FX Forecasts

Desjardins Economic Studies
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Will the Canadian dollar rebound?

HIGHLIGHTS

- Given that the Canadian data should be better in the coming quarters, especially if U.S. and global demand grow as forecast, we can be optimistic about the Canadian dollar. A return to US$1.00 is within reach by year's end.
- Although the U.S. economy is doing better, the country's monetary policy will remain very expansionary, a situation that will hurt the greenback. Also, the U.S. dollar's safe-haven effect will slowly wane as global growth firms up.
- The ongoing recession in euro area and the possibility of further monetary easing should keep the euro close to US$1.30 until the middle of the year. This currency should appreciate in the second half of the year, however.
- After some sharp depreciation, the potential for further declines by the yen and pound now seems smaller. The pound seems poised for a substantial rise in the second half of the year, given that the expectations of monetary easing or of a change of mandate for the Bank of England are probably exaggerated.

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Editorial

Most of the major currencies remain highly volatile. However, the currency war has been raising less interest in the last few weeks. As long as big exchange depreciations reflect normal adjustments associated with laudable monetary policy objectives, such as inflation targets and reasonable growth, it will be hard to accuse a country of deliberately devaluing its currency.

The yen and pound have posted the biggest pullbacks in anticipation of monetary easing. The euro has corrected after appreciating early in the year, a movement that has taken it back to around US$1.30. The U.S. dollar is capitalizing on the other currencies' weakness, especially as U.S. statistics are encouraging and doubt emerged about the Federal Reserve's ability to drag out its quantitative monetary policy for a long time. The Canadian dollar, for its part, has depreciated to US$0.967. A string of disappointments from Canadian statistics and a softening Bank of Canada (BoC) stance have prompted investors to reposition themselves. A question that arises now: Will the Canadian dollar rebound?

CONCERNS ABOUT CANADA'S ECONOMY

Over the last three years, the Canadian dollar has been above the symbolic US$1.00 mark more often than it has been below it. Times when it has oscillated below parity have frequently been characterized by a very uncertain climate and strong fears about the global economy. Now, while some worries have resurfaced in Europe recently, we cannot characterize the current situation as very strained. This time, the Canadian dollar's weakness is more due to domestic factors.

A number of the statistics on the Canadian economy released in January and February came in below expectations, including the major correction by housing starts in December. The figures for January were better, but the trend remains downward for housing construction in Canada, following several booming years (graph 1 on page 2). Weak retail sales

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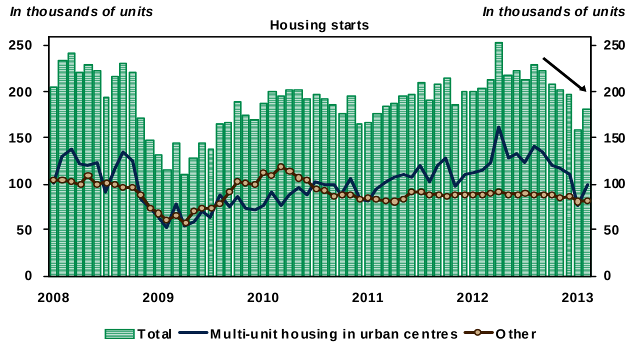
Graph 1 – Canadian residential construction corrects and December's numbers were especially worrisome

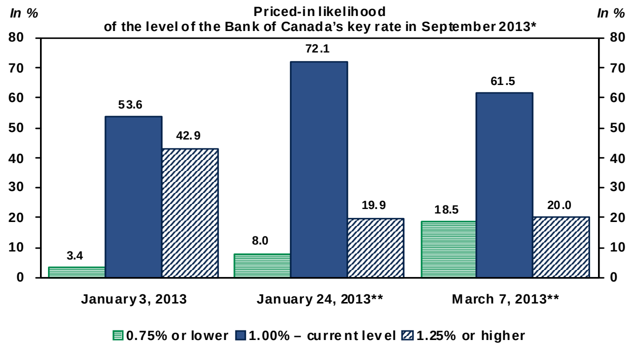


Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

in December, as well as the job losses posted in January were among the most disappointing statistics.

The BoC put in its two cents by softening its stance and downgrading its economic outlook for 2013. The BoC also pushed back the timing of an initial rate hike, stating that the "considerable monetary policy stimulus currently in place will likely remain appropriate for a period of time, after which some modest withdrawal will likely be required." Combined with the low Canadian inflation rate, the BoC's change of stance even prompted the markets to start expecting an interest rate cut by the fall (graph 2). However, this trend did not hold up and helped the loonie stabilize.

