

Will the greenback continue to fall?

Highlights

- The fall of the U.S. dollar has been first and foremost absorbed by the currencies of the country's main trading partners, especially the euro. To resolve the global imbalances, Asian currencies must bear the brunt of the greenback's decline.
- At US\$1.47, the euro continues to benefit from the pessimism surrounding the U.S. economy. While the risks of a correction seem high for the euro, the currency is the best alternative to a weaker dollar.
- The pound sterling briefly touched US\$2.11 before falling back to US\$2.05. The growing probability of an economic slowdown has led the markets to expect interest rate cuts.
- The yen has climbed against the U.S. dollar in recent weeks to just under 108. The Japanese currency continues to benefit from risk aversion and the unwinding of carry trades. However, it is still structurally weak and may undergo a correction shortly.
- The Canadian dollar has drifted back to earth. Despite high oil prices, the loonie has lost some of its appeal due to the high probability of a rate cut.

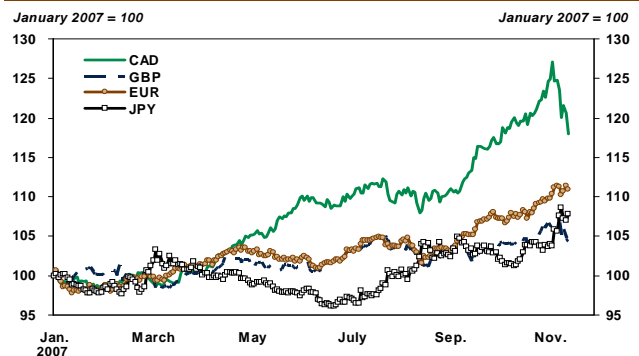
CONTENTS

Editorial	1
Euro	4
British pound	5
Yen	6
Canadian dollar	7
Australian dollar	8
Mexican peso	9
Chinese yuan	9
Technical analysis	10
Tables	12

Editorial

The U.S. dollar's downward trend continues to fuel debates on global imbalances. The subprime mortgage debacle has increased pessimism regarding the greenback, driving the effective exchange rate index for the U.S. dollar to an all-time low. The euro, as the world's second leading currency, and the Canadian dollar, fuelled by high oil prices, continue to pay the price (Graph 1). The euro has appreciated 6% in the last three months and 10% since the beginning of the year while the loonie has climbed 17% since January and 6.0% since August.

Graph 1 – The euro and loonie have absorbed most of the greenback's recent losses



Sources: Datastream and Desjardins, Economic Studies

NO CONSENSUS IN SIGHT

Under these conditions, and with the U.S. authorities showing little inclination to endorse their strong dollar policy, it comes as no surprise that dissatisfaction is on the rise. At the European Central Bank's last press conference (November 8, 2007), the president reiterated:

“...disorderly movements of exchange rates are undesirable for economic growth. This is true, now more than ever. In the recent period, we have observed moves that, I would say, were undoubtedly

François Dupuis
Vice-President and Chief Economist

Yves St-Maurice
Director and Deputy Chief Economist

Mathieu D'Anjou
Economist

Martin Lefebvre
Senior Economist

Hendrix Vachon
Economist

514-281-2336 or 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

IMPORTANT: This document is based on public information, obtained from sources that are deemed to be reliable. Desjardins Group in no way guarantees that the information is complete or accurate. The document is provided solely for information purposes and does not constitute an offer or solicitation for purchase or sale. The document may under no circumstances be construed as a commitment by Desjardins Group, which takes no responsibility for the consequences of any decision made based on the information herein. The prices and rates shown are for information purposes only as they may change at any time based on market conditions. Past returns are no guarantee of future performance, and Desjardins Group does not hereby purport to provide any investment advice. The opinions and forecasts contained herein are, unless otherwise indicated, those of the document's authors and do not represent the official position of Desjardins Group. Copyright © 2007, Desjardins Group. All rights reserved.

sharp and abrupt. And I have said already that brutal moves are never welcome.”

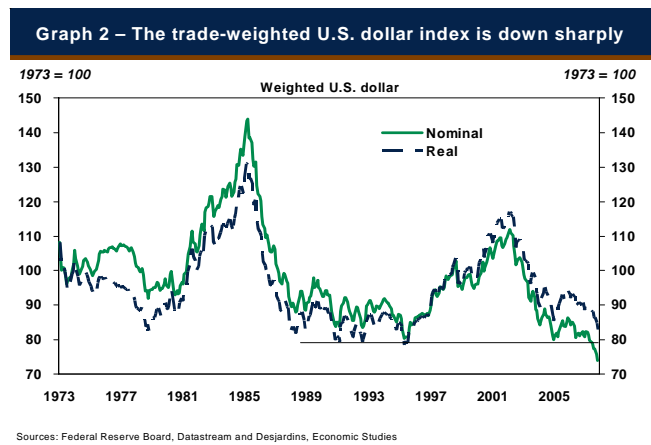
More recently, Paul Jenkins, the Bank of Canada’s Senior Deputy Governor, went one step further, stating:

“With the rapid and significant fall in the value of the U.S. dollar, there is increased risk of disorderly adjustment to global imbalances [...]. Given the recent, rapid rise of the Canadian dollar, Canada is bearing a disproportionate share of the adjustment [...] All this points to the heightened need for more exchange rate flexibility on the part of other countries, particularly China.”

