FX ANALYSIS

Dollar Debasement?

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HIGHLIGHTS

- Investors are questioning the credibility of US debt management, putting the US dollar in their crosshairs.
- But the US is not the only economy with concerns about debt. Currency debasement isn't about the US dollar alone.
- The USD sell-off is about sentiment, not fundamentals. Don't chase it.
- An interim Canada–US trade deal remains elusive for now. But the market has become accustomed to tariff noise.
- Core inflation in the euro area remains subdued. But hawks within the ECB are keeping the September meeting live.
- Joint intervention in the yen got a strong reaction from markets, but it fails to address the underlying driver of yen weakness.
- China's domestic weakness is increasing its reliance on exports as an engine of growth. Meanwhile its trade surplus is surging to record highs, putting a spotlight on its undervalued currency.
- Election noise may create some turbulence in the Brazilian real, but carry and fundamentals remain attractive. We expect any pullbacks to be temporary.

USD

Is the US Panicking?

The US dollar sold off sharply in August after the US Treasury surprised the market with a bond buyback announcement. Traders wagered that if US authorities try to hold down their borrowing cost, they will make it less appealing to invest in US Treasuries and, ultimately, the US dollar. Markets have seen this before, most notably in Japan, where attempts to hold down bond yields led to persistent yen weakness. Some call it the "debasement trade."

The "debasement trade" is the view that years of deficit spending and rising government debt will erode the value of fiat currencies, pushing investors toward hard assets such as precious metals. Fair enough. But why is the US dollar being singled out? Fiscal challenges are worse in other major economies, especially the UK, France and Japan. Bonds are under pressure everywhere, not just in the US.

The simplest explanation for the sharp USD sell-off last week is that markets believe that US policymakers are panicking. When confidence erodes, traders adjust their positions first and ask questions later. But US policymakers will not sit idle if markets lose faith in the world's reserve currency and deepest bond market. They possess both the tools and the incentive to push back if FX volatility becomes disruptive. In particular, bond yields up + dollar down is not the kind of regime they will tolerate for long.

The DXY Index is down 3% over the last month, but it remains in the middle of the last 12-month range of 96–102. The USD had become popular in FX carry trades over the summer, and those positions were likely unwound last week. Put simply, the volatility is about sentiment and positioning, not fundamentals. We remain medium-term bears on the US dollar but would caution extrapolating from last week's move.

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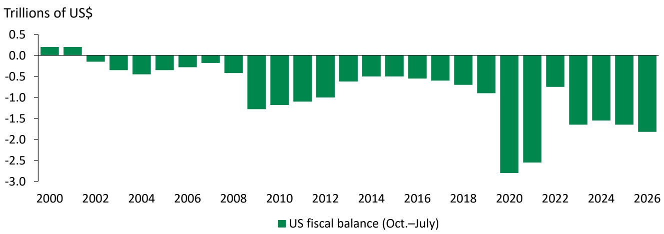
We remain bearish on the US dollar over the medium term, but the sharp sell-off in August may prove temporary. We continue to forecast gradual USD weakness through 2027.

Graph 1
US Fiscal Balance for the First 10 Months of the Fiscal Year (Oct.–July)



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CAD

No Deal? Big Deal!

The Canadian economy has proven more resilient than many expected in recent months despite ongoing trade uncertainty. We've brought forward our forecast for the Bank of Canada's next rate hike to Q1 2027, even though trade talks between the US and Canada remain stalled.

In contrast, softer US inflation and labour market data suggest the Federal Reserve is likely to keep rates unchanged through this year, with the policy outlook tilting toward rate cuts in 2027.

