Commentary
Currency Management

October 2021

Currency Market Commentary

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Summary of Views

	Short/Medium Term Outlook	Strategic Outlook	Comment
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 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.
NOK	↑	↑	A steady post-COVID growth recovery, strong oil prices, the recently started monetary policy tightening cycle, and a cheap valuation provide a foundation for short- and long-run NOK appreciation. In the ultra-short term it is due for a correction after its strong rally this year, and the Norges bank announcement of smaller daily NOK purchases in November.
CAD	↑	—	We've turned more positive CAD on higher yields, validated by the Bank of Canada's decision to end QE and comments that Canada's output gap should close by mid-2022. That view is further anchored by gradually improving growth and strong oil prices. G10-leading YTD performance and fully priced short-end yields may slow further gains, but we still see ample room for CAD strength against the more defensive EUR, CHF, and USD.
NZD	↑	↓	Fast recovering labor markets, solid manufacturing PMI, and rising inflation support NZD gains. The recent RBNZ rate hike and future expected monetary tightening reflect those strong conditions and add additional support for the currency. Recent lockdowns under NZ's zero tolerance policy for COVID cases may create some volatility, but medium term we see the pandemic headwinds gradually waning.
SEK	—	↑	SEK remains among the cheapest G10 currencies while both Swedish and EU growth remain on solid footing. Despite that, we shift to neutral as moderate core inflation supports the Riksbanks zero rate policy at least through 2022 and early '23. We prefer undervalued commodity-linked currencies backed by rising yields and stronger growth prospects, even if they are not as undervalued as SEK.
AUD	—	↓	We saw an AUD-positive regime shift during October as the economy reopens from lockdown and inflation surprises strongly to the upside. The market challenged the RBA's commitment to keep the April 2024 bond yield around 0.1%, and the RBA chose to allow yields to rise substantially. This signals a shift in monetary policy, though probably not as dramatic a shift as the market expects, which could result in near term AUD weakness.
USD	↓	↓	Skittish equity markets and steeper yield curves driven by stagflation fear in September gave way to a more positive environment of rising equities alongside rising short-term yields. USD suffered and is likely to continue to struggle as we enter a more synchronized global recovery in 2022 with strong commodity markets and widespread central bank tightening. Fully valued equity and credit markets heighten risk of periodic USD rallies.
EUR	↓	↓	We remain negative EUR due to negative interest rates, elevated long-term valuation, and weak potential growth. We see scope for a cyclical bounce in EUR over the next year, especially vs. USD and CHF, 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. A notable absence of recent SNB CHF intervention has created some short-term upside risk, as would any future periods of heightened equity market volatility, 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.

Macro Environment

The big story in October was the repricing of expected central bank policy, resulting in a sharp rise in short-end yields across the G10. Commodity-sensitive currencies such as AUD, CAD, and NZD led the move higher in two-year rates and currencies in response to continued upside inflation surprises, expected inflation, and a nearly 2.5% gain in the Bloomberg commodity index. Australian two-year yields rose 0.73% on the month, while New Zealand's moved 0.84% and Canada's jumped 0.56%. In a complete reversal from September's market behavior, these higher rates were accompanied by stronger investor risk sentiment and a recovery in equity markets from their September/early October lows.

As we pointed out in our September commentary, to anticipate the impact of changes in the yield curve on currency in Q4, look beyond the simple relationship that higher yields are good for a currency and lower yields are bad. That positive relationship held in October, but the opposite was true in September. More important going forward will be the degree to which changes in the yield curve are a sign of health or dysfunction, whether the yield changes are good or bad. A good yield increase would be one that accompanies stronger growth conditions and stabilizes long-run growth/inflation expectations. Too great an increase and central banks risk choking off the recovery, too little and inflation expectations can become unhinged, which would require excessively restrictive policy in the future. Interest rate changes are good or bad depending on the degree to which investors perceive central bank policy to properly balance these growth/inflation and short/long-term tradeoffs. In terms of currency markets, an environment of good rate increases tends to benefit currencies with the fastest yield increases and, conversely, in bad rate increase environments those currencies suffer. In October we saw the former and in September we saw the latter.