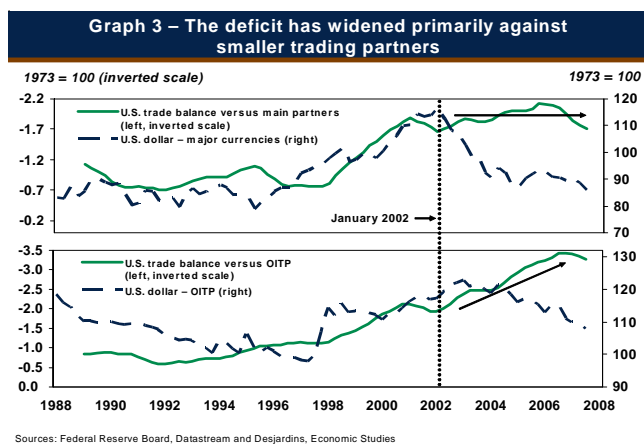
As such, the issue of global imbalances was on the agenda of the G20 meeting held on November 17 and 18 in Cape Town, South Africa. It was agreed that reforms to boost domestic demand in emerging Asia were required together with greater exchange rate flexibility in a number of surplus countries. However, with China at the table, no concrete action was taken.

CAN THE GREENBACK DROP ANY MORE?

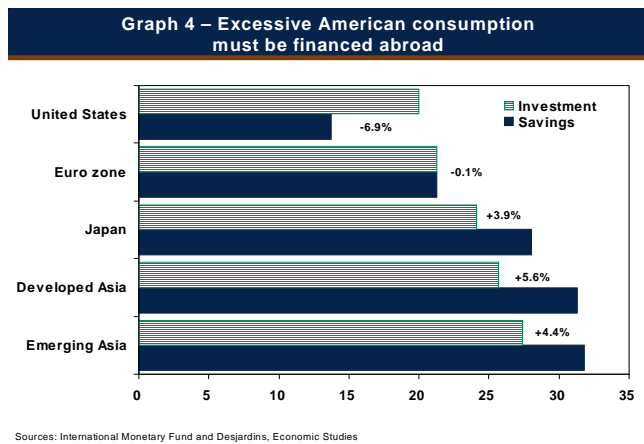
The U.S. trade-weighted index of the currencies of its main trading partners has fallen nearly 36% since its cyclical high in January 2002, to its lowest level in history. Taking inflation into account, the decline of the real U.S. dollar is similar at -30%, but the index remains slightly higher than in 1995 (Graph 2).



The problem is that the appreciation of the major currencies does little to relieve the global imbalances. This is because the U.S. current account deficit has deteriorated primarily against the country’s other trading partners. Moreover, the U.S. trade-weighted index of the currencies of other important trading partners (OITP) is only just starting to fall (Graph 3).



Essentially, this reflects, on the one hand, excessive U.S. consumer spending and its financing¹, and on the other, emerging Asia’s weak domestic demand and excessive saving (Graph 4). Consequently, in order to address global macroeconomic imbalances, Asian exchange rates need to be adjusted.

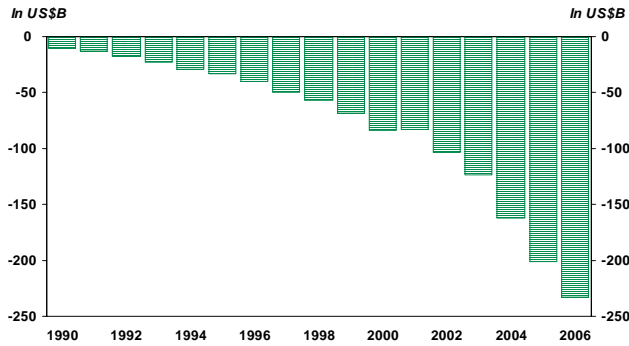


CHINA IS PART OF THE SOLUTION

The finger is clearly pointed at China. With economic growth in excess of 11.5%, massive net direct foreign investment inflows and astronomical trade surpluses with the most industrialized countries (Graph 5), it is becoming increasingly clear that the Chinese currency is undervalued. The imbalance is evidenced by the marked accumulation of currency reserves, which in September had surpassed US\$1.433 trillion.

¹ For more information on the current account imbalance see our *Economic Viewpoint*, “Will the U.S. dollar continue to plunge? The trend, causes and outlook...”, June 18, 2004.

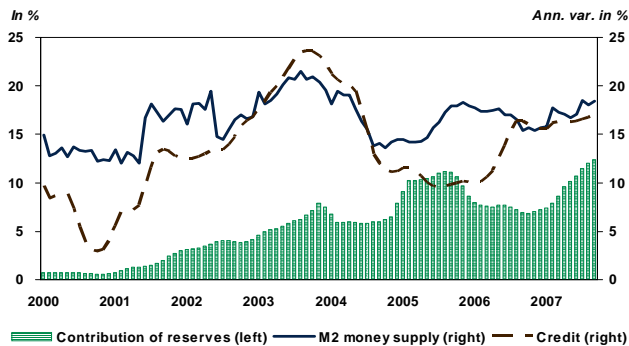
Graph 5 – U.S. trade deficit with China has clearly widened



Sources: Datastream and Desjardins, Economic Studies

We still think that the sharp accumulation of foreign currency reserves poses a real risk for Chinese inflation. The government’s sterilization policy, which involves sopping up the yuans put in circulation by issuing an equivalent number of bonds, has helped contain some of the pressures exerted on the money supply and on liquidity. However, at the rate China is accumulating currencies, the money supply will be difficult to control in the longer term (Graph 6).

Graph 6 –The contribution of reserves to credit growth is increasing



Sources: Datastream and Desjardins, Economic Studies

To counteract the inflation that could arise from the currency’s lack of flexibility, our base scenario anticipates an accelerated appreciation of the yuan by the end of 2008.

