Commentary
Currency Management

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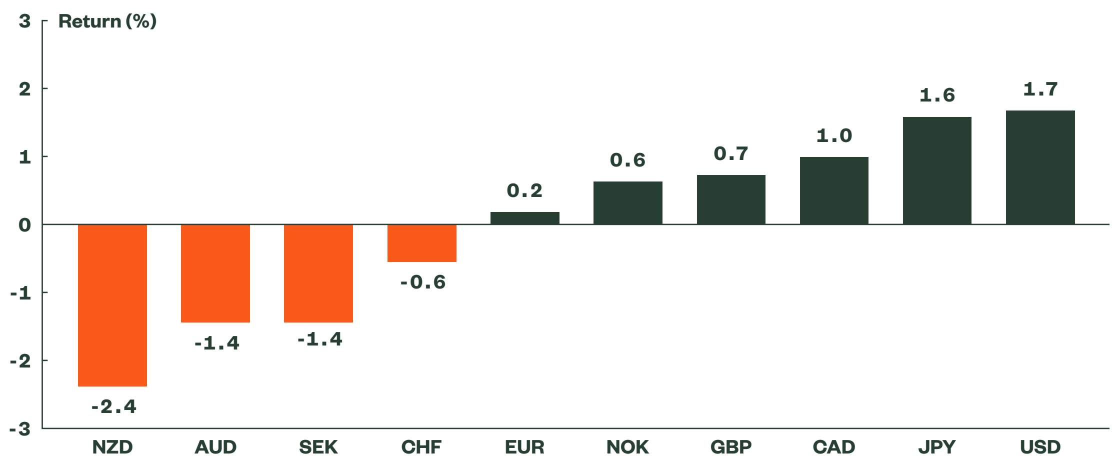
Currency Market Commentary

Aaron R Hurd, FRM
Senior Portfolio Manager, Currency

Summary of Views

Ongoing high inflation, expectations for greater monetary policy tightening, equity market weakness, and, to a lesser extent, strong energy prices dominated currency market behavior in January. Increased yield dispersion between high and low interest-rate countries along with greater risk aversion (higher equity market volatility) pushed more defensive currencies such as the US dollar and Japanese yen to the top of the G-10 while more cyclically sensitive currencies such as the Australian and New Zealand dollars and low interest-rate currencies such as the Swedish krona and Swiss franc underperformed. The typically risk sensitive NOK and CAD held up better than expected given their exposure to rising oil prices.

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



Source: Bloomberg and State Street Global Advisors, as of January 31, 2022.

Over the near term, we expect this behavior to continue. Inflation has yet to peak, and the timing of the eventual peak is difficult to predict given the opacity of inflation dynamics. As a result, a bias remains for the market to price the risk of even tighter monetary policy which, combined with fiscal drag, is likely to cause further periods of risk aversion and equity market volatility.

As we progress through Q1 and early Q2, we expect to see some stabilization in inflation, which should begin to fall later this year. Meanwhile, expect global growth to remain above average for 2022 albeit slower than in 2021 as accumulated excess savings and strong employment markets help offset the drag from tighter monetary and fiscal policy. Thus, sometime in Q2 we expect to see a peak and maybe even the start of an easing in monetary policy expectations and a more constructive risk environment. That should eventually favor more pro-cyclical currencies vs. the more defensive USD, JPY, and CHF.

Figure 2

January 2022 Directional Outlook

	Short/Medium Term Outlook	Strategic Outlook
NOK	↑	↑
USD	↑	↓
NZD	↑	↓
CHF	—	↓
GBP	—	—
CAD	—	—
AUD	↓	—
SEK	↓	↑
EUR	↓	↓
JPY	↓	↑

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

The risk to this baseline view is that central banks tighten too quickly forcing a much more pronounced slowdown in growth in late 2022 to early 2023. This is a risk we are monitoring carefully. A central bank engineered soft landing from historically high levels of inflation is extremely difficult to achieve.

Review and Outlook by Currency

US Dollar (USD)

The US dollar led the G-10 with a 1.7% gain vs. the average on support from tighter monetary policy expectations resulting from a near 40-year high in inflation at +7% YoY and continued robust economic data. Equity market weakness added an important positive influence via the usual flight to quality demand for the dollar. The Federal Reserve validated higher rate expectations by signaling a March rate hike at its January 26 meeting and choosing not to rule out a rate hike at every meeting this year when asked in the press conference. However, at month-end, Fed speakers pushed back on the possibility of a 0.5% rate increase in March, sending USD slightly lower to finish the month.

We see scope for further near-term USD strength as strong labor markets and high inflation underpin further expected Fed policy tightening, particularly the potential terminal rate, and equity market volatility is likely to persist. Beyond that, we are negative on USD. The dollar is already very expensive compared to our estimates of long-run fair value, G-10 leading US growth is likely to revert more quickly back toward its long-run average, and USD tends to fall after the Fed actually begins raising rates. It is important to recognize that in addition to the USD's overvaluation, which already reflects US advantages, the USD is not the only game in town during this policy tightening cycle. Unlike the 2013–2018 policy tightening cycle, other central banks are also tightening rather than easing policy and commodity markets are enjoying a bull rather than a bear market.

Euro (EUR)

The euro had a quiet month, up 0.2% against the G-10. Negative ECB policy rates and a weak long-term growth outlook relative to much of the G-10 limited EUR upside. Downside was limited by the consensus negative EUR view at the start of the year and equity market volatility, which tends to be mildly supportive given the eurozone's large current account surplus.

We are broadly negative euro due to its somewhat elevated valuation against commodity currencies and an increasingly negative yield differential against the majority of G-10 currencies. That said, the market is, we think correctly, beginning to price limited ECB policy tightening. We also see potential for depressed relative European equity valuations to attract capital as the year progresses. As a result, we see some upside potential vs. other low yielding currencies such as CHF and JPY. Later this year, if we are correct in our call for broad USD weakness, we could also see EUR rally back toward 1.20 vs. USD. A material hawkish shift by the ECB in coming months could hasten the euro's upside potential. But even if that happens, we'd prefer to position for EUR upside vs. the other defensive low yielders, CHF and JPY.

British Pound (GBP)

The pound finished January with a 0.7% gain vs. the G-10 average. UK yields rose on expectations of further Bank of England (BOE) rate increases in response to near 30-year highs in inflation, solid employment data, better than expected November growth data, and resilient PMI data despite the omicron COVID-19 surge. These positive factors helped GBP shrug off equity market volatility to post a gain for the month. Political risk rose slightly on the risk that PM Johnson could face a no confidence vote in response to controversy over social events during the COVID lockdown. This had little discernible impact on GBP as it represents a possible change in Conservative party leadership, not a general election and possible change in party.

Our GBP view is mixed. We see limited downside given support from the BOE and resilient fundamentals, but upside will also be slow to materialize. For now, buy GBP selectively mostly against lower yielding currencies such as EUR, CHF, JPY, and cautiously against SEK to capture the positive impacts of BOE policy tightening. We see GBP in a range to slightly weaker against USD for now, but the cheap GBP valuation and our expectation for broad USD weakness as the year progresses should see the currency appreciate vs. the dollar. We would be more inclined to sell GBP against currencies that enjoy the benefits of both rising yields and strong commodity prices such as NZD and NOK but warn that such positions may be volatile near term due to equity market volatility.

Japanese Yen (JPY)

The yen was the second-best performing currency in the G-10, up 1.6%. Negative equity market performance helped the traditional safe haven JPY overcome the negative impulse from sharply rising global yields relative to Japanese yields, which are stuck near zero. At the January 17 Bank of Japan (BOJ) meeting, Governor Kuroda reemphasized the bank's intention to leave interest rates at current levels while inflation remains well below target. National CPI ex-fresh food and energy remains stuck in deflationary territory, -0.7% YoY for December.

The yen is at 30-year lows on a real effective exchange rate basis. However, the BOJ's commitment to ultra-loose monetary policy in a world of rising rates and above average growth is likely to lead to even more weakness over the near term. JPY tends to underperform during a global economic recovery and is also somewhat hurt by high and rising oil prices. The key benefit to buying yen is its ability to diversify equity market risk. Indeed, the recent and ongoing pickup in equity market volatility has been positive for the haven yen and is likely to help limit losses going forward. But until we see a more substantive, sustained downturn in global economic activity and monetary policy expectations, the yen is unlikely to correct back up toward long-term fair value.

Canadian Dollar (CAD)

After posting the best performance in the G-10 during 2021, the Canadian dollar enjoyed a strong start to 2022, +1.0% vs. the G-10 average. Rising oil prices and stellar employment data underpin a strong economic recovery. The Bank of Canada recognized that strength at its January 26 meeting, pointing to the need for policy tightening this year. Canada's close ties with the US and USD also helped stabilize CAD relative to other commodity sensitive currencies in the face of January equity market correction.

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 pushing CAD higher vs. the USD toward our estimate of fair 1.18, a gain of nearly 7%. However, higher equity market volatility and further upside potential in US Fed policy expectations may delay that appreciation. Against the other higher yielding commodity currencies — NOK, AUD, and NZD — CAD looks like a conservative way to gain exposure to the ongoing pandemic recovery and strong energy prices as those other commodity currencies are more exposed to equity market and/or Chinese growth risks. Relative to low yielding currencies, CAD stands out as particularly attractive vs. the Swiss franc. CHF is extremely expensive compared to our long-run fair value estimates, and long CAD vs. CHF also provides a healthy yield pickup and exposure to rising energy prices.

Swiss Franc (CHF)

During January, the franc defied its usual performance as a haven during times of equity market volatility losing 0.6% vs. the G-10 average. This is not terribly surprising as CHF has enjoyed a multi-month uptrend and the Swiss National Bank (SNB) stands out as one of the most dovish central banks in the G-10 alongside the Bank of Japan. A key policy tool of the SNB is currency market intervention to limit CHF strength. A surge in sight deposits early in January suggest heightened intervention, which likely helped to suppress CHF during the month.

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 and Russia-Ukraine risk may limit near-term CHF downside, but we look through that and suggest max short the franc positions. We appear to be reaching the peak in EU omicron cases, which should help to alleviate some support for CHF. An apparent slower pace of SNB intervention over recent months makes sense in the face of rapidly rising import costs has helped keep CHF at elevated levels, but that support should abate as we see inflation easing by mid-year sending CHF gradually lower.

Norwegian Krone (NOK)

The krone gained 0.6% against the G-10 average in January. The steady uptrend in oil prices, gradual expected tightening of monetary policy that began in September, and higher-than-expected inflation helped support NOK. On the negative side, NOK has been one of the most equity market sensitive currencies in G-10 over the past few years. This relationship was evident as NOK fell 1.75% from January 20 to 24 triggered by equity prices breaking down through their early December lows. The move was short lived, and NOK rebounded back to positive territory alongside the late month recovery in major equity markets.

The elevated equity market risk of NOK notwithstanding, we are positive on the currency over both short- and long-term horizons. NOK is historically cheap on a real effective basis and against our estimates of long-run fair value. Additionally, cyclical fundamentals also support NOK appreciation. Supply/demand dynamics suggest continued oil market strength, which will only bolster the record trade surplus. High inflation and what we believe will prove to be a mild, short-lived setback in growth from omicron should keep the Norges Bank on its tightening projected path. In short, the krone is a cheap currency with commodity support, rising yields, and solid growth fundamentals.

Swedish Krona (SEK)

The krona struggled in January finishing down 1.4% against the G-10. While other G-10 central banks ratchet up plans for monetary tightening, the Riksbank remains firmly on hold at a zero-interest rate thanks to December core inflation running at only 1.7%. The threat of a Russian invasion of Ukraine and the negative potential consequences to the EU growth outlook and regional stability also likely weighed on SEK during the month. Month-on-month core inflation has jumped up to 0.4% and Q4 GDP surprised to the upside, but that was not enough to offset the impact of rising global yields and regional political risk.

SEK remains among the cheapest G-10 currencies but is likely to remain so near term due to the divergence between Riksbank policy and those of other central banks. Continued uncertainty regarding the EU growth outlook and Russia- Ukraine risks are also likely to persist for at least the next month or two. That said, the recent sell-off in SEK looks excessive given its cheap valuation and 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. The Swedish economy and SEK are closely tied to the EU. If we are correct about the potential for a EUR bounce vs. US dollar later this year, then SEK is likely to outperform USD in H2 2022 as well.

Australian Dollar (AUD)

The Australian dollar fell 1.4% against the G-10 in January despite strong commodity markets, higher-than-expected inflation, rising yields, and impressive employment growth. The negative AUD impulse from weak equity markets and the significant headwinds facing Chinese growth were too much for the AUD to overcome.

We recognize the AUD positive local fundamentals reasonable long-run valuation but continue to see near-term downside risks vs. the G-10. The Reserve Bank of Australia (RBA) is more likely to disappoint expectations compared to other major central banks as they wait for high, sustained wage growth, which has yet to materialize. We forecast much improved Chinese growth in the second half of the year, but the current headwinds and lockdown risks from its zero COVID-19 policy promise a difficult road over the next few months. We prefer to gain exposure to strong commodities, rising yields, and the post-omicron global recovery via other commodity-linked currencies, such as NOK, CAD, and NZD. Ongoing equity market volatility is likely to continue to weigh on AUD vs. USD, which may push the pair back below support at 0.70. Longer term, we see scope for AUD to recover against USD back toward its fair value around 0.80.

New Zealand Dollar (NZD)

The New Zealand dollar underperformed all G-10 currencies with a loss of 2.4% vs. the average and a loss of 4.1% against USD. The usually risk sensitive NZD followed its usual script and suffered as equity markets fell. NZD also likely lagged as its agricultural export prices lagged the energy-led rally in commodity markets. And, like Australia, China is also a key trading partner, making New Zealand and NZD sensitive to the difficult near-term Chinese growth outlook.

Unlike AUD, we are more positive on NZD over the near-term. NZD faces challenges from ongoing equity market volatility and Chinese growth weakness. But, the Reserve Bank of New Zealand (RBNZ) has already started to raise policy rates, unemployment is at a record low, Q4 CPI surprised to the upside at 5.9%, we see room for a strong post-omicron re-acceleration of economic activity, and it is modestly oversold after the recent depreciation. NZD is slightly expensive to CAD and AUD and is very expensive compared to NOK, but it is the economy most obviously at risk of significant overheating. Against low yielders and the USD, NZD is cheap to fair value with a growing yield advantage and stronger growth outlook.

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United States: State Street Global Advisors, 1 Iron Street, Boston, MA 02210-1641.
T: +1 617 786 3000.

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