What changed? Firstly, growth expectations stabilized. Most hard economic data released in October was from August and September, and continued to come in weak due to the impacts of the fourth wave of COVID. But more timely survey data such as PMI and consumer sentiment indicators stabilized and improved slightly, while COVID cases moderated and more lockdowns were lifted than imposed during the month. Secondly, central banks at least partially validated the increase in short-term yields on average. This reduced fears that policy would fall behind the curve and result in even higher inflation alongside disruptively severe policy tightening down the road. We can see this in the average flattening of G10 yield curves during the month. Finally, Q3 equity earnings have held up well during this reporting season, suggesting that businesses have largely been able to weather supply chain pressures, the recent COVID-related slowdown, and rising input costs. In September, it was very difficult to assess the extent and duration of the COVID fourth-wave slowdown while rising inflation and a lack of central bank/short-end yield response increased perceived risks of a policy error.

Going forward, we stick with our core view that excess household savings and the gradually fading pandemic, along with gradually moderating supply-side constraints will more than offset global fiscal and monetary tightening to allow growth to continue well above average in 2022. However, growth risks remain elevated. The recent surge in global COVID cases may not be the last, and COVID's transition from a pandemic to an endemic problem introduces uncertainty into the growth outlook via its impacts on consumer psychology and business behavior. Inflation should begin to ease later next year as supply chains become more orderly. That does not mean we think the entire increase in inflation from pre-pandemic averages is transitory. It seems very likely that the pandemic did change the world in some permanent ways, and G10 central banks have broadly shifted toward a permanently less aggressive response function led by the FED's average inflation targeting framework. It is far too early to assess the permanent and transitory components of inflation. At this point, it seems reasonable to expect a healthy reversion to the mean over the next couple of years, but not a full reversion. As a result, inflation uncertainty is likely to remain higher than usual for some time.

The bottom line is that we see a continued robust recovery, but as we expect higher than average growth and inflation uncertainty coupled with tightening fiscal and monetary support, we see risks for greater financial market volatility around that stable to better cyclical baseline recovery. This should help support USD from time to time and create choppier conditions for cyclically sensitive currencies such as AUD, NZD, CAD, and NOK. Moreover, the recent rise in short-term yields which significantly boosted those cyclical currencies in October appears to be a bit overdone and has some room for retracement.

Longer term, it is important to be mindful of the divergence in currency market valuations relative to those of equity and credit markets. Strong earnings expectations, somewhat elevated valuation levels in equities, and historically tight credit spreads increase the risks that returns relative to volatility in those markets deteriorates. This will likely spill over to currency markets; however, currency valuations are not as optimistically priced and have more room to price the post-pandemic recovery. Pro-growth currencies such as NOK, AUD, NZD, and CAD remain cheap to fair, relative to 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 vs. the more defensive and expensively valued currencies such as the US dollar and Swiss franc. This will seem like a modest decoupling of currency with broader market risk sentiment, but we'd argue that the decoupling has already happened with pro-growth currencies remaining cheaper than in past recovery cycles, and such a move would represent currencies catching up to, or recoupling, with the optimism of equity and credit markets. Note that this decoupling does not apply to a deep and/or sharp equity market correction which, if it happens, is likely to result in a substantial negative impact on cyclically sensitive currencies and support defensive currencies.

Detailed Currency Views

US Dollar (USD)

The US dollar trended steadily lower throughout the month to finish down 1.6% relative to the G10 average. Most of the weakness came vs. the more commodity-sensitive cyclical currencies which enjoyed the benefits not only of higher commodity prices but also a larger increase in short-term yields. US two-year yields did rise 22 basis points on the month, as investors pulled forward the first expected 0.25% Fed rate hike to July 2022, effectively predicting a rate move immediately following the unwind of QE. This seems overly optimistic as recent Fed comments do not even project and end to QE until mid-2022. However, despite the more aggressive Fed expectations USD also underperformed the low-yielding Swiss franc and Swedish krona. USD was even down vs. EUR through the 28th and only beat it for the month thanks to a sharp sell-off in EURUSD on the final business day. This broad weakness against both high- and low-yielding currencies suggests that the improvement in risk sentiment and stronger equity markets were also important driving force. Just as USD enjoyed strong demand as equity markets wobbled in September, it fell on the positive environment in October.