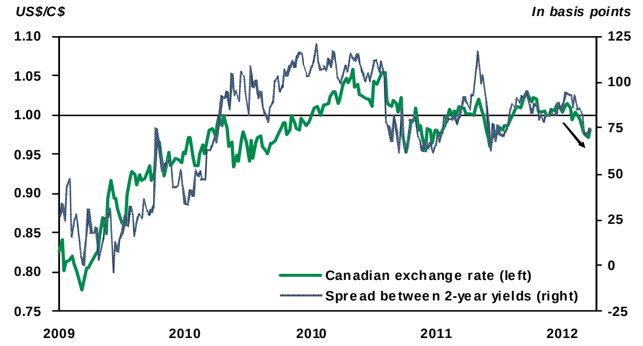
Graph 2 – The Bank of Canada's change of stance influenced market expectations



* According to 3-month swaps indexed to the overnight rate; ** Day after the Bank of Canada meeting.
Sources: Bloomberg and Desjardins, Economic Studies

Canada's disappointing economic figures and the postponed onset of monetary firming still affected interest rate spreads between Canada and the United States. The Canadian dollar followed that movement (graph 3). The relationship between the exchange rate and 2-year interest rate spreads has been especially strong since 2011.

Graph 3 – The Canadian dollar retreated in tandem with interest rate spreads

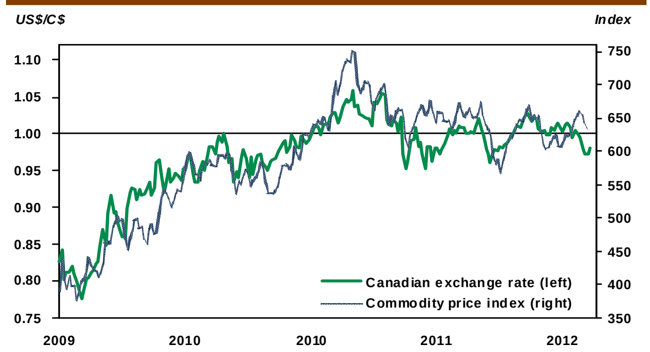


Sources: Datastream and Desjardins, Economic Studies

THE UPSWING BY COMMODITY PRICES HAD NO IMPACT

The Canadian dollar depreciated even as commodity prices edged up in January and February (graph 4). Historically, the relationship between resource prices and the Canadian exchange rate has been very strong, particularly with oil prices, but this has never been the only determining factor. Factors associated with Canadian domestic demand and future interest rate movements have had a heavier weight recently. Moreover, the relationship between the loonie and oil prices seems to have been affected by the problems with exporting Alberta's oil to major world markets, due to inadequate infrastructure. The lower prices that currently prevail for Alberta's oil are also hurting the improvement to Canada's terms of trade, subduing the wealth effect.

Graph 4 – The rise by commodity prices has not changed anything



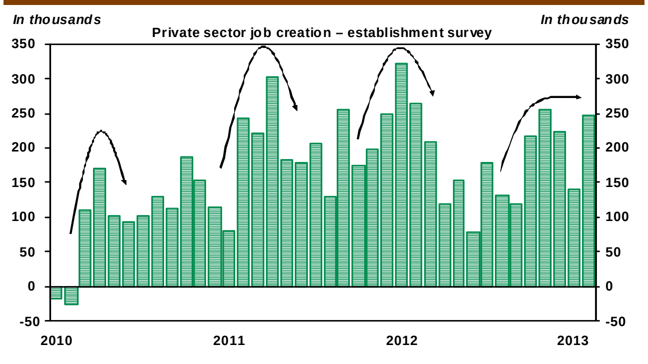
Sources: Datastream and Desjardins, Economic Studies

U.S. DEMAND WILL SUPPORT CANADIAN EXPORTS

Despite the drop in housing construction and the impacts of the austerity measures that are still being felt, we expect Canadian growth to continue to be buoyed by consumers and business investment. February's rebound by employment was reassuring. However, a big piece will have to come from international merchandise trade, which seems perfectly credible given that the U.S. economy is doing better and better.

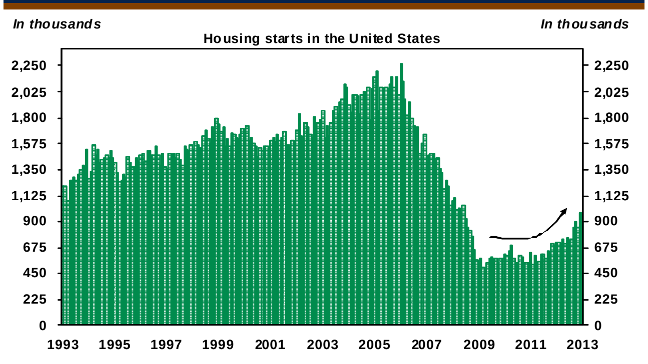
One piece of good news for U.S. demand is the acceleration in job creation (graph 5). The last establishment survey reported that a net 236,000 jobs were created in February, following the 119,000 jobs added in January, and 219,000 in December. The situation is also improving in housing. In particular, the rebound seems to be well underway in the construction sector (graph 6). Lastly, despite the increase in the payroll tax early in the year, retail sales continue to show good growth, meaning that we can be optimistic about U.S. consumption for the coming quarters. The negative impacts on growth resulting from the tax hikes on the wealthy and automatic cuts to public spending will be largely offset.

