FX Forecasts

Desjardins Economic Studies
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The U.S. dollar's recent rise is unlikely to last

HIGHLIGHTS

- The drop in concern in the United States is now fuelling a perception that the Federal Reserve could start to taper off its interventions earlier than expected. This change of view comes when several other central banks are announcing additional measures, which, relatively speaking, is giving the U.S. dollar substantial support.
- However, the U.S. dollar is still a counter-cyclical currency and we must also note that greenback appreciation would not be very compatible with the United States' need to reduce its debt level.
- The Canadian dollar should return to US$1.00 by the end of the year if Canada's economy stays on course and global demand slowly improves, as forecast. A slight uptick by commodity prices would also help.
- The unfavourable economic climate and possibility of another key rate cut should keep the euro to get back above the US$1.30 mark over the next few months. An improvement to the economic outlook should prompt an uptick by the euro in the second half of 2013.

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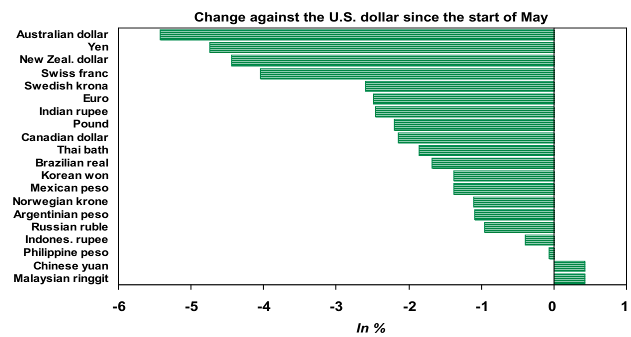
Editorial

The U.S. dollar is surging again. The surge seems fairly widespread, as shown by the limited number of currencies that have made gains against the greenback since early May (graph 1). The main factors behind this trend are the upswing in fears about European and Chinese economic growth, as well as about the likelihood that the Federal Reserve (Fed) will taper off its interventions earlier than previously expected. However, these factors will not be able to sustain the U.S. dollar very long and the dollar's counter-cyclical nature should reassert itself.

Graph 1 – Most currencies fell against the greenback in May



Sources: Datastream and Desjardins, Economic Studies

DISAPPOINTMENTS IN EUROPE AND CHINA

The latest economic news from Europe and China has strengthened concerns about the strength of global economic growth and heightened the U.S. dollar's safe-haven appeal. China's PMI manufacturing index moved closer to the psychological threshold of 50 and industrial output advanced more slowly than forecast. In the euro zone, the primary focus is that the recession is dragging on and the zone's first quarter contraction by GDP was bigger than anticipated. The European Central Bank (ECB) also lowered its key interest rates at the start of May and left

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the door open for further action to support growth. Several other central banks have followed in the ECB's footsteps in recent weeks, including the central banks of Australia, India and Korea.

LESS CONCERN ABOUT THE UNITED STATES

While worry about the economy is intensifying elsewhere in the world, in the United States, perception seems to be on a different path. Fears of seeing another tough spring have ebbed substantially. Of course, the 2.5% growth posted by U.S. GDP in the first quarter came in below expectations, but the 3.2% rise by real consumption was a surprise. Moreover, the optimism continues in the second quarter with improved employment figures in April after March's disappointment. Retail sales figures are also encouraging, advancing 0.1% in April (0.7% excluding gas station sales). Lastly, the housing market is apparently continuing to recover.

However, the drop in concern in the United States is now fuelling a perception that the Fed could start to taper off its interventions earlier than expected. This change of view comes when several other central banks are announcing additional measures, which, relatively speaking, is giving the U.S. dollar substantial support.

IT IS ONLY TEMPORARY

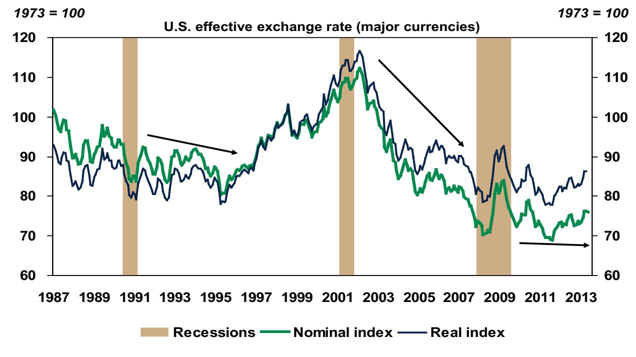
Based on the still-realistic assumption that the global economy will gradually improve in the coming quarters, it is hard to believe that the factors currently buoying the U.S. dollar will persist. Its safe-haven value will wane as fears ebb, and interventions by most of the other central banks should be limited. What's more, we must not lose sight of the fact that the Fed, for now, is still expanding its balance sheet and monetary base. Moreover, we do not expect the Fed to partially reduce its action until the fall. Cuts to government spending and soft business investment mean we should remain cautious about the U.S. economy.

