but that was well anticipated given the Covid-related lockdowns. The RBA struck an optimistic tone, noting that Covid impacts would be temporary, but it held policy steady, buying AUD 4 billion a week in bonds under its QE program and projecting rates on hold near zero into 2024.

It was the final week of the month in which AUD broke from skittish equity market behavior and rallied back to finish with a small gain. This bullish AUD divergence appears to be the result of three factors which offset negative mood toward global risk. Firstly, while iron ore, a key export, trended substantially lower, its impact was more than offset by the strong spike in LNG and rise in coal prices. Secondly, Covid lockdowns were eased as vaccination rates steadily increased. Government officials hinted at a reopening of foreign travel and the need to learn to live with Covid as an endemic problem, as opposed to relying almost exclusively on economic lockdowns in response to rising cases. This helped support near-term growth forecasts. Finally, the rise in yields during the last week of the month, +23 basis points on the Australian 10-year government bond, helped to lend some support to the currency.

During September, we shifted our tactical position in AUD from neutral to short. We continue to see AUD appreciating against the G10 average on solid short- and long-term growth prospects and decent valuations. We also think that the currency remains modestly oversold after its fall in Q2. However, we see better opportunities and have stronger forecasts in NOK, GBP and NZD. Using short AUD to fund those more attractive long positions makes sense as it neutralizes some of their exposure to commodity and equity market risk. Thus, we have moved to a short position despite having a generally positive AUD outlook.

Our strategic view is 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.

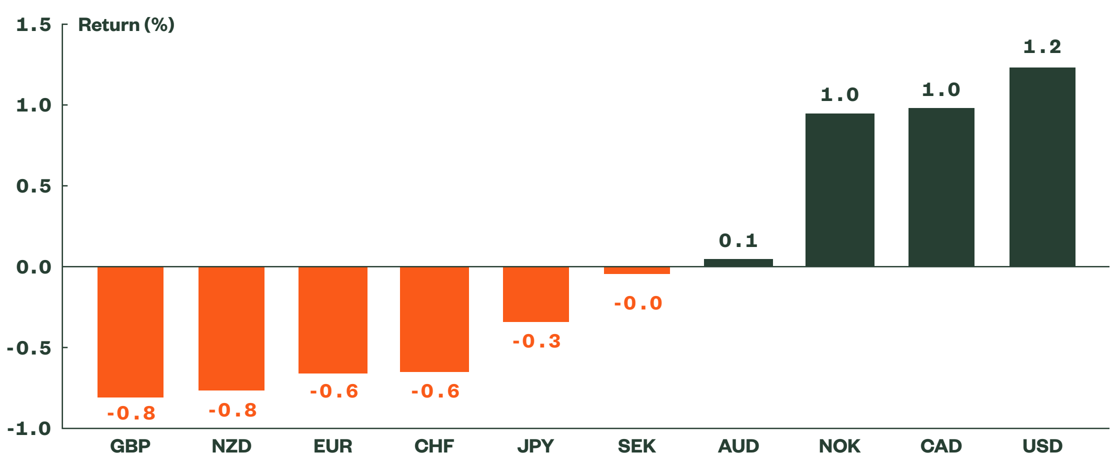
## New Zealand Dollar (NZD)

NZD lost 0.8% vs. the G10 average for the month, the second-worst performance in the group. For most of the month, the currency held up well with the economy near full employment, inflation above target and expectations of a Reserve Bank of New Zealand (RBNZ) rate increase as soon as the October 5 policy meeting. Lockdowns in response to the fourth wave of Covid, which hit NZ in August, weighed on business sentiment but had little impact on the currency. Terms of trade is also a concern as New Zealand is exposed to the risk of falling Chinese demand but does not enjoy the benefits of the recent spike in energy prices given their protein-centric export basket.

The biggest issue facing NZD and likely reason it underperformed toward the end of September was an unwind of previously accumulated long investor positions, especially vs. AUD. Given its strong economic performance, tighter monetary policy projections and great success in containing Covid, NZD has been heavily favored over AUD during the last few months. As Australia looks to ease lockdowns and enjoys the benefits of high energy prices, AUD looks relatively more attractive vs. NZD, prompting investors to take profit on long NZD, short AUD positions sending the AUDNZD pair 1.7% higher from its low on September 23 to month end.

Despite the recent correction lower, we remain long NZD over the tactical horizon and continue to prefer it to AUD over the medium term. New Zealand still 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 AUD. 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 vs. 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 vs. AUD and EUR.

Figure 1
**September 2021 Currency Return vs. G10 Average**




Source: Bloomberg and State Street Global Advisors, as of September 30, 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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**United States:** State Street Global Advisors, 1 Iron Street, Boston, MA 02210-1641.


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