STATE STREET GLOBAL ADVISORS

2019

Global Market Outlook

Not Over Until It's Over

Currency Outlook

Use Short-Term Moves to Hedge Long-Term Currency Exposures

While 2019 may initially provide more of the same for international currency markets, the potential for a significant shift should not be discounted.

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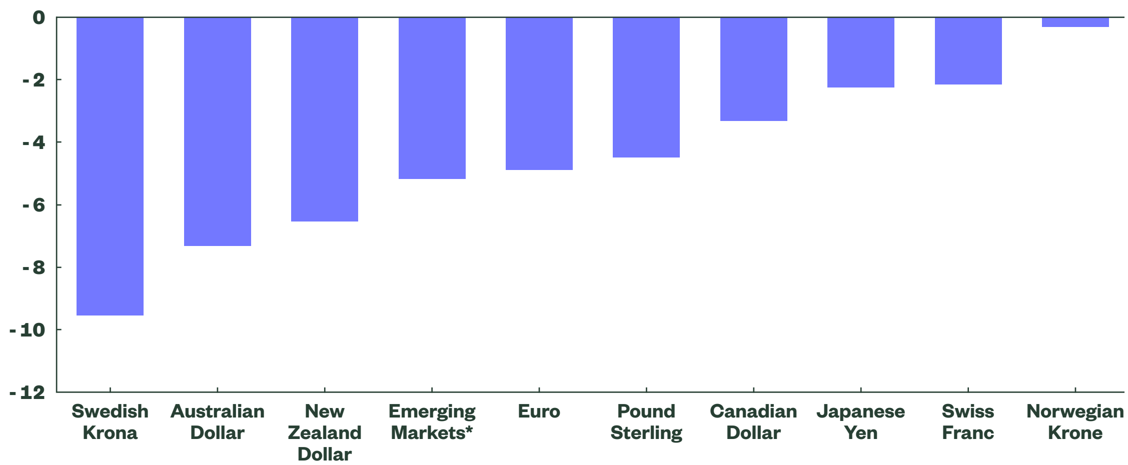
The US dollar showed unexpected strength in 2018, thanks to tightening monetary policy, strong US growth and trade uncertainty (see Figure 1). We expect these factors to continue to support the dollar into early 2019. By the second half of the year, however, the dispersion between the US and the rest of the world could start to peak, especially if trade disputes are resolved more swiftly than anticipated; as a result, we could see a rerating in currencies. Investors could aim to use these shorter-term dislocations as a means to capitalize on longer-term reversions to equilibrium through currency hedging.

Figure 1
The US Dollar Showed Unexpected Strength in 2018
Currency return versus US dollar



Source: State Street Global Advisors, Bloomberg (December 31, 2017 to September 30, 2018).

*Emerging Markets are represented by MSCI Emerging Markets Index currency returns weighted by equity-market capitalization.

US Dollar Strength to Persist Into 2019

US fiscal stimulus and additional Federal Reserve (Fed) rate hikes are likely to add to the already impressive US short-term yield advantage and support the US dollar (USD) in the first half of 2019, despite the dollar being expensive versus its long-run valuation. This could put further pressure on emerging markets and on less liquid, risk-sensitive G10 currencies such as the Swedish krona (SEK) and the Australian dollar (AUD).

The Norwegian krone (NOK) is extremely cheap despite improving growth, rising inflation and the start of the Norges Bank rate-hiking cycle (the first rate increase of 25 basis points[1] was delivered in September 2018). Thus, NOK appreciation is supported by both short-term cyclical conditions and long-run valuation.

The Australian dollar is susceptible to further escalation of the US-China trade war, but we believe much of that is already in the price. AUD still offers more than 2% positive carry to the Swiss franc (CHF), EUR and SEK, as economic growth has been extremely resilient and exports to China are holding up better than expected despite a softer Chinese economy. The Canadian dollar (CAD) is a relatively new member of our preferred group due to impressive growth, steadily rising interest rates and the resolution of NAFTA negotiations with the US, even as it has been slightly undervalued versus USD.

1 One basis point is equivalent to 0.01%.

Negative Outlook on EUR, CHF and SEK

In Europe, issues such as Brexit, Italian political uncertainty and the erosion of Chancellor Merkel's support in Germany are likely to weigh on sterling (GBP) and the euro (EUR). At the same time, growth across the eurozone shows little sign of accelerating to 2017 levels. The European Central Bank (ECB) has all but promised to keep the rate of its deposit facility unchanged at -0.40% through the summer of 2019 and the Swiss National Bank is unlikely to increase rates until after the ECB begins to tighten.

Sweden appears to be the riskiest position. Growth and core inflation have been positive but erratic in 2018 and the central bank, the Riksbank, has held strong to its -0.50% policy rate. That said, the currency is extremely cheap to long-run fair value, the economic situation is improving and the Riksbank projects tighter policy by the first quarter of 2019. We remain negative on the currency for now, but will continue to monitor these upside risks carefully.