THE U.S. DOLLAR IS STILL COUNTER-CYCLICAL

Unlike most other currencies, the U.S. dollar tends to be counter-cyclical. It has either trended down or tended to stabilize following the latest recessions (graph 2). Its safe-haven value contributes to this phenomenon. Investors with a renewed appetite for risk at the start of an expansion phase generally sell U.S. dollars to buy other foreign assets, which are often less liquid and more risky. The currencies of emerging markets and countries that export commodities have the advantage then.

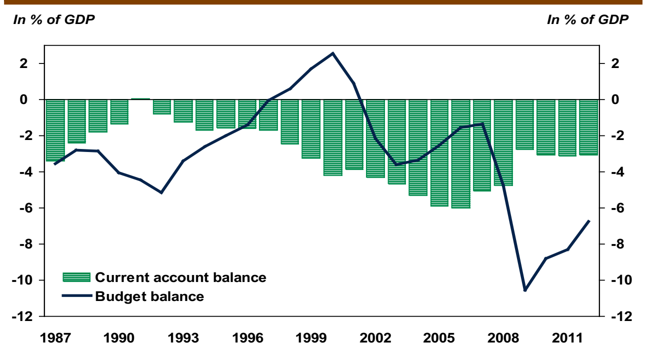
More fundamentally, we must also note that greenback appreciation would not be very compatible with the United States' need to reduce its debt level (graph 3). To ensure a lasting global expansion cycle, countries with less debt and a trade surplus will have to allow their currencies to appreciate more. Given that many mature economies have too much debt, the pressure is intensifying on emerging nations.

Graph 2 – The U.S. dollar rarely appreciates at the start of an expansion cycle



Sources: Datastream and Desjardins, Economic Studies

Graph 3 – The twin U.S. deficit is incompatible with a sustained raise by the U.S. dollar



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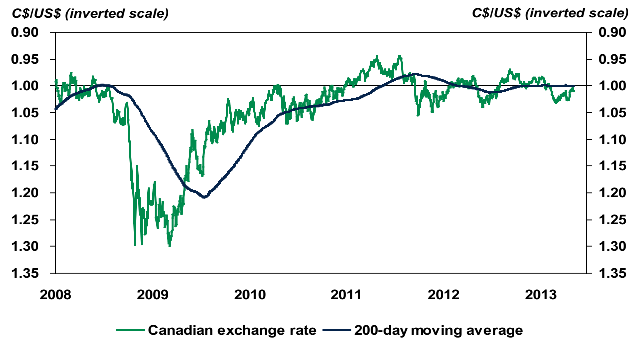
CANADIAN DOLLAR (CAD)

Another dip against a backdrop of concern about global demand

- The Canadian dollar wrapped up April on a high note and came very close to parity against the U.S. dollar at the start of May. This renewed vitality did not last long, however. The Canadian dollar is now trading at around US$0.98 again.
- Technically, the loonie's rebound at the end of April was not enough to put it back over its 200-day moving average and reverse its momentum. Net speculative positions on the loonie have edged up, but remain very low historically. The Canadian dollar is holding up fairly well, however, despite the negative sentiment being expressed by speculators.
- Fundamentally, some variables have been more favourable to the loonie lately, for example, Canadian real GDP by industry, which rose 0.3% in February following an identical upward revision in January. The momentum early in the year will have positive repercussions on growth for all of 2013.
- Some caution is required with these numbers, however, as much of the improvement to Canada's economy comes from international trade, and the global economy is still coping with a recession in Europe and signs of weakness in China. Movement by global demand also has a direct impact on commodity prices and on mining and oil company investment plans. In terms of oil, the International Energy Agency has upgraded its growth outlook for production, a situation that could further limit price increases for this resource in the years to come.
- Inflation pressures should remain subdued in Canada, and monetary authorities will likely wait until the fall of 2014 before starting to gradually bring up key interest rates. It remains to be seen whether the Bank of Canada's new governor, Stephen Poloz, will bring a change in the official stance with him when he arrives, particularly with regard to the remark on eventual monetary firming. Investors initially saw the new governor as more dovish, but this sentiment evaporated quickly.