GREENBACK EXPECTED TO FALL AGAINST ASIAN CURRENCIES

The impact of the currency’s revaluation is already being felt. In the event of a floating Chinese exchange rate or an accelerated appreciation of the yuan, there will be less need to intervene to keep the other Asian currencies weak against the greenback. This will cause the OITP index to fall further, which will help to gradually reverse the global imbalances. It bears mentioning that the “Asia” bloc of the Fed’s U.S. dollar index accounts for nearly 30% of its total, with China alone

representing more than 15%. At the same time, lifting controls on Asian currencies will allow the yen to recoup some of the ground lost against the euro. However, this will happen in small steps. Thus, in the near term, the greenback is likely to stabilize against the other major currencies, but only through concerted efforts from the G20 nations.

François Dupuis
Vice-President and Chief Economist

Martin Lefebvre
Senior Economist

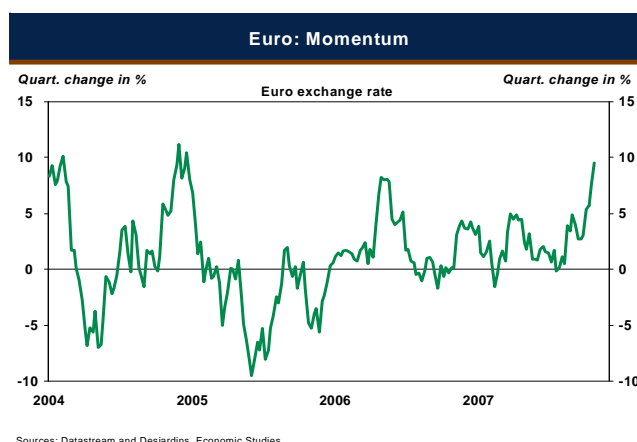
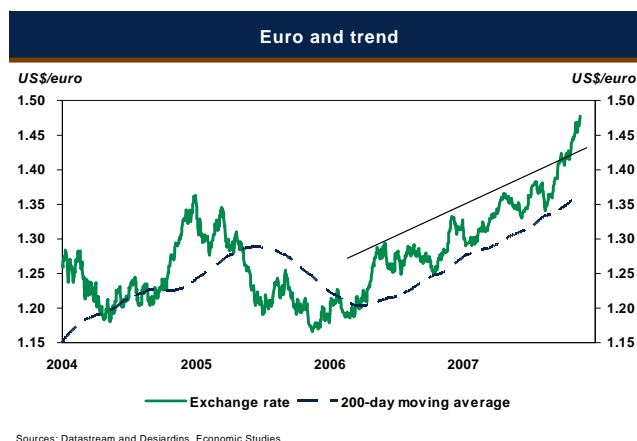
EURO (EUR)

The euro continues to rise

- The last few days have seen the euro continue its ascension, reaching a new high of US\$1.47 as the weak greenback played in its favour. Another rate cut announced by the Federal Reserve (Fed) at the end of October and a statement by a Chinese official that the government may diversify its massive foreign currency reserves further increased the euro's appeal. Unlike most of the other currencies, the euro has held up against the greenback in recent days despite growing investor fears. It looks like the euro is increasingly establishing itself as a safe haven currency.
- However, according to technical indicators, the euro is poised to fall. Notably, momentum increased following the latest appreciation, and although speculative positions have fallen slightly, they are still high. Still, in light of the many positive factors supporting the euro, a sharp correction is unlikely.
- In the short term, the context is very favourable for the euro. The European Central Bank (ECB) is still very concerned about inflation and has not yet ruled out an interest rate hike. That said, the status quo is the most likely scenario since signs of an economic slowdown are becoming more apparent. For its part, the Fed should continue easing rates in the coming months. The evolution of interest rates will therefore continue to favour the euro against the greenback.
- In the longer term, the euro could be headed towards a correction. The European economy is expected to slow next year, and foreign trade is particularly vulnerable since exporters will have to contend with a very strong euro and more moderate U.S. demand. This should convince the ECB to cut rates in the next few quarters. The economic context could then shift back in favour of the greenback as the Fed's preventive actions begin to bear fruit.

Forecasts

The euro should consolidate its recent gains and close the year above US\$1.45. However, it will likely fall back under US\$1.35 by the second half of 2008.



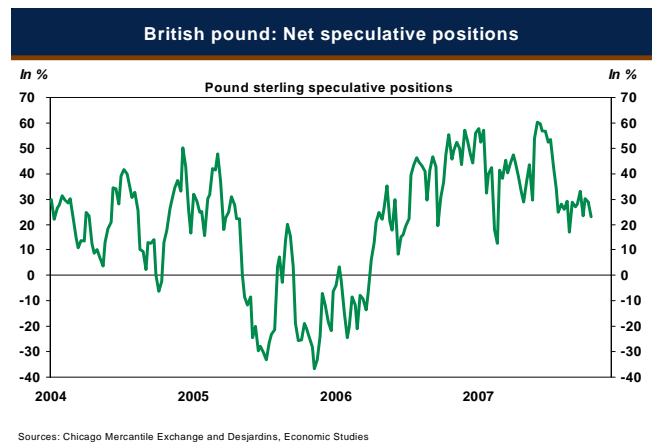
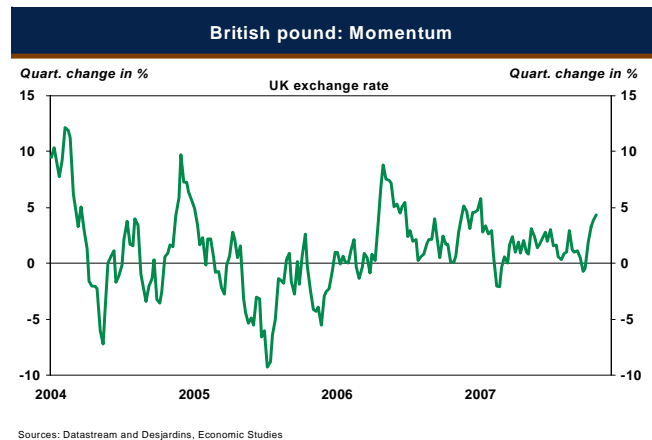
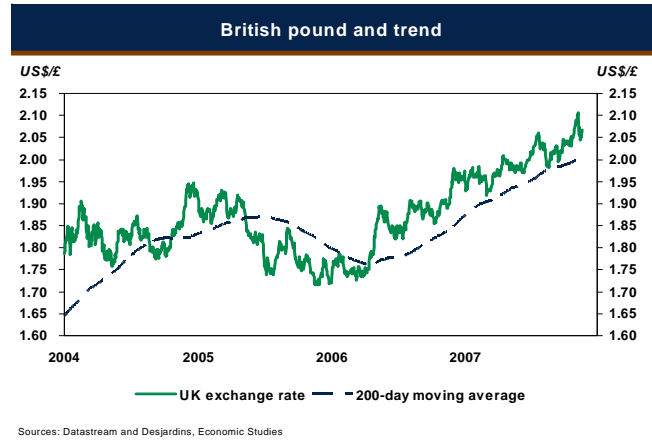
BRITISH POUND (GBP)

