

FX ANALYSIS

An Open and Shut Case

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HIGHLIGHTS

- ▶ The US dollar is trading like a barometer of risk appetite but remains in a broad trading range for now.
- ▶ The bears think shifting rate differentials will drive it lower. But if physical shortages force energy-importing nations to shutter production, all bets are off. The greenback would surge in that scenario.
- ▶ A soft labour market in Canada is limiting pass-through to core CPI. We expect the BoC to stay on hold this year. We trimmed our forecast for the loonie as the expected terms of trade boost has not materialized.
- ▶ The ECB is set to hike rates due to its inflation-only mandate and a tight labour market. Any hikes will be aimed at shoring up credibility rather than signaling a tightening cycle.
- ▶ Fiscal challenges remain a drag for the British pound. Unfortunately, a leadership challenge against Prime Minister Starmer will not deliver a quick solution.
- ▶ The Bank of Japan remains excessively cautious on rate hikes. Savers are losing out to inflation; Japanese bonds and currency are paying the price.
- ▶ China has maintained a stable yuan as it quietly promotes its currency as a credible alternative to the US dollar's hegemony.
- ▶ The best may be over for the Mexican peso, as interest rate spreads fall below a key threshold.

OVERVIEW

The US dollar has whipsawed with the ebb and flow of geopolitical risks. While the endgame for the US–Iran conflict remains unclear, one lasting legacy is likely to be greater divergence between central banks, all of which are grappling with an awkward trade-off between “*stag*” and “*flation*.”

Policymakers are splitting into two camps. The *patience* camp—led by the Federal Reserve, the Bank of Canada, and the Bank of Mexico—argues that inflation expectations remain anchored and that abrupt tightening may do more harm than good. The *credibility* camp, which includes the European Central Bank, the Reserve Bank of Australia and some

Asian central banks, is prepared to act early to prevent second-round inflation.

Policy divergence can be a powerful catalyst for currency markets. While geopolitical noise and risk sentiment will drive near-term volatility in foreign exchange, investors should focus on whether non-US central banks deliver on hawkish expectations as the Fed ultimately leans the other way.

But there is a caveat. The energy crisis has so far largely been about prices, not physical shortages. If supply disruptions persist, Europe and large parts of Asia will be forced into industrial rationing. That would mark a far more consequential shock and raise the risk of disorderly moves in foreign exchange markets.

USD
Round Trip to Nowhere

The US dollar benefited disproportionately from a flight to quality in March but gave back these gains once risk appetite improved on hopes of a ceasefire.

Intra-day correlations between risk sentiment and the US dollar have been unusually strong since the Iran conflict began. In fact, it might be easier to watch the USD rather than the confusing stream of geopolitical headlines and social media posts.

But take a step back, and it's clear that the broad US dollar has basically been in a range over the last 12 months. The widely followed DXY index has been stuck between 101 and 96. USDCAD has been fluctuating in a narrow 1.35–1.41 band. These ranges have survived powerful narratives like “de-dollarization,” assault on the Fed’s independence and shifting views on the safe haven appeal of the greenback.

We believe the US dollar is in a long-term decline. But currencies are a beauty contest, and the other major currencies have their own blemishes.

Policy divergence is a powerful catalyst for currency markets. As such, we are closely monitoring rate differentials as a potential catalyst for USD weakness in the coming months. The OIS market now expects the Fed to remain on hold this year but cut rates next year. On the other hand, some analysts are predicting the ECB will hike in June. If interest rate spreads clearly shift against the US dollar, the year-long trading ranges could finally break down.

But investors should not ignore the risks on the other side. The energy crisis has so far been about price, not physical shortages. The long lead-times of in-transit ships and existing inventories have allowed life to go on largely as normal in energy-importing Europe and Asia. Of course, the price of fuel and utilities has increased, but few businesses have been forced to shutter outright.

However, if supply disruptions persist for much longer, these regions will be forced to ration supply. That could mean that businesses, or even entire industries, would be forced to pare down operations, creating further shortages and unemployment downstream. Meanwhile, the energy-abundant (and net exporting) economy of the United States would largely motor on relatively unscathed.