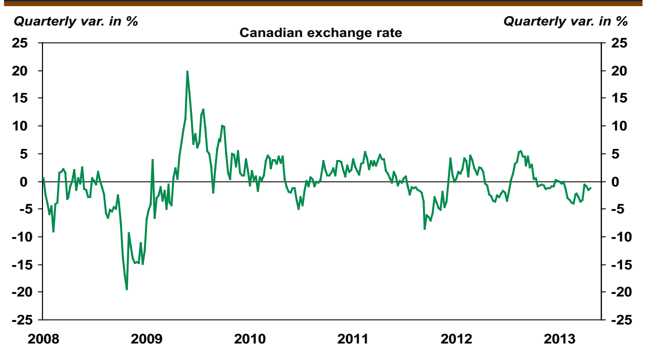
Forecasts: The Canadian dollar should return to US$1.00 by the end of the year if Canada's economy stays on course and global demand slowly improves, as forecast. A slight uptick by commodity prices would also help the dollar. However, appreciation could be temporarily curbed by fears about global growth.

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

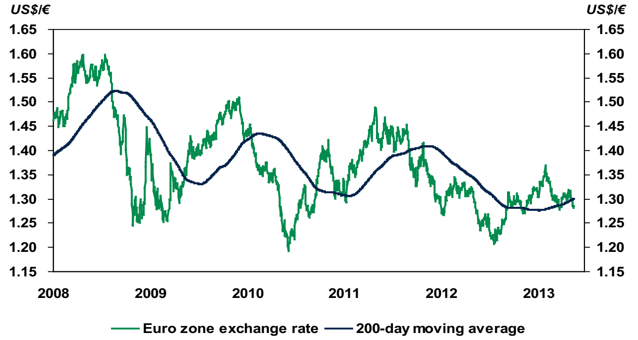
EURO (EUR)

The European Central Bank takes action

- The euro ended April on a strong note and temporarily rose above US$1.32 on May 1. It retreated temporarily after the European Central Bank's (ECB) May 2 meeting, at which a key rate cut was announced. Subsequently, the U.S. dollar's surge took the euro below US$1.30.
- After several months of hesitation, the ECB finally announced monetary easing at the start of May. It lowered the refi rate to 0.50%, a new historic low. The deposit rate remained at 0.00%, while the rate on the marginal lending facility was lowered by 50 basis points. This gesture had been broadly expected, with economic statistics still disappointing and inflation down to 1.2% in March. Since then, the national accounts have confirmed that the recession was still present in the first quarter of 2013, with the euro zone's real GDP contracting by 0.3%.
- While the 25 basis point cut to the ECB's primary key rate had been anticipated, May's meeting held a few surprises. Firstly, Euroland's monetary authorities clearly indicated that further key rate cuts were possible. They even discussed a cut of more than 25 basis points as of May and President M. Draghi did not rule out lowering the deposit rate into negative territory. The ECB also announced that it was extending the extraordinary measures to provide the banking sector with unlimited liquidity. Lastly, the ECB decided to start consultations with other European institutions on initiatives to promote a functioning market for asset-backed securities collateralised by loans to non-financial corporations. This initiative strives to make monetary policy more effective as financing remains very tough for small and mid-sized businesses, especially in euro zone peripheral nations.
- Overall, financial strains are currently weak in the euro zone, yields on Italian and Spanish bonds are down to lows that date back several years, and some stock exchanges have hit new peaks. This positive development for the euro seems to stem partly from the very aggressive actions announced by the Bank of Japan.

Forecasts: The unfavourable economic climate and possibility of another key rate cut should keep the euro to get back above the US$1.30 mark over the next few months. An improvement to the economic outlook, however, should prompt an uptick by the euro in the second half of 2013.