The pound could soon sink to a new low against the euro

- The greenback's broadbased weakness drove the pound sterling to nearly US\$2.11 in early November. However, it quickly fell back to US\$2.05 a few days ago as the U.S. dollar rebounded slightly and market expectations of rate cuts in the U.K. rose. This recent decline of the pound pushed the EURGBP above 0.71, or very close to its high of 0.725, reached in May 2003.
- According to market indicators, speculators are showing moderate interest in the pound sterling. The technical analysis is therefore not providing very clear signals about this currency.
- The short-term outlook for the pound is fairly neutral. Fuelled by consumer spending, real GDP growth in England was solid in the third quarter. This strong economic performance, combined with increased inflation risks as a result of higher commodity prices, prompted the Bank of England (BoE) to hold rates steady at its most recent meetings. Given the many uncertainties weighing on the global economy, the monetary authorities could well decide to stay the course in December.
- However, the BoE is realistic and expects a sharp economic slowdown in the coming quarters as the prior rate hike and tougher credit conditions following the liquidity crisis begin to take their toll on consumer spending and investment. In fact, retail sales already slipped in October. The BoE therefore believes that the balance of risks for growth is tilted to the downside and is neutral for inflation. We therefore expect two rate cuts in England by the middle of next year.

Forecasts

The pound should fall slightly against the dollar by year end and reach a new low against the euro. The depreciation against the dollar should continue next year but the correction will be less severe for the pound than for the euro.



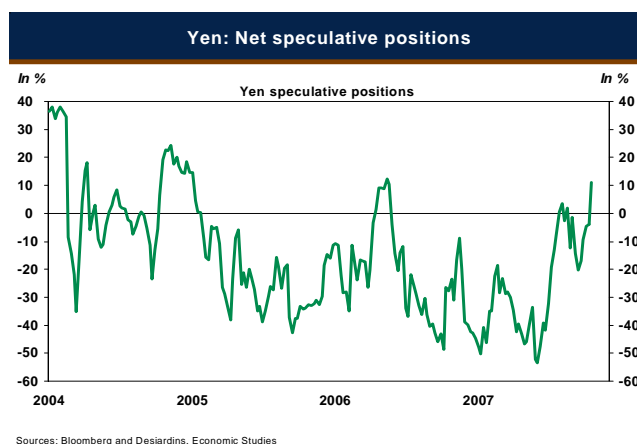
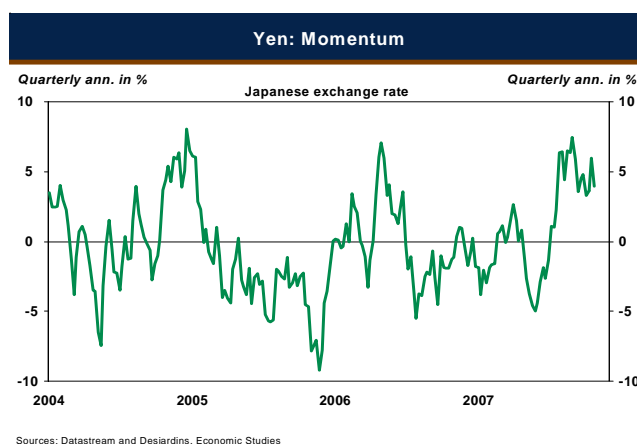
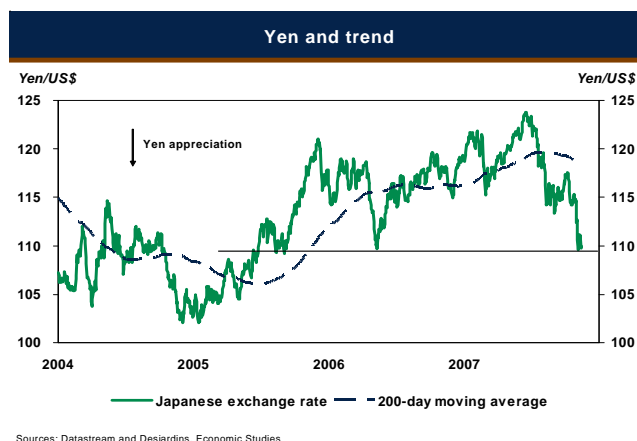
YEN (JPY)