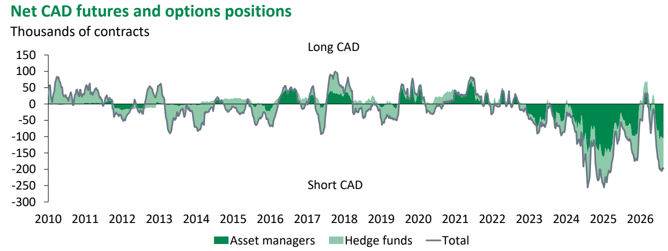
As such, we expect a gradual narrowing of front-end rate differentials, which underpins our view that the Canadian dollar will appreciate over the medium term. But there is another argument for a stronger loonie: the bar is low.

Business investment in Canada has been soft for years. Reviving it is a cornerstone of Prime Minister Carney's economic plan. The plan has bridged political divides, and markets have taken note. The government-brokered Canada Investment Summit in mid-September will bring together roughly 100 of the world's largest asset managers and institutional investors, with the aim of securing investment in Canadian infrastructure, energy and critical minerals projects. If successful, it could mark an important step toward reversing years of weak business investment.

We expect trade uncertainty to persist in the near term. But the market has learned to live with the noise. We don't expect a lasting impact on the Canadian dollar.

There may be volatility on trade headlines, but we expect USDCAD to end 2026 around 1.38 and 2027 around 1.34.

Graph 2
Short CAD Positions Are Elevated



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EUR

Euro Rides on the Anti-Dollar Trend, But It Won't Last

On balance, we still believe the European Central Bank will keep rates unchanged for the rest of this year. However, the September 10 meeting is live, and we cannot rule out one additional rate hike.

As the conflict in Iran drags on, energy prices have moved from the ECB's "mild" scenario toward the "baseline" scenario presented in June. Inflation firmed in July, with core inflation (excluding energy and food) rising to 2.5% y/y from 2.4% in June. Services inflation also edged up to 3.3% from 3.2% y/y. However, much of the increase appears to reflect base effects rather than a renewed acceleration in underlying price pressures. Indeed, the recent run rate of monthly core inflation remains broadly consistent with the ECB's 2% target.

Some members of the Governing Council appear concerned that energy prices could remain elevated and that memories of the 2022 inflation episode may cause households and firms to react more rapidly this time. Publicly, President Lagarde has maintained that second-round effects are "not yet" visible. Yet the minutes of the June meeting suggest the internal debate was more hawkish than her public remarks implied.

The euro also benefits from its status as the world's second reserve currency. If investors begin to seriously question US fiscal credibility or Fed independence, the euro could attract short-term inflows as traders look for an "anti-dollar." However, we would advise caution. The euro area has unresolved fiscal problems too. In fact, the spread between French and German government bonds — a measure of French sovereign debt risk — has widened to its highest level since the European debt crisis. We remain cautious on the euro's longer-term prospects given mounting pressures on Europe's industrial base from high energy costs and competition from China. However, if dollar weakness remains the dominant market theme, the euro could benefit, though eventually investors will focus on the euro area's own fiscal challenges.

We've raised our expected range in EURUSD to 1.15–1.18 for the rest of this year but see it trading back down to 1.15 next year.

GBP

Turning Neutral

It has been a difficult year for the UK. Growth has slowed, inflation remains sticky, political risks are elevated and the public debt burden continues to rise. Gilts have come under pressure, with government bond yields rising by more than those in most other G7 economies.

Yet sterling has defied the bearish narrative. The pound has outperformed both the euro and the US dollar this year despite our expectation of a decline. This serves as a useful reminder that the most obvious risks may already be reflected in market pricing.

Will the pound continue to outperform? Consensus views remain bearish on the UK economy, so the bar seems low. We think positive surprises could come from one of the following sources.

First, growth could surprise to the upside, particularly if consumer spending and business investment prove more resilient. Second, the Bank of England could surprise with a rate hike, especially if oil prices continue rising. Third, while sweeping fiscal reform appears unlikely, even modest measures that reassure investors about the sustainability of public finances could support UK assets and the pound.

Our longstanding bearish view on the pound has not materialized. We acknowledge that the bear case may already be priced in and are turning neutral on the currency.

We've upgraded our 2026 forecast for the GBP to 1.39 vs. the USD and 0.85 vs. the EUR.

JPY

Another Band-Aid for the Yen

After USDJPY climbed to nearly 164, its weakest level since the 1980s, the Japanese Ministry of Finance and the U.S. Treasury conducted their first coordinated yen-buying intervention since 1998.

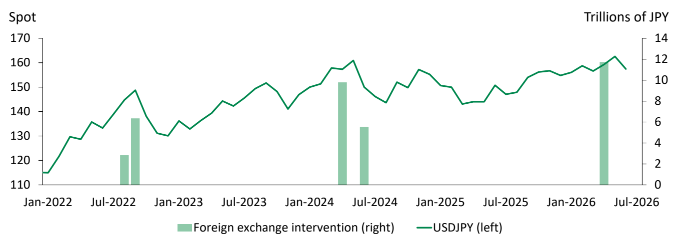
While the size of the intervention has not been disclosed yet, market participants estimate that Japanese authorities sold around US$60 billion, comparable to the May operation. Washington's market operations were considerably smaller. Ultimately, Secretary Bessent was more interested in preventing Tokyo from selling US Treasuries than managing the yen's value. He also mentioned the possibility of increasing Japan's access to the Fed's FIMA Repo Facility, though the Fed hasn't confirmed this.

The intervention got a strong reaction from markets, but it failed to address the underlying driver of yen weakness: the Bank of Japan, under pressure from the Takaichi administration, continues to hold the short rate well below inflation. Japanese savers expect to earn a positive real yield and may not be persuaded by intervention alone. Japanese authorities may have bought some time, but without a meaningful shift in the underlying policy mix, it's only a short-term fix.

Over the medium term, we think the gap in US and Japanese short rates will narrow and eventually lead to a stronger yen. But it is difficult to pin down the inflection point.

We expect the JPY to remain volatile around 160 in the coming months. However, we continue to forecast a move down to 150 next year, premised on a gradual narrowing of US–Japan policy rate differentials.

Graph 3
Japanese Official Interventions in USDJPY



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CNY

Surging Exports, Falling Growth

China's economy continues to lose momentum. July activity data disappointed across the board, with retail sales, industrial production and fixed asset investment all slowing markedly and undershooting expectations. Credit demand was even weaker. New bank lending contracted by CNY340 billion, while households paid down debt at the fastest monthly pace since records began in 2002.

The backdrop was already weak, and not just in the property sector. Q2 GDP growth slowed to a three-year low of 4.3% y/y, revealing a broad-based loss of momentum in domestic demand and consumer spending. Deflationary pressures are also resurfacing. Both headline and core CPI fell below 1% y/y in July despite the recent rise in global commodity prices.

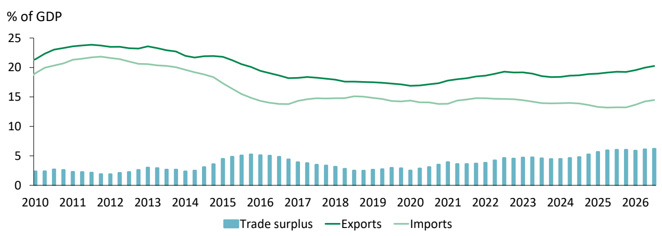
The lone bright spot is the external sector. Exports surged 24% y/y in July and now account for nearly 21% of GDP. China's trade surplus is running at an annualized pace of roughly US$1.2

trillion, equivalent to about 6% of GDP. While the widening surplus is consistent with an undervalued CNY, it also highlights the growing imbalance between robust manufacturing output and subdued domestic demand. In that sense, China's export strength is not simply a sign of competitiveness, but also a reflection of weakness at home.

Investors are increasingly speculating that Beijing will need to deploy another round of fiscal stimulus to revive domestic demand. At the same time, the PBoC has taken incremental steps to lean against further CNY appreciation, although there is little indication that policymakers are targeting or defending any specific exchange rate level.

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

Graph 4
China's Trade Surplus Is Rising



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BRL

Brace for Election Turbulence

The Brazilian real has performed well this year and we see scope for further gains, although election-related uncertainty could trigger bouts of volatility in the next two months.

The BRL continues to benefit from one of the highest policy rates in the emerging market universe, with the Selic rate at 14.5%. The BCB has signalled a cautious approach to policy easing, helping preserve the currency's yield advantage. Brazil is also a net energy exporter and stands to benefit from higher oil prices if the war in Iran drags on.

That said, political risks are likely to move back into focus as the election approaches. The first round is scheduled for October 4, but current polls suggest neither of the two leading candidates is likely to secure an outright majority, setting up a tight runoff on October 25.

The government has announced a series of populist measures, including subsidies, credit programs and debt relief initiatives, raising concerns about debt sustainability. While such spending has become a familiar feature of Brazilian politics, it nevertheless has the potential to weigh on market sentiment and increase currency volatility.

We expect the BRL to fluctuate near 5.20 around the elections but maintain our forecast of 5.00 once political noise subsides.

Table
History and Forecast

End of period		2025 Q3	2025 Q4	2026 Q1	2026 Q2	2026 Q3f	2026 Q4f	2027 Q1f	2027 Q2f	2027 Q3f	2027 Q4f
US dollar											
Canadian dollar	USD/CAD	1.39	1.37	1.39	1.42	1.39	1.38	1.36	1.35	1.35	1.34
Euro	EUR/USD	1.17	1.18	1.16	1.14	1.17	1.18	1.18	1.16	1.15	1.15
British pound	GBP/USD	1.33	1.35	1.32	1.32	1.37	1.39	1.32	1.33	1.34	1.35
Swiss franc	USD/CHF	0.80	0.79	0.80	0.80	0.80	0.80	0.79	0.78	0.77	0.75
Yen	USD/JPY	148	157	159	162	160	160	158	155	152	150
Australian dollar	AUD/USD	0.66	0.67	0.69	0.72	0.72	0.75	0.76	0.77	0.78	0.78
Chinese yuan	USD/CNY	7.12	6.98	6.89	6.85	6.70	6.70	6.68	6.65	6.60	6.50
Mexican peso	USD/MXN	18.40	17.98	17.93	17.30	17.00	17.20	17.50	17.60	17.50	17.50
Brazilian real	USD/BRL	5.32	5.45	5.18	5.10	5.20	5.10	5.10	5.10	5.05	5.00
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	0.70	0.72	0.72	0.74	0.74	0.74	0.75
Euro	EUR/CAD	1.63	1.62	1.61	1.62	1.63	1.63	1.60	1.57	1.55	1.54
British pound	GBP/CAD	1.85	1.85	1.84	1.87	1.90	1.92	1.80	1.80	1.81	1.81
Swiss franc	CAD/CHF	0.58	0.58	0.57	0.56	0.58	0.58	0.58	0.58	0.57	0.56
Yen	CAD/JPY	106	115	114	114	115	116	116	115	113	112
Australian dollar	AUD/CAD	0.92	0.92	0.96	1.02	1.00	1.04	1.03	1.04	1.05	1.05
Chinese yuan	CAD/CNY	5.12	5.09	4.95	4.82	4.82	4.86	4.91	4.93	4.89	4.85
Mexican peso	CAD/MXN	13.24	13.12	12.88	12.18	12.23	12.46	12.87	13.04	12.96	13.06
Brazilian real	CAD/BRL	3.83	3.98	3.72	3.59	3.74	3.70	3.75	3.78	3.74	3.73

f: forecast; [1] Trade-weighted against major US partners (January 2006 = 100).
Datastream, Federal Reserve Board and Desjardins Economic Studies