Euro and trend



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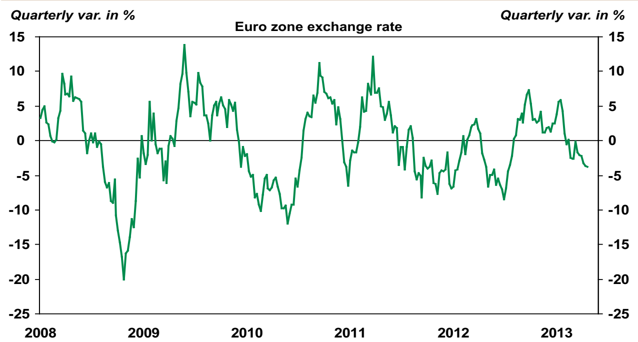
Euro: momentum



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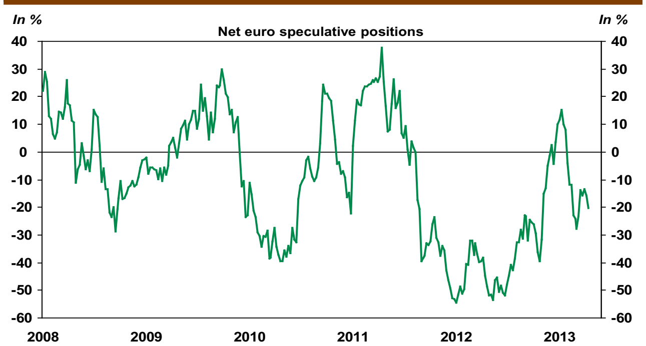
Euro: net speculative positions



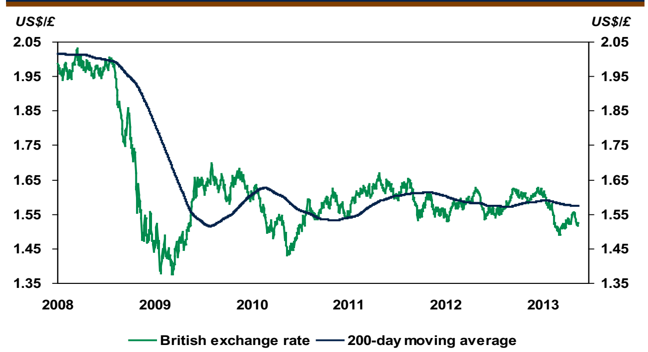
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

Waiting for Carney

- The pound continued to rise in the last few weeks of April, climbing above US$1.555. The U.S. dollar's recent surge pulled the pound down to around US$1.520, however. The pound did not fluctuate much against the euro, with the EUR/GBP pair staying around £0.85 since the end of March.
- Unlike several other central banks, the Bank of England (BoE) did not announce any changes at its latest monetary policy meetings. However, it announced an improvement to the Funding for Lending program in mid-April, primarily aimed at stimulating corporate credit. With Britain's economy return to growth in the first quarter of 2013, the BoE slightly upgraded its economic forecast in its last *Inflation Report*. The forecast for inflation was trimmed slightly, but inflation should stay above the 2% target for several more quarters. Despite this, some analysts are calling for quantitative easing measures to be reactivated in the months to come, following the arrival of Mark Carney. **In our view, the BoE should remain much less aggressive than most other central banks, a scenario that will play in the pound's favour.**

British pound and trend



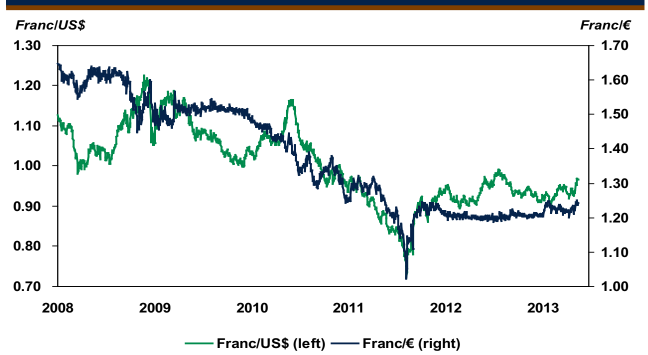
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

