

FX ANALYSIS

The USD Rally May Run Out of Gas

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HIGHLIGHTS

- ▶ The US dollar is winning amidst growing stress in global energy and bond markets. We expect conditions to shift into year-end.
- ▶ The loonie has weakened more than our forecasts on wider rate differentials. But we are sticking to our view that the Canadian dollar will recover.
- ▶ Pressure on French finances and German politics has sharpened market focus on the euro's structural challenges.
- ▶ Intervention is not enough to stabilize the yen. Japanese savers expect to earn a real yield. BoJ needs to accelerate the hikes.
- ▶ The PBoC warned traders to stop buying CNY. That won't stop it from strengthening.
- ▶ BRL is poised to strengthen once the election dust settles.

USD

Winning the Crisis Trade

Since the end of July, market pricing for Fed rate hikes has increased sharply. The global energy shock, and with it, the rout in global bond markets has intensified. Against that backdrop, the US dollar has strengthened back to the summer highs against most currency pairs.

FX markets appear to be at a key juncture. The US dollar has been in a broad range for the last 18 months, but it is now testing key resistance levels. A close in the DXY Index above 102 would signal a topside breakout. Key levels to watch include 1.135 in EURUSD, 1.425 in USDCAD, 160 in USDJPY and 1.300 in GBPUSD, a clear break of which would represent a meaningful extension of dollar strength.

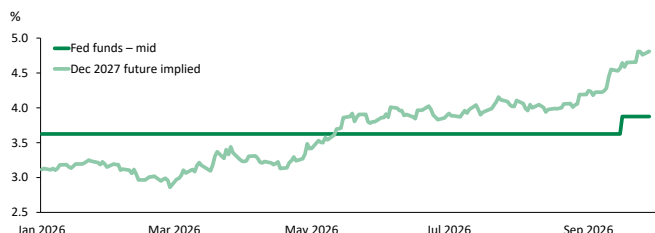
We are not convinced the dollar is entering a new bull market. Much of the recent move reflects unusually severe geopolitics and an aggressive repricing of Fed expectations. We are cautious about assuming current levels of geopolitical and

energy-related stress will persist indefinitely. If energy markets stabilize or the Fed remains on hold at the October meeting as we expect, some of the dollar's recent gains could reverse.

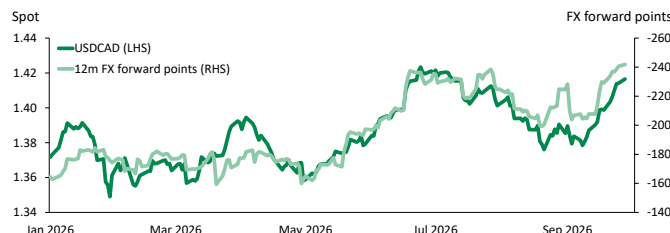
Forecasting geopolitical conflicts and commodity prices is exceptionally difficult. With the US mid-term elections approaching, the Trump administration will likely face growing pressure to demonstrate progress on energy prices. Markets are also contemplating a Democratic sweep, which could introduce legislative gridlock and complicate the administration's domestic agenda.

Graph 1 on page 2 shows the Fed funds rate against interest rate futures pricing for end 2027. Since the July 29 meeting, markets have added 75 basis points (bps) in hikes. Assuming energy prices normalize in coming months, we believe the Fed will underdeliver.

The US dollar has come out ahead as energy prices spiked and bond markets unravelled. We expect some of those gains to unwind into year-end.

Graph 1
Markets Expect Substantial Tightening from the Fed
Fed funds rate vs. interest rate futures for Dec 2027


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Graph 2
USDCAD Higher on Wider Rate Differentials
USDCAD vs. 12-month FX forwards


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CAD

Rate Differentials Appear Stretched

The Canadian dollar has weakened more than we expected. The move in USDCAD from 1.380 to 1.415 appears warranted by the shift in rate differentials between the US and Canada. The spread between 2Y swap rates widened to about 150bps, which is very stretched on a historical basis.

To be sure, it is risky to assume that the spread will mean-revert, particularly since the labour market in the US appears much tighter than Canada's. Markets are also pricing in more tightening from the Bank of Canada than the Federal Reserve over the next year. If energy prices retreat, it's possible that the very front end of the CAD OIS curve drops more than USD OIS, thus widening the spread at first.

Canadian political risk could become a modest source of FX volatility in the month ahead, as markets navigate Quebec's provincial election and Alberta's referendum. Finally, trade talks between the US and Canada remain stalled, with both sides betting that the other will cave first.

However, we are maintaining our FX forecast for USDCAD to end the year around 1.39 and 1.35 next year. We believe

improving prospects for business investment could eventually support the loonie. For now, interest-rate differentials remain the more important driver. A sustained widening in Canada-US rate differentials would present the clearest challenge to our constructive medium-term CAD view.

EUR

The Core Issue

The European Central Bank raised rates by 25bps in September and struck a hawkish tone, citing higher inflation risks from the Iran conflict. We expect one more rate hike in December but would not rule out that hike occurring earlier, at the October meeting.

The ECB reacted to energy prices earlier than its peers and remains highly sensitive to the size and duration of supply disruptions. However, with markets now pricing in three to four Fed hikes, broadly matching expectations for the ECB, much of the euro's support from rate differentials has evaporated.

We remain cautious on the euro's longer-term prospects as Europe's industrial base faces pressure from high energy costs and intensifying competition from China. At the same time, fiscal and political risks are beginning to re-emerge. The Bund-OAT spread has widened beyond 105bps, its highest level since the 2011–12 European debt crisis, while Germany's euro-sceptic AfD party has posted strong gains in recent regional elections.

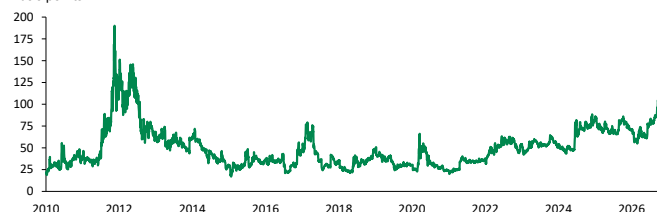
Germany and France remain the core pillars of the monetary union. The euro survived the sovereign debt crisis because the stresses were concentrated in the periphery while the core remained committed to the European project. Today, however, the combination of French presidential elections next year, mounting fiscal pressures and growing support for euro-sceptic parties in Germany is raising the spectre of political fragmentation within the currency bloc. While a break-up scenario remains remote, investors may increasingly demand compensation for these risks, particularly if fiscal and political tensions continue to build.

We expect EURUSD to hold in a core trading range of 1.12–1.15 for the rest of this year.

Graph 3

Rising Bond Yields Have Put France on Notice

10Y French bond yield minus 10Y German bond yield
Basis points



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GBP

Stand and Deliver

The UK is a large energy importer, relying on imports for roughly 44% of its energy consumption. It is also a highly indebted economy, with government debt at 105% of GDP and total non-financial debt approaching 250% of GDP.

Against this backdrop, rising energy prices and bond yields are a double whammy to the economy. The UK natural gas benchmark has climbed above USD25/mmbtu, its highest level since September 2022 and roughly 7.3 times the US Henry Hub benchmark. Meanwhile, 10Y gilt yields have risen to 5.4%, up 90bps year to date. With no obvious end to energy supply disruptions and winter approaching, the UK macro-outlook remains fragile.

Fiscal and monetary policy remain in focus. Markets are looking to Prime Minister Andy Burnham's first budget on October 28, while the Bank of England appears set to raise rates by 25bps on November 5. Yet neither is likely to deliver the kind of adjustment needed to materially strengthen the UK's underlying fundamentals. Incremental policy changes may buy time, but they will do little to reduce the economy's dependence on imported energy, elevated debt burdens and external financing.

The pound has been remarkably resilient in the face of external shocks this year, but with the environment becoming more challenging, downside risks remain prominent.

We expect GBPUSD to end the year around 1.35 and EURGBP around 0.85.

JPY

Intervention Is Not Enough

The Bank of Japan has sold about USD175 billion to prop up the yen this year, spending about 15% of its forex reserves since the start of the year. The US Treasury has publicly expressed support for Japan's efforts to stabilize the yen, with Secretary Bessent going as far as to warn traders not to bet against the currency. Japanese authorities have effectively created a line in the sand for USDJPY at 160 and are rumoured to have prodded the state-owned pension fund to buy the yen again in September.

For all that effort, USDJPY is roughly unchanged year-to-date and currently sits in the middle of a broad trading range of 164–152. Intervention is a temporary solution to a broader disconnect: The BoJ, under pressure from the Takaichi administration, continues to hold the short rate well below inflation. While the central bank hiked rates in September to 1.25%, it was not a unanimous decision, and its guidance of gradual, data-dependent tightening fell short of expectations. Moreover, with the Federal Reserve also raising rates, the difference in front-end interest rates remains wide.

Japanese savers expect to earn a positive real yield and are not persuaded by intervention alone. Japanese authorities may have capped USDJPY for now, but a stronger yen requires faster BoJ tightening. Over the medium term, we expect narrowing US-Japan rate differentials to support the yen, though the timing remains uncertain.

We expect the JPY to remain volatile around 160 in coming months, followed by a move down to 150 next year.

CNY

Don't Fight the Trend

China's central bank issued another warning about "herd behaviour" in the foreign exchange market, underscoring its discomfort with the renminbi's steady appreciation.

There is some merit to these concerns. Implied FX volatility has fallen to just 2%, its lowest level in more than a decade, while bullish CNY positioning has become increasingly crowded among offshore investors.

Any policy-induced correction would likely be another buying opportunity. As [we argued](#), China's enormous trade surplus has created a persistent glut of dollars that state-owned banks continue to absorb in order to slow the renminbi's advance. The scale of this "stealth" intervention suggests the currency remains well below its market-clearing level.

Trade policy remains a key risk. EU-China negotiations are due to reach a critical stage in October, with European officials seeking a credible path toward reducing trade imbalances and potentially considering additional tariffs against specific Chinese imports. Meanwhile, Washington and Beijing agreed to lower tariffs on USD30bn of each other's exports and extended the Busan Agreement to not raise bilateral tariffs to January 10.

While these discussions could generate periodic volatility, they are unlikely to alter the fundamental driver of the renminbi: China's exceptionally large external surplus.

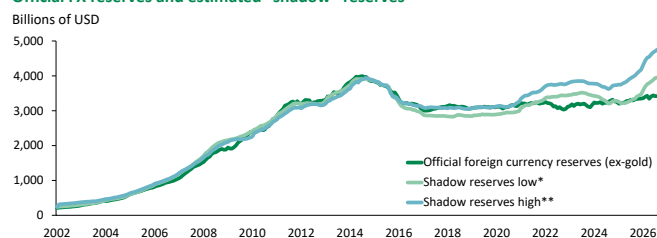
We maintain our forecast for USDCNY to fall to 6.70 by the end of this year and to 6.50 next year.

view any election-related weakness as temporary. Once the dust settles, Brazil's still-elevated carry and rising commodity exports should continue to support the currency.

We expect BRL to fluctuate near 5.20 through the election period and maintain our forecast of 5.00 once the political noise subsides.

Graph 4
China Continues to Intervene in Forex

Official FX reserves and estimated "shadow" reserves



* Net forex settlement; ** Add: foreign currency deposits of residents.

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BRL

Room to Ease

In contrast to most major central banks, the Banco Central do Brasil cut rates by another 25bps this month, its fifth consecutive rate cut. Policymakers signaled that further easing is likely, although the pace will remain gradual and data dependent.

While inflation expectations have risen alongside global energy prices, the BCB has substantial policy flexibility. At 13.75%, the Selic rate remains among the highest in the world, leaving policymakers with ample room to cut rates. We think the current easing cycle has considerable runway. The real has softened in recent months but remains one of the best performing emerging-market currencies this year.

Attention now turns to October's presidential election. Polling suggests neither of the two leading candidates is likely to secure an outright majority in the first round (October 4), raising the prospect of a closely contested runoff on October 25. Political uncertainty could generate near-term volatility, but we would

Table
History and Forecast

End of period		2025		2026				2027			
		Q3	Q4	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f
US dollar											
Canadian dollar	USD/CAD	1.39	1.37	1.39	1.42	1.42	1.39	1.37	1.36	1.35	1.35
Euro	EUR/USD	1.17	1.18	1.16	1.14	1.14	1.15	1.15	1.14	1.14	1.15
British pound	GBP/USD	1.33	1.35	1.32	1.32	1.32	1.35	1.34	1.33	1.34	1.35
Swiss franc	USD/CHF	0.80	0.79	0.80	0.80	0.84	0.83	0.79	0.78	0.77	0.75
Yen	USD/JPY	148	157	159	162	158	160	158	155	152	150
Australian dollar	AUD/USD	0.66	0.67	0.69	0.72	0.70	0.72	0.76	0.77	0.78	0.78
Chinese yuan	USD/CNY	7.12	6.98	6.89	6.85	6.71	6.70	6.68	6.65	6.60	6.50
Mexican peso	USD/MXN	18.40	17.98	17.93	17.30	18.00	17.80	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	114	113	112	112	112	111
Canadian dollar											
US dollar	CAD/USD	0.72	0.73	0.72	0.70	0.70	0.72	0.73	0.74	0.74	0.74
Euro	EUR/CAD	1.63	1.62	1.61	1.62	1.62	1.60	1.58	1.55	1.54	1.55
British pound	GBP/CAD	1.85	1.85	1.84	1.87	1.87	1.88	1.84	1.81	1.81	1.82
Swiss franc	CAD/CHF	0.58	0.58	0.57	0.56	0.59	0.60	0.58	0.57	0.57	0.56
Yen	CAD/JPY	106	115	114	114	111	115	115	114	113	111
Australian dollar	AUD/CAD	0.92	0.92	0.96	1.02	0.99	1.00	1.04	1.05	1.05	1.05
Chinese yuan	CAD/CNY	5.12	5.09	4.95	4.82	4.73	4.82	4.88	4.89	4.89	4.81
Mexican peso	CAD/MXN	13.24	13.12	12.88	12.18	12.68	12.81	12.77	12.94	12.96	12.96
Brazilian real	CAD/BRL	3.83	3.98	3.72	3.59	3.66	3.67	3.72	3.75	3.74	3.70

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

Datastream, Federal Reserve Board and Desjardins Economic Studies