

Is the greenback's spectacular comeback sustainable?

HIGHLIGHTS

- Change in perception overseas drives greenback up, but conditions are still not in place for a sustainable upward trend.
- Euro falls too fast.
- Pound sterling falls to a two-year low against the greenback.
- Poor economic data weigh heavily on the yen.
- Canadian dollar short on support, but a comeback is still possible.
- Australian dollar's correction keeps pace with commodity prices.
- Mexican peso gains from interest rate hikes.
- Yuan's appreciation held back by greenback's resurgence.

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Editorial

The trade-weighted U.S. dollar index made a spectacular comeback in mid-August (graph 1). While the end of the greenback's decline had been widely anticipated for some time, last week's gains were unexpected. Although the U.S. dollar may well continue to rise in the short term, the speed of the turnaround as well as the magnitude of the recent upward correction is cause for caution.

Graph 1 – Greenback surges against major currencies



Sources: Datastream and Desjardins, Economic Studies

PERCEPTION CHANGES OVERSEAS

The greenback's quick surge is explained by a big change in growth expectations overseas. Everyone now agrees that the effects of the subprime mortgage crisis and the U.S. economic slowdown have spread to all the industrialized nations. As such, the theory of global decoupling is finding fewer takers. Given that the Federal Reserve (Fed) has already taken the lead by easing its monetary policy, any action taken by the other major central banks aimed at revitalizing their economies will reduce interest rate spreads.

In the euro zone, after an annualized gain of 2.9% in the first quarter, real GDP fell 0.8% in Q2, signalling the possibility of a recession. The president of the European Central Bank

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(ECB) even hinted that the Bank would probably cut its growth forecasts for 2008. Therefore, despite the hawkish tone of Euroland’s monetary policymakers, the odds of another rate hike by year-end are now nil. The markets reacted strongly, pushing the euro down almost 8% against the greenback in just one month, marking the end of the upward trend observed since January 2006 (graph 2).

Graph 2 – End of euro’s upward trend

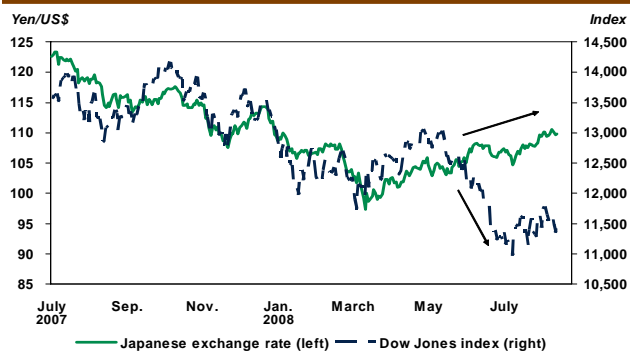


Sources: Datastream and Desjardins, Economic Studies

The story is much the same for the United Kingdom where signs of stagflation abound. The last report on inflation delivered a heavy blow to the pound sterling as the Bank of England revised its inflation forecasts upward and economic growth projections downward. The sinking housing market is taking a growing toll on the economy. Retail sales fell 4.3% in June, creating an unfavourable base effect, and consumer spending is expected to be weak in the third quarter.

While inflation is clearly less of a threat in Japan, the country is nevertheless feeling the fallout of the U.S. and Chinese slowdown. For the yen, the economy’s structural weakness is now front and centre, leaving little room for the reassessment of risk caused by the credit crisis (graph 3).

Graph 3 – Yen continues to weaken despite sluggish financial markets

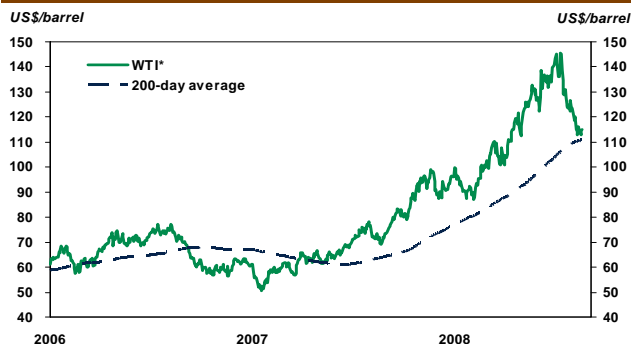


Sources: Datastream and Desjardins, Economic Studies

COMMODITY PRICES TUMBLE

At the same time, softening global demand, together with the greenback’s appreciation, has had an impact on commodity prices. From a record US\$149 in mid-July, oil prices fell 25% to below US\$115 in just one month (graph 4). Natural gas prices fell even more sharply (-40%) while base metal and gold prices were not spared.

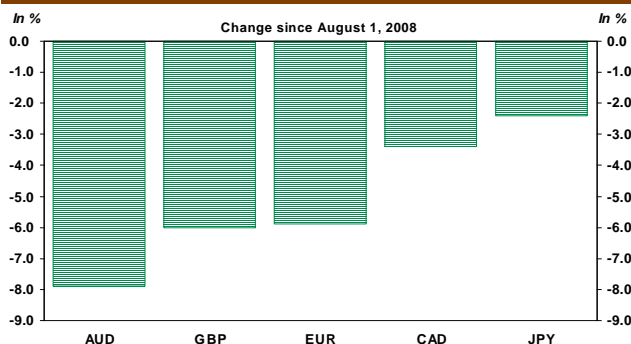
Graph 4 – Oil prices fell sharply in the last few weeks



* West Texas Intermediate.
Sources: Datastream and Desjardins, Economic Studies

Consequently, the greenback didn’t just gain ground against the major currencies as commodity-driven currencies also fell sharply during the period (graph 5).