Potential for Step Change in Second Half

Toward the second half of 2019, markets may begin to anticipate that US exceptionalism has run its course as pressures on other regions dissipate. Our base case is a mildly negative US convergence, in which tighter monetary policy and the impact of trade tariffs slow global growth slightly, with the US rate and growth cycle slowing more than elsewhere. In this scenario, USD comes under pressure, but not to the same extent as in 2017, and low-yielding currencies outperform higher-yielding cyclically-sensitive ones.

Global growth remains above potential, which preserves expectations that low-yielding countries can begin to raise interest rates, sending EUR, SEK and JPY higher. (CHF is historically expensive and Switzerland is likely to lag the ECB in raising rates, so we would not expect as large a move.) On the other hand, slower global growth would limit the extent of gains in the higher-yielding, growth-sensitive currencies such as AUD and many emerging markets.

Risks to the Second-Half Outlook

Whether or not this step change is going to occur will become clearer after the end of the first quarter, as we get more insight into Fed behavior and whether US growth is strong enough to sustain US divergence. If Europe and emerging markets do start to show signs of catch-up as the year progresses, this could hamper USD, while EUR, AUD and SEK should outperform. Alternatively, if the rest of the world slows enough to spur fear of recession and the US slows even faster, then USD is likely to be better supported after an initial shock and the less cyclically-sensitive CHF and JPY will likely outperform the growth-sensitive AUD and SEK.

In such a scenario, it is difficult to predict EUR moves, as it usually holds up reasonably well in a negative environment, but investors will be quick to price out any hope of an ECB rate increase. On a related note, if we see too rapid an acceleration of monetary policy tightening in the US relative to growth, it is also likely to result in bouts of risk aversion, supporting JPY, CHF and, to some extent, USD regardless of the specific policies in those countries.

Strategic Hedging
Focus on the Long Run

Short-term currency moves in 2019 could provide opportunities for strategic investors to adjust their hedge ratios in anticipation that currencies will revert to fair value over the medium term. Cyclical over- and under-valuations of currency directly alter the relative competitiveness of countries and their inflation rates, creating pressures that lead to a reversion back to equilibrium.

Importantly, the most appropriate hedge ratio varies by currency base and is not the same for all foreign currencies. This is illustrated in the heat map in Figure 2. The bottom line is that we recommend investors increase hedges on expensive (overvalued) currencies and decrease hedges on cheap (undervalued) currencies.

USD-based investors. The heat map shows that higher US rates and growth in 2018 have pushed the dollar up to expensive levels. So, for US-based investors, we recommend low hedges against all G10 currencies except CHF in 2019.

EUR-based investors. EUR is near fair value versus USD, resulting in a neutral USD hedge. We suggest low hedge ratios to the cheap GBP, JPY, NOK and SEK, and a high hedge ratio on the expensive CHF.

GBP-based investors. Brexit uncertainty has led to GBP being undervalued. We therefore suggest that UK-based investors have high hedge ratios to most G10 currencies, including USD, thereby locking in post-referendum profits made on any unhedged exposure.

CAD-based investors. CAD is modestly undervalued versus USD, suggesting a slightly higher USD hedge ratio. USD aside, we suggest low hedge ratios to the cheap GBP, JPY, NOK and SEK, and a high hedge ratio on the expensive CHF.

Figure 2
To Hedge or Not to Hedge?
Currency value heat map

Undervalued Currencies
Overvalued Currencies

		Foreign Currency (%)								
		AUD	CAD	CHF	EUR	GBP	JPY	NOK	SEK	USD
Base Currency (%)	AUD	0.0	-3.6	18.1	-2.6	-16.7	-23.9	-22.7	-30.3	2.1
	CAD	3.8	0.0	22.5	1.1	-13.6	-21.0	-19.8	-27.7	6.0
	CHF	-15.3	-18.4	0.0	-17.5	-29.5	-35.5	-34.5	-41.0	-13.5
	EUR	2.6	-1.1	21.2	0.0	-14.6	-21.9	-20.7	-28.5	4.8
	GBP	20.1	15.7	41.8	17.0	0.0	-8.6	-7.1	-16.3	22.7
	JPY	31.4	26.6	55.1	28.1	9.4	0.0	1.6	-8.4	34.2
	NOK	29.3	24.6	52.7	26.0	7.7	-1.6	0.0	-9.8	32.1
	SEK	43.5	38.2	69.4	39.8	19.5	9.2	10.9	0.0	46.5
	USD	-2.1	-5.7	15.6	-4.6	-18.5	-25.5	-24.3	-31.7	0.0

Note: Positive values (red) indicate currencies are overvalued against a counterpart, while negative values (green) show they are undervalued. For example, for AUD-based investors, CHF is 18.1% overvalued and GBP is undervalued by 16.7%. So those investors would want to have a high hedge against CHF and a low hedge against GBP.

Source: State Street Global Advisors as of September 30, 2018.

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Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

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