

## FX ANALYSIS

# Deal or No Deal?

By Jimmy Jean, Vice-President, Chief Economist and Strategist,  
and Mirza Shaheryar Baig, Foreign Exchange Strategist

### HIGHLIGHTS

- ▶ While most nations have been scrambling for energy supplies, the US economy has powered ahead thanks to a capex boom and energy abundance.
- ▶ The US dollar has firmed and Fed rate cuts have been priced out. A negotiated deal to re-open the Strait of Hormuz could reverse these trends. A “no deal” scenario would mean a stronger US dollar.
- ▶ We believe the Bank of Canada will not raise rates as quickly as the market expects. The loonie won’t like that.
- ▶ The ECB is set to lift rates in June to shore up credibility but will stress it’s not the start of a rate hike cycle.
- ▶ As politics heat up in the UK, the economy continues to soften and fiscal credibility remains low.
- ▶ Japanese intervention in USDJPY will remain ineffective unless monetary and fiscal policies are tightened meaningfully.
- ▶ CNY FX forwards are now priced in line with our expected path. We still like the currency, but the risk/reward is less compelling.
- ▶ Brace for more fiscal slippage and election noise in Brazil. The real has probably peaked for now.

### OVERVIEW

The US dollar has been trading as a proxy for risk assets and geopolitical risks and remains in a broad range for now. But the economy continues to outperform expectations, driven by a capex boom and energy abundance.

The market is pricing almost two rate hikes from the Bank of Canada, and we expect the Bank will disappoint. The ECB and the BoJ are set to hike in June. But the Fed is a wild card—the committee is turning less dovish, but it is unclear how the new chair views the risk of energy price transmitting to core.

While geopolitical noise and risk sentiment will drive near-term volatility in foreign exchange, investors should focus on whether core inflation is diverging among major economies, and which of them can remain resilient should energy disruptions persist.

### USD

#### Energy Prices and Fed Credibility to Drive the US Dollar

In a world jolted by energy disruption, the US economy has managed to keep its footing.

US data have been beating expectations, while numbers elsewhere have fallen short. US equities have outperformed global benchmarks in recent weeks, which typically signals a net inflow of capital. Most countries that import oil and gas are drawing down inventories or paying up in spot markets. Meanwhile US-based producers have become the swing suppliers for critical jet fuel and LNG.

The widely followed DXY Index is sitting in the middle of its 12-month trading range between 96 and 101. This long period of sideways trading points to a balanced tug of war between bulls and bears. On one side, state-driven sales of US assets

and higher FX hedge ratios by foreign real money have been a drag on the greenback. On the other, safe-haven demand and continued private sector inflows into US assets are providing support. But ranges are made to be broken. Eventually, something will tip the scale.

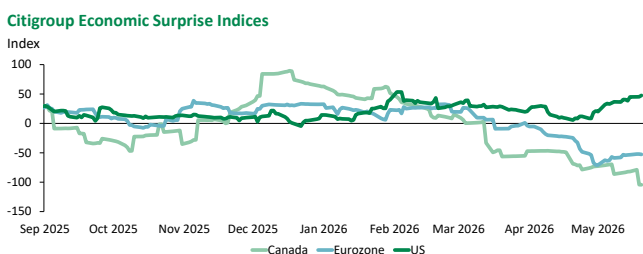
The Strait of Hormuz remains central to the story. The prevailing view is that oil prices have already peaked, flows through the Strait will resume in the third quarter, Fed cuts will come back into view, and the dollar will resume its gradual decline. This is a reasonable base case and is incorporated into our FX forecasts. But with each day the Strait remains closed, risks are shifting to the other side. The IEA's [latest monthly report](#) notes that global oil inventories are falling at a record pace.

Unless the Strait re-opens very soon, deeper demand destruction may be inevitable. Some oil-importing emerging market economies like India, Indonesia and the Philippines have already seen their currencies plunge due to balance of payment strains. Industrialized economies may have deeper buffers, but if they too are forced to cut back industrial use, their currencies would come under pressure as well. In that environment, the dollar's safe-haven status and the US's relative energy abundance could be the catalysts that break the dollar range to the upside.

What about catalysts for a downside break? Two stand out. First, President Trump could call off the Iran war, triggering "risk-on" selling of US dollars. Second, monetary policy under a Warsh-led Fed is an unknown quantity. The US economy appears resilient, and core inflation is elevated. If the new chair pushes for an explicit easing bias under these conditions, it could undermine the Fed's credibility and weigh on the USD.

**Net-net, the US dollar has firmed and Fed rate cuts have been priced out. A potential de-escalation in the war with Iran and a dovish Fed could reverse these trends.**

**Graph 1**  
US Data Surprises Have Been Much Better than Other Economies'



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## CAD

### Rate Differentials Have Shifted Against the Loonie

The Bank of Canada will take comfort from the latest inflation print. Underlying price pressures remain weak. While headline inflation has been pushed higher by energy, core prices rose just 1.5% y/y in April, down from 1.9% in March. Soft domestic demand has limited the pass-through. Unemployment is still elevated and household savings have been run down. Higher gasoline prices appear to be crowding out discretionary spending elsewhere.