So will rate differentials weigh on the US dollar, or will fuel shortages in energy-importing nations push it higher? With geopolitical headlines shifting by the hour, conviction is understandably low. In this environment, price action should lead: a decisive break above or below DXY’s year-long range would likely mark the next sustained move.

We maintain our forecast for a weaker USD over the medium term. But the near-term path will be determined by geopolitics, and there are risks to the upside from geopolitics.

Graph 1
The US Dollar Has Been in a Range for 12 Months


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CAD
Inflation Contained, Growth Restrained

Governor Tiff Macklem acknowledged that headline inflation will rise on energy prices, but he played down concern about inflation expectations, saying the Bank would tolerate a temporary pickup without reacting. In that light, the March inflation reading was reassuring. While headline CPI rose 0.9% month over month, there was only a modest impact on underlying inflation metrics.

We expect that Canada’s soft housing and labour markets, together with lingering business uncertainty, will continue to limit the pass-through from energy prices to core inflation. As a result, the Bank of Canada should be able to remain on the sidelines for the rest of this year to spur a revival of economic activity.

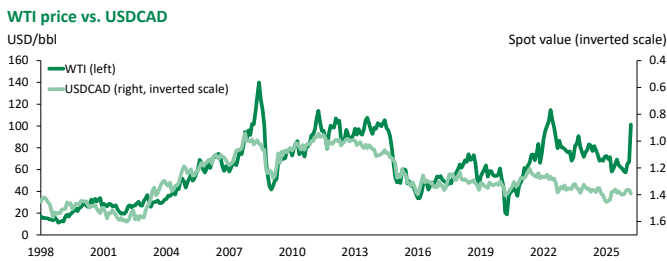
Moreover, higher oil prices have not benefited the loonie much. Canadian oil companies like Cenovus and Tamarack Valley have been [very explicit](#) that the windfall from higher oil prices will mostly go back to shareholders via buybacks, not into materially higher capex. Many of these shareholders are not Canadians and would expect to be paid in USD. A smaller share of oil revenues returning to Canada means the terms of trade gains will have a limited impact on overall employment and GDP.

Finally, news about the CUSMA review is set to hit the tapes in coming weeks. Based on recent interviews given by US Trade Representative Jamieson Greer, an outright extension of the deal for another 16 years is unlikely, but the deal will probably not be terminated either. Instead, the most likely outcome appears to be a prolonged period of annual reviews and targeted changes, resulting in entrenched uncertainty. While

the final decision is due on July 1, the news headlines will likely hit in early June when USTR Greer is expected to submit a report to Congress to provide clarity on the US stance.

We have slashed our forecast for CAD appreciation. We now see USDCAD at 1.35 by the end of 2026 and 1.30 by the end of 2027, up from 1.34 and 1.28 previously.

Graph 2
CAD Has Not Benefited from Higher Oil Prices



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EUR

Policy Support vs. Energy Drag

EURUSD has made a round trip since late February, initially falling to 1.14 and returning to 1.18, where it traded prior to the conflict in the Gulf. EU–US yield differentials have moved substantially in the euro’s favour since June 2025, when EURUSD first touched 1.18.

ECB rate expectations have undergone a sharp hawkish repricing, shifting from an easing outlook to a cycle that now prices roughly two 25bps rate hikes this year. The ECB has not pushed back against this market pricing, acknowledging that energy shock and full employment conditions may require policy tightening. After all, the ECB has a single mandate of maintaining headline CPI at 2%.

Nevertheless, we remain cautious on the euro’s prospects. The apparent divergence between a hawkish ECB and on-hold Fed could make the single currency more appealing, but only if the worst of the energy shock is behind us. The continent is short on energy, and its supply of LNG and refined products like jet fuel have been severely curtailed by the closure of the Strait of Hormuz. If the closure continues much longer, or even expands to the Bab al-Mandab corridor (which leads to the Suez Canal), it would trigger not just higher prices, but physical shortages of fuel.

Europe experienced such a crisis after Russia’s invasion of Ukraine in 2022 and has not fully recovered from it. Investors should remember that when industries were forced to shutter because of energy disruption, the euro went down despite rate hikes by the ECB.