Graph 5 – Job creation accelerates to over 200,000 per month in the United States



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Graph 6 – Housing construction has started to come back



Sources: Datastream and Desjardins, Economic Studies

IN THE EURO ZONE, GROWTH WILL BE BACK IN THE SECOND HALF OF THE YEAR

The United States will not be the only place in which the economic situation improves. Japan, the United Kingdom and the euro zone should all return to growth, although it could be modest. In the euro zone, we will probably see a first real GDP increase in the second half of the year.

The inconclusive outcome of Italy's election was not as destabilizing as Greece's last year. Several reforms have already been instituted in Italy, and it would prove difficult for a weak coalition government to cancel these. Elsewhere in the euro zone, reforms must continue to ensure a lasting return to growth. The plans for a banking union, which raised a great deal of interest last year, should materialize, although negotiations seem to be stumbling. European leaders have repeatedly shown that they are capable of reaching an agreement. However, it often takes a reminder from the financial markets and, as a result, a little upheaval is still expected in the Old World in the near term. Financial strains from Cyprus should be temporary.

SEVERAL CURRENCIES COULD RISE AGAINST THE GREENBACK BY YEAR'S END

Given that the Canadian data should be better in the coming quarters, especially if U.S. and global demand grow as forecast, we can be optimistic about the Canadian dollar. A return to US$1.00 is within reach by year's end.

However, the loonie will not be the only currency to rebound. The forecast renewed growth in the euro zone in the second half of the year should mark the start of more sustainable appreciation by the euro. Although the U.S. economy is doing better, the country's monetary policy will remain very expansionary, a situation that will hurt the greenback. Also, the U.S. dollar's safe-haven effect will slowly wane as global growth firms up.

After some sharp depreciation, the potential for further declines by the yen and pound now seems smaller. The pound seems poised for a substantial rise in the second half of the year, given that the expectations of monetary easing or of a change of mandate for the Bank of England are probably exaggerated.

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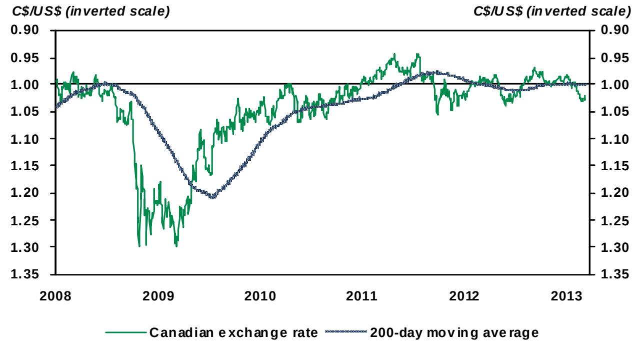
CANADIAN DOLLAR (CAD)

Heading for parity with the U.S dollar by the end of the year

- The Canadian dollar continued the slide it began in mid-January. A series of disappointments from Canadian economic statistics and a change in stance from the Bank of Canada (BoC) have carried more weight than the upswing by commodity prices. After falling below US$0.97 a few times in early March, the loonie now seems to be stabilizing.
- Technically speaking, the previous trough of US$0.96 was not tested. This low point was hit last June when financial strains in Europe were surging and global economic growth weakened. However, net speculative positions show greater pessimism about the Canadian currency this time. An upward revision of investors' positions is not out of the question in the short term.
- Fundamentally, even if the data has been rather disappointing lately, conditions are hardly abysmal in Canada. Consumption seems able to hold up, although, compared with recent years, growth by consumption will tend to be modest to avoid a debt overload. Residential investment is expected to contract to a level that is more sustainable in the long term, but a rise in business investment will mitigate its negative impact. That being said, one key element for Canada's economic growth over the coming quarters will be a stronger contribution from exports, which should be sustained by the rebound observed in U.S. demand.
- Canada's weak economy in the last few quarters has increased surplus production capacity, thus justifying postponing the first increase to key interest rates until late 2014. After softening their remarks about eventual key rate hikes last January, the BoC took an additional step on March 6, stating that current monetary stimulus would probably remain in place for some time. The reference to eventual rate hikes could even disappear when the next *Monetary Policy Report* is released in April. The correction that has begun in the real estate sector no longer justifies this remark, which specifically targeted mortgage borrowers.