Economic data was mixed and not likely a major driver. September employment was substantially below expectations, +194K new jobs compared to +500K expected. The unemployment rate fell from 5.1% to 4.8%, but that was largely due to a decline in labor force participation. A continued hangover from the latest wave of COVID likely had an impact on September employment, which should ease as new COVID cases come down and emergency unemployment benefits roll off. The impacts of the fourth wave of COVID in conjunction with supply chain and labor market constraints can be seen more in the large Q3 GDP miss, +2% QoQ annualized vs. +2.6% expected. This is down from Q2's 6.7% pace. On a more positive note, the consumer appears to be reengaging as COVID cases fall. September retail sales surprised positively while October services PMI jumped to 58.2 from 54.9 in September. The fiscal policy outlook took a hit as the

Democrats pare back the expected social support program amidst internal divisions. However, the impact on USD was probably small, as investors expected a much smaller bill than the original $3 trillion dollar proposal. In addition, negotiations also seemed to reduce the chance of a broad increase in corporate and top marginal personal tax rates, which could have been disruptive to the income and earnings outlook.

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. In addition to having an expensive valuation, the cyclical outlook is also challenged. Growth outside of the US looks increasingly attractive on a relative basis, and while the Fed is set to begin tightening monetary policy, it is or is expected to be behind several other G10 countries, such as Canada, Norway, New Zealand, and the UK. In terms of timing, it is hard to see sustained USD downside over the next month or two, as investors uncertainty of potential changes in the growth, inflation, and monetary policy outlooks may lead to bouts of greater volatility across risky assets. Increased equity and credit market volatility tends to help support USD. That said, we prefer to look through the risks of short-term bounces in USD to position for medium to long run.

One common pushback to our negative USD view has been the strong USD strength during the last Fed policy tightening cycle from 2013–2018. We do not think the prior tightening cycle is an appropriate template for this cycle. As we entered the last Fed tightening cycle, USD was extremely cheap relative to fair value; now it is more than 10% more expensive than an MSCI World xUS basket of currencies. The ECB introduced significant quantitative easing programs and negative rate policy, and the yen fell precipitously on the introduction of Abenomics. And investor and central bank confidence in the EUR as a store of value remained impaired by the 2011–2012 EU debt crisis. Now, monetary policy outlooks for both the ECB and BOJ are stable and EU funding conditions are stronger. The last Fed cycle began during a multi-year commodity bear market, depressing commodity-sensitive currency. Yes, USD rose impressively as the Fed tightened policy during the last cycle, but that was very much a function of deteriorating currency fundamentals outside the US. In contrast, currency fundamentals outside the US are improving alongside USD fundamentals, and we are not seeing the same massive divergence that we saw in the prior tightening cycle. Not only do we not expect a repeat of 2015–2018 USD strength, but we also see ample scope for depreciation.

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 see some technology-enabled reshoring of manufacturing. We respect these positive long-run factors and think that they likely result in the mildest USD bear market since currencies were floated in the early 1970s. 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 10–12% fall in USD from current levels.

Euro (EUR)

The euro lost 1.8% vs. the G10 average in October. The story was straightforward. A more positive global growth outlook alongside rising commodity prices and strong increases in short-end yields outside of the eurozone favored EUR weakness. That is not to say eurozone fundamentals are weak, just that they are more attractive in the pro-cyclical higher-yielding countries. Yields are also rising across the EMU, and the ECB offered only mild pushback. ECB President Christine Lagarde made the case that inflation pressures were likely transitory but also declined to meaningfully push back against market expectations for a more rapid rate-hiking cycle when asked about it by reporters at the press conference following the policy meeting on the 28th. But the extent of the shift in yields and ECB outlook was small relative to other countries. Eurozone growth remains strong, Q3 GDP beat expectations at 2.2% QoQ, but on the margin PMI and retail activity is moderating while rising energy costs threaten to further slow activity by effectively acting as a consumption tax. Investors do not appear ready to look to the EU as a growth leader, although a large pool of excess savings, decent fiscal outlook, room for further recovery from COVID-related frictions, and easier monetary policy may make it a growth leader, at least for a few quarters. In fact, EU growth has already outpaced the US for the past two quarters. We outline the potential for a stronger EUR vs. USD in the final paragraph of this section.

Against the broader G10 we remain bearish on 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 readings on all 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 6- to 12-month horizon. The EU vaccination program has surpassed the US's. 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 finished the month nearly unchanged against the G10 average, though that was enough to meaningfully outperform JPY, EUR, and USD. GBP rose during the first half of the month, recovering from its sell-off in August–September. Economic data during that time pointed to continued above-average growth, but at a slightly disappointing pace. Employment 3M/3M gained 235K jobs in August, a good result, but below the 250K expected. After peaking on the 15th GBP, gave back all its gains during the second half of October in favor of commodity-sensitive currencies, which enjoyed more rapidly rising rates as well as the commodity-driven boost in growth expectations. Local UK news flow was mixed, with a negative surprise in September retail sales but a slightly more generous than expected government spending plan released on the 27th, and a positive surprise in October composite PMI. Ongoing concerns over inflation and productivity impacts were exacerbated by some concern the UK may back out of the Northern Ireland Protocol, the EU-UK customs arrangement design to keep the Irish border with the EU open.