A pullback that could be temporary

- After casting around with no clear trend in the last weeks of April and early May, the Swiss franc recently depreciated against the major currencies. The USD/CHF pair went from 0.930 francs at the start of May to around 0,970 francs recently, while the EUR/CHF pair climbed above 1.245 francs.
- At first glance, it is surprising to see the Swiss franc depreciate against the euro since the European Central Bank (ECB) lowered its key rate. However, demand for the Swiss franc is more dependent on financial risks in the euro zone than interest rate spreads. While much remains to be settled in the euro zone, the sharp drop in the financing costs of peripheral nations combined with a more proactive ECB seems to reduce the Swiss franc's appeal as a save-haven currency. Ongoing substantial deflation in Switzerland also suggests that the Swiss National Bank will maintain its floor of 1.20 Swiss francs per euro for a long time. **In the next few months, the Swiss franc should benefit from an upswing in concern about the situation in the euro zone.**

Swiss franc and trend



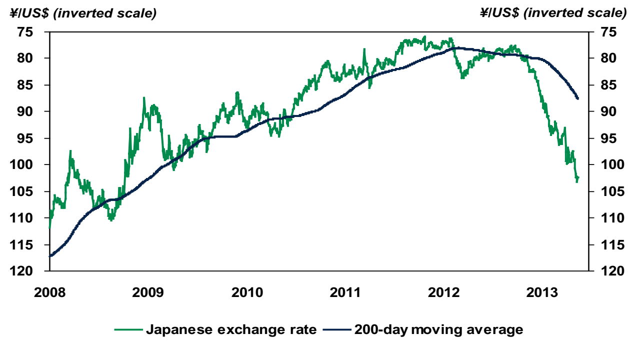
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

The ¥100/US$ mark has been crossed

- The expansion of the monetary base led by the Bank of Japan (BoJ) continues to pull the yen down; the ¥100/US$ mark was crossed in May. Japan's exchange rate had not settled in above this level since April 2009. The BoJ did not announce new measures at its last meeting, but the update to its inflation outlook shows that it will be tough to reach the 2% target in 2014. The BoJ could thus have to expand its monetary policy. However, the element that is playing most against the yen at this time is the investor attention focused on sales and purchases of Japanese securities. Recent data suggests that demand is sagging for these securities, given their low yields, prompting the Japanese to look to foreign securities, among other things.
- There is nothing to indicate that the yen's trend will reverse shortly. Proportionately, the BoJ is now more active than all of the other central banks, a situation that will persist next year. **Japan's exchange rate should hit ¥105/US$ by year's end, and ¥110/US$ in 2014.** The depreciation could be more evident depending on additional actions the BoJ could take to reach its inflation target.

Yen and trend



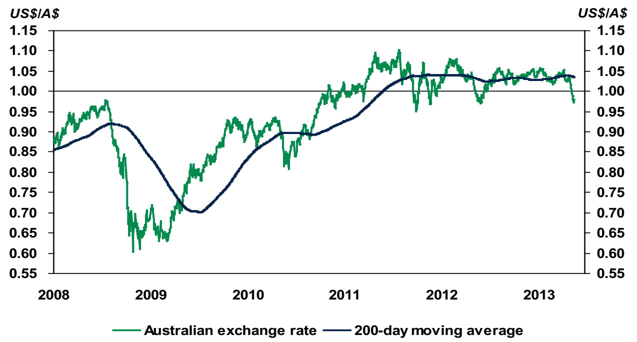
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

Less growth, less inflation, more deficits

- The Australian dollar is having some trouble. It recently hit US$0.97, an 11-month low. This new downtrend seems to be primarily due to the less positive outlook for Australia's economy. Lower prices for some commodities could also be blamed, as could the fears about China's economy.
- The Reserve Bank of Australia (RBA) and government have downgraded their economic scenarios. The RBA has lowered its key interest rate to 2.75% and has the leeway to take further action if needed. The monetary policy report released on May 10 backs the idea of ongoing easing. In it, the RBA mentioned that a high exchange rate influences the inflation outlook: "the sustained high level of the exchange rate could lead to further downward pressure on tradables prices." For its part, the government announced that it would not achieve fiscal balance next year, breaking its promise. **The Australian dollar correction seems justified for now. Nevertheless, some of the losses should be recouped if the economic outlook does not deteriorate further in Australia.**

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

Revaluation continues in China, even though competition in Asia is heating up

CHINESE YUAN (CNY)

- China's exchange rate is now below 6.15 yuan/US$. We might have thought that Chinese authorities would be more reluctant to allow the yuan to appreciate in a context where the yen is dropping sharply against the U.S. dollar. In fact, China is not in direct competition with many Japan export products, and exchange rate movements for other Asian currencies remain limited. What's more, a stronger yuan could make it easier to control inflation and transition to a Chinese economy that is more focused on consumption.
- **At this pace, China's exchange rate should reach the 6.00 yuan/US$ mark this year.** Chinese authorities could then want to take another break before going any further, to take time to assess the impacts of the revaluation.