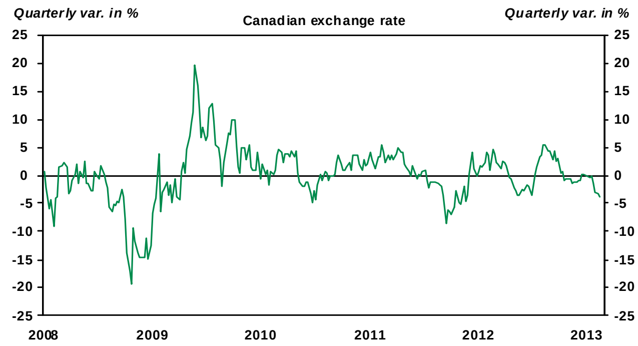
Forecasts: The Canadian dollar could weaken again if the BoC softens its stance further. As was the case in early March, some investors could position themselves for an interest rate cut. The weak inflation rate also points in this direction. Nevertheless, these expectations seem exaggerated. Inflation is forecast to rise shortly, and economic statistics should be less disappointing. This will help the Canadian dollar to climb back near the parity by year end.

Canadian dollar and trend



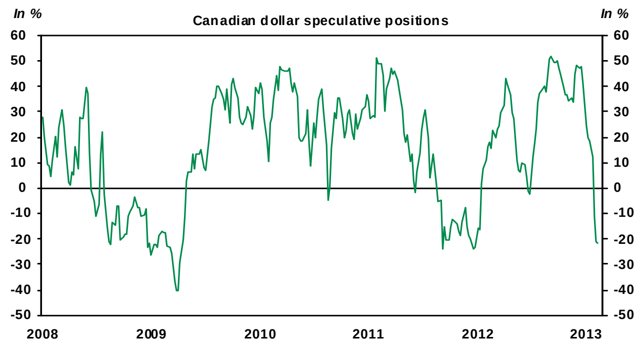
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

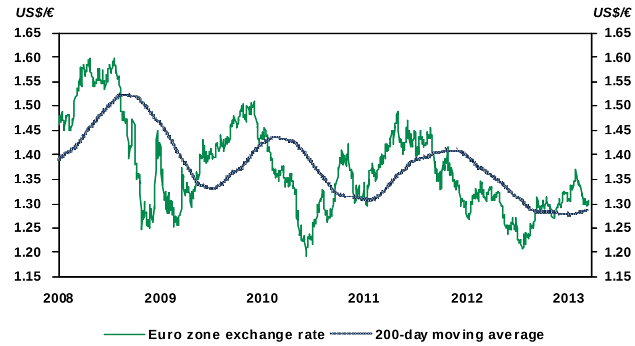
EURO (EUR)

Back near US$1.30

- Recent weeks have shown that we were right to be sceptical about the euro's thrust in early 2013. The common currency, which had reached US$1.37 at the beginning of February, began to retreat when the European Central Bank (ECB) stated that an overly strong euro could lead to downside risks to price stability. Subsequently, Italy's inconclusive election and new disappointing economic statistics steepened the euro's decline, bringing it to around US$1.30, close to its 200-day average.
- Italy's election on February 24 and 25 was a major risk for the euro. The result was one of the worst imaginable, as voters clearly rejected policies implemented by the previous government, led by Mario Monti, and no party seems capable of forming a solid government. The good performances by Silvio Berlusconi's coalition on the right and of former comedian Beppe Grillo's protest movement mean that the balance of power will be held by anti-austerity, even anti-Europe politicians. These results could have led to a surge in financial strains in the euro zone, especially since it is hard to see how the ECB can support Italian debt without a government capable of negotiating with the rest of Europe. To date, though, pressure has been limited on Italian bonds, as investors seem relatively unconcerned by the situation. One advantage of a weak government is that it would be harder to do away with previous reforms.
- After showing some optimism at the start of the year, the ECB noted recently that economic problems persist as everything suggests that the recession in the euro zone will continue through the first half of 2013. The ECB thus had to slightly downgrade its growth forecasts for the euro zone. As inflation has dropped back below 2% and should stay there for several more quarters, the door is open to further monetary easing. A key rate cut was discussed during the March meeting and the ECB could take action soon. It could also implement new unconventional measures, in particular to facilitate financing for small and medium businesses.