The market appeared to tolerate rising yields better in October than in September, when stagflationary fears drove the currency. The market is now pricing four 0.25% rate hikes by next summer, at least five by end of 2022, bringing the two-year yield up another 30 basis points for the month, almost doubling the August–September move, yet GBP was still relatively strong. At current levels, pricing of BOE policy tightening seems overly aggressive to us. Inflation is a concern but remains narrowly driven by energy, hospitality, and transport sectors and is thus more likely to be transitory. It may make sense for the BOE to fire a warning shot to help contain long-run inflation expectations by raising rates once soon, maybe even following that up with a second hike in H1 2022, but beyond that patience is warranted. If the BOE agrees with us and disappoints, the knee-jerk reaction is likely a lower GBP. But, given the medium- to long-run growth challenges, a more gradual monetary tightening cycle may ultimately be positive for the currency.

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, rising yields, and significant discount to our estimates of long-run fair value is sufficient to justify a long position, even if Brexit limits longer-term productivity 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 merge 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 Q1 gains were a good example of the need for long-term, strategic investors to look beyond short-term uncertainty.

Japanese Yen (JPY)

The yen had a difficult month, down 3.8% vs. the G10 average. Following well-established patterns, JPY fell alongside improved equity market performance, rising global yields, and rising oil prices. Japanese economic and monetary policy expectations did not keep pace with the improved outlook and rising yields outside Japan. The Bank of Japan maintained its yield curve control policy with national core CPI still stuck below zero and composite PMI remaining in contractionary territory. There was some urgency to the yen sell-off in October. It seems likely that Japanese investors who missed the opportunity to buy foreign bonds during the yield spike back in March moved a bit quicker this time. Also, the combination of rising oil prices and a rising US dollar appears to have forced importers to unexpectedly accelerate hedging activities. Often during periods of yen weakness, the bulk of the moves lower happen outside of Tokyo hours. Since late September, the yen has sold off as rapidly and at times more rapidly during Tokyo hours, suggesting that local Japanese investors and importers have been rushing to buy USD.

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 month and 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 JPY is substantially below fair value by our estimate. 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, though that has admittedly not been the case this year. 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 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 back 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 governments efficiently allocates 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.

Canadian Dollar (CAD)

The Canadian dollar gained 0.6% vs. the G10 average in October and remains the top performing currency in the group year-to-date. Recovering economic growth after an unexpected mid-year slowdown, strong oil prices, and central bank tightening all helped to support CAD. September brought an additional 157.1K net new jobs vs. +60.0K expected, and Canada has now fully regained all the jobs lost during the pandemic. Rising oil prices help Canadian terms of trade remain near their highest levels since 2008. One major concern hanging over CAD at the start of the month was whether the Bank of Canada (BoC) would push back on the aggressive policy tightening priced in rates markets. Not only did they not push back but they also managed to deliver a hawkish surprise. The BoC ended the QE bond purchasing program and noted that even with reduced 2021 growth forecasts they expect the Canadian economy to close its output gap by mid-2022. This points to a high likelihood of a policy rate increase as early as Q2 next year.

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 signal is being partly offset by a negative signal on our long-run potential growth model. GDP growth has not kept pace with the pickup in employment, pushing productivity lower. 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. We see scope for further appreciation vs. EUR, CHF, and USD, but expect CAD returns to lag other more cyclically sensitive 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 CAD-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 0.4% vs. the G10 average in October. CHF performance stood out during the month, as it rose while the other typically defensive currencies, USD and JPY, fell. It's even more interesting because, aside from positive equity sentiment, which tends to be CHF negative, CHF also shrugged off higher global yields. The expected monetary policy divergence, with many other central banks tightening policy while the SNB maintains negative rate policy, is usually negative for the franc.

To understand CHF strength during the month we must look beyond interest rate policy to the other key component of monetary policy, SNB intervention in the currency market to limit CHF strength.