Japan's slowing economy limits the yen's rise

- The lingering liquidity crisis and the resurgence of risk have led to an unwinding of carry trades and caused the yen to rise. Since its mid-June low, the yen has climbed more than 10% against the greenback and recently fell below 108 yens/US\$, its lowest level since June 2005.
- Despite its appreciation, the yen's structural weakness remains. Although real GDP rebounded in the third quarter, the growth outlook remains weak. Given the uncertain inflation situation, the Bank of Japan is quite unlikely to raise rates this year. This will limit the yen's rise notwithstanding the expected rate cuts in the United States.
- Consequently, the currency's appeal could be short lived. Investors' speculative positions are positive again and momentum has reached a level that typically signals an upcoming correction, and that has always been the case for the yen.
- In the second half of 2008, Japan's anticipated economic recovery and stronger signs of inflation will provide the central bank with the required leeway to raise interest rates, which by extension, will drive up the country's currency.
- Moreover, the fact that the Chinese currency is expected to appreciate more sharply in 2008 will make Japanese exporters more competitive, allowing the yen to gain in value.

Forecasts

Currency pressures are balanced in the near term. The Japanese exchange rate should remain in the vicinity of 112 yens/US\$ until the first quarter of 2008. However, should the situation deteriorate in the United States, the perceived increased risk could exacerbate the unwinding of carry trades and cause the yen to appreciate further.



CANADIAN DOLLAR (CAD)

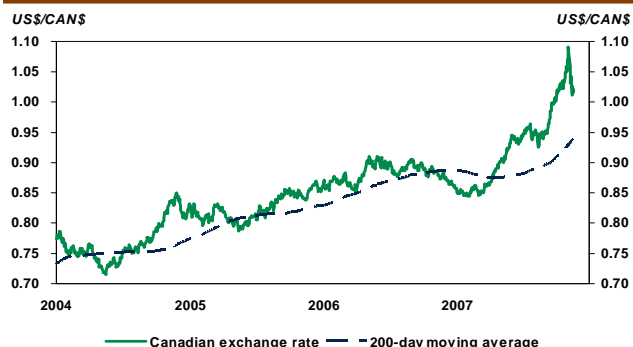
The loonie is on a roller coaster ride

- The last few weeks have been volatile for the Canadian dollar. First, it soared to new heights, easily flying past its 1957 record of US\$1.0614 and even briefly touching US\$1.10 in early November. However, it could not hang on to these gains and lost close to US\$0.09 in just seven days.
- From a technical perspective, the Canadian dollar was ripe for a correction. The loonie had been trading well above its long-term trend; net positions on non-commercial Canadian dollar contracts (a measure of market speculation) reached unparalleled levels, and the currency's movement exceeded levels consistent with a correction.
- The fundamentals remain positive on balance but we have every reason to believe that the currency will not continue to head in just one direction. Oil prices are still providing good support but unless the price of crude breaks US\$100 a barrel, the loonie is unlikely to recoup most of its recent losses.
- Moreover, it will be important to monitor the impact of the loonie's strength on the Canadian economy. The merchandise trade balance already deteriorated sharply in September and could have a very negative impact on third quarter growth. According to Paul Jenkins, the Bank of Canada's Senior Deputy Governor, "While domestic demand in Canada remains robust, if recent levels of the Canadian dollar were to persist, the risk is that output and inflation would be significantly lower."
- These events prompted the markets to change their interest rate expectations, and the probability of a rate cut is growing. The unexpected slowdown in inflation has given the Bank of Canada greater leeway. However, at 2.4%, it is still hovering in the upper limit of the Bank's target range, meaning the monetary authorities may decide to wait until early next year before easing rates.

Forecasts

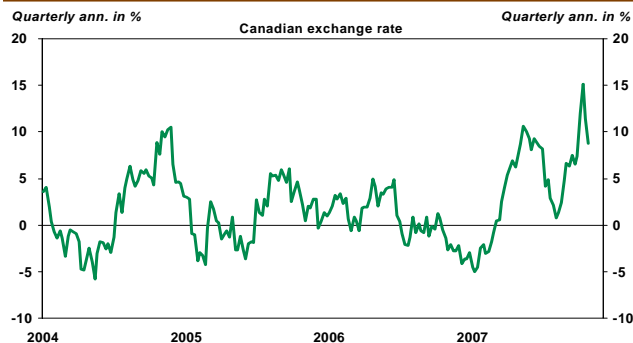
The loonie will remain highly volatile. The markets' changing perception of the Canadian economy has put the brakes on the loonie's frenetic ascent. However, unless the Bank of Canada radically changes its tone, high oil prices should push the loonie to close the year at US\$1.04.

Canadian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: Momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: Net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

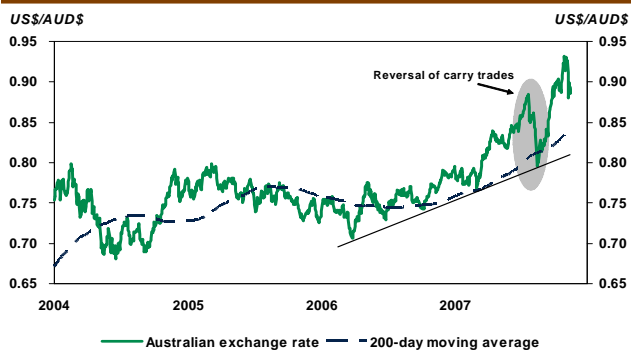
The Australian dollar is penalized by risk aversion

- After reaching a cyclical high of US\$0.9313 on November 6, a new unwinding of carry trades caused by the resurgence of risk on the markets drove the dollar down. However, this reversal (-5.5%) is not as serious as the one recorded in August (-10.1%) at the outset of the liquidity crisis.
- The momentum and net positions on non-commercial Australian dollar contracts augur well for a potential reversal in the currency's direction. These two indicators are now down, reducing the odds of a further depreciation.
- The fundamentals remain positive. The Australian economy is robust thanks to the country's proximity to China and its strong demand for commodities. However, inflationary risks are to the upside and the Australian Central Bank, despite the difficulties of the global financial markets, did not hesitate to increase the benchmark interest rate at the beginning of the month. Although the higher exchange rate will help contain inflation, we still expect one or two more rate hikes to help support the Australian dollar on the markets.
- It bears mentioning that general elections are scheduled for November 24. According to recent polls, the opposition will take power. However, no major changes in governance are expected and as such, the markets should remain calm.