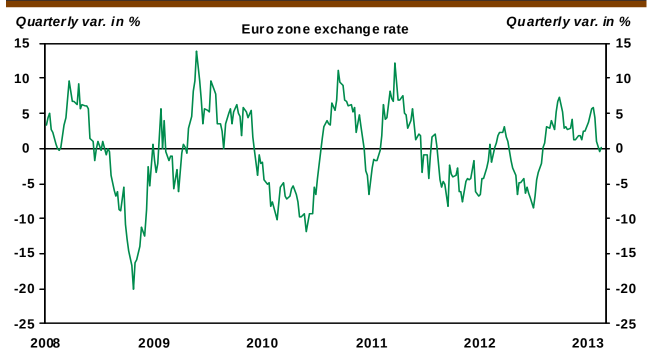
Forecasts: The ongoing recession and the possibility of further monetary easing should keep the euro close to US$1.30 until the middle of the year. However, this currency should appreciate in the second half of the year, when the euro zone's economy should return to growth. The main downside risk for the common currency remains Italy's unstable political situation.

Euro and trend



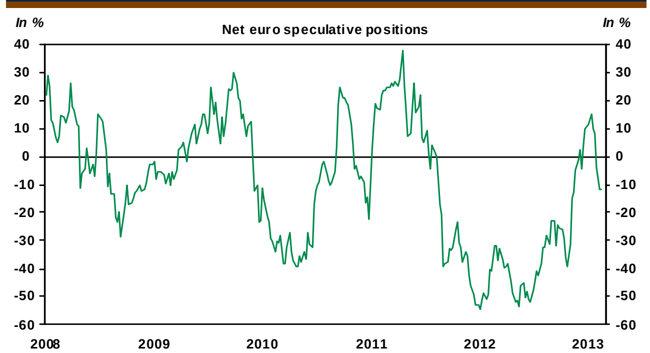
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



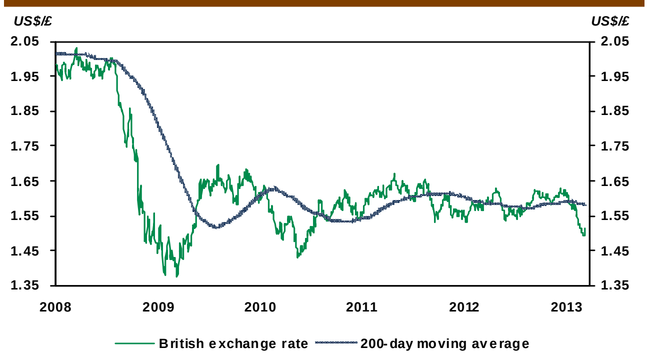
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

The pound is still tumbling

- Early in the year, the Bank of England (BoE) was wondering if the pound was too strong. Since then, the pound has posted a spectacular retreat, even dropping below US$1.50 for the first time since the summer of 2010. The pound is also very weak against the euro. The United Kingdom's economic problems are partially responsible for the weak pound. Added to this is a downgrade of the British government's debt. These problems are worst than in the rest of Europe, however.
- In the end, the BoE did not make any announcements at its March meeting. Several BoE leaders, however, are taking very dovish stances. Added to this are government pressures on the BoE to do more and rumours of a change in the remit of the bank. With the inflation outlook and expectations well above the BoE's 2% target, such talk can worry investors. **All in all, however, changes to the British monetary policy should be slight, allowing the pound to rise in the second half of the year.**

British pound and trend



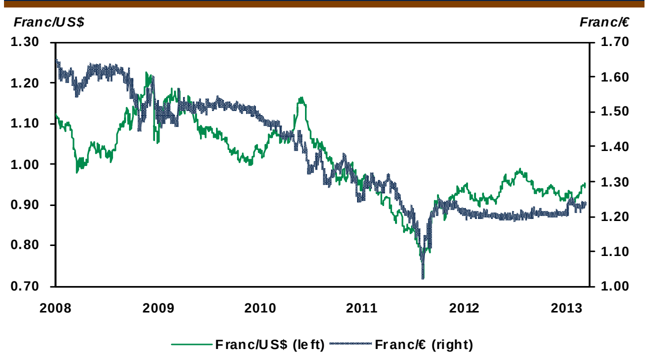
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

Monetary policy will remain expansionary

- Like the other European currencies, the Swiss franc has pulled back sharply against the greenback in the last few weeks. The USD/CHF pair went from 0.905 francs at the start of February to over 0.95 francs in mid-March. The EUR/CHF pair, however, has stayed around 1.23 francs, a little above the 1.20-franc floor set by the Swiss National Bank (SNB).
- In mid-March, the SNB clearly stated that it planned to maintain a highly accommodative monetary policy. It deems that a rise of the franc would threaten price stability and have serious repercussions for Switzerland's economy. The SNB downgraded its inflation outlook and Switzerland should see a second year of deflation in 2013. However, keeping the key rate close to zero has some negative consequences. The Swiss government therefore announced some measures to force banks to hold more equity. The SNB proposed the action, deeming that the imbalances in the mortgage and residential real estate markets represented a risk to financial stability. **Despite this, the Swiss franc could appreciate against the euro in the near term if international financial strains intensify.**