We continue to expect a broad range in EURUSD between 1.15 and 1.20 in 2026, but in a scenario of extensive fuel shortages, the risks would be larger on the downside.

GBP

Policy Reboot?

The ruling Labour party is poised for heavy losses in nationwide local elections on May 7, which we expect will trigger a leadership challenge against Prime Minister Keir Starmer. While there could be several contenders, the most likely candidates to replace the PM would be either Angela Rayner or Wes Streeting.

From a financial market confidence perspective, Rayner would start off with a credibility deficit due to her prominent role in forcing the government to U-turn on plans for fiscal consolidation. Meanwhile Streeting would be seen as the continuity candidate. Put simply, the leadership change is unlikely to result in a significant improvement in fiscal governance or jump start stalled tax and entitlement reforms. The spread between 10-year gilt and US Treasury yields remains close to 60bps, the widest in 25 years, reflecting some of these concerns.

This was highlighted in the analysis of the IMF Spring Meetings, during which the UK growth forecast for 2026 was lowered by the largest margin among developed nations from 1.3% to just 0.8%, while the estimate for the fiscal deficit was increased slightly from 4.5% to 4.6%. The multilateral institution echoed our concerns about faltering nominal growth, rising public debt and eroding institutional credibility.

Governor Bailey has argued that the BoE must be patient in raising rates as stagflation threatens economic complications. In fact, we are not sure whether the market would reward the pound if the Bank hiked rates due to surging energy prices, or whether it would punish it for potentially pushing the UK over the fiscal cliff. After all, the crisis in the UK is one of fiscal credibility, not monetary policy. Overall, we remain bearish on the GBP against both the USD and EUR.

We maintain our 2026 forecast for the GBP to fall to 1.30 vs. USD and to 0.92 vs. EUR.

JPY
Moving Goalposts

The yen remains on the back foot. USDJPY has been trading just under 160, close to the levels when the US Treasury conducted a “rate check”—a form of verbal intervention—in January. Moreover, since mid-March, the Japanese Ministry of Finance has stepped up their own verbal intervention. Finance Minister Katayama has repeatedly said Japan is prepared to take decisive action if FX moves become excessive or disorderly. But we think the framing has shifted. While previously it was about defending the 160 *level*, now the pushback is against speed. This begs the question why the yen requires any support from the government at all.

In very simple terms, the JPY has remained weak because:

- (a) Bank of Japan policy has been kept accommodative in the presence of high and persistent inflation; and
- (b) Japanese investors have continued to invest overseas and keep their foreign assets under-hedged. Therefore, for the JPY to reverse course, either one or both of these conditions must change.

While most major central banks have become less dovish or even hawkish in the last month, the Bank of Japan has moved the other way. The JPY OIS is pricing in less tightening now than it did before the US–Iran conflict began, in stark contrast to global trends. This isn’t about a debate over headline versus core inflation. It reflects the BoJ’s institutional caution: policy normalization is implemented in tentative increments, and only under near-perfect economic conditions.

As inflation persistently outpaces deposit rates, Japanese savings are being eroded in real terms—keeping pressure on both long-end JGB yields and the yen.

We maintain our year-end USDJPY forecast of 155 for 2026 and 140 next year, though we think the JPY will first fall to around 165 in the coming months.

Graph 3
JPY Continues to Weaken



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CNY
Beijing Backs CNY

It is widely known that China is heavily dependent on oil imports and is Iran’s main customer. Despite the obvious threat to China’s supply chains, the Chinese yuan has modestly strengthened during the US–Iran war. We are not surprised by this.

The first anchor is policy. Since March, the PBoC has consistently leaned against USD strength via the daily fixing, setting it materially stronger than model-implied levels. This signaled to the market that Chinese authorities wanted to maintain a stable currency amidst global market uncertainty. In fact, this is nothing new. Beijing has been engineering a gradual appreciation for several months.

Second, China’s external position continues to provide a buffer. On a cumulative basis, China ran a goods trade surplus of roughly US\$265B in Q1 (5.5% of GDP), with exports up close to 15% year over year. That sustained surplus drives corporate demand for CNY and helps insulate the currency during global risk-off episodes.