Forecasts

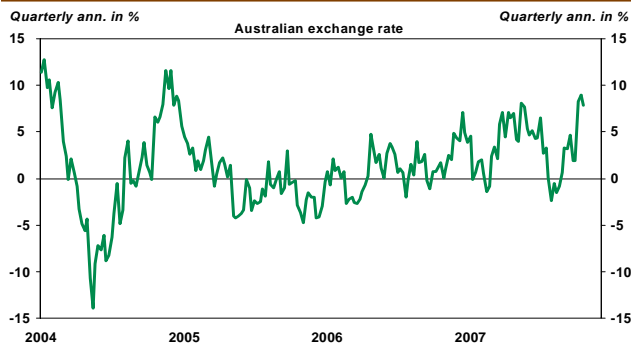
Despite the unwinding of carry trades, the further monetary tightening and strong Chinese demand for Australian commodities will keep the exchange rate at about US\$0.92/AUS\$.

Australian dollar and trend



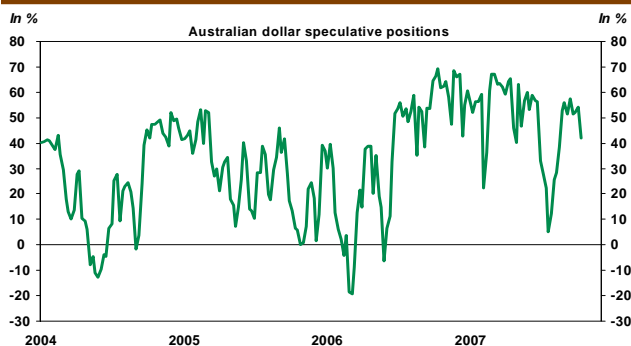
Sources: Datastream and Desjardins, Economic Studies

Australian dollar: Momentum



Sources: Datastream and Desjardins, Economic Studies

Australian dollar: Net speculative positions

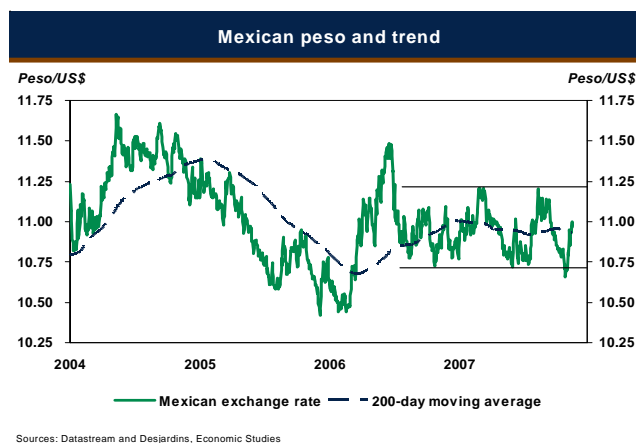


Sources: Datastream and Desjardins, Economic Studies

MEXICAN PESO (MXN)

The peso has started to slide

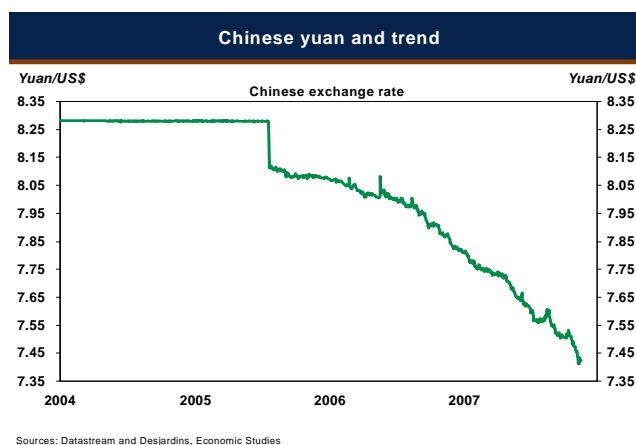
- At the end of October, the Mexican peso rose to 10.656 pesos/US\$, its highest level since March 2006. Last month, inflation caused the Central Bank to hike its key rate to 7.50%. However, the increase was short lived, with market fears of a slowdown in the United States driving the peso back down to about 11.00.
- Economic growth picked up to 3.7% in the third quarter, but Mexico's heavy dependence on its northern neighbour leads us to believe that growth will be limited at year end and next year. This is because many Mexican construction workers who benefited from the U.S. real estate boom are now without jobs. Moreover, Mexican exports will be affected by the current U.S. economic downturn.



