Commentary
Currency

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Currency Market Commentary

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Summary of Views

	Short/Medium Term Outlook	Strategic Outlook	Comment
GBP	∧	—	The UK economy is holding up well, but risks remain from Brexit-related supply constraints, stubbornly high COVID-19 cases, fiscal tightening, and rising inflation. These factors may delay an expected BOE rate to the detriment of GBP. However, GBP is already cheap, limiting further downside. UK growth for 2022 looks attractive and we expect 2022 BOE rate hikes supporting GBP over the medium term.
SEK	∧	∧	SEK remains among the cheapest G-10 currencies but is likely to remain so near term in the face of COVID-19 uncertainty across the EU and a zero rate policy into 2024. But, after the recent sell-off, SEK is the weakest G-10 currency YTD and that looks excessive given a solid medium- to long-term growth outlook. We see room for a recovery, though it may be best to express that vs. other low yielders such as EUR and CHF.
JPY	∧	∧	The yen is substantially below fair value and its yields are competitive vs. other low-yield current account surplus countries. But JPY tends to underperform in a global recovery; is losing its yield advantage vs. pro-cyclical currencies; and is hurt by rising oil prices. Despite these important headwinds, we still value long JPY as a hedge to short-term equit market risk with long-term upside potential.
NOK	∧	∧	Recent oil price pressure, rising global risk aversion, and a decelerating pace of monetary tightening have dragged NOK lower. However, the growth outlook remains strong albeit possibly delayed by omicron, and the Norges bank is likely to continue gradual policy tightening. These factors in addition to NOK's historically cheap valuation support a positive medium- to long-run view.
CAD	—	—	We've turned more cautious on CAD given moderating growth and weak oil prices. But, the economy is on track to reach full employment by mid-2022, Canada should prove resilient to COVID-19 surges given high vaccination rates, monetary tightening in 2022 is likely, and we see the oil price correction as temporary. We maintain a small long bias and look to add on dips.
NZD	—	∨	Fast recovering labor markets, solid manufacturing PMI, and rising inflation support NZD gains. We are cautious at the moment as the RBNZ disappointed by sticking with 25 bps rate hikes and NZ's zero-tolerance policy for COVID-19 cases in the face of omicron may create some volatility. Medium term we see the pandemic headwinds gradually waning and NZD resuming an upward trajectory.
AUD	∨	—	AUD is supported by a positive growth impulse after lockdowns were lifted in October. Unfortunately, the negative forces from softening commodity prices, the RBA's insistence that it will keep rates at historic lows, and uncertainty from omicron outweigh the reopening surge. We prefer to capture medium- to long-run pandemic recovery opportunities via other commodity-sensitive currencies such as CAD, NOK, and NZD.
USD	∨	∨	The spike in inflation, strong employment data, and resulting hawkish shift by the Fed provide a strong near-term environment for USD. Omicron fears only bolster the positive USD case. The problem: USD is almost as expensive as it was at the peak of the COVID-19 market crisis in March 2020 and US growth is leading now but will also most likely lead reverting to long run averages next year. We see the USD rally running out of steam.
EUR	∨	∨	We remain negative EUR due to negative interest rates, elevated long-term valuation, surging COVID-19 cases, and weak potential growth. We see scope for an out-of-consensus cyclical bounce in EUR later next year, especially vs. USD, but prefer to gain exposure to an EU recovery via higher beta and/or higher yielding currencies with regional EU ties such as the CE3, NOK, and SEK.
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. Recent volatility in risky asset markets has created some short term upside risk, but we look through that and remain max short the franc.

Note: All individual currency views in the table above are relative to the G-10 average.