The contrast with the US is stark. Core inflation remains firmer south of the border, and activity is holding up. The Atlanta Fed's nowcast currently points to Q2 growth running at a 4% annualized pace.

The divergence is starting to show up in interest rate differentials. The spread between 2Y USD OIS and 2Y CAD OIS has widened by 25bps over the last month. Our rates colleagues expect the Bank of Canada to stay on hold, defying market expectations for almost two rate hikes. The Fed is a wild card, but even under a dovish chair, the committee is unlikely to pivot meaningfully in the near term.

USDCAD continues to track front-end rate differentials closely. A wider spread should keep pressure on the loonie through the summer. We cut our CAD forecast last month, but even our revised year-end call of 1.35 now looks optimistic given the growing gap in front-end rates.

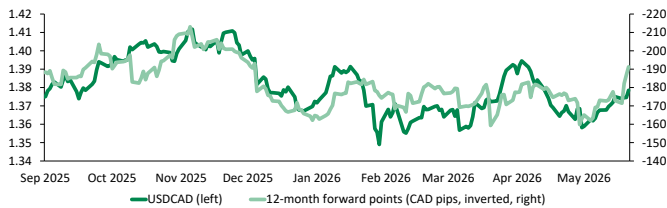
We highlight two additional themes below: the proposed pipeline MOU and the upcoming CUSMA review.

- ▶ **Pipeline MOU:** Ottawa and Alberta are close to signing a deal, possibly over the summer, which will create a framework for accelerated permitting. But execution risk remains high. There is no private sector sponsor yet, and even in a best-case scenario, construction would not start before 2027, and completion would be further out still. In the meantime, Canada is adding capacity at the margin through brownfield upgrades (Trans Mountain Expansion upgrade, Sunrise Expansion Program). For now, the link between energy prices and the CAD remains weak.
- ▶ **CUSMA review:** Trade talks lack momentum. Any meaningful trilateral or bilateral engagement has been limited so far. Washington has pushed for revisions on rules of origin, market access and broader industrial policy alignment, while Section 232 tariffs on steel and aluminum remain in place. But neither side appears in a hurry. With the formal review set to conclude July 1, the most likely path is a drawn-out process—annual reviews, incremental tweaks and elevated uncertainty rather than a clean extension.

**We maintain our forecast for USDCAD to end the year around 1.35 and 1.30 next year.**

**Graph 2**  
Rate Differentials Are Moving in Favour of the USD

USDCAD vs. 12-month FX forward points (more negative = CAD yields lower than USD)



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## EUR

### The ECB Is Set to Hike in June

Our base case has shifted to a 25bps hike at the next monetary policy meeting on June 11. It's a close call, but if energy prices remain elevated by the time of the Governing Council meeting, we expect the hawks to carry the day. We expect the ECB will hike once again in September and then remain on hold.

Headline inflation climbed to 3.0% y/y in April, while core held steady just above 2%. With the labour market remaining tight, the ECB is wary of second-round effects. Several Governing Council members have expressed support for hiking early to bolster the central bank's credibility.

We remain cautious on the euro's prospects. The divergence between a hawkish ECB and an on-hold Fed could make the single currency more appealing, but the market has already priced in three rate hikes by March 2027, which would put additional strains on an economy dogged by energy insecurity and trade uncertainty. A weaker euro is not the answer to Europe's problems, but a stronger currency would only make things worse. We expect President Lagarde will guide the market away from expecting an extended rate hike cycle.

**We continue to expect a broad range in EURUSD between 1.15 and 1.20 in 2026.**

## GBP

### More Muddle-Through

The bear case for the pound is now well flagged: the Bank of England is unlikely to hike as much as currently priced, and the UK bond market is one of the most fragile among developed markets due to weak political appetite for difficult reforms. Has anything changed? Is all the bad news priced in?

On the monetary policy front, we still hold the view that the BoE is unlikely to deliver the two rate hikes the market is pricing by the end of this year. If anything, the debate may shift back towards rate cuts whenever energy supply normalizes.

The fiscal story is also in limbo. The embattled prime minister Keir Starmer continues to hold office for now but will soon face a formal leadership challenge by Andy Burnham, assuming Mr. Burnham can win a by-election on June 18 to secure a seat in Parliament. Most analysts expect Burnham to change the fiscal framework towards more borrowing, but bond vigilantes in the gilts market may constrain his agenda.

The bottom line is that it's too early to call a clear policy pivot. We recognize that the market has become very pessimistic on the UK, but fundamentals are not improving.

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

## JPY

### If You Fail Once, Try Again

Japanese authorities spent about US\$30–\$35 billion in May to push USDJPY below 160. But less than a month later, the pair is back to almost the same level. We're not surprised. As we argued last month, intervention can slow the depreciation, but it's not going to change the direction—at least not until the excessively loose fiscal and monetary policies are tightened meaningfully.