Swiss franc and trend



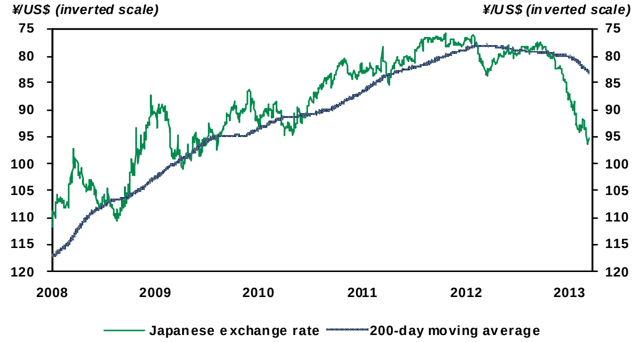
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

Will the Bank of Japan's new governor meet expectations?

- The yen continues to retreat in anticipation of the additional monetary easing that may soon be announced in Japan. No announcements were made following the monetary policy meetings in February and March, but that could change in April, when Haruhiko Kuroda steps in as governor. He has stated on several occasions that the Bank of Japan (BoJ) should intervene more.
- The yen's depreciation seems appropriate to reverse the erosion of the trade balance and revive economic growth in Japan. At around ¥100/US$, the exchange rate is returning to where it was four years ago.
- However, **this depreciation may be too fast, and a correction of its trajectory cannot be ruled out in the short term, especially if the BoJ fails to meet expectations.** In the longer term, the yen should continue to trend down. Japan will continue to be affected by its ageing population and high public debt, so the BoJ will probably be the last to cease its monetary interventions and raise interest rates.

Yen and trend



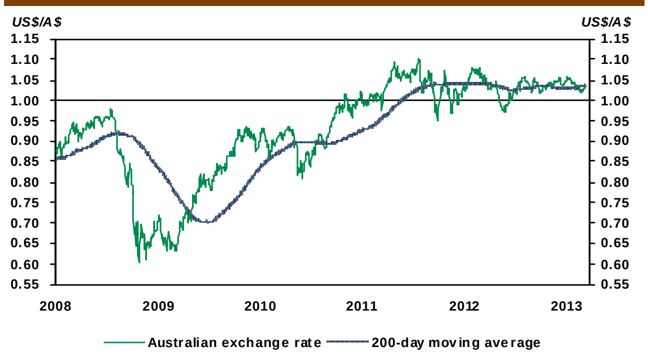
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The Reserve Bank of Australia could lower its key rate further

- The Australian dollar has weakened, recently testing a technical support at US$1.02 before rising a little. Three factors are playing against the currency. First, the fact that several commodity prices have flagged limits the improvement to the terms of trade. Second, Australia's economy is showing soft spots outside of the natural resources sector. Of course, Australia's economic growth beat that of most other advanced nations in the fourth quarter, but it will become increasingly difficult to stay the course if mining investments crest. Finally, due to concerns about growth, the Reserve Bank of Australia (RBA) is leaving the door open to further key interest rate cuts, especially since inflation does not appear threatening for the coming quarters.
- The potential for monetary easing seems limited, however. The overnight rate has already been lowered to the 3.00% floor it reached in 2009, and the RBA has been reluctant to take it further in the last four months. Between now and the end of the year, the **Australian dollar could gain a few cents as global demand for commodities improves.** Here, any sign that China is recovering will be especially welcome.

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

Inflation climbs in several emerging nations

CHINESE YUAN (CNY)

- China avoided a hard landing, with the annual growth rate rising to 7.9% in the fourth quarter, among other things. Inflation pressures also seem to be entering back the picture: the inflation rate stood at 3.2% last February.
- Some statistics remain mitigated, however. The trade balance dipped in February, retail sales grew less quickly than expected and the purchasing manager indexes (PMI) remain weak. As a result, **China's exchange rate could hold close to 6.20 yuan/US$ for a few more months, until more encouraging statistics reassure the monetary authorities.** The yen's sharp depreciation also adds uncertainty about the competitiveness of Chinese exporters.