Graph 5 – Commodity-driven currencies also fell



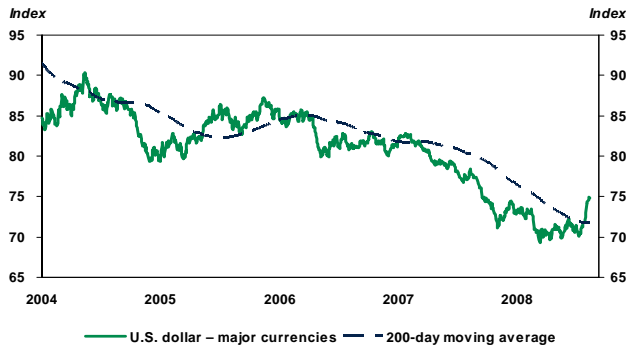
Sources: International Energy Agency and Desjardins, Economic Studies

NO SUSTAINABLE INCREASE IN SIGHT FOR THE GREENBACK

The change in investors’ perception suggests that there could be continued upward pressure on the greenback. However, the magnitude of the recent adjustments, coupled with fundamental and technical factors, all point to a possible decline in the near term. As such, we foresee a period of stabilization for the U.S. dollar rather than the beginning of a new upward trend.

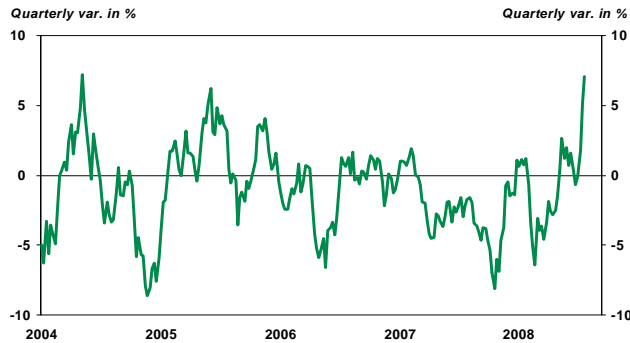
On the technical level, the significant upward break confirms that the downward trend of the USD Index is over. However, the momentum and speculative positions on the currency have exploded to levels that in the past have always coincided with a correction (graphs 6 to 8).

Graph 6 – The upward break signals a trend reversal for the greenback



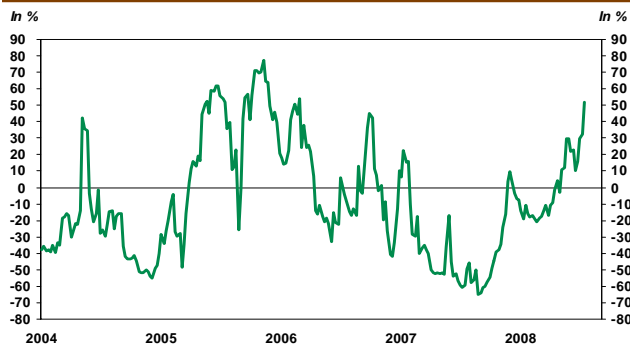
Sources: Datastream and Desjardins, Economic Studies

Graph 7 – But the momentum level is consistent with a correction...



Sources: Datastream and Desjardins, Economic Studies

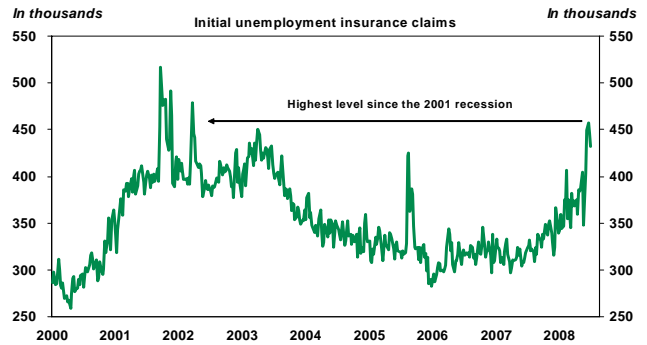
Graph 8 – ...like the net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

Moreover, the American economy remains fundamentally weak. The tax rebates helped stave off the worst in the spring and in July, but consumer spending, at a time when household confidence is almost at an all-time low, should slow in the second half of the year and into the beginning of 2009. This is all the more likely given the visibly deteriorating labour market. Already, between January and July, the net job losses amounted to 463,000, and the number of unemployment insurance claims rose to 450,000 in the last few weeks (graph 9), signalling more cuts in August.

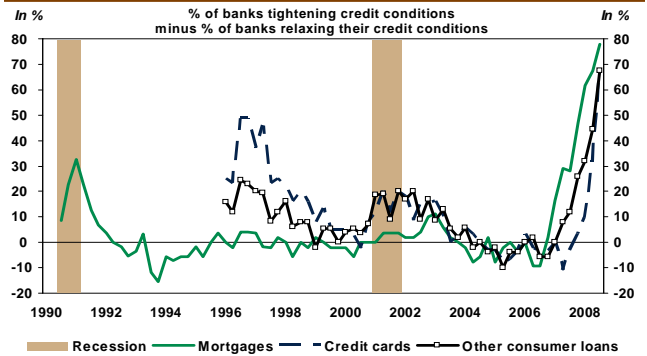
Graph 9 – Number of initial unemployment insurance claims on the rise



Sources: Bloomberg and Desjardins, Economic Studies

Moreover, the Fed's July Senior Loan Officers Opinion Survey shows that commercial banks have continued to tighten lending conditions (graph 10). As such the housing market has not yet stabilized, and it looks like the government will have to intervene to recapitalize the country's two biggest mortgage lenders (Freddie Mac and Fannie Mae).

Graph 10 – Credit conditions are increasingly difficult for households



Sources: Federal Reserve Board and Desjardins, Economic Studies

With the ECB still closed to the idea of cutting rates and with few indications that the U.S. economy is on sufficiently solid ground to start tightening its monetary policy this year, the conditions are simply not in place for the greenback to stage a sustainable rebound in the coming months.

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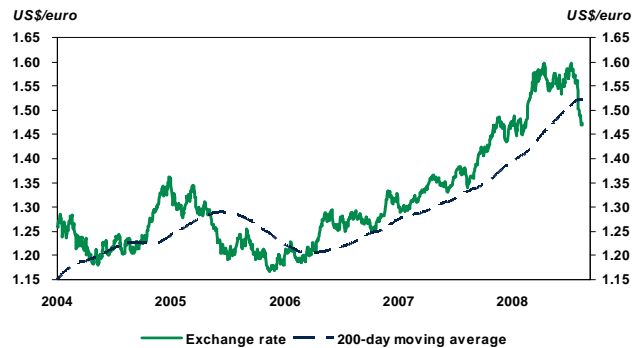
EURO (EUR)

Euro falls too fast

- The last few weeks have been tough on the euro, which lost about 8%, falling from US\$1.597 in mid-July to nearly US\$1.450 as Europe's economic outlook darkened. While we still think that the euro is on a negative trend in the medium term, the speed of the recent fall means that it will probably rebound briefly.
- Market indicators confirm this possibility. Net speculative positions are extremely negative, reflecting strong investor pessimism regarding the euro. The currency's momentum is in very negative territory as the currency continues to slide below its 200-day moving average.
- The euro's recent fall is mainly due to deterioration in its fundamental determinants. After a surprisingly robust first quarter, the euro economy contracted from April to June, and the latest statistics point to more of the same in the third quarter. Economic indicators show that output fell further in July while household and business confidence indexes continued to fall. The hope that the Euroland economy would not suffer unduly from the slowdown plaguing other parts of the world has therefore vanished.
- Changes in monetary policy expectations have played against the euro and even the European Central Bank (ECB) cannot ignore the weakening economic outlook. While it is still very concerned about inflation, which remained unchanged at 4% in July, the ECB softened its tone somewhat at its August meeting and no longer seems to be contemplating additional rate hikes.
- Economic conditions in the euro zone will not help its currency in the medium term. Unlike the U.S., its economy does not benefit from strong monetary and tax incentives and will have to face the slowdown with a strong currency. The slump could therefore last several quarters which, combined with lower commodity prices, should convince the ECB to ease its monetary policy next year.

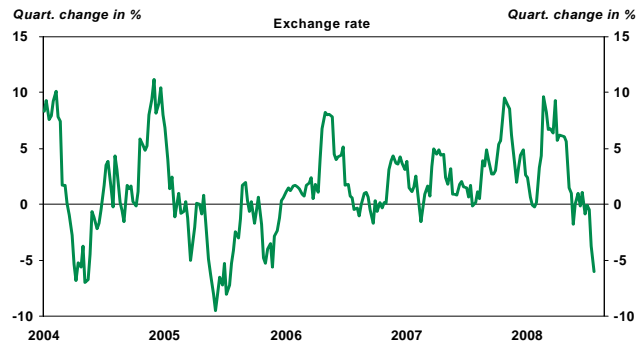
Forecast: In the near term, technical factors and a likely decline in investor optimism for the greenback should help prop the euro back to about US\$1.50. After consolidating for a few months at this level, the euro should resume a consistent downward trend once the ECB opens the door to monetary easing. We therefore suggest waiting for the EUR/USD pair to bounce back to over US\$1.50 before increasing short positions.

Euro and trend



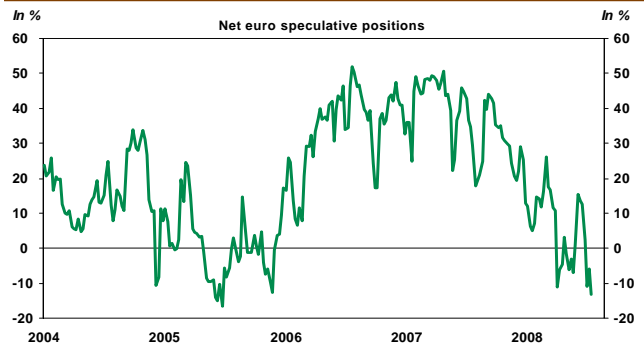
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



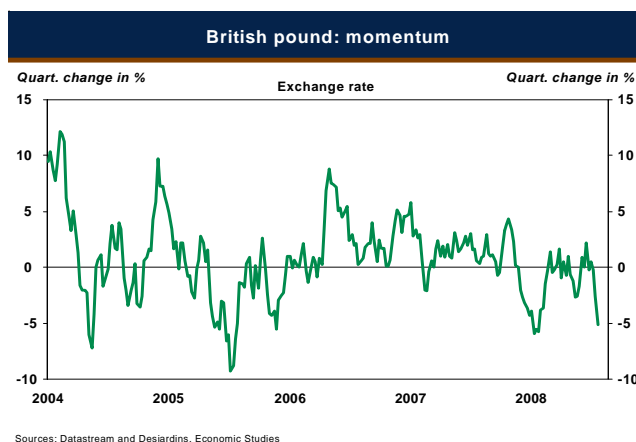
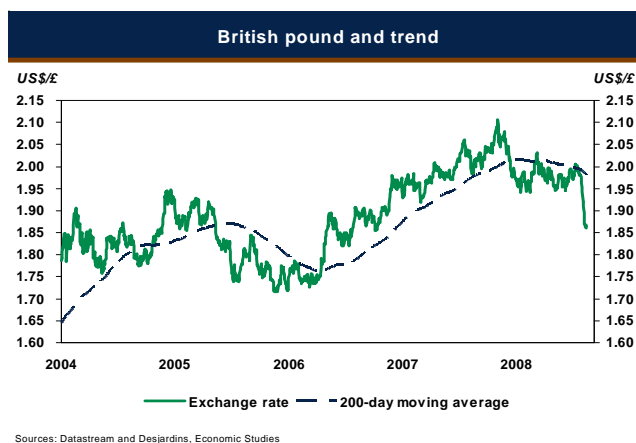
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

Pound sterling falls to a two-year low against the greenback

- The pound sterling fell against the greenback in recent weeks as concerns grew about the British economy. The cable rate thus fell from just over US\$2 in mid-July to US\$1.8513, its lowest level since July 2006. Historically, the pound remains very weak against the euro while the EUR/GBP pair is hovering at 0.79.
- On a market basis, the pound seems ripe for a comeback, or at least stabilization in the short term. Speculative positions are extremely negative and the pound is a far cry from its 200-day average, two signs that its decline should soon come to an end. The fundamental determinants are, however, less encouraging.
- Just as in the euro zone, the darkening economic outlook and change in market expectations regarding monetary policy are behind the pound's recent correction. In its latest quarterly report on inflation, the Bank of England (BoE) painted a very bleak picture of the British economy. After zero growth in the second quarter, the BoE is predicting that real GDP will continue to stagnate over the next year, and the risks in this regard are tilted to the downside. The British economy definitely appears to be on the verge of a recession as the housing market continues to drop.
- At first blush, the price situation appears to be just as worrisome. Annual inflation rose to 4.4% in July and could soon hit 5%. The British economy therefore appears to be a perfect example of stagflation, i.e. economic stagnation accompanied by high inflation. However, the decline in commodity prices and the fact that the effect of high energy prices has not spread to wages leads us to believe that inflationary pressures could ease very soon. Consequently, the BoE should focus more on economic risks and resume easing monetary policy before year-end.

Forecast: Because of the pound's steep decline, we can now expect a consolidation period between US\$1.85 and US\$1.90. A technical recovery would be a good opportunity to take short positions against the greenback and the euro, because the pound will then very likely resume its downward trend. In fact, the BoE is expected to be one of the first central banks to begin easing its monetary policy and it may have to cut rates aggressively to help lift the economy out of the recession.

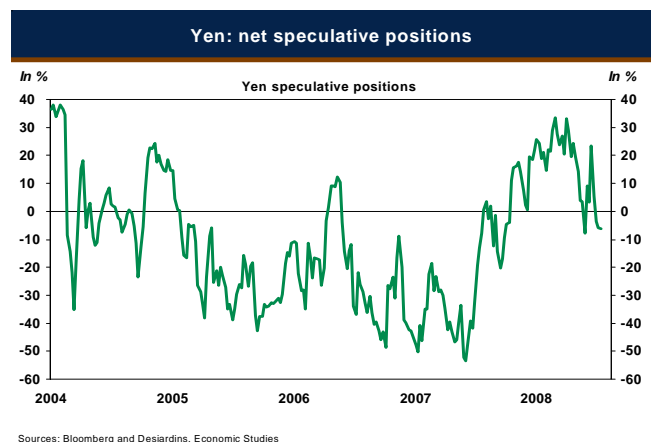
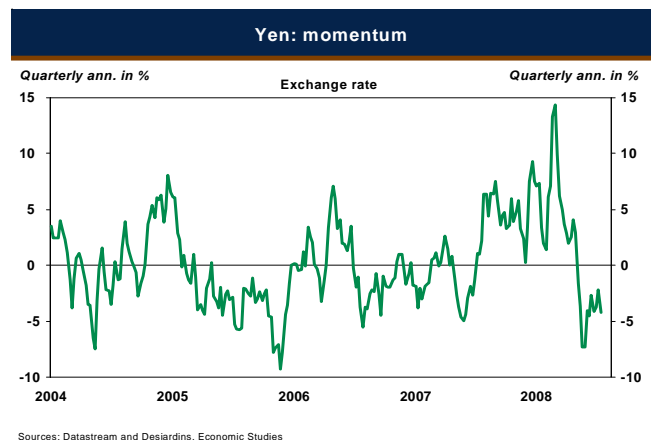
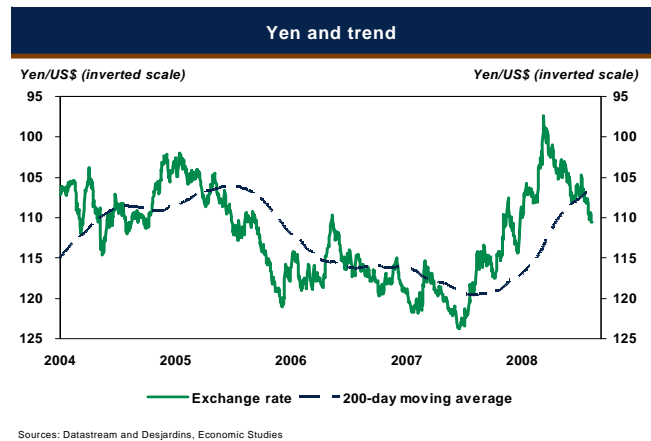