There was little sign of the usual currency intervention in response to the October run-up in CHF, which invited further gains. High import costs, particularly energy import prices, are politically unpopular and risk an unhealthy spike in local consumer inflation. That creates a plausible incentive for the SNB to sit back and allow greater appreciation as a stronger CHF offsets rising import prices. The five-year low in EURCHF is around 1.05, and the SNB has historically stepped up intervention around 1.06. Given that pattern, we'd expect higher intervention over the near term. However, if those levels were to break with little or no sign of SNB pushback, then we would expect a bit of an air pocket that could see CHF jump even higher. Weekly sight deposit data, a good proxy for intervention activities, will be important to watch over the coming weeks.

If there is a sharp sell-off, we would view it as temporary. We see a large portion of global inflation as transitory and think that Switzerland will once again find itself in a strong disinflationary environment in late 2022 and 2023 as those transitory forces fade. Moreover, as other central banks raise rates over the next 12–24 months, selling CHF and its -0.75% yield in search of better returns will become increasingly attractive.

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% more expensive than its long-run fair value vs. an MSCI World currency basket. Over the tactical horizon, we face uncertainty regarding SNB intervention as described above. But aside from that temporary uncertainty, low inflation, an overvalued currency, and weak growth point to a weaker currency. As domestic and EU growth continue to recover from the pandemic, 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. Such dynamics are not positive for CHF. All of that said, the uncertainty about near-term intervention policy and ongoing uncertainty over the pace of global recovery and impacts of supply chain disruptions are likely to support CHF to some extent.

Norwegian Krone (NOK)

The krone gained 1.6% vs. the G10 average during the month thanks to strong oil prices and a market preference for currencies backed by aggressive central banks. The Norges Bank was the first G10 central bank to raise policy rates with its hike in September. The bank expects another hike in December, another three 0.25% hikes in 2022, followed by two more in 2023–2024. Economic data was also broadly supportive. The sharp fall in retail sales for July and August finally reversed with a +0.5% MoM gain for September, while the unemployment rate fell to its pre-pandemic level at 2.2%. Manufacturing PMI was less positive, falling back slightly from 62.2 in August to 59.2, but that is well above 50, signifying strong growth. The one negative for NOK came on the final trading day of the month. Norges Bank announced planned purchases of 700M NOK per day in November, down from 1.7B in October, triggering a near 1% drop in NOK. The reduced level of purchases is consistent with reduced fiscal support as the economy recovers from the pandemic and shouldn't have a massive, sustained impact on the currency.

We retain a positive view on NOK over both the tactical and strategic horizons because of cheap valuations, continued growth supported by strong oil prices, and tightening 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 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 re-evaluate 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 NOK-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 had another quiet month, gaining 0.2% against the G10 average. This is sensible behavior given the macro forces at play. The Swedish economy tends to be somewhat procyclical and tied to the EU economy, but has been held back by ultra-low interest rates. Stabilizing global growth and strong EU growth is krona positive. However subdued inflation and a still elevated unemployment rate has the central bank, the Riksbank, on the sidelines for an extended period. The preference for currencies backed by tighter monetary policy expectations worked to offset improved investor sentiment to keep SEK nearly unchanged. Local economic conditions appear to be improving but inconsistently. September composite PMI jumped from 63.4 in August to 68.2 on strong contributions from both the manufacturing and services surveys. However, September retail sales fell 0.3% MoM and core CPIF inflation remains subdued at 1.5% vs. 1.7% expected. As the Riksbank's Thomas Jansson reminded markets mid-month, there is still "some way" to go before the central bank needs to think about tightening policy.

The lack of a catalyst for monetary tightening and inconsistent economic data led us to cut our long tactical SEK position to neutral in October. By our estimates, SEK remains the cheapest G10 currency relative to long-run fair value and we still see a solid, albeit gradual, economic recovery as COVID recedes. However, low inflation and less than stellar growth data compared to other G10 countries lends credibility to the Riksbank's outlook that rates will remains at zero through 2024. We prefer the stronger growth and increasingly attractive yields of the more cyclical G10 currencies. Over the strategic horizon, we focus on SEK's extreme undervaluation as the primary driver and 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 led the G10 in October with a 2.3% gain vs. the average and an impressive 6.1% gain vs. the yen. Investors sought pro-cyclical, commodity-sensitive currencies with rising yields, and AUD fit that profile perfectly. A strong surprise in trimmed mean core inflation for Q3, +2.1% QoQ vs. expectations of +1.8%, rightfully cast doubt on the RBA's commitment to keep the three-year yield around 0.1% and refrain from interest rate increases until 2024. Growth data remains subdued, as the government only recently lifted COVID lockdowns, but we should see that strong reopening surge over the next 1–2 months.

Armed with the positive growth and inflation outlook investors tested the RBA's resolve by pushing two- to three-year yields higher. As those yields rose past 0.2% and the RBA neglected to defend its April 2024 yield peg, two-year rates surged from 0.2% to 0.77% in the final two trading days of the month. Conditions justify a more hawkish stance from the RBA at its next meeting on November 2nd, but much of the massive 50 basis point move in the final days of the month was probably more related to technical conditions and stop losses. It is highly unlikely that the RBA will move quickly from a yield curve control policy with no rate hikes until 2024 to the current market pricing of around six hikes by the end of 2023.

We moved back to neutral AUD over the tactical horizon on the improved growth outlook and pick-up in yields. We continue to see AUD appreciating against the G10 average on solid short- and long-term growth prospects and decent valuations. However, over the very short term the AUD rally and rise in short-term yields is likely to correct temporarily. 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 is far more certain than for Australia. That said we will watch the pace of the post-lockdown recovery carefully. as well as the evolving RBA stance. Risks are skewed to a more positive AUD outlook.

Our strategic view is mixed. By our estimates, AUD is now only 2.3% below fair value relative to an MSCI World xAU basket of currencies, a nearly full recovery from March 2020's 16.9% undervaluation. However, 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 AUDUSD long-term fair value of 0.790, nearly 5.5% above current levels. More broadly we recommend Australian investors leave positions in the cheaper GBP, CAD, JPY, and Scandinavian currencies mostly unhedged; AUD is rather expensive relative to these currencies.

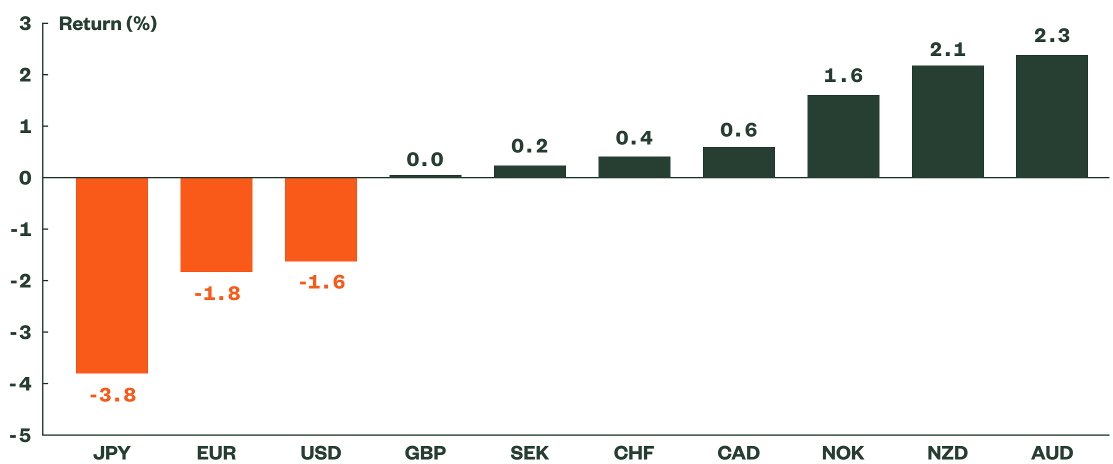
New Zealand Dollar (NZD)

The New Zealand dollar closely followed AUD to finish up 2.1% vs. the G10 average. Like AUD, CAD, and NOK, NZD fit the profile of the preferred currency in October: procyclical and commodity sensitive with rising yields. The Reserve Bank of New Zealand (RBNZ) became the second G10 central bank to tighten policy with a 0.25% rate increase on October 5th, while pointing to further hikes by noting that "further removal of monetary policy stimulus is expected over time."

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 the country reopens to international travel, though that may not happen until well into 2022. A steady pace of policy rate increases over the next year is well supported by the return to near full employment and a large positive inflation surprise of +2.2% QoQ for Q3 vs. +1.5% expected. The story is not all positive. Business confidence and credit card spending remain weak, and the arrival of the Delta variant will not be particularly helpful. Still, the outlook is strong given the high level of vaccination, recent improvement in terms of trade, and surging manufacturing PMI. 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
October 2021 Currency Return vs. G10 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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ID807371-3917780.1.1.GBL.RTL 1121
Exp. Date: 11/30/2022