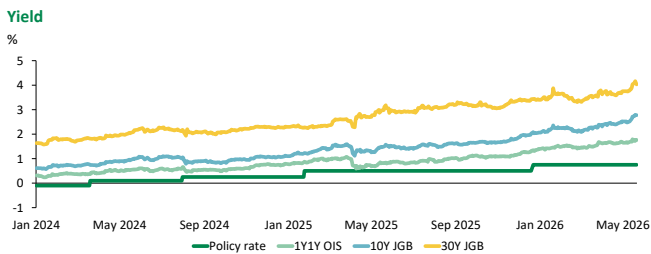
To be fair, the Bank of Japan is edging toward a hike. June is now a live meeting, with roughly a two-thirds probability priced for a 25bps move. But it may be too late to repair the Bank's credibility. Even if the Bank hikes rates twice this year as the market expects, policy rates will remain below inflation for the fifth year in a row. Japanese savers are losing out, and the currency continues to pay the price.

Meanwhile, the bond market is sending a clear warning. Japanese Government Bonds (JGBs) have continued to bear-steepen. The spread between 2Y and 10Y JGBs widened to the highest level since 2004. But fiscal policy isn't listening. In fact, it appears the populist administration of Prime Minister Takaichi is set to announce a supplementary budget to reduce the burden

of higher energy costs on households. That means more supply of government bonds amidst a buyers' strike. The BoJ is still buying bonds to suppress yields, and if the Bank is pressured into more bond buying, it could increase the pressure on the yen.

**We continue to expect the JPY to fall to 165 in the coming months but expect it to rebound to 145 next year.**

**Graph 3**  
Japanese Interest Rates



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**CNY**

**A Stronger CNY Is Now Baked into Forwards**

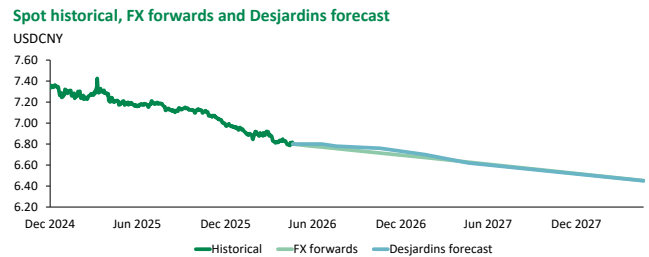
We continue to expect a stronger Chinese renminbi on the back of strong external surplus and stabilizing domestic demand. Beijing also sent a clear message last year that it will accept a stronger yuan to project macro stability and encourage exporters to move up the value chain and compete less on low price alone.

However, the CNY is now up 6% y/y vs. the USD, which is a substantial move by the standards of China's managed float regime. Forwards have shifted as well and are now in line with our forecasts. Finally, speculative positioning has become substantial, as Asia-based fast money has bought USDCNY puts at scale in recent weeks. We consider that a contrarian signal.

Net-net, while we still expect the CNY to strengthen gradually, we believe FX forwards are now discounting this adequately.

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

**Graph 4**  
A Stronger CNY Is Now Priced In



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**BRL**

**Bad Medicine**

The Brazilian real has been the top performing liquid emerging market currency this year, supported by high real rates, gradual rate cuts and rising commodity prices. The BRL strengthened to around 4.88 vs. the USD earlier this month. We expect the currency to consolidate on rising macroeconomic and political uncertainty in the coming months.

The Lula administration has rolled out relief measures to shield consumers from rising oil prices. These include a temporary elimination of federal taxes and direct subsidies to importers of LPG and diesel. (Brazil exports crude oil but imports refined products.) The program has an estimated fiscal cost of 0.3% of GDP on an annualized basis. The government has argued that this will be offset by higher oil-related revenues. But some slippage is likely, which could put this year's target of a 0.2% primary balance deficit out of reach, particularly as there is likely to be more populist spending as the country heads into closely contested elections in October.

Moreover, subsidizing gas prices for consumers amidst a global shortage usually backfires. Fuel subsidies create incentives for smuggling the cheaper fuel from domestic sources to international markets, which leaves the government with an inflated subsidy bill and shortages at local pumps. There is strong historical precedent for this in Latin America.

**We maintain our forecast for USDBRL to trade between 5.10 and 5.20 in H2. Risks are skewed towards a weaker BRL on election noise.**

**Table**  
**History and Forecast**

End of period	2025		2026				2027				
	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	
<b>US dollar</b>											
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	145	145
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	17.30	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	5.20	5.10	5.00
Effective dollar <sup>1</sup>		111	112	113	112	111	110	108	107	106	105
<b>Canadian dollar</b>											
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	111	112
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	12.54	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	3.94	3.89	3.85

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

Datastream, Federal Reserve Board and Desjardins Economic Studies