Macro Environment

The emergence of the omicron coronavirus variant was the dominant risk event in November and could have an important impact on currency and risky asset markets over the next few months. But before we get to that, it's important to recognize that FX markets were already experiencing substantial moves on the back of increasing differentiated monetary policy and growth outlooks before the omicron news broke. Overly optimistic monetary policy expectations and strong commodity prices in October gave way in November as central banks pushed back on those market expectations and the combination of the COVID-19 surge in the EU, driven by the delta variant, and the US release of oil from its strategic petroleum reserve pushed energy prices lower. Between October month end and November 25, pre-omicron, the Norwegian krone fell nearly 6% vs. USD and the Australian and New Zealand dollars fell more than 4% vs. USD. The euro and Swedish krona benefit from weaker energy prices but suffered from the EU COVID surge and chronically low interest rates. Relative to the G-10 average, EUR lost more than 3% and SEK lost more than 5% vs. USD by November 25.

News of the new omicron variant gripped markets on November 26, sending equities sharply lower, the VIX index up nearly 10 points, and risk-sensitive currency pairs such as the Norwegian krone and Australian dollar vs. Japanese yen down nearly 3% in a day. Omicron has the potential to significantly impact economic and market behavior over the next one to two months, and maybe longer in the worst-case scenario. However, it's been less than a week since the news broke and we simply don't have enough information yet to definitively assess the impact.

It seems clear that omicron spreads more easily than the delta variant and, based on early reports from South Africa, it appears to be capable of displacing delta. That could be good or bad. If omicron proves milder, it will accelerate the transition from pandemic to endemic and could be positive for global growth and market behavior, even if it partially evades vaccine-based and natural immunity. If we learn that omicron can evade immunity and is nearly as dangerous or more dangerous than delta, then it could be a significant setback in the COVID battle. We simply don't know at this point. Early indications suggest it may be relatively mild yet still able to displace delta, a good outcome. But because that is far from certain, it is sensible for markets to include the higher risk premium. Fortunately, we are likely to learn quite a lot about the behavior of omicron over the next few weeks thanks to South Africa promptly notifying the scientific community of its discovery. Unfortunately, it makes forecasting financial markets in December much more difficult, as markets may whipsaw in reaction to a series of far-from-conclusive preliminary reports on the possible severity of the new variant.

Even with the uncertainty still surrounding omicron, we see a limit to its impact. In the worst-case scenario, vaccine producers can reengineer vaccines over the next few months, though there will probably be distribution delays as well. This will significantly impact Q1 and partly Q2, but have less of an impact on full-year 2022 growth. Even if lockdowns intensify, consumers have learned to spend in the face of restrictions; and, aside from a few zero-tolerance countries such as China, lockdowns and restrictions tend to be far more targeted now than they were early in the pandemic. Chances are that the final assessment on omicron will be mixed, somewhere between the best- and worst-case scenarios. In this case omicron behaves something like the recent delta waves, with prior immunity providing some reasonable, albeit weaker, protection against severe disease. In that scenario growth will slow modestly for a quarter or two and inflation will get another boost from supply-side disruptions and a continued consumer preference for goods over services. Markets may experience higher volatility but are likely to largely look through the setback, as they did during the recent August-September wave.

Faced with this heightened near-term uncertainty, we remain more cautious near term and look for opportunities to position for our base case of above-average growth for 2022 as a whole, resilient commodity prices, and increased differentiation in monetary policy. That translates into a bias toward undervalued commodity-sensitive currencies with central banks that are expected to raise rates in 2022 — the Canadian dollar, Norwegian krone, and New Zealand dollar. That said, we do expect generally higher volatility across risky assets in 2022, which will most likely spill over to higher volatility in these pro-cyclical currencies. The US dollar is also likely to continue to find support over the near term given heightened uncertainty, the recent hawkish pivot by the Federal Reserve, and US reluctance to impose COVID lockdowns. However, the recent surge in USD looks overdone and we expect the broader 2021 rally to run out of steam in 2022. See the USD section for more details.