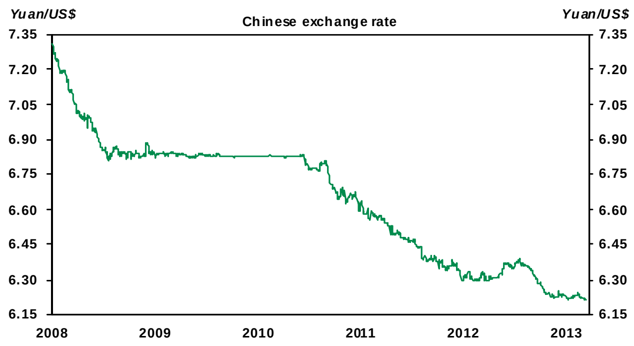
MEXICAN PESO (MXN)

- The Bank of Mexico (BoM) caused some surprise on March 8 when it cut its key rate by 50 basis points, bringing it to 4.00%. Although the BoM took a more dovish tone at the start of the year, this monetary easing may seem rushed, as inflation remains relatively high and Mexico's economic situation is not alarming. The BoM justifies the action with the fact that expansionary monetary policies in many other countries are creating unnecessary firming in Mexico's monetary conditions. This cut should not be the beginning of a monetary easing cycle.
- If the key rate cut was intended to weaken the peso, the results are not conclusive. The USD/MXN pair, which has been oscillating around 12.70 pesos, recently fell close to 12.40 pesos. The release of encouraging U.S. economic statistics explains the peso's appreciation.

BRAZILIAN REAL (BRL)

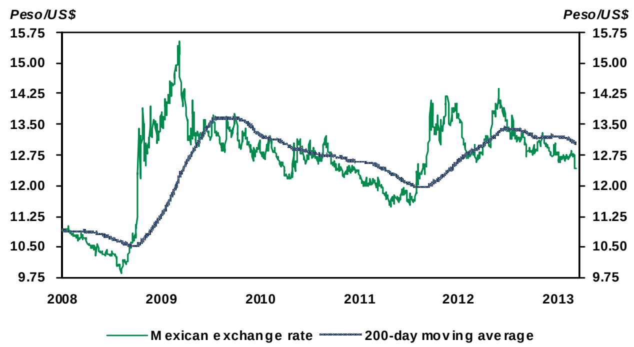
- The real was dragged down somewhat by renewed uncertainty in Europe at the end of February and weaker-than-forecast economic growth in Brazil. The currency's retreat was only temporary, however. In fact, growth continues to accelerate, putting upward pressure on the inflation rate, which rose to 6.3% in February, very close to the Central Bank of Brazil's (CBB's) upper limit of 6.5%.
- The upswing by inflation is prompting the CBB to be cautious. It has not announced any other interest rate cuts since last October. For now, the bank is showing neither upward nor downward bias in its statements. This neutral tone is limiting appreciation by the real, an issue that remains important for Brazil. **The exchange rate should not deviate much from the 2.00 real/US$ mark until the end of the year.**

Chinese yuan and trend



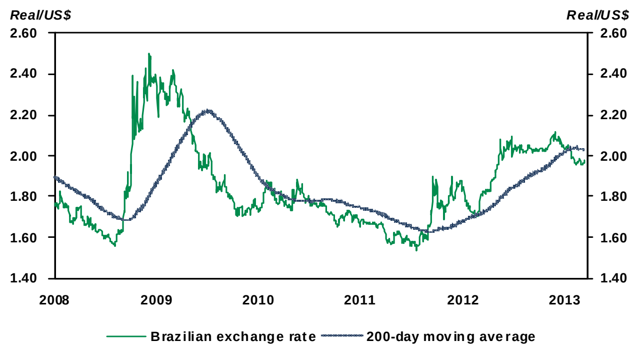
Sources: Datastream and Desjardins, Economic Studies

Mexican peso and trend



Sources: Datastream and Desjardins, Economic Studies

Brazilian real and trend



Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

Country – Currency*	Spot price March 17	Percentage return since: 1 month	3 months	6 months	1 year	Last 52 weeks: Higher	Average	Lower
Americas								
Argentina – peso	5.0913	1.6218	4.2488	8.9387	16.9394	5.0913	4.6847	4.3538
Brazil – real	1.9756	0.7471	-5.6588	-2.7445	9.5577	2.1108	2.0031	1.8033
Canada – dollar	1.0192	1.3223	3.5248	4.8724	2.8043	1.0411	1.0003	0.9685
Canada – (CAD/USD)	0.9812	-1.3050	-3.4048	-4.6460	-2.7278	1.0325	0.9997	0.9605
Mexico – peso	12.4364	-1.9443	-2.5662	-2.4489	-1.8608	14.4463	13.0857	12.3982
Asia and South Pacific								
Australia – (AUD/USD)	1.0412	1.0516	-1.3067	-0.5779	-1.7128	1.0610	1.0315	0.9704
China – yuan renminbi	6.2135	-0.3049	-0.3736	-1.6462	-1.7318	6.3885	6.2919	6.2135
Hong Kong – dollar	7.7611	0.0845	0.1426	0.1206	-0.0354	7.7696	7.7562	7.7500
India – rupee	54.0300	-0.5430	-1.5040	0.2691	7.7583	57.1250	54.2059	50.1400
Japan – yen	95.2750	1.8821	13.5781	21.0533	14.1702	96.2800	82.5662	77.4900
New Zeland – (NZD/USD)	0.8275	-2.0770	-2.0273	0.1158	0.3724	0.8480	0.8132	0.7514
South Korea – won	1,110	2.9959	3.5385	-0.4929	-1.3722	1,185	1,116	1,055
Europe								
Denmark – krona	5.7037	2.1519	0.6378	0.3501	1.0175	6.1688	5.7805	5.4693
Euro zone – (EUR/USD)	1.3066	-2.1310	-0.7256	-0.5405	-0.7972	1.3696	1.2893	1.2085
Norway – kroner	5.7601	3.8848	2.6481	1.0491	0.3720	6.1228	5.7760	5.4572
Russia – ruble	30.6275	1.6293	-1.2032	0.1350	4.8618	33.7117	31.0579	28.9975
Sweden – krona	6.3946	1.1532	-3.9280	-2.7326	-5.1753	7.2694	6.7042	6.2899
Switzerland – swiss franc	0.9388	1.6238	2.2715	1.3878	2.4780	0.9938	0.9386	0.9022
United Kingdom – (GBP/USD)	1.5131	-2.5284	-6.5901	-6.9920	-4.5001	1.6284	1.5832	1.4886

