FX ANALYSIS

The Dollar's Second Wind

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HIGHLIGHTS

- The US dollar broke out of its trading range on hawkish Fed communications and foreign buying of US stocks. We expect the USD to remain firm for a few months. A sustained depreciation now looks more like a 2027 story.
- With the old trading ranges broken, and the BoC unlikely to match the Fed's hawkishness, we expect USDCAD to move in a broad 1.40–1.45 range in H2 2026.
- The ECB is now balking at further rate increases. We believe the fading "de-dollarization" narrative will weigh disproportionately on the euro.
- Fundamentals point to a weaker JPY, and threats of intervention have become less effective. But we think the consensus has become too bearish and is ignoring a steep rise in real yields.
- Chinese authorities are now intervening more firmly to stop RMB appreciation. Their goal is stability, after what has been a stellar run for the currency.
- In Mexico, remittances have flatlined and growth is faltering. Banxico may be forced to cut rates, even if it destabilizes the peso.

OVERVIEW

US inflation remains firm despite the normalization in energy markets. The latest concerns surround surging prices for semiconductors and chips, both of which are key inputs for consumer electronics. Core inflation in the US continues to diverge relative to other advanced economies.

The Fed has completely abandoned its easing bias, and markets are pricing in hikes. The US dollar is back in vogue as higher short-term interest rates and large tech IPOs attract capital inflows.

We expect the dollar to remain on the front foot over the next few months until the inflation picture becomes clearer. We don't expect hikes, but a return to the aggressive rate-cut expectations seen earlier this year is unlikely.

USD

Read the Data, Not the Fed Chair

The US dollar surged to its highest levels in over a year in June, as markets began to price in a more hawkish Fed. The market is now fully pricing in at least one rate hike this year.

Meanwhile, expectations for tighter policy elsewhere are fading. ECB officials are now balking at further rate hikes as oil prices have fallen back to pre-war levels, while the yen has hit a 40-year low on concerns the government wants the Bank of Japan to slow down further rate increases. In Canada, soft labour market and core inflation readings have dimmed prospects for rate hikes any time soon.

Front-end rate differentials have moved substantially in favour of the US dollar since May. Ex-ante real rates have increased as well, as rising nominal yields coincided with falling inflation expectations. But can these trends be sustained? Will rates continue to support a stronger dollar?

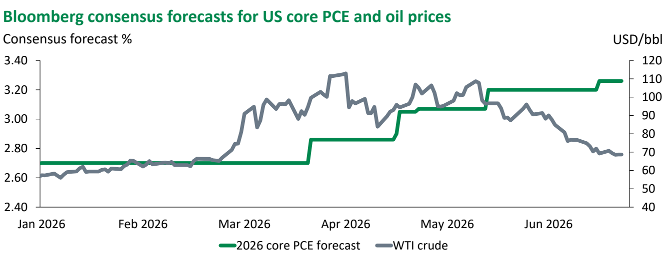
Many analysts are wasting time trying to determine whether Fed Chair Warsh is genuinely hawkish or merely posturing to boost his credibility. The more important issue is that core inflation forecasts remain stubbornly high, even as energy markets have normalized. The latest concern is about surging chip prices, which have forced firms to hike prices of electronics like smartphones and laptops.

Our rates colleagues believe the Fed will remain on hold this year. But if inflation does not clearly decelerate over the next couple of prints, the Fed would be forced to raise rates as early as September.

We expect the dollar to remain firm over the next few months until the inflation picture becomes clearer. Stronger-than-expected CPI prints would likely drive further gains, while softer readings could trigger some pullback. Even so, a return to the aggressive rate-cut expectations seen earlier this year isn't in the cards.

Rate differentials are driving the US dollar. Unless US inflation meaningfully softens, the dollar is likely to stay on the front foot in coming months. A sustained depreciation of the US dollar looks more like a 2027 story.

Graph 1
US Inflation Forecasts Remain Firm Despite Lower Oil Prices



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CAD

Life After 40

USDCAD rose well above our projected ranges, largely on the back of wider rate differentials, which it continues to track closely.

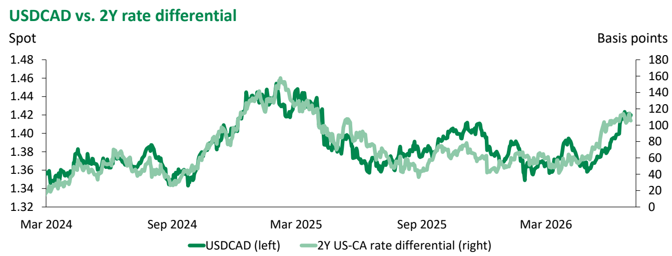
At the time of writing, markets are pricing in about 40bps of tightening from the Fed by March 2027 and 25bps from the Bank of Canada (BoC). We happen to disagree, specifically on the US leg. We expect both the Fed and the BoC to remain on hold this year but have penciled in a cut from the Fed later on in 2027, and hikes from the BoC next year. If we're right, then rate differentials should gradually narrow, supporting a stronger Canadian dollar over time.

Too optimistic? Perhaps. The main risk to our view is that US inflation continues to run hot and forces the Fed to hike by 25bps or 50bps, while the BoC stands pat. Our sensitivity analysis of year-to-date correlations shows that a 25bps change in the 2Y differential translates to almost 2 cents on USDCAD. That puts the Jan 2025 level of 1.45 within a plausible forecast range.

But if we're right on our rate forecasts, then the rate differential should narrow meaningfully from current levels. Thus, our medium-term forecast for USDCAD remains anchored at 1.35, though we admit that this is now more of a 2027 story.

We have marked our forecasts to market and set 1.42 as the starting point. We expect USDCAD to trade within a broad 1.40–1.45 range through the remainder of this year, ending 2026 at 1.40 and 2027 at 1.35.

Graph 2
Wider Rate Differentials Have Driven USDCAD Higher



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EUR

Oops, I Did It Again

The European Central Bank has long faced criticism for hiking rates in 2008 and 2011 in response to commodity-price spikes that ultimately proved transitory. Unfortunately, its 25bps rate hike in June may one day be viewed in a similar light.

The ECB raised rates by 25bps in June and presented four scenarios that were mainly built around different assumptions for oil prices: mild, baseline, adverse and severe. But crude oil prices have fallen rapidly and are now below even the mild scenario's assumptions. President Lagarde continues to defend the June decision publicly, but the May and June CPI reports provide little evidence that elevated energy prices are feeding through to the broader inflation basket. Meanwhile, several hawkish members of the Governing Council have notably softened their rhetoric.

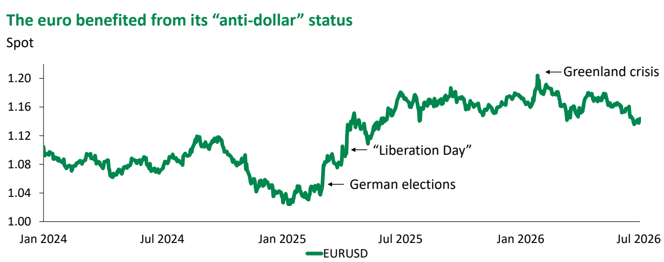
We believe the June hike was a one-off and expect the ECB to keep rates unchanged for the rest of this year. In fact, we see roughly a one-in-three chance that President Lagarde revives the familiar "we're in a good place" language at the July 23 meeting, explicitly signalling a pause.

We remain cautious on the euro's prospects. In our view, the single currency has undergone three distinct re-ratings since early 2025. The first was in February 2025 on hopes of an economic revival in Germany after Chancellor Merz was elected. The second and third occurred in April 2025 ("Liberation Day") and January 2026 (Greenland crisis). These were essentially waves of euro buying by European asset managers to reduce their exposure to the US dollar.

However, Germany's economy continues to disappoint, and the de-dollarization narrative has faded. Consequently, the euro appears vulnerable to a sizable de-rating in coming months.

We're lowering our expected range for EURUSD to 1.12 to 1.16 for the rest of this year.

Graph 3
Euro Optimism Is Fading



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GBP

New Leadership, Old Problems

The pound continues to struggle under the weight of familiar structural challenges. Andy Burnham is set to become prime minister in late July, but markets have largely taken the impending leadership change in stride.

The central issue remains fiscal credibility. Burnham's "Manchesterism" agenda may resonate with Labour supporters and local governments, but investors have yet to be convinced that a more active industrial policy and greater public-sector involvement can be reconciled with meaningful fiscal discipline.

Meanwhile, the Bank of England (BoE) continues to strike a cautious tone. Although inflation remains above target, policymakers have increasingly highlighted signs of weakening domestic demand. We continue to believe the BoE's next move will be a rate cut rather than a hike. More broadly, however, sterling's challenges are rooted less in monetary policy than in concerns around fiscal credibility. Until confidence in the fiscal outlook improves, or economic growth shows clearer signs of strengthening, we remain cautious on the pound.

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

JPY

Everyone Hates the Yen

USDJPY briefly traded above 162 in June, its highest level in 40 years.

Japanese officials continue to threaten intervention, but they face a credibility problem. Intervention can buy time, but without a meaningful shift in the underlying policy mix, it's losing its effectiveness.

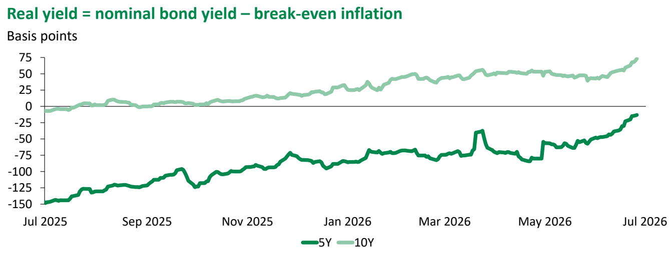
The Takaichi administration may have tolerated a modest rate hike in June, but that does not mean the Bank of Japan has been given a free hand to normalize monetary policy. The government's draft annual economic blueprint—a key signal of policy priorities—makes clear that monetary policy is expected to support growth and remain closely aligned with broader government objectives.

Moreover, the government's response to the recent energy crisis—releasing strategic petroleum reserves and a ¥3.1 trillion supplementary budget centred on energy subsidies—shows that this administration prefers to burn through limited buffers rather than take unpopular decisions.

That said, we believe markets may have become excessively bearish on the yen. According to CFTC data, speculative investors are holding record short yen positions. At the same time, ex-ante real yields have improved significantly—albeit remaining negative out to the five-year sector—as inflation expectations have declined. We also expect authorities to resist a disorderly depreciation in the currency, even if they are no longer defending specific exchange-rate levels.

We continue to expect the JPY to fall to 165 vs. the USD in the coming months. However, we believe the balance of risks becomes more supportive for the yen thereafter and continue to forecast a move back to 150 next year.

Graph 4
JGB Real Yields Have Risen Sharply



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CNY

Too Strong for Comfort

The Chinese renminbi has appreciated 7% against the US dollar, and 10% in broad trade-weighted terms, over the last 12 months. By the standards of China's heavily managed exchange rate, this is a substantial advance.

While Chinese authorities previously signalled their preference for a strong currency, partly to boost the renminbi's international appeal, they have now shifted their guidance. The People's Bank of China (PBOC) does not disclose its FX intervention, but the persistent rise in FX assets of state-owned banks suggests authorities are now systematically mopping up excess dollar inflows. Market sources indicate that the PBOC has relaxed restrictions on USD deposit rates—allowing large banks to offer higher rates on corporate dollar deposits—to encourage exporters to retain their earnings in US dollars.

These measures form part of a broader effort to push back against further currency appreciation. In our view, the authorities' primary objective is exchange-rate stability, allowing exporters time to adjust to the renminbi's earlier gains. At the same time, it would not be out of character for the PBOC to engineer a period of two-way volatility to discourage speculative positioning and reinforce the message that USDCNY is not a one-way bet.

We're maintaining our forecast for USDCNY to stay around 6.80 by the end of this year and fall to 6.50 next year.

MXN

Rich and Vulnerable

We remain cautious on the Mexican peso.

The currency has traded in a relatively stable 17.0–18.0 range this year and remains popular among emerging-market investors thanks to its attractive real yields.

Beneath the surface, however, there are growing signs that the peso's strong valuation may be difficult to sustain. In real trade-weighted terms, the currency is at its strongest level since 2008. At the same time, Mexico's growth outlook has deteriorated considerably. Real GDP growth has averaged barely 1% over the past three years, remittance inflows have stalled, and uncertainty surrounding the future of CUSMA continues to weigh on investor sentiment.

Banxico is likely to hold rates at 6.5% over the next couple of meetings, but we do not believe the easing cycle is over. In our view, the central bank would prefer to move in lockstep with the Fed to avoid destabilizing the peso. But policymakers may ultimately have little choice but to resume easing even if that means diverging from the Fed.

Our analysis suggests that MXN volatility rises significantly when the spread between Mexican and US policy rates falls below 300bps. We expect that threshold to be breached within the next six months, either because the Fed hikes and Banxico does not follow, or because the Fed remains on hold while Banxico resumes rate cuts.

Given the large stock of carry-trade positions in MXN, a clear narrowing in interest-rate differentials could trigger a meaningful depreciation in the currency.

We expect MXN to weaken to 18.0 vs. the USD by the end of this year and to remain stable around those levels next year.

Graph 5
MXN Is Becoming Overvalued

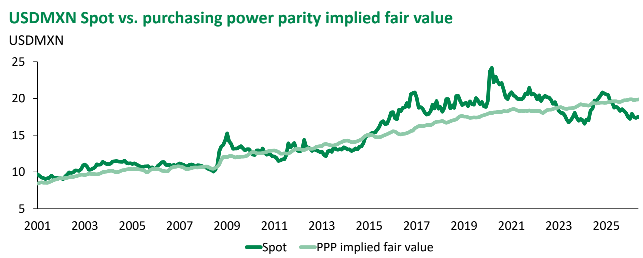

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Table
History and Forecast

		2025		2026				2027			
End of period		Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US dollar											
Canadian dollar	USD/CAD	1.39	1.37	1.39	1.42	1.42	1.40	1.38	1.37	1.36	1.35
Euro	EUR/USD	1.17	1.18	1.16	1.14	1.12	1.13	1.14	1.14	1.15	1.15
British pound	GBP/USD	1.33	1.35	1.32	1.32	1.30	1.30	1.32	1.33	1.34	1.35
Swiss franc	USD/CHF	0.80	0.79	0.80	0.80	0.82	0.80	0.79	0.78	0.77	0.75
Yen	USD/JPY	148	157	159	162	165	165	160	158	155	150
Australian dollar	AUD/USD	0.66	0.67	0.69	0.69	0.68	0.69	0.70	0.71	0.72	0.72
Chinese yuan	USD/CNY	7.12	6.98	6.89	6.80	6.80	6.80	6.75	6.70	6.60	6.50
Mexican peso	USD/MXN	18.40	17.98	17.93	17.50	17.80	18.00	17.80	18.00	18.10	18.20
Brazilian real	USD/BRL	5.32	5.45	5.18	5.10	5.20	5.20	5.20	5.20	5.10	5.00
Effective dollar[1]		111	112	113	114	116	115	114	113	112	112
Canadian dollar											
US dollar	CAD/USD	0.72	0.73	0.72	0.70	0.70	0.71	0.72	0.73	0.74	0.74
Euro	EUR/CAD	1.63	1.62	1.61	1.62	1.59	1.58	1.57	1.56	1.56	1.55
British pound	GBP/CAD	1.85	1.85	1.84	1.87	1.85	1.82	1.82	1.82	1.82	1.82
Swiss franc	CAD/CHF	0.58	0.58	0.57	0.56	0.58	0.57	0.57	0.57	0.57	0.56
Yen	CAD/JPY	106	115	114	114	116	118	116	115	114	111
Australian dollar	AUD/CAD	0.92	0.92	0.96	0.98	0.97	0.97	0.97	0.97	0.98	0.97
Chinese yuan	CAD/CNY	5.12	5.09	4.95	4.79	4.79	4.86	4.89	4.89	4.85	4.81
Mexican peso	CAD/MXN	13.24	13.12	12.88	12.32	12.54	12.86	12.90	13.14	13.31	13.48
Brazilian real	CAD/BRL	3.83	3.98	3.72	3.59	3.66	3.71	3.77	3.80	3.75	3.70

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