Chinese yuan and trend

Sources: Datastream and Desjardins, Economic Studies

MEXICAN PESO (MXN)

- The Mexican peso continued to surge in the last few weeks. The USD/MXN pair even dropped below 12.00 pesos on May 8. Relatively encouraging economic figures and interest rates that are attractive to investors are still the factors most favourable to the peso. The U.S. dollar's recent surge took the USD/MXN pair back to around 12.20 pesos, however.
- The peso's strength, which partly stems from the very aggressive measures by some central banks and strong speculation, with some investors apparently using the currency to bet on the United States outperforming Europe and China, is making the Bank of Mexico's job harder. Lately, it has been taking a fairly dovish stance, despite the upswing by inflation in the last few months. **The strong likelihood of another interest rate cut should keep the USD/MXN pair above 12.00 pesos.**

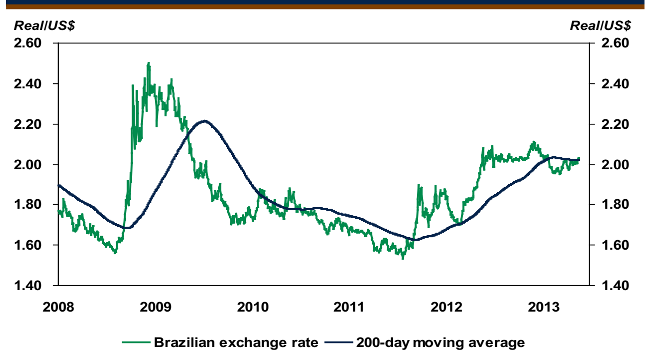
Mexican peso and trend

Sources: Datastream and Desjardins, Economic Studies

BRAZILIAN REAL (BRL)

- Brazil's exchange rate climbed back above the 2.00 real/US$ mark, even though Brazil's central bank raised its main key rate to 7.50%. The monetary policy committee's decision was not unanimous, however (six votes for and two against), suggesting that the firming cycle could be small. Inflation also edged down in April.
- **The exchange rate should drop back below 2.00 reals/US$ by year's end, but the potential for gains is slight.** Monetary authorities remain prepared to limit exchange rate fluctuations and the pace of foreign currency reserve accumulation has intensified. The currency is also sensitive to movement by commodity prices, where the potential seems more limited.

Brazilian real and trend



Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

Country – Currency*	Spot price May 20	Percentage return since 1 month	3 months	6 months	1 year	Last 52 weeks Higher	Average	Lower
Americas								
Argentina – peso	5.2413	1.5500	4.3710	9.0450	17.6817	5.2413	4.8189	4.4538
Brazil – real	2.0336	1.4973	3.7896	-2.2684	1.2648	2.1108	2.0267	1.9490
Canada – dollar	1.0280	0.1949	1.3008	3.0062	0.9923	1.0411	1.0042	0.9685
Canada – (CAD/USD)	0.9728	-0.1946	-1.2841	-2.9184	-0.9825	1.0325	0.9958	0.9605
Mexico – peso	12.3267	0.8414	-2.6500	-5.4538	-10.3982	14.4463	12.9399	11.9901
Asia and South Pacific								
Australia – (AUD/USD)	0.9809	-4.5513	-4.2864	-5.5615	-0.3580	1.0593	1.0311	0.9704
China – yuan renminbi	6.1389	-0.6265	-1.5823	-1.5034	-2.9921	6.3885	6.2692	6.1309
Hong Kong – dollar	7.7627	-0.0167	0.1051	0.1613	-0.0573	7.7672	7.7560	7.7500
India – rupee	55.0400	2.0393	1.7846	-0.1180	1.1300	57.1250	54.6282	51.7450
Japan – yen	102.2700	2.7633	9.3095	25.2158	29.4147	103.2100	85.4794	77.4900
New Zeland – (NZD/USD)	0.8173	-2.9585	-2.1249	0.0817	7.9765	0.8629	0.8184	0.7514
South Korea – won	1,117	0.0448	3.5610	3.1854	-4.7792	1,185	1,112	1,055
Europe								
Denmark – krona	5.7859	1.3097	3.0088	-0.5637	-0.5688	6.1688	5.7936	5.4693
Euro zone – (EUR/USD)	1.2856	-1.7200	-3.8408	0.4217	1.0571	1.3696	1.2870	1.2085
Norway – kroner	5.8348	0.2199	4.2236	1.7340	-2.2778	6.1228	5.7815	5.4572
Russia – ruble	31.2600	-0.9050	3.8997	-0.1262	0.0253	33.7117	31.3396	29.8739
Sweden – krona	6.6541	1.7945	4.8195	-1.6640	-6.8705	7.2694	6.6580	6.2899
Switzerland – swiss franc	0.9681	4.0243	4.8070	2.8418	2.5477	0.9938	0.9432	0.9029
United Kingdom – (GBP/USD)	1.5221	-0.2360	-0.5261	-4.3577	-3.7072	1.6284	1.5711	1.4886