* In comparison w ith the U.S. dollar, unless otherw ise indicated.
Note: Currency table base on previous day closure.

Table 2
Currency market: history and forecasts

End of period		2012 Q3	2012 Q4	2013 Q1f	2013 Q2f	2013 Q3f	2013 Q4f	2014 Q1f	2014 Q2f	2014 Q3f	2014 Q4f
American dollar											
Canadian dollar	(USD/CAD)	0.9838	0.9922	1.0204	1.0204	1.0101	1.0000	0.9901	0.9804	0.9709	0.9615
Euro	(EUR/USD)	1.2865	1.3184	1.3000	1.3000	1.3100	1.3300	1.3400	1.3500	1.3500	1.3600
British pound	(GBP/USD)	1.6148	1.6255	1.5200	1.5300	1.5500	1.5800	1.6000	1.6100	1.6200	1.6300
Swiss franc	(USD/CHF)	0.9351	0.9153	0.9400	0.9400	0.9500	0.9500	0.9500	0.9500	0.9600	0.9600
Yen	(USD/JPY)	77.92	86.75	95.00	92.00	93.00	95.00	96.00	98.00	100.00	100.00
Australian dollar	(AUD/USD)	1.0376	1.0398	1.0300	1.0300	1.0400	1.0500	1.0500	1.0400	1.0300	1.0300
Chinese yuan	(USD/CNY)	6.2845	6.2303	6.2000	6.2000	6.1500	6.1000	6.0500	6.0000	5.9500	5.9000
Mexican peso	(USD/MXN)	12.86	12.87	12.50	12.50	12.40	12.30	12.20	12.00	11.75	11.50
Brazilian real	(USD/BRL)	2.0303	2.0432	1.9800	1.9900	1.9800	1.9600	1.9400	1.9200	1.9100	1.9000
Effective dollar*	(1973 = 100)	72.71	73.44	76.00	75.60	75.20	74.60	74.20	74.20	74.10	73.80
Canadian dollar											
American dollar	(CAD/USD)	1.0165	1.0079	0.9800	0.9800	0.9900	1.0000	1.0100	1.0200	1.0300	1.0400
Euro	(EUR/CAD)	1.2657	1.3081	1.3265	1.3265	1.3232	1.3300	1.3267	1.3235	1.3107	1.3077
British pound	(GBP/CAD)	1.5886	1.6128	1.5510	1.5612	1.5657	1.5800	1.5842	1.5784	1.5728	1.5673
Swiss franc	(CAD/CHF)	0.9505	0.9225	0.9212	0.9212	0.9405	0.9500	0.9595	0.9690	0.9888	0.9984
Yen	(CAD/JPY)	79.20	87.43	93.10	90.16	92.07	95.00	96.96	99.96	103.00	104.00
Australian dollar	(AUD/CAD)	1.0208	1.0317	1.0510	1.0510	1.0505	1.0500	1.0396	1.0196	1.0000	0.9904
Chinese yuan	(CAD/CNY)	6.3880	6.2793	6.0760	6.0760	6.0885	6.1000	6.1105	6.1200	6.1285	6.1360
Mexican peso	(CAD/MXN)	13.07	12.97	12.25	12.25	12.28	12.30	12.32	12.24	12.10	11.96
Brazilian real	(CAD/BRL)	2.0637	2.0593	1.9404	1.9502	1.9602	1.9600	1.9594	1.9584	1.9673	1.9760

f: forecasts; * Trade-w eighted against major U.S. partners.
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies