Commentary
Currency Management

February 2022

Currency Market Commentary

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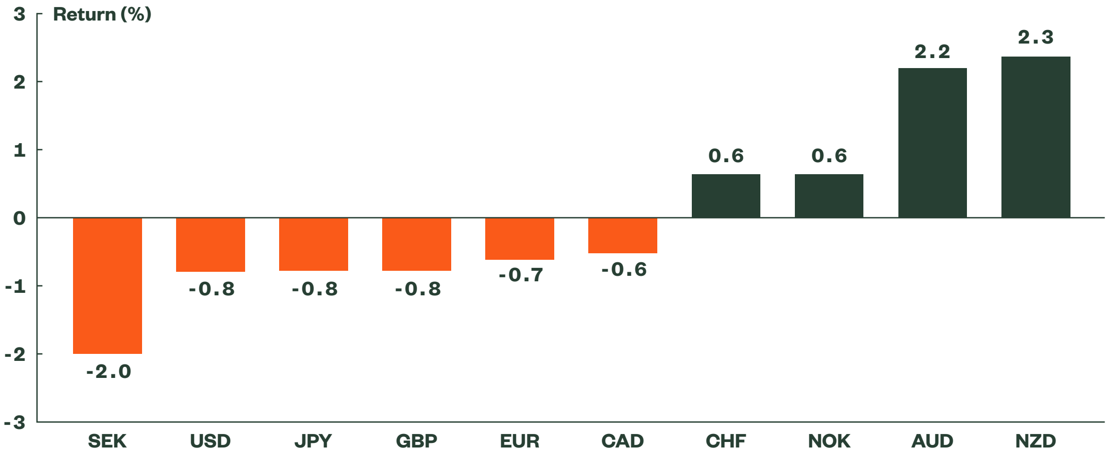
Summary of Views

February began with hawkish surprises from the Bank of England (BOE) and the European Central Bank (ECB), and later from the Reserve Bank of New Zealand (RBNZ), which pushed the GBP, the EUR and the NZD higher. The AUD rose in sympathy with New Zealand and on stronger commodity prices. The Russia-Ukraine War abruptly changed the financial landscape. Volatility spiked and price action during the final days centered entirely on stagflationary risks from the potential loss of energy/commodity exports from Russia and fear that the conflict would spill across Ukrainian borders.

Figure 1
February 2022 Currency Return vs. G-10 Average



Source: Bloomberg, State Street Global Advisors, as at 28 February 2022.

Rather than a broad and indiscriminate risk-off move in currency markets, the relative risks of the event were rationally priced based on these factors: geographic proximity to Russia and Ukraine; dependence on oil imports; and the general sensitivity to global risk sentiment. European currencies, including the EUR, the GBP and the SEK, have been among the worst performers as countries using these currencies are close to Ukraine and depend on Russia for energy. Conversely, the AUD and the NZD performed well as they are geographically separate from Europe and benefit from strong commodity prices. The USD and the JPY likely gained support from rising global risk aversion but did not enjoy the usual big gains they often make during global risk shocks.

The duration and severity of the war and related sanctions remain uncertain. To date, sanctions have been significant but have largely stopped short of prohibiting commodity trade, which would have adversely affected the global inflation and growth outlook. However, this could change if the conflict intensifies. We will see continued headwinds to European currencies until we have greater clarity. Commodity-related currencies should benefit going forward but with elevated downside risks. Thus far, rising commodity prices have overpowered the negative effects of increasing global risk aversion. However, if we see a tangible drop in Russian commodity exports and a super spike in commodity prices, the resulting risks to global growth and risk sentiment may dominate the positive terms of trade and push the commodity-linked currencies lower.

Figure 2
February 2022 Directional Outlook

	Tactical Outlook	Strategic Outlook
USD	∧	∨
EUR	∧	∨
GBP	∧	—
JPY	∧	∧
CHF	∨	∨
CAD	∨	—
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 at 28 February 2022.

Review and Outlook by Currency

US Dollar (USD)

The USD lost 0.82% against the G-10 average in February. The month started on a negative note as, on 2 February, the ADP employment report disappointed with a loss of 301k jobs compared to expectations of a 180k gain. The next day a modest hawkish surprise from the ECB and the BOE further weakened the dollar. A positive surprise in Consumer Price Index (CPI) on 10 February — 7.5% YoY versus expected 7.3% — pushed short end US yields sharply higher and helped the USD to recover some of the losses. The rally extended on news of the Russia-Ukraine War as the initial risk-off reactions pushed the USD back into positive territory. However, those gains quickly evaporated as investors rotated into currencies of commodity exporters, which stood to gain from possible restrictions on Russian and Ukrainian commodity exports.

We are negative on the USD over the longer term. However, any sustained downtrend is likely to be delayed as the uncertain situation in Ukraine depresses European currencies and perpetuates the USD supportive equity market volatility. Looking ahead of the Russia-Ukraine War, longer-term fundamentals point to a weaker USD. The dollar is very expensive compared to our estimates of long-run fair value, and the G-10 leading US growth, especially through the pandemic, is likely to revert quickly back to its long-run average. In addition, the USD tends to fall in a rising rate environment. Unlike the 2013–2018 policy tightening cycle, the United States is not in a uniquely positive position. Other central banks are also tightening and commodity markets are enjoying a bull rather than a bear market. Once the Russia-Ukraine War finds a resolution, we will have to examine the potential for headwinds from a more rapid rotation away from the US dollar as a reserve currency in response to the sanctions on Russia's foreign currency reserves.

Euro (EUR)

The euro lost 0.69% versus the G-10 average. The EUR rallied after a record 5.1% YoY CPI print on 2 February, continuing higher the next day after the ECB President Christine Lagarde indicated that a 2022 rate hike was possible. The initial appreciation on 3 and 4 February gave way to a steady downtrend, which accelerated as the Russia-Ukraine War materialized. The eurozone, and by extension the EUR, is facing serious stagflationary risks due to the high dependence on Russian energy imports, which may get affected by war-related sanctions. Of course, there would be other economic and humanitarian risks as well if the conflict were to move beyond Ukraine's borders.

We are broadly negative on the euro due to the risks from the war, which threaten the European Union's (EU) growth outlook, and point to looser monetary policy for longer. Longer term, once the uncertainty over Ukraine subsides (which could take very long in the worst-case scenario), we see room to have a more constructive discussion on the EUR. The current conflict is a clear negative for now, but it also incentivizes greater EU integration, higher fiscal spending and a more rapid transformation toward alternative energy sources. All these factors could ultimately promote a higher, long-run potential growth rate and support a sustained post-crisis recovery in the EUR.

British Pound (GBP)

The pound finished February down 0.8% against the G-10 average but performed quite well for the rest of the month. The BOE meeting on 3 February saw four to five votes to raise interest rates by 0.25%, with four voters calling for a 0.5% hike, which was a GBP positive hawkish surprise. A recovery in the Purchasing Managers Index (PMI) data after a brief Omicron-related pullback in December along with a positive CPI surprise, 5.5% YoY relative to 5.4% expected, underpinned the hawkish tilt of the BOE, leading to further GBP gains. All these gains unraveled with the onset of the Russia-Ukraine War, which sent the GBP sharply lower into the month-end. The United Kingdom is less dependent on Russian energy exports, but its gas prices are linked to EU gas prices, which spiked higher. The GBP was also pulled down as lower rates and the impact of financial sanctions on Russia resulted in a dramatic sell-off in financial companies, a key sector for the UK economy.

Our GBP view is mixed. Near term, the bias is likely lower due to risks from the Russia-Ukraine War. For now, we would be more inclined to sell the GBP against the safer USD and the JPY. However, we also see some near-term potential in selling the GBP against currencies that enjoy the benefits of both rising yields and strong commodity prices, such as the NZD and the NOK, but warn that such positions may be volatile in the current environment. Once geopolitical uncertainty resolves, we should see greater room for sustained GBP appreciation powered by its cheap valuation versus long-run fair value, resilient fundamentals, rising policy rates and our expectation of broad USD weakness.

Japanese Yen (JPY)

The Japanese yen fell 0.82% relative to the G-10 average in February. Rising global yields prior to the Russia-Ukraine War kept the JPY on the back foot for most of the month. Like the USD, the JPY experienced a strong surge immediately following the war, but that quickly reversed as the focus of investors shifted in favor of commodity currencies. Japan is a major oil importer, and the Bank of Japan has been resistant to tightening policy to boost the currency as an offset to rising import prices.

Our long- and short-run models favor the JPY. Long term it looks very cheap and is near its 30-year low on a real effective exchange rate basis. Shorter-term models are also positive in this risk-off environment due to the ability of the JPY to act as a diversifier of risky assets during times of global turmoil. However, as we saw in late February, the yen is unlikely to appreciate as much in this crisis compared to historical crisis periods because the commodity-positive impact favors currencies with a positive or at least neutral commodity exposure. That said, we would expect the JPY to perform better if the war intensifies enough to cause a more severe expected downturn in global economic activity and monetary policy expectations.

Swiss Franc (CHF)

The CHF gained 0.58% versus the G-10 average in February. The CHF trended lower in response to hawkish ECB surprise on 3 February and a general uptrend in global yields. The gradual increase in geopolitical tensions mid-month caused a defensive rotation back into the CHF, lifting it into positive territory for the month. The fears were realized with Russia's recognition of Ukraine's breakaway regions and ultimate invasion. However, rather than pushing the CHF even higher, it resulted in very volatile trade for several reasons. Switzerland is not as dependent on Russian energy imports as the EU and also tends to function as a safe haven in times of European crises. But the CHF is also exposed to the broad negative growth impact to the European region and has some energy import price exposure.

We are negative on the CHF due to ultra-low yields, low inflation, prospects for accelerated interventions by the Swiss National Bank to limit further CHF gains and its extreme overvaluation versus the long-run fair value. Recent volatility in risky asset markets and the ongoing Russia-Ukraine War will likely limit near-term CHF downside, but we look through medium term and favor short franc positions.

Canadian Dollar (CAD)

The CAD lost 0.55% versus the G-10 average in February. The entire loss happened quickly in the opening days of the month with the CAD falling more than 1% by 4 February after a disappointing Canadian payroll and hawkish central bank surprises outside of Canada. Rising oil prices during the first half of the month helped the CAD to recover some of that initial loss, but by 22 February the currency was still trading near its early month lows. The impact of the Russia-Ukraine War pushed the CAD higher, retracing about half its loss by the month-end. Canada benefits from higher commodity/oil prices and is geographically removed from Ukraine. The CAD fits the profile of currencies that rallied in response to the crisis.

Going forward, our CAD view is mixed. Over the course of the year, we see steady monetary policy tightening, a strong economy and high oil prices, which should push the currency higher versus the USD toward our fair-value estimate of 1.18, a gain of nearly 7%. Continued upward pressure on commodity prices from the Russia-Ukraine War should be a net positive for the currency. But if the situation deteriorates significantly, the general fall in global growth expectations and rising risk aversion will likely overpower the positive commodity impact to send the CAD lower relative to the usual safe havens: the USD, the JPY and likely the CHF. Against the other higher-yielding commodity currencies, the NOK, the AUD and the NZD, the outlook for the CAD is more complicated. If the intensity of the crisis remains as is, cheaper commodity currencies will likely outperform. However, in a severe scenario, we expect all commodity currencies to fall but for the CAD as it is stabilized by its ties to the more resilient US economy.

Norwegian Krone (NOK)

The krone gained 0.6% against the G-10 average in February, thanks to a late-month rally prompted by the spike in oil prices. After a quiet start to the month, the NOK slid lower until the onset of the Russia-Ukraine War. On 10 February, the Norwegian CPI for January disappointed with expectations falling to 3.2% YoY versus expectations of 4.2%. This weakness in CPI reduced the incentive for aggressive Norges Bank monetary policy tightening at a time when global yields were rising aggressively, which affected the NOK. This reversed sharply after the start of the Russia-Ukraine War as the dramatic increase in oil prices pushed the currency back into positive territory despite Norway's proximity to Russia.

Notwithstanding the near-term risks to the NOK from elevated equity market volatility, we are positive on the currency over both short- and long-term horizons. The NOK is historically cheap on a real effective basis and against our estimates of its long-run fair value. Additionally, cyclical fundamentals also support the NOK's appreciation. The rising geopolitical risks and longer-term underlying supply/demand dynamics suggest continued oil market strength, which will only bolster Norway's record trade surplus. Inflation is moderating but should remain strong enough to keep the Norges Bank on its projected tightening path. In short, the krone is cheap with commodity support, rising yields and solid growth fundamentals.

Swedish Krona (SEK)

The krona was the worst-performing currency in G-10, down 2.0% versus the average. It started with a strong rebound from its period of underperformance in Q4 2021 and January 2022 triggered by rising PMI readings for January. The hawkish ECB shift on 3 February likely supported the currency as investors projected the possibility that the Riksbank would move next. However, the Riksbank quickly put an end to the SEK strength at its meeting on 10 February. Once again, the central bank showed no intention of tightening monetary policy before mid-2024. The krona's downtrend continued following the Russia-Ukraine War due to worries that the weakness in the EU would impair Sweden's growth expectations and that the crisis could spill beyond the borders of Ukraine.

The SEK remains among the cheapest G-10 currencies but is likely to remain so near term due to the divergence between the Riksbank's policy and those of other central banks as well as the acute uncertainty regarding the EU's growth outlook. That said, the recent sell-off in SEK looks excessive given its cheap long-run valuation and a solid medium- to long-term growth outlook. We see room for recovery once we gain even a modest amount of clarity on the war, though it may be best to express a positive SEK view versus other low yielders such as the EUR and the CHF that are also exposed to the crisis.

Australian Dollar (AUD)

The Australian dollar rallied steadily through the month to finish up 2.2% versus the G-10 average. The continued rapid recovery from Omicron and near-record strength in commodity terms of trade supported the currency. The Russia-Ukraine War initially hurt the AUD as it is generally sensitive to a broad risk sentiment. But the weakness quickly reversed as investors differentiated based on geographic location and sensitivity to commodity prices. Australia is geographically away from Europe and benefits from the positive commodity price shock, even though that shock is happening for wrong reasons.

Positive Australian fundamentals and our expectation that the Reserve Bank of Australia will eventually begin to tighten monetary policy point to further upside for the currency. Looser fiscal and monetary policy in China should support China's growth as the year progresses, which should have positive spillover effects for the AUD. Near term, the AUD should continue to rise in the face of the risks related to the war, but that could change quickly. If Russian and Ukrainian commodity exports volumes were to fall substantially, the stagflationary impact and rising risk aversion would likely overpower the positive commodity price impact, sending the AUD lower.

New Zealand Dollar (NZD)

The New Zealand dollar was the top-performing currency in G-10, +2.3% versus the G-10 average. The reasons for the NZD's rally through the month were nearly identical to that of the AUD. It enjoys very strong commodity terms of trade, strong growth, high employment and is geographically distant from Ukraine. The NZD's strength was further bolstered by a more hawkish than expected RBNZ, which raised rates to 1% on 22 February and signaled a continued steady pace of policy tightening. New Zealand has the highest policy rate in the G-10, and investors still expect the RBNZ to deliver the greatest number of hikes of all G-10 central banks between now and year-end.

With rising yields and strong underlying growth fundamentals, the NZD looks quite attractive. However, our models have turned slightly negative due to a recent deceleration in economic activity, which makes sense as the country reaches and surpasses full employment. Relative to long-run valuations, the NZD appears attractive against the USD and the CHF, but is not as cheap as the other commodity currencies. This is likely to restrain any upside in the NZD against the broad G-10.

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