* In comparison with the U.S. dollar, unless otherwise indicated.
Note: Currency table base on previous day closure.

Table 2
Currency market: history and forecasts

End of period		2012 Q3	2012 Q4	2013 Q1	2013 Q2f	2013 Q3f	2013 Q4f	2014 Q1f	2014 Q2f	2014 Q3f	2014 Q4f
American dollar											
Canadian dollar	(USD/CAD)	0.9838	0.9922	1.0175	1.0204	1.0101	1.0000	1.0000	0.9901	0.9804	0.9709
Euro	(EUR/USD)	1.2865	1.3184	1.2841	1.3000	1.3000	1.3200	1.3300	1.3500	1.3500	1.3600
British pound	(GBP/USD)	1.6148	1.6255	1.5185	1.5400	1.5600	1.5800	1.5900	1.6000	1.6100	1.6200
Swiss franc	(USD/CHF)	0.9351	0.9153	0.9495	0.9400	0.9500	0.9500	0.9500	0.9500	0.9600	0.9600
Yen	(USD/JPY)	77.92	86.75	94.22	101.00	103.00	106.00	108.00	110.00	111.00	112.00
Australian dollar	(AUD/USD)	1.0376	1.0398	1.0419	0.9900	1.0100	1.0200	1.0300	1.0400	1.0300	1.0300
Chinese yuan	(USD/CNY)	6.2845	6.2303	6.2108	6.1000	6.0500	6.0000	6.0000	5.9500	5.9000	5.9000
Mexican peso	(USD/MXN)	12.86	12.87	12.32	12.30	12.20	12.00	12.00	11.90	11.70	11.50
Brazilian real	(USD/BRL)	2.0303	2.0432	2.0135	2.0000	1.9900	1.9800	1.9600	1.9500	1.9400	1.9200
Effective dollar*	(1973 = 100)	72.71	73.44	76.23	76.70	76.70	76.30	76.20	75.80	75.70	75.40
Canadian dollar											
American dollar	(CAD/USD)	1.0165	1.0079	0.9828	0.9800	0.9900	1.0000	1.0000	1.0100	1.0200	1.0300
Euro	(EUR/CAD)	1.2657	1.3081	1.3065	1.3265	1.3131	1.3200	1.3300	1.3366	1.3235	1.3204
British pound	(GBP/CAD)	1.5886	1.6128	1.5449	1.5714	1.5758	1.5800	1.5900	1.5842	1.5784	1.5728
Swiss franc	(CAD/CHF)	0.9505	0.9225	0.9332	0.9212	0.9405	0.9500	0.9500	0.9595	0.9792	0.9888
Yen	(CAD/JPY)	79.20	87.43	92.60	98.98	101.97	106.00	108.00	111.10	113.22	115.36
Australian dollar	(AUD/CAD)	1.0208	1.0317	1.0601	1.0102	1.0202	1.0200	1.0300	1.0297	1.0098	1.0000
Chinese yuan	(CAD/CNY)	6.3880	6.2793	6.1043	5.9780	5.9895	6.0000	6.0000	6.0095	6.0180	6.0770
Mexican peso	(CAD/MXN)	13.07	12.97	12.10	12.05	12.08	12.00	12.00	12.02	11.93	11.85
Brazilian real	(CAD/BRL)	2.0637	2.0593	1.9790	1.9600	1.9701	1.9800	1.9600	1.9695	1.9788	1.9776

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