Detailed Currency Views

US Dollar (USD)

USD gained 3.4% vs. the G-10 average in November, second only to the yen's 3.8% gain. The dollar found support from many directions during the month. Better-than-expected October employment data, 531,000 new jobs vs. 450,000 expected, and impressive October retail sales, up 1.7% month-over-month vs. 1.4% expected, point to a strong reacceleration in economic activity. This stands in stark contrast to growth pressures from the COVID surge in the EU and drag on commodity-sensitive countries from weaker energy prices. Monetary policy divergences increased with the Bank of England (BOE), Reserve Bank of New Zealand (RBNZ), and Reserve Bank of Australia (RBA) all pushing back on market expectations by taking a more patient approach while the US Federal Reserve announced QE tapering of $15 billion a month. US monetary policy tightening expectations were further amplified on November 10 by the eye-catching 0.9% m/m inflation print for October. In response to strong labor market conditions and that surprise inflation print, Fed Chair Jerome Powell signaled faster QE tapering and stepped away from using the term "transitory" to describe inflation that has proved more persistent than expected.

In addition to USD supportive divergences in growth and monetary policy, USD found support vs. pro-cyclical and commodity currencies from the rise in risk aversion after the omicron news. However, it did underperform other traditionally defensive currencies such as the Swiss franc, euro, and yen. Higher US yields and growing USD long positions in the market favored the lower yielding defensive currencies as investors unwound yield-seeking carry trades amid the spike in volatility after the omicron news.

Going forward, at least over the next one to three months, the backdrop for USD remains strong. The Fed is unlikely to reverse course from its recent hawkish shift. If it does, the most likely cause would be a very negative outcome regarding the omicron variant. But, in that case we'd still expect USD to outperform the more pro-cyclical half of the G-10, though it may continue to struggle vs. the defensive EUR, CHF, and JPY. Growth in the US should hold up well during future COVID surges, as the US is extremely reluctant to impose lockdowns. That said, the recent USD surge looks overdone. From a medium- to long-term perspective, we estimate that the USD finished November 13.4% expensive against an MSCI World xUS basket of currencies. It was 13.6% expensive on March 31, 2020, the height of the COVID market crisis. The supportive environment may keep USD afloat at expensive levels for now, but further sustainable gains will be increasingly difficult.

Expensive current valuations and expected erosion of some of the recent growth and monetary policy advantage over 2022 leaves us with a more neutral near-term and negative medium- to long-term USD bias. Right now, near-term USD support derives from the US growth leadership, the recent tempering of expectations for monetary tightening outside the US, and weaker commodity prices. These are unlikely to be permanent features. Monetary policy expectations may have been tempered in November, but New Zealand and Norway are already raising rates. The Bank of Canada and Bank of England will most likely hike before the Fed, even if the BOE starts a few months later than previously expected. This is very different from the outright divergence during the early years of the 2013–2018 Fed tightening cycle, during which other central banks were cutting rates and the ECB introduced large-scale QE for the first time. The global growth divergence and recent commodity price correction, which both favor USD, are related to the pace of COVID recovery. The US is leading in COVID recovery, but that also implies that it is likely to revert to longer-term average growth levels sooner than the rest of the world; hence we see risk that the US loses its growth advantage over the course of 2022, and maybe much sooner with respect to commodity prices. Even if we look at the very short-term horizon of three to six weeks, the recent move higher in USD looks like a bit of an overreaction if we are correct that omicron is at worst a temporary one- to two-quarter setback.

We may be USD negative, but we expect a historically mild USD bear market. 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 the US remains well-positioned to lead in a global economy driven by innovation and the development of intellectual property, while we may also see some technology-enabled re-shoring of manufacturing. We respect these positive long-run factors and think that they most likely result in the mildest USD bear market since currencies were floated in the early 1970s. Whereas the USD typically moves 15% to 20% below fair value at the trough of a bear market, we think USD falls back only to and maybe slightly through fair value in this cycle. However, that still implies a broad 12% to 15% fall in USD from current levels.

Euro (EUR)

The euro managed a gain of 0.6% vs. the G-10 average thanks to a sharp short covering rally following news of the omicron variant on November 26. For most of the month prior to omicron, EUR struggled alongside a parabolic rise in COVID cases in the EU. By mid-month Austria, Germany, and the Netherlands were reaching new all-time highs in the number of daily cases and implementing, or at least discussing, partial lockdowns targeting unvaccinated residents. The greater willingness in the EU to impose restrictions in response to the COVID surge dented growth expectations and any remote hope of ECB rate hikes in late 2022–2023. Investors increased short EUR positions in favor of higher yielding alternatives to EUR, particularly the USD. The omicron variant further increased the risk of weaker EU growth and negative rates for longer, but it also triggered a general spike in risk aversion and reduction in risk positions. Because the market appears to have been materially short EUR, the unwind of risk positions post-omicron favored a short covering rally, sending EUR sharply higher into month end.

Economic news had little impact on EUR. Backward looking retail sales, PMI, and other growth-related data were no longer relevant to expected growth over the next quarter given the impact of the new COVID surge. For example, Q3 GDP came in as expected at +2.2% quarter-over-quarter, marking the second quarter of growth exceeding that of the US. But the resilience and strength of the Q2–Q3 recovery is unlikely to extend through Q4 and Q1 2022 as lockdown measures take effect. On month end we learned that November inflation was 0.5% m/m vs. 0.1% expected, but that is down from 0.8% m/m in October and is unlikely to cause a near-term shift in ECB policy.

Against the broader G-10 we remain 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 with GBP, NOK, SEK, CAD, and JPY and fairly valued only 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 was the ongoing recovery as the EU economies reopen, but the recent COVID surge and resultant lockdowns will surely dim that.

While our central case is negative EUR against the G-10, we recognize the risk that EUR could defy bearish market expectations and surge vs. the US dollar at some point in 2022. The EU vaccination program has surpassed that of the US. Growth 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 cheaper cyclical 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 EURUSD 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 high yielding currencies.

British Pound (GBP)

The pound lost 0.1% against the G-10 average in November. GBP began the month on a negative note following a surprise 7–2 vote from the BOE to keep policy rates unchanged. BOE Governor Andrew Bailey pushed back on investors, noting that monetary policy rate hike expectations were “overdone.” Sterling sold off nearly 1% relative to the G-10 in response and remained at low levels until stronger-than-expected employment data on November 16 and surprisingly high October inflation, 4.2% year-over-year vs. 3.9% expected, reinforced expectations for a December rate hike of 15 bps. That positive news resulted in a two-day rally pushing GBP back into positive territory for the month. It slipped modestly during the post-omicron sell-off but held up quite well as most of the selling was focused on commodity-sensitive currencies after the nearly 14% drop in oil prices.

The UK and GBP may still react more negatively to the omicron news. The UK has done an impressive job remaining open and growing despite persistently high daily COVID case rates, much like the US. However, risks from omicron and the recent pickup in delta cases in the UK may be enough to delay a BOE rate hike until Q1 2022, most likely at the February meeting. GBP has been quite sensitive to BOE expectations, so we expect further weakness if anything reduces the probability of a December hike. That said, we do think BOE will raise rates at some point in the next few months because inflation is likely to continue to exceed target and both wage growth and employment gains remain high.

We retain a long GBP position due to its cheap long-run valuation and continued above-average growth. Growth has decelerated since its reopening surge earlier this year, but consensus growth estimates remain near 7% for this year and 5% for next, both significantly above long-run averages. The above-average UK growth, likely monetary tightening, and significant discount to our estimates of long-run fair value are sufficient to justify a long position even if omicron dents near-term growth.

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 that may further help to accelerate GBP gains. With a long horizon it is better to ensure that you are in the market with a positive GBP position once the recovery takes hold and GBP reverts to fair value. The pound's gains Q1 were a good example of the need for long-term, strategic investors to look through short-term uncertainty.

Japanese Yen (JPY)

The yen continues to be driven by external factors such as global yields, growth expectations, and risk sentiment. Rising central bank tightening expectations across several G-10 currencies and more growth optimism as the fourth wave of COVID subsided pushed JPY down 3.8% in October. The opposite conditions dominated in November, pushing JPY back up 3.8%. Specifically, central bank expectations were reined in as the BOE, Norges Bank, and RBA pushed back on market expectations, the fifth wave of COVID centered in the EU reduced growth expectations, and the omicron news threatened growth and prompted a spike in risk aversion. These factors drove a steady appreciation in JPY throughout the month, with a distinct spike higher in response to omicron.

Domestic data has not been a driver of JPY and is unlikely to have an impact unless we get close to growth and inflation levels that would prompt a change in monetary policy. We are not close to those levels. Q3 GDP disappointed at -0.8% q/q relative to -0.2% expected. Growth is likely to turn positive in Q4 but at an unsatisfying pace. October retail sales missed estimates of +1.1% m/m, coming in at +0.9%, and October industrial production rose only 1.1% m/m vs. expectations of 1.9%. National inflation ex-fresh food and energy remained in negative territory year-over-year for October, -0.7%. A massive fiscal stimulus of near 10% of GDP announced in mid-November will help growth, as will the expected gradual improvement in COVID conditions over the course of 2022. But even with those positive forces, we remain far from levels at which growth and inflation will impact monetary policy.

Aside from JPY being very cheap to long-run fair value, its growth and interest rate trajectory favor continued weakness over the next couple of quarters. We favor long JPY only because of its diversification properties during adverse shocks. This paid off nicely in late November, but with rising global yields and equity prices it has been a painful hedge over the course of the year; even after the post-omicron rally, the yen is tied with the Swedish krona as the worst performing G-10 currency for the year.

Over the longer-term horizon, we have a more definitive positive yen view. The yen is quite cheap to long-run fair value relative to most G-10 currencies except 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 to middle stages of global recovery, but by late 2022 investors will turn their attention to the reversion of global growth back to sub-par long-run averages. In fact, depending on the drag from high global debt levels, the potential misallocation of capital due to ultra-easy policy, and the degree to which governments efficiently allocate fiscal spending, global long-run potential growth may even be lower than the already weak level prior to the pandemic. That late 2022/early 2023 period of a mature and decelerating expansion is more consistent with outright yen appreciation given its cheap valuation.

Canadian Dollar (CAD)

CAD was nearly unchanged vs. the G-10 average, +0.01% in November. This seems unexciting, but it is impressive given the near 20% drop in WTI crude prices during the month. Canada is on stable footing thanks to high vaccination rates, a near complete recovery in employment to pre-pandemic levels, and improving growth since the late summer wave of new COVID cases. It also benefits from the stability of USD and resilience in the US economy. Inflation ticked up to 4.7% for October, more than enough to keep the Bank of Canada on track to raise rates as soon as Q1 or early Q2 2022. The recent pickup in manufacturing PMI and strong labor markets also support tighter monetary policy. Omicron as well as the increasingly global uptick in delta cases may present a minor setback, but the strong recovery and high vaccination rates in Canada should give it the flexibility to manage any further COVID surges without derailing the broader recovery.

We reentered a tactical long CAD position in October on the gradual improvement in growth and tighter monetary policy outlook. Like the UK, the stronger near-term growth impulse in Canada is partly offset by a negative signal on our long-run potential growth model. Strong employment improves the resilience of the growth outlook, but unless investment and productivity growth pick up, the Canadian economy risks falling behind over the next several years. For now, the strong cyclical recovery and expected monetary policy trajectory favor further appreciation vs. EUR, CHF, and USD. CAD returns may lag other more cyclically sensitive G-10 currencies that sold off more aggressively in recent weeks, but those currencies are also riskier, as we saw in November. From a risk-adjusted standpoint, long CAD remains a stable and conservative way to position for the continued medium-term global recovery from COVID.

Longer term, the story is mixed. We mentioned our concerns regarding long-run potential growth and lackluster investment levels. CAD is also slightly expensive vs. the G-10 average. However, 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 Canada-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 gained 2.0% vs. the G-10 average in November. As is often the case, CHF followed a similar path as JPY during the market turmoil in November. Prior to the omicron news on November 24, CHF rose gently as three factors provided support. The rising number of COVID cases across the EU helped make the traditional safety of the franc more attractive. Falling yields in the UK, Australia, and New Zealand as their central banks pushed back on aggressive rate hike expectations prompted a rotation out of yield-seeking currency carry trades. As the lowest yielding currency in the G-10, the franc benefited. That modest carry unwind was further helped by weakness in energy prices. The omicron news then supercharged the franc's uptrend, sending it 1.4% higher against the G-10 average on November 26.

As we mentioned last month, we've also been watching Swiss National Bank (SNB) intervention to support CHF. The SNB considers CHF to be significantly overvalued and a key pillar of its monetary policy has been to intervene to limit further appreciation. The tepid increase in sight deposits, an indicator of SNB intervention, alongside the steady franc appreciation vs. EUR, introduced concerns that the SNB may be willing to tolerate greater appreciation. Using sight deposits as a proxy, it appears intervention picked up in mid- to late October and continued through much of November. However, that intervention was not enough to fully offset the CHF appreciation pressure from rotation away from higher yielding commodity-sensitive currencies and rising EU COVID cases.

We continue to hold a large short CHF position over both tactical and strategic horizons. Our strategic negative view is driven almost entirely by the franc's extreme overvaluation and ultra-low yields. By our estimates, CHF is more than 20% expensive to its long-run fair value vs. an MSCI World currency basket. In addition to expensive valuation, factors including low inflation, ongoing CHF selling by the SNB, and ultra-low interest rates also point to franc depreciation. As domestic and EU growth recover from the pandemic, capital outflows are likely to accelerate as Swiss investors look for higher return opportunities, much like they did during the 2017 EU growth spurt. Such flows are a likely catalyst for sustained franc weakness, though the EU recovery process has clearly been delayed by ongoing waves of new COVID cases and omicron.

Norwegian Krone (NOK)

The krone lost 3.8% relative to the G-10 average in November and more than 7.0% against both USD and JPY. NOK fell 1.46% after the omicron news on November 26, in line with its usual sensitivity to oil prices, equity market behavior, and general global risk sentiment. But that omicron loss was less than half of the total loss. NOK trended materially lower well before the omicron shock.

The month started on a negative note as markets anticipated a more dovish Norges Bank meeting on November 4. As expected, the policy committee decided to leave the rates unchanged, but did help stem further losses by pointing at a December hike. Mid-month NOK continued to struggle alongside oil market weakness in response to risks of a US release of supply from its strategic petroleum reserve and worry that the accelerating surge in COVID cases across the EU would dent demand. Another shock hit the currency on November 18 when the Norges Bank announced it was suspending NOK purchases for the remainder of the month thanks to stronger-than-expected oil cash flows. It had previously announced planned purchases of 700 million NOK per day in November, down from 1.7 billion in October, triggering a near 1% drop in NOK. The extension of that reduction from 700 million to zero had a similarly negative impact on NOK, pushing it nearly 1% lower on the day. Finally, the severe drop in oil prices and spike in global risk aversion following the omicron news pushed NOK to new lows in the final days of the month.

Aside from the negative factors mentioned above, underlying economic data remained strong and suggestive of gradually tightening monetary policy and continued recovery from the pandemic, though both may suffer a temporary setback depending on the response to omicron. September industrial production surprised to the upside, Q3 GDP met aggressive expectations of +2.6% q/q, and October retail sales came in at +1.0% vs. expectations of +0.3% m/m. October core CPI was surprisingly weak, -0.3% vs. +0.1% expected, and most likely helped to weigh on central bank expectations and NOK. It is important to remember, however, that the Norges Bank has a below-target inflation forecast and yet still predicts gradual rate hikes to protect against excessive growth in debt.

We retain a positive view on NOK over both the tactical and strategic horizons justified by cheap valuations, the resumption of strong growth supported by strong oil prices after we work through the current COVID surge, and a continued gradual tightening of monetary policy. 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 certainly reasserted itself with the dramatic sell-off in late November. 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 through those short-term volatility risks and focus more on long-run valuation. By our estimates, NOK is now 30% cheap relative to the currency exposures in MSCI World xNOK. We recommend that Norway-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 fell 2.0% against the G-10 average in November. SEK began the month quietly until breaking into a steady downtrend after November 9 on weaker industrial orders, -2% m/m for September; broad US dollar strength; and a tepid rebound in September household consumption, 0.1% m/m after -1.1% in August. SEK experienced further headwinds mid-month from rising COVID cases as new lockdown measures in Austria, Germany, and the Netherlands weighed on EU growth expectations. Core CPIF inflation for October surprised higher at 1.8% y/y vs. 1.6% expected, but remains below the Riksbank target. Nevertheless, the Riksbank struck a slightly more hawkish tone by pulling forward its expectations for a first rate hike to Q2 2024 at its November 25 meeting — a long way off, but at least in the right direction. SEK gained 0.59% vs. the G-10 on that day, but retraced most of the move the next day in response to the omicron news.

Like NOK, SEK is extremely cheap to our estimates of long-run fair value, nearly 38% cheap relative to an MSCI World xSEK basket of currencies. On this long-run basis, we see ample upside potential for strong SEK appreciation and recommend that SEK-based investors adopt high hedge ratios on most foreign currencies. Conversely, we suggest foreign investors adopt low hedge ratios on SEK investments. Near-term fundamentals are mixed given the lack of a catalyst for monetary tightening and likely drag from broader EU growth due to the current surge in COVID cases. However, recent weakness appears excessive even given those near-term headwinds. After the November sell-off, SEK is now the weakest performing G-10 currency YTD and our short-term value model suggests room for a rebound. Over the medium term we also see upside. We expect that the recent COVID surge and likely omicron impact will prove to be a temporary setback in the global pandemic recovery. Sweden and its important trading partners in the EU have ample room to grow as COVID fades, which should help support the krona, especially vs. low yielding, less cyclically sensitive currencies such as EUR, CHF, JPY, and even USD given our expectation for USD strength to reverse later in 2022.

Australian Dollar (AUD)

The Australian dollar lost 2.2% vs. the G-10 average in November. The loss effectively happened on only three days. On November 2 the RBA validated the surge in two-year rates during late October by formally dropping its yield curve targeting framework. But RBA Governor Philip Lowe also specifically pushed back on investor expectations of a 2022 rate hike, calling it a "complete overreaction to the latest inflation data." This disappointed the market and sent AUD almost 0.8% lower against the G-10 on that day. From there AUD traded sideways until a weaker-than-expected October employment report, -46,300 new jobs compared to expectations for more than 50,000, precipitated another 0.50% drop in AUD. Finally, the omicron news on November 26 sparked a one-day depreciation of 0.88%. Altogether those three days account for the entire 2.2% fall in AUD for the month.

Other than those three days, AUD held up well sideways. Australia was not immune to the general pressure on commodity-linked currencies throughout the month and ongoing concerns of the economic slowdown in China, but those concerns were mostly offset by the expected benefits of the reopening of the economy after strict COVID lockdowns. October employment was weak, but October retail sales jumped 4.9% m/m from 1.3% in September, well above the 2.2% expected. November services PMI rose from 52.1 to 55.0, signaling that consumer spending continues to recover.

We are neutral to negative on AUD near term. Despite the improvement in growth from lifting lockdowns, we still see substantial near-term headwinds from weak employment data, omicron uncertainty, and the reduced likelihood of a 2022 rate hike. The RBA clearly tied rate hikes to employment and wage pressures and expects that it can hold rates at record lows until 2024. We are marginally more optimistic on labor markets through 2022, but even with the lifting of COVID lockdowns, it will take time for wage pressures to build. When they do, the RBA will probably want to see those pressures sustained for two to three quarters before acting. This suggests a high likelihood that the RBA keeps rates at a low level through 2022 or longer. Therefore, we remain cautious and see scope for further AUD downside. At this point we continue to see better opportunity in other commodity-linked FX with rising interest rates. The monetary tightening cycle of Canada, Norway, and New Zealand may also slow as the result of the COVID surge and weaker commodity prices, but the path of their policy rates looks far more certain than for Australia.

Our strategic view is mixed. By our estimates, AUD is now only 7.8% cheap to fair value relative to an MSCI World xAUD basket of currencies, about half of March 2020's 16.9% undervaluation but much cheaper than the 2.3% undervaluation last month. In addition, this average measure of valuation differs quite a lot across individual currencies. We recommend that Australian investors maintain higher-than-average hedge ratios on foreign investments against the USD and fully hedge CHF positions. We estimate an AUDUSD long-term fair value of 0.7985, nearly 12.6% above current levels; reversion to fair value would result in a substantial drag on unhedged US assets for Australian investors. More broadly, we recommend that Australian investors leave positions in the cheaper GBP, CAD, JPY, and Scandinavian currencies mostly unhedged; AUD is rather expensive relative to these currencies.

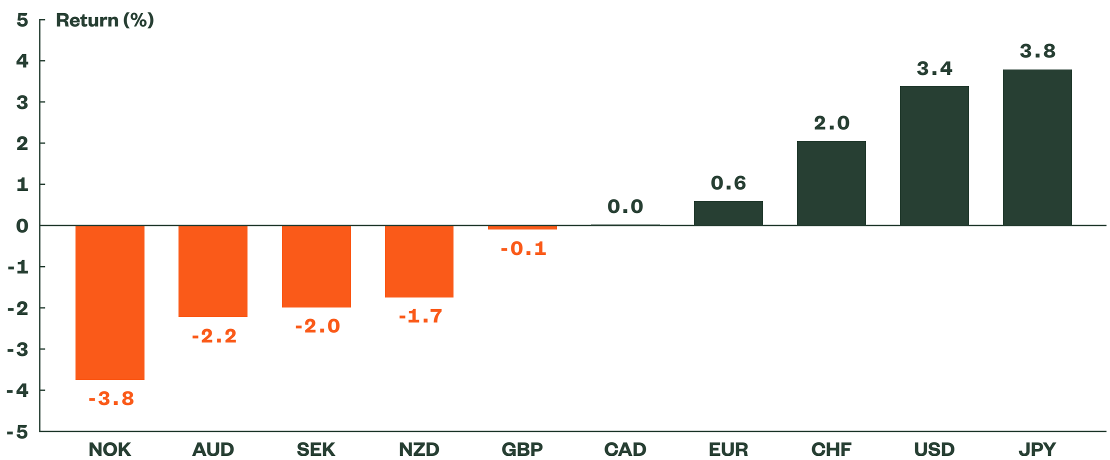
New Zealand Dollar (NZD)

NZD lost 1.7% relative to the G-10 average in November. For the first few weeks of the month, it shrugged off shaky commodity markets and the general pullback in other commodity currencies to trade sideways. Strong domestic data bolstered confidence in the RBNZ rate tightening cycle. The unemployment rate for Q3 dropped 0.5% to 3.4%, a level last seen in Q4 2007 and 0.5% below the pre-pandemic level in Q4 2019. BusinessNZ's manufacturing PMI gauge for October rose to 54.3 from 51.4 the prior month. Broad commodity prices were weak, led by energy, but prices in New Zealand's more protein-based commodity export basket rose steadily through the month. As investors discounted monetary policy expectations in other pro-cyclical countries such as the UK, Norway, and Australia, they raised expectations for the RBNZ to a 50-basis point increase at the November 24 meeting, up from the usual 25 bps. RBNZ did raise rates on November 24, but by only 25 bps, and further indicated that it would most likely limit future increases to 25 bps as well. Investors were disappointed, sending NZD almost 1% lower vs. the G-10 average over the subsequent two days. The omicron news and resultant spike in global risk aversion on November 26 sent the currency another 0.5% lower into month end.

We remain long NZD over the tactical horizon and continue to prefer it to AUD over the medium term. Even with the risks of omicron on the horizon, New Zealand still enjoys robust local economic conditions that have proved resilient through the ongoing global waves of COVID. The market may have been disappointed by the projected pace of rate hikes from the RBNZ, but a steady pace of policy rate increases over the next year is very likely. New Zealand enjoys a strong and growing yield advantage over the G-10. We see upside potential against the currencies with more dovish central banks, such as EUR, CHF, JPY, and, to some extent, AUD.

For long-term strategic hedgers, we suggest a maximum hedge ratio on CHF and a 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
November 2021 Currency Return vs. G-10 Average



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

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of September 30, 2021 and includes approximately $59.84 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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