CHINESE YUAN (RMB)

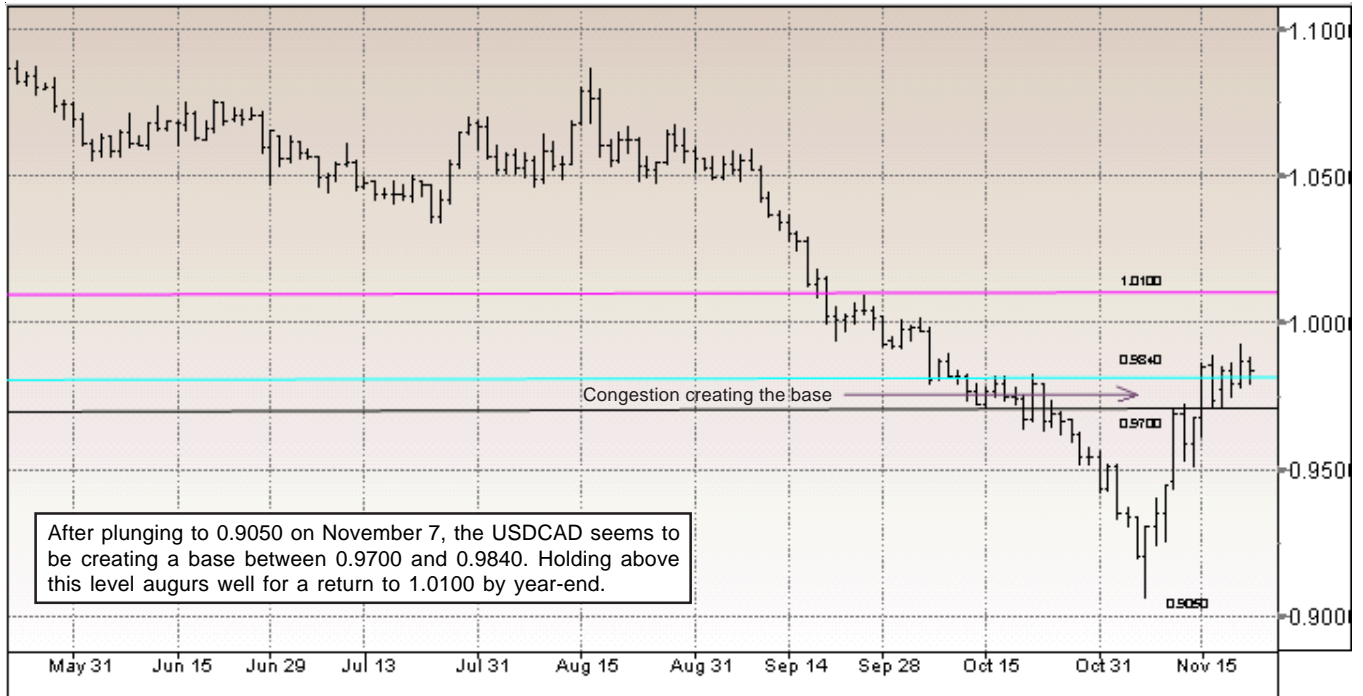
The yuan's sharp ascent continues in November

- The yuan has been gaining momentum against the greenback for some time now. The currency rose half a percent against the U.S. dollar in October and is expected to pick up more than one percent in November. Still, given the broadbased weakness of the dollar, the yuan's value remains high against the other major currencies.
- International pressures to make the yuan more flexible have increased lately. Recent data on the Chinese trade surplus show a new high of US\$27 billion in October, an increase of 13.5% over last year. There is therefore still plenty of room for the yuan to appreciate.
- As such, it should increase further to close the year at close to 7.30 yuan/US\$. We believe the People's Bank of China will have no choice but to let its currency float by the end of 2008. However, the transition may be less disruptive since the pace of the adjustments are picking up.