Finally, FX stability appears to have taken on added strategic significance. Beijing has been quietly advocating for yuan-based settlement to reduce the US dollar’s hegemony. It would send the wrong message if the Chinese currency plunged at the first sign of geopolitical conflict. Moreover, Chinese leaders are preparing for high-stakes talks with President Trump, who is expected to visit China in May. Ahead of these talks, Beijing has a strong incentive to project financial control and macro stability.

We maintain our forecast for USDCNY to fall to 6.70 by the end of this year and 6.50 next year.

MXN
Losing Its Carry Appeal

The Bank of Mexico cut its policy rate by 25bps to 6.75% at its March 26 meeting, citing softening economic activity despite sticky inflation and surging oil prices. Crucially, the statement signaled that further easing remains on the table.

Our analysis shows that when the spread between Mexican and US policy rates falls below 300bps, volatility of the MXN increases significantly. It appears there is some psychological significance of investors demanding a minimum risk premium for holding the Mexican peso.

Banxico is likely aware of this historical relationship. But the MXN is now at a very strong level, having appreciated about 15% since last year, and the central bank acknowledged that the peso’s strength was an input into its latest rate cut. We believe this signals that scope for further appreciation is limited, as

the central bank would see that as an opportunity to cut rates further.

We maintain our forecast for MXN to weaken to 17.80 by the end of this year.

Graph 4
The Mexico–US Rate Differential Has Tightened

1Y Mexican bond yield minus 1Y US bond yield



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Table History and Forecast

End of period	2025		2026				2027				
	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	
US dollar											
Canadian dollar	USD/CAD	1.39	1.37	1.39	1.38	1.37	1.35	1.33	1.32	1.31	1.30
Euro	EUR/USD	1.17	1.18	1.16	1.15	1.15	1.18	1.19	1.20	1.21	1.22
British pound	GBP/USD	1.33	1.35	1.32	1.28	1.30	1.30	1.32	1.33	1.34	1.35
Swiss franc	USD/CHF	0.80	0.79	0.80	0.78	0.77	0.76	0.76	0.75	0.75	0.74
Yen	USD/JPY	148	157	159	165	160	155	148	146	143	140
Australian dollar	AUD/USD	0.66	0.67	0.69	0.72	0.74	0.75	0.76	0.77	0.78	0.78
Chinese yuan	USD/CNY	7.12	6.98	6.89	6.85	6.80	6.75	6.70	6.65	6.60	6.50
Mexican peso	USD/MXN	18.40	17.98	17.93	17.20	17.40	17.80	17.70	17.60	17.50	17.50
Brazilian real	USD/BRL	5.32	5.45	5.18	5.10	5.20	5.10	5.20	5.30	5.40	5.50
Effective dollar ¹		111	112	113	112	111	110	108	107	106	105
Canadian dollar											
US dollar	CAD/USD	0.72	0.73	0.72	0.72	0.73	0.74	0.75	0.76	0.76	0.77
Euro	EUR/CAD	1.63	1.62	1.61	1.59	1.58	1.59	1.58	1.58	1.59	1.59
British pound	GBP/CAD	1.85	1.85	1.84	1.77	1.78	1.76	1.76	1.76	1.76	1.76
Swiss franc	CAD/CHF	0.58	0.58	0.57	0.57	0.56	0.56	0.57	0.57	0.57	0.57
Yen	CAD/JPY	106	115	114	120	117	115	111	111	109	108
Australian dollar	AUD/CAD	0.92	0.92	0.96	0.99	1.01	1.01	1.01	1.02	1.02	1.01
Chinese yuan	CAD/CNY	5.12	5.09	4.95	4.96	4.96	5.00	5.04	5.04	5.04	5.00
Mexican peso	CAD/MXN	13.24	13.12	12.88	12.46	12.70	13.19	13.31	13.33	13.36	13.46
Brazilian real	CAD/BRL	3.83	3.98	3.72	3.70	3.80	3.78	3.91	4.02	4.12	4.23

f: forecast; ¹ Trade-weighted against major US partners (January 2006 = 100).

Datastream, Federal Reserve Board and Desjardins Economic Studies