YEN (JPY)

Poor economic data weigh heavily on the yen

- Bad economic news continues to plague Japan, taking a toll on the yen. The exchange rate reached a cyclical high of 110.67 yens/US\$ on August 15. The Japanese currency was also not spared from the effects of the resurging greenback. Although the drop in the price of oil and other commodities may breathe a bit of life into the Japanese economy, exports will be hard hit by the economic slowdown taking hold in many other industrialized countries.
- On a market basis, the yen appears to have solidly embarked on a downward trend after falling below its 200-day moving average. The yen's momentum has been extremely negative lately and net speculative positions are down, signalling a loss of interest in the currency. However, these positions could rebound in the near term, pushing up the yen.
- Monetary policy will have little impact on the yen in the coming months. The Bank of Japan is expected to stay pat until year-end despite rising inflation since the beginning of the year. Annual inflation was 2% in June, but only 0.1% if energy and fresh food are excluded. Therefore, inflation is no cause for concern for the moment, particularly since wages are growing less rapidly than at the beginning of the year and, with unemployment rising, the labour market appears to be slowly losing steam.
- Weak output indicators increasingly point to a recession. According to the second quarter national account results, real GDP fell an annualized 2.4% quarter over quarter. Consumption and investment both declined, and exports made their weakest contribution to growth in two years. This sluggishness is expected to continue. Still high energy prices and the fact that many other economies are struggling do not bode well for Japan's economic outlook. The Tankan index, which measures sentiment as regards capital and machinery investments, slipped again, as did small business and consumer confidence.

Forecast: Overall, bad economic news will continue to drag down the yen, which may stabilize for a while at around 110 yens/US\$ and possibly rebound in the near term if the greenback undergoes a correction. In such a case, it would be a good time to sell.

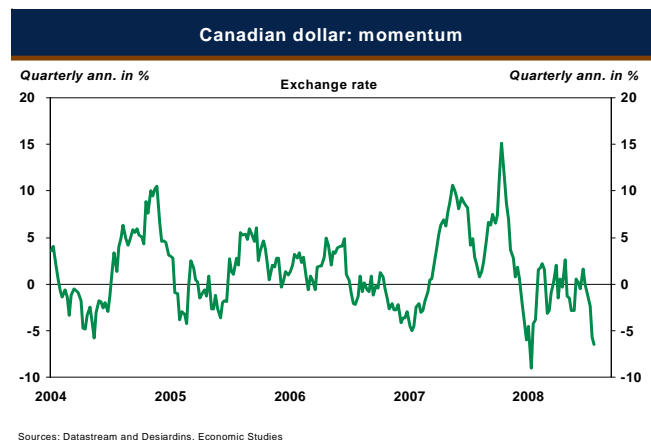
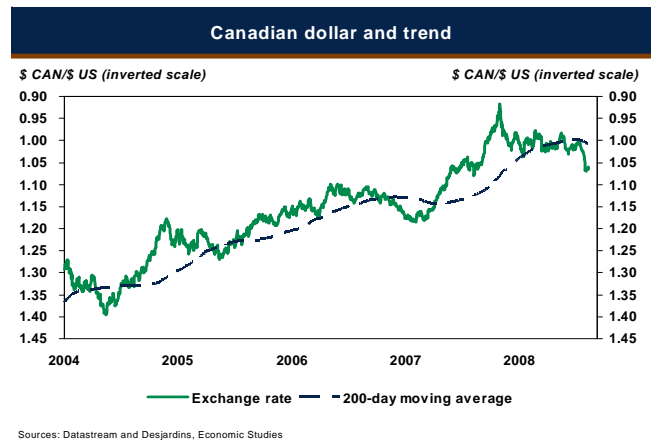


CANADIAN DOLLAR (CAD)

Dollar short on support, but a comeback is still possible

- The loonie was hard hit by the greenback's broad-based appreciation against the major currencies, the drop in commodity prices and the weakening Canadian job market. After remaining in the C\$0.98 to C\$1.03 range since the beginning of the year, downward pressure increased, propelling the USD/CAD to a high of C\$1.0728 on August 12. Since then, the loonie has been inching up slightly.
- On a market basis, the recent correction has driven the Canadian dollar sufficiently below its long-term trend to levels that in recent years have been consistent with a rebound. However, the fundamentals are not yet in place to justify a significant appreciation. Moreover, the momentum and speculative positions on the currency are still not sufficiently in negative territory to create investment opportunities on a contrarian view.
- In the short term, we foresee a period of stabilization for the Canadian dollar. The weakening employment situation has the financial markets once again banking on interest rate cuts by year-end; however, we rather foresee a period of monetary stability. While the economy will definitely slow, we should be able to sidestep a recession. With inflation expected to remain above the Bank of Canada's upper target until early next year, the monetary authorities will prefer to play it safe by holding rates steady in the coming months.
- However, we are more optimistic down the road. The housing market seems to be flattening, but there is no risk of a crash like in the U.S. Moreover, while the nearly 25% correction in the price of crude partially explains the recent direction of the loonie, it is possible that oil prices, now more in line with their equilibrium level, will re-establish the historical connection between oil prices and the Canadian currency. At US\$115 per barrel, the loonie is currently heavily undervalued.

Forecast: In the short term, the loonie's value will depend on the impact of the U.S. slowdown on the Canadian economy, on demand for commodities, on interest rate expectations and market reaction to a sustained appreciation in the greenback. In our opinion, the loonie should stabilize at around its current levels in the months ahead. For the longer term, however, we remain optimistic and still recommend buying the currency on weakness.

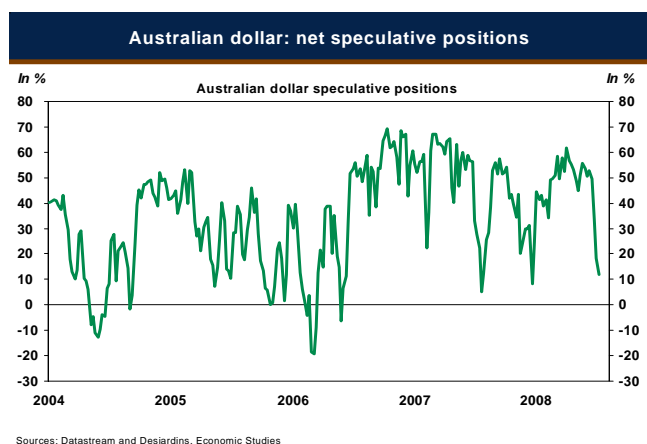
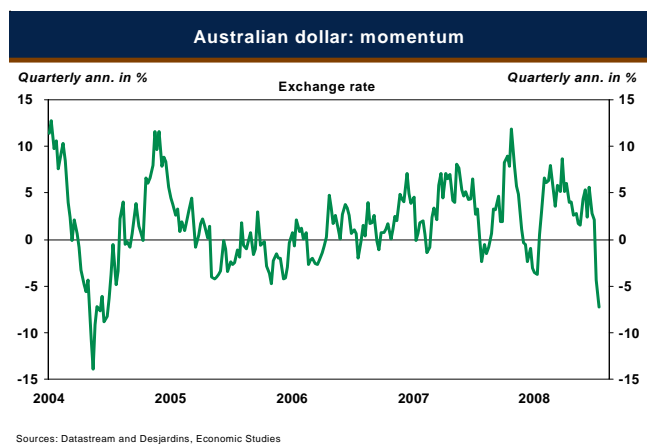
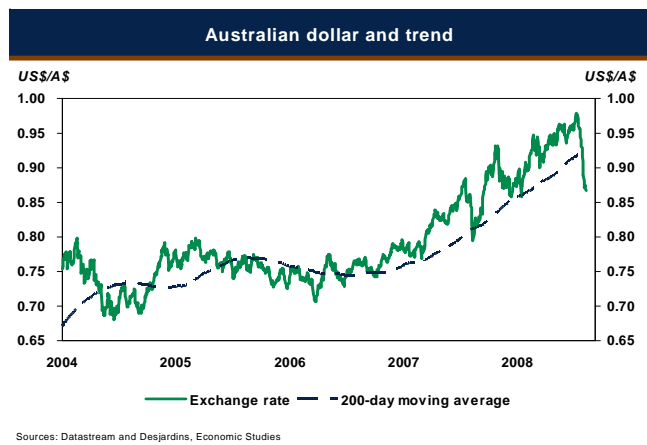


AUSTRALIAN DOLLAR (AUD)

Australian dollar's correction keeps pace with commodity prices

- The anticipated period of stability for the Australian dollar has been cut short due to the price corrections on several commodity markets, including gold. The resurgence of the greenback as well as the more dovish than expected tone of the Reserve Bank of Australia has also set back the Australian dollar, which had reached a peak of US\$0.9849 on July 15 before falling back to US\$0.8593 on August 12.
- The Australian dollar's correction was quite steep, but the market may have overreacted. Momentum is at historically low levels and consistent with a correction. Net speculative positions have declined sharply and could rebound.
- Hitting 4.5% in the second quarter, inflation remains a concern in Australia. However, although the monetary authorities expect it to remain high until year-end, they are confident that it will fall back in 2009, and return towards its target in 2010.
- The Australian central bank's tone is now clearly dovish. The August 5 board meeting minutes indicate that a rate cut may be forthcoming to ease tough credit conditions and by extension, reduce the risks of a severe, protracted slowdown. Following the example of the central bank of New Zealand, which has already embarked on a rate cutting cycle, Australia's monetary authorities may follow suit at their next meeting on September 2. In this context, carry trades in Australian dollars with loans in yens are now much riskier. In fact, the Australian currency has lost ground against the yen.
- Previous interest rate hikes seemed to have had their effect as mortgage and investment loans have decreased of late. Consumer and business confidence is down, and signs of a weakening labour market have also emerged. The Australian economy and its currency have benefited from the increase in the terms of trade due to high commodity prices. However, price corrections since mid-July have driven down the currency and are now limiting income growth.

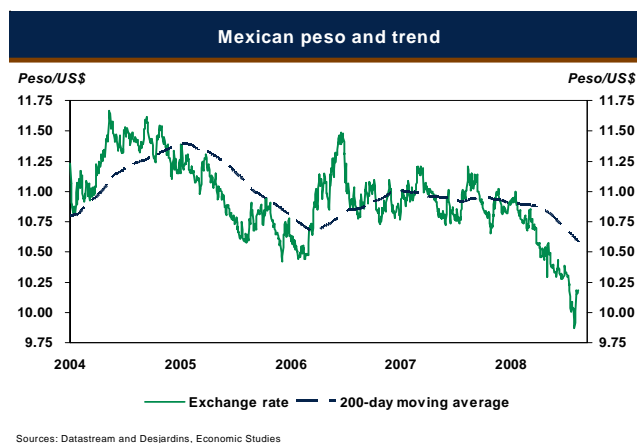
Forecast: A more dovish tone at the central bank is limiting gains for the Australian dollar. The decrease in commodity prices is taking a toll, but a rebound is possible in the near term. This should briefly help the currency which, for the time being, remains affordable.



MEXICAN PESO (MXN)

Mexican peso gains from interest rate hikes

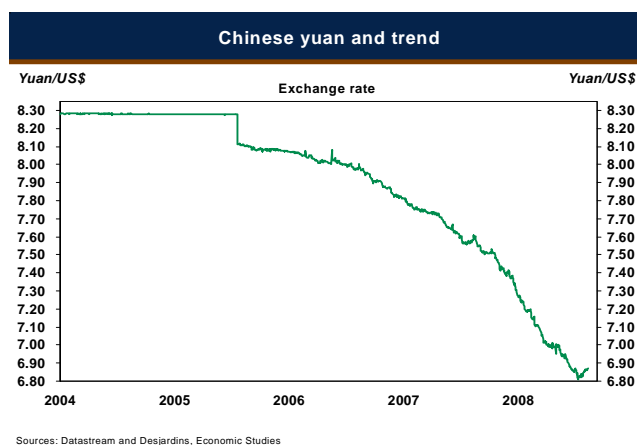
- The Mexican peso has been surprisingly robust in the past few weeks, climbing to a five-year high. On August 4, it only cost 9.85 pesos to buy a U.S. dollar. The appreciation reflected expectations of an interest rate hike due to high inflation in Mexico. A 25 basis point increase took effect in July, bringing the key overnight rate to 8%, and all signs pointed to another hike in August. Since then, the peso has been trading slightly lower against the greenback, with the USD/MXN oscillating in a tight spread between 10.1 and 10.2 pesos.
- Inflation control continues to play in favour of a slight appreciation of the peso in the coming months. However, with the United States accounting for close to 85% of Mexico's export market, the U.S. slowdown could have an adverse effect on the Mexican economy between now and the end of the year.



CHINESE YUAN (RMB)

Yuan's appreciation held back by greenback's resurgence

- After reaching a high of 6.81 yuans/US\$ on July 16, the Chinese currency lost ground against the greenback, although it did appreciate against other currencies, including the euro, the pound sterling and the yen. The dollar's resurgence since mid-July has prompted China to readjust the pace of its currency's appreciation against the greenback. That said, the yuan should continue to gain ground against the U.S. dollar over the longer run or when the dollar falters in the shorter term.
- China is careful with its currency's appreciation, seeking to keep its exports competitive. However, international pressure is being exerted. The major macroeconomic imbalances must be adjusted, and the yuan's appreciation is clearly part of the solution. Inflation fell again in July but is still high at 6.3%. To contain monetary expansion, China has, among other things, raised the mandatory reserve ratio to 17.5%.



TECHNICAL ANALYSIS

USD INDEX

The USD Index has literally exploded in recent weeks. The break in the downward trend (orange line) in place since 2001 confirms that enthusiasm for the USD is still alive and well. Momentum is playing in its favour, but it is expected to fall to 75.0/75.5 before resuming its ascent toward 80.



USD/CAD

As suggested on July 9, parity (1.00) was a good buying level. After surging by more than 700 points, the pair ran up against 1.0730, right in the middle of our 1.07-1.08 target range. This upward movement may not be over just yet and it may not be long before we see 1.08. However, the next few weeks could bring their share of USD sellers, which could drive the pair down to 1.0300. This support should be monitored because if it gives way, the upward trend could be jeopardized in the medium term (1-3 months).



GBP/USD

The forecasted downward scenario (May 14) recently became a reality as our 1.88 target was reached. However, support on the lower end of its descending channel (green lines) at 1.85 signals a potential rebound in the near term before the cable rate returns to 1.8311. The target is 1.72 in the medium term.



Table 1
Currency market

Country – Currency*	Spot price	Percentage return since					Last 52 weeks		
	August 21	1 month	3 months	6 months	1 year	Higher	Average	Lower	
North America									
Canada – dollar	1.0451	4.14	6.30	3.22	-1.29	1.0693	1.0071	0.9161	
Canada – (CADUSD)	0.9569	-3.97	-5.93	-3.12	1.31	1.0916	0.9929	0.9352	
Mexico – peso	10.1028	-0.65	-2.56	-6.47	-9.19	11.1482	10.6579	9.9169	
South America									
Argentina – peso	3.0263	0.08	-3.39	-3.94	-4.19	3.1838	3.1250	3.0130	
Brazil – real	1.6129	1.79	-2.16	-5.73	-20.78	2.0359	1.7303	1.5590	
Asia									
China – yuan renminbi	6.8452	0.21	-1.66	-4.16	-9.82	7.6030	7.1761	6.8119	
South Korea – won	1,054.90	3.62	1.23	11.24	11.72	1,054.90	969.81	900.70	
Hong Kong – dollar	7.8065	0.12	0.07	0.10	0.01	7.8146	7.7920	7.7507	
India – rupee	43.4255	1.74	1.52	8.99	5.85	43.6315	40.6076	39.0755	
Japan – yen	108.48	1.92	5.31	1.10	-5.06	117.58	108.57	97.39	
Europe									
Denmark – krona	5.0076	6.88	6.04	-0.45	-9.42	5.5282	4.9928	4.6644	
Euro zone – (EURUSD)	5.3208	5.19	7.04	0.09	-10.72	5.9594	5.3127	4.9583	
Norway – kroner	1.8759	-6.01	-4.50	-4.29	-5.42	2.1082	1.9936	1.8586	
Russia – ruble	24.3032	4.60	3.07	-0.79	-6.08	25.8757	24.2389	23.1169	
Sweden – krona	6.2814	5.83	6.53	0.01	-9.92	6.9728	6.2649	5.8368	
Switzerland – swiss franc	1.0860	6.24	5.52	-0.79	-9.75	1.2129	1.0898	0.9860	
United Kingdom – (GBPUSD)	1.4883	-6.17	-5.61	0.62	10.33	1.5979	1.4959	1.3489	
South Pacific									
Australia – (AUDUSD)	0.8796	-9.94	-8.68	-4.43	9.98	0.9786	0.9059	0.7998	
New Zealand – (NZDUSD)	0.7207	-5.37	-7.34	-10.08	3.61	0.8175	0.7630	0.6875	

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

Note: Currency table base on previous day closure.

Table 2
Currency market: History and forecasts

End of period	2007		2008				2009			
	Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
American dollar										
Canadian dollar (USDCAD)	0.9944	0.9979	1.0259	1.0309	1.0309	1.0000	1.0000	1.0204	0.9804	0.9524
Euro (EURUSD)	1.4222	1.4620	1.5846	1.5755	1.5000	1.4500	1.4200	1.3800	1.3600	1.3200
British pound (GBPUSD)	2.0471	1.9865	1.9833	1.9936	1.9000	1.8700	1.8500	1.8500	1.8500	1.8500
Yen (USDJPY)	114.80	111.69	99.91	106.09	108.00	106.00	104.00	102.00	100.00	98.00
Australian dollar (AUDUSD)	0.8885	0.8755	0.9137	0.9582	0.8800	0.8700	0.8800	0.8700	0.8500	0.8500
Mexican peso (USDMXN)	10.94	10.92	10.64	10.31	10.80	11.35	11.25	11.15	11.10	11.00
Chinese yuan (USDRMB)	7.51	7.31	7.01	6.86	6.85	6.70	6.54	6.40	6.25	6.00
Effective dollar* (73 = 100)	74.38	70.27	70.31	70.96	73.23	74.12	73.00	75.22	75.25	74.30
Canadian dollar										
American dollar (CADUSD)	1.0056	1.0021	0.9748	0.9700	0.9700	1.0000	1.0000	0.9800	1.0200	1.0500
Euro (EURCAD)	1.4143	1.4589	1.6256	1.6243	1.5464	1.4500	1.4200	1.4082	1.3333	1.2571
British pound (GBPCAD)	2.0357	1.9823	2.0346	2.0553	1.9588	1.8700	1.8500	1.8878	1.8137	1.7619
Yen (CADJPY)	115.44	111.92	97.39	102.90	104.76	106.00	104.00	99.96	102.00	102.90
Australian dollar (AUDCAD)	0.8836	0.8737	0.9373	0.9879	0.9072	0.8700	0.8800	0.8878	0.8333	0.8095
Mexican peso (CADMXN)	11.00	10.94	10.37	10.00	10.48	11.35	11.25	10.93	11.32	11.55
Chinese yuan (CADRMB)	7.5521	7.3254	6.8333	6.6497	6.6445	6.7000	6.5400	6.2720	6.3750	6.3000

f: forecasts; * Trade-weighted against major U.S. partners.

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