TECHNICAL ANALYSIS

USDCAD



EURUSD

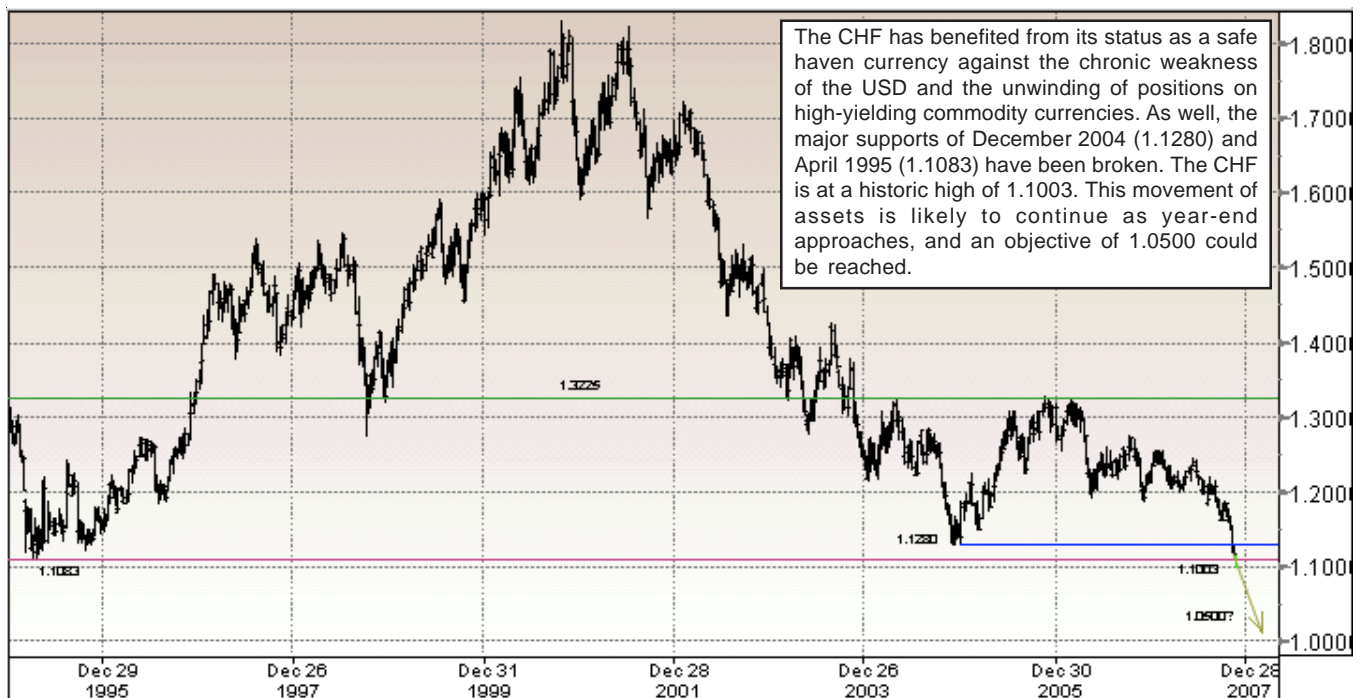


TECHNICAL ANALYSIS

USDJPY



USDCHF



Currency markets

Country – Currency*	Spot price		Previous data			Last 52 weeks		
	Nov. 21	-1 month	-3 months	-6 months	-1 year	Higher	Average	Lower
North America								
Canada – dollar	0.9903	0.9647	1.0588	1.0843	1.1486	1.1860	1.0901	0.9161
Canada – (CADUSD)	1.0098	1.0366	0.9445	0.9223	0.8707	0.8432	0.9174	1.0916
Mexico – peso	11.0161	10.8027	11.1251	10.7996	11.0062	11.2456	10.9292	10.6680
South America								
Argentina – peso	3.1383	3.1638	3.1588	3.0763	3.0788	3.1838	3.1070	3.0488
Brazil – real	1.7911	1.8003	2.0359	1.9454	2.1662	2.1834	1.9875	1.7318
Asia								
China – yuan renminbi	7.4120	7.5093	7.5910	7.6650	7.8730	7.8730	7.6574	7.4120
Hong Kong – dollar	928.95	915.85	944.25	930.50	935.40	951.40	928.77	900.70
India – rupee	7.7799	7.7513	7.8054	7.8217	7.7861	7.8299	7.7999	7.7507
Japan – yen	39.2755	39.5205	41.0255	40.4255	44.7905	45.0295	41.7671	39.0755
South Korea – won	108.57	114.52	114.26	121.51	117.84	123.82	118.34	108.57
Europe								
Denmark – krona	5.0210	5.2122	5.5282	5.5359	5.8030	5.8030	5.5036	5.0210
Euro zone – US\$/€	5.4103	5.3549	5.9594	6.0613	6.4268	6.4856	5.9384	5.2714
Norway – kroner	2.0551	2.0464	1.9833	1.9694	1.8993	2.1082	1.9936	1.8993
Russia – ruble	24.3402	24.8683	25.8757	25.8795	26.6527	26.6527	25.7675	24.3402
Sweden – krona	6.2794	6.4123	6.9728	6.8569	7.0941	7.1091	6.8034	6.2628
Switzerland – swiss franc	1.1044	1.1723	1.2033	1.2305	1.2412	1.2546	1.2084	1.1044
United Kingdom – US\$/£	1.4823	1.4251	1.3489	1.3458	1.2827	1.4823	1.3550	1.2827
South Pacific								
Australia – (USDAUD)	1.1474	1.1210	1.2504	1.2177	1.2968	1.3013	1.2091	1.0733
New Zealand – (USDNZD)	1.3296	1.3367	1.4376	1.3697	1.4921	1.4954	1.3768	1.2415

* In comparison with the U.S. dollar, unless otherwise indicated.

Note: Currency table base on previous day closure.

Currency markets: History and forecasts

End of period	2006		2007				2008			
	Q3	Q4	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f
American dollar										
Canadian dollar (USDCAD)	1.1179	1.1654	1.1535	1.0651	0.9944	0.9615	1.0000	1.0204	1.0000	0.9756
Euro (EURUSD)	1.2667	1.3186	1.3311	1.3506	1.4222	1.4700	1.4200	1.3600	1.3200	1.3100
British pound (GBPUSD)	1.8723	1.9589	1.9673	2.0080	2.0471	2.0200	2.0000	1.9800	1.9500	1.9300
Yen (USDJPY)	118.03	119.03	117.67	123.20	114.80	112.00	110.00	110.00	108.00	106.00
Australian dollar (AUDUSD)	0.7461	0.7889	0.8090	0.8503	0.8885	0.9200	0.9200	0.9400	0.9200	0.9200
Mexican peso (USDMXN)	10.99	10.80	11.04	10.81	10.94	10.75	10.90	11.00	11.25	11.35
Chinese yuan (USD RMB)	7.91	7.81	7.73	7.61	7.51	7.40	7.29	7.18	7.00	6.00
Effective dollar* (73 = 100)	81.83	81.41	80.53	78.65	74.38	74.23	73.57	72.91	72.26	72.00
Canadian dollar										
American dollar (CADUSD)	0.8945	0.8581	0.8669	0.9389	1.0056	1.0400	1.0000	0.9800	1.0000	1.0250
Euro (EURCAD)	1.4161	1.5367	1.5355	1.4385	1.4143	1.4135	1.4200	1.3878	1.3200	1.2780
British pound (GBPCAD)	2.0931	2.2828	2.2694	2.1387	2.0357	1.9423	2.0000	2.0204	1.9500	1.8829
Yen (CADJPY)	105.58	102.14	102.01	115.67	115.44	116.48	110.00	107.80	108.00	108.65
Australian dollar (AUDCAD)	0.8341	0.9194	0.9332	0.9056	0.8836	0.8846	0.9200	0.9592	0.9200	0.8976
Mexican peso (CADMXN)	9.83	9.27	9.57	10.15	11.00	11.18	10.90	10.78	11.25	11.63
Chinese yuan (CAD RMB)	7.08	6.70	6.70	7.15	7.55	7.70	7.29	7.04	7.00	6.15

f: forecasts

* Trade-weighted against major U.S. partners.

Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies