FX Forecasts

Desjardins Economic Studies
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Exchange rates adjust to more tempered expectations regarding monetary policies

HIGHLIGHTS

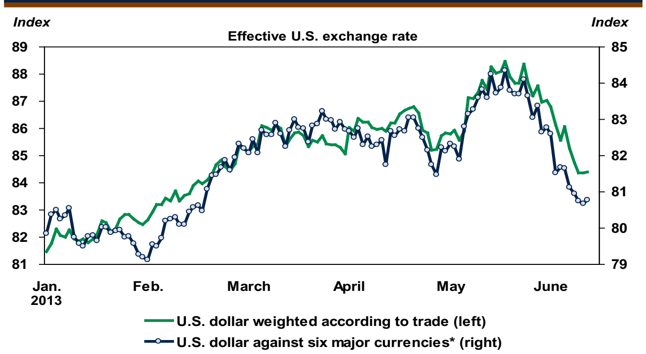
- The surge by the U.S. dollar observed in May ran out of steam. The depreciation against the European currencies and the yen is particularly striking.
- Many data and events have swayed expectations about monetary policy. Changes to these expectations are likely to keep generating volatility in the months ahead.
- Keep an eye on the European council meeting on June 27 and 28. Any sign of discord or absence of progress on the banking union could revive financial strains. The euro should continue to fluctuate around US$1.30 in the months ahead.
- The Canadian dollar should move back to US$1.00 by the end of this year if the Canadian economy and global demand improves, as expected.
- The Bank of Japan will remain more interventionist than the other central banks, which should cause the yen to depreciate further. The exchange rate should settle sustainably above ¥100/US$ in the upcoming quarters.

Contents

Editorial

Volatility has been very high in the currency market in recent weeks. A strong surge by the U.S. dollar was observed in May, but it quickly ran out of steam; the greenback is now lagging far behind (graph 1). Its depreciation against the European currencies and the yen is particularly striking. However, the currencies of many emerging countries have sustained their losses, or have intensified them. These trends reflect more tempered expectations about monetary policies in the developed countries, as well as concerns about growth in the emerging countries. And these concerns are weighing down the commodity currencies, although the Canadian dollar has nonetheless managed to appreciate.

Graph 1 – The U.S. dollar's gains are wiped out



* Euro, yen, pound, Canadian dollar, Swedish krona and Swiss franc.
Sources: Datastream, Bloomberg and Desjardins, Economic Studies

LESS DIFFERENTIATED MONETARY POLICIES

The main factor supporting the U.S. dollar in May was the different expectations regarding monetary policies in the United States, Japan and Europe. Improvement in some U.S. data, including employment, and somewhat hawkish comments by a few officials of the Federal Reserve (Fed) raised expectations of an early reduction to monetary easing in the United States. Conversely, expectations centred on more interventions in Japan and in Europe. For one thing,

François Dupuis
Vice-President and Chief Economist

Yves St-Maurice
Senior Director and Deputy Chief Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

Mathieu D'Anjou
Senior Economist

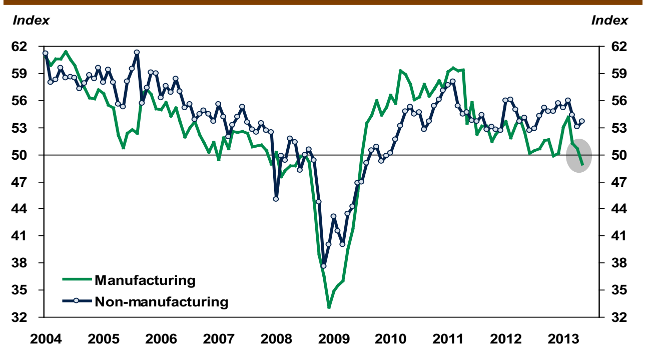
Jimmy Jean
Senior Economist

Hendrix Vachon
Senior Economist

the European Central Bank (ECB) had opened the door at the beginning of May to purchase asset-backed securities (ABS) to support credit to businesses.

In recent weeks, this support for the U.S. dollar has crumbled to a great extent. Many data and events have swayed expectations about monetary policy. In the United States, two conditions must be met in order for the Fed to begin gradually tapering off its interventions. First, there must be strong and sustained improvement in the job market and second, there must be conviction that this improvement will last. The decline in the ISM purchasing managers' index below the symbolic 50 mark has shaken that conviction (graph 2). Moreover, although job creation was still acceptable in May, the increase in the unemployment rate reminds us that the 6.5% target set by the Fed will not be so easy to reach. The return of job-seekers who were previously discouraged by the state of the economy is expanding the labour force, as well as the unemployment rate.

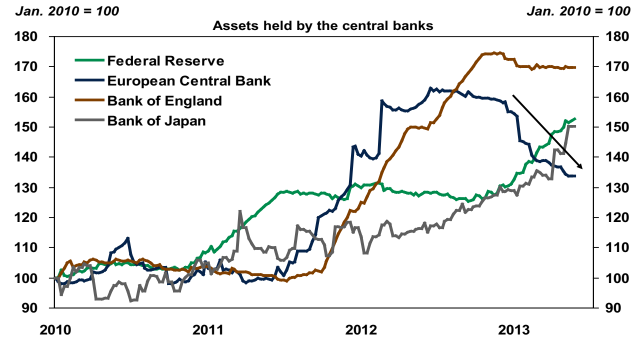
Graph 2 – It would be very surprising if the Fed* were to reduce its interventions when the ISM manufacturing index shows a contraction



* Federal Reserve.
Sources: Institute for Supply Management and Desjardins, Economic Studies

In Japan, rising bond yields have increased doubts about the ability of the Bank of Japan (BoJ) to double the monetary base to raise inflation. In Europe, Mario Draghi implied in June that ABS purchases are no longer really part of the ECB's plans. In the short term, the door seems to be more open to another interest rate cut, which will do nothing to rein in the size of the ECB's balance sheet (graph 3). Lastly, at the Bank of England, there seems to be less interest in further asset purchases, since the latest data have been fairly encouraging in terms of the continuation of the economic recovery. Thus the yen, the euro and the pound have all benefited from more tempered expectations.

Graph 3 – The European Central Bank stands alone in reducing the size of its balance sheet



Sources: Datastream and Desjardins, Economic Studies

SEARCHING FOR THE MIDDLE GROUND

Changes to these expectations are likely to keep generating volatility in the months ahead. For one thing, it would be surprising if the BoJ were to decide not to carry its policy through to its conclusion. If any changes are made, they will be guided by the extent to which the inflation target is reached. The U.S. dollar should therefore reappreciate against the yen. Gains could also be made against the euro in the short term. Last winter, Mario Draghi reacted when the euro moved too far from US$1.30. He explicitly tied the inflation trend to the exchange rate trend. Too strong a euro could also threaten to prolong the recession in that zone.

On the other hand, the U.S. dollar is unlikely to make many more gains against emerging currencies and certain commodity currencies. Certainly, concerns about economic growth and the volatility of financial markets could still discourage capital flows towards the emerging countries, but those factors should gradually abate. Moreover, the monetary tightening cycle has already started in some emerging countries, and this trend will intensify once economic outlooks firm up.

François Dupuis
Vice-President and Chief Economist

Hendrix Vachon
Senior Economist

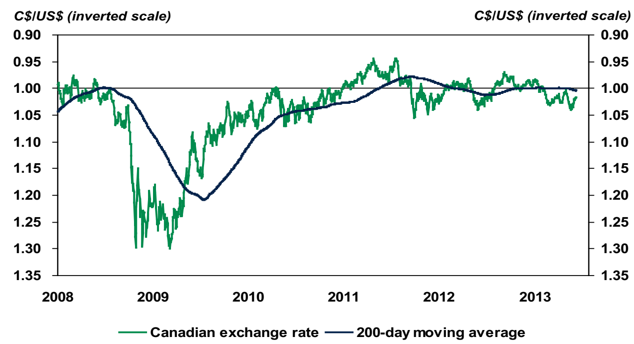
CANADIAN DOLLAR (CAD)

Surprising data from Canada

- The loonie depreciated to US$0.96 in May before resuming an upwards trajectory in June that took it back above US$0.98. The pullback by the U.S. dollar certainly cast the Canadian currency in a better light, but the release of several positive economic data in Canada seems to have contributed even more significantly to this rise. In comparison with other commodity currencies, the Canadian dollar fared better.
- From a technical standpoint, the momentum has returned to a neutral position after languishing in negative territory for several months. However, the speculative positions still show lukewarm enthusiasm for the currency, although the picture is improving. The potential for correction appears higher for upwards movement than for downwards movement.
- Several data from Canada have attracted attention in recent weeks, starting with the 2.5% increase in real GDP (annualized) in the first quarter of 2013. This is a definite improvement compared to the mixed results of the previous quarters. Significant improvement was also recorded in employment, with the addition of 95,000 jobs in May, a 10-year peak. The number of housing starts also rose, to 200,178 units in May, versus 175,922 in April.
- However, these data must be considered in context. The acceleration in economic growth was mainly supported by international trade. Global economic trends will therefore be a determining factor in Canada's economic health. As for employment, this statistic is highly volatile, and the May figures actually counterbalance previous disappointments. Meanwhile, the real estate market was stimulated by an exceptional increase in condos in Ontario.
- So the latest Canadian data are reassuring, but do not provide sufficient reason to revise our scenarios. The Bank of Canada (BoC) is likely to keep sitting on the sidelines until the fall of 2014, especially since inflation poses no threat. However, the rally in the real estate market could give the BoC food for thought, since it has been wishing normalization in that sector and a reduction in household debt, for some time now.

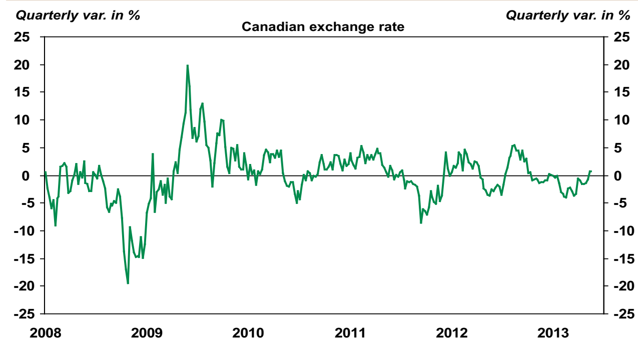
Forecasts: The Canadian dollar should move back to US$1.00 by the end of this year if the Canadian economy stays on track and if global demand gradually improves, as expected. One thing to watch out for is signs that concerns about global demand for commodities are abating. In the shorter term, the loonie may struggle to stay above US$0.98, since the effect of the latest economic data needs to be moderated.

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

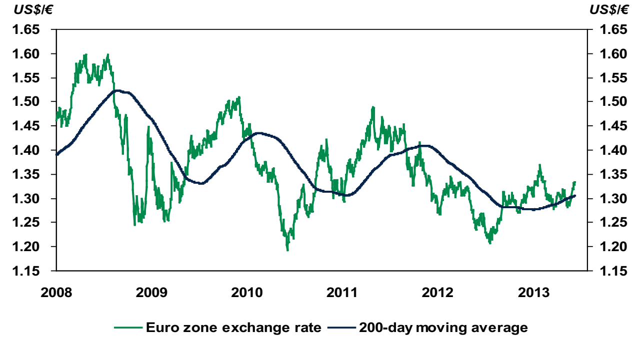
EURO (EUR)

The euro is unlikely to stray too far from US$1.30

- After a troubled month of May that took it to around US$1.280, the euro has rebounded in recent weeks to reach US$1.330. This puts the currency slightly above its 200-day moving average, thanks to a combination of international and domestic factors.
- The euro's recent appreciation began on May 29, when doubts emerged regarding the effects of the Bank of Japan's very aggressive policies. This, combined with disappointing U.S. data hinting that no slowdown in the Federal Reserve's quantitative measures was imminent, put an end to the greenback's surge and promoted a rally in European currencies. The release of somewhat more encouraging economic data in the euro zone, including an upturn in confidence indexes and purchasing managers' indexes, boosted the common currency's escalation after that. It should be noted, however, that in general, the leading indicators still point to a decline in activity in the euro zone.
- The June 6 meeting of the European Central Bank (ECB) also contributed to the euro's appreciation. After announcing an interest rate cut and opening the door to new, unconventional actions in May, the ECB seemed to do an about-face in June. In particular, it seemed to close the door on any imminent action to support credit for small and medium-sized businesses. It claims to be technically able to lower deposit rates into negative territory, but the ECB officials seem unconvinced that such action would be of any use. Since inflation is likely to stay well below 2.0% in the upcoming quarters, the ECB could lower its main key interest rate to 0.25% if economic or financial conditions deteriorate further. On this point, we will have to keep an eye on the European council meeting on June 27 and 28. Any sign of discord or absence of progress on the issue of the banking union could revive certain financial tensions.

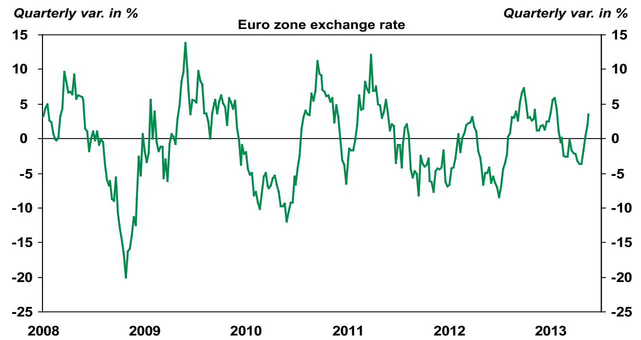
Forecasts: The euro's recent appreciation is partly justified by the fact that all signs indicate that the ECB will remain much less aggressive than most of the other major central banks. However, one last cut in the main key interest rate is probable in the third quarter, when the ECB may have to react to deteriorating economic outlooks, which could result from increased upwards pressure on the euro, or from resurgence in financial tensions. The euro should therefore continue to fluctuate around US$1.30 in the months ahead.

Euro and trend



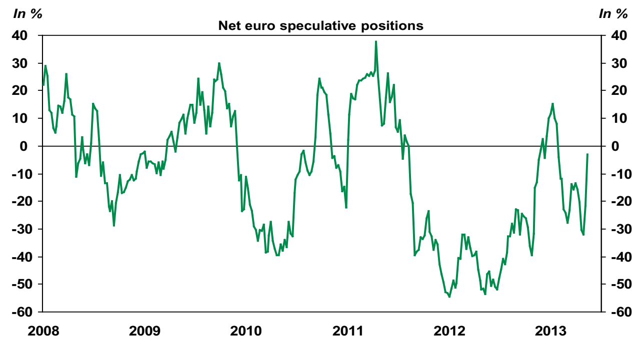
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



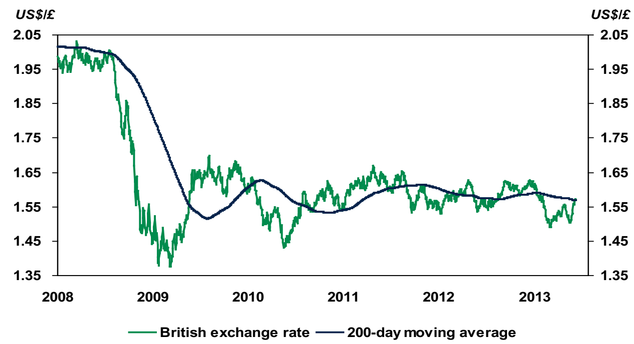
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

The British economy shows some encouraging signs

- Like most other currencies, the pound sterling has rebounded against the greenback, rising from US$1.50 on May 29 to around US$1.57 at mid-June. However, it has remained relatively stable against the euro since the end of March.
- The latest data seem to indicate that the British economy is continuing to expand. The PMI indexes are up, and all three of them (manufacturing, service and construction) now stand above the 50 mark for the first time since the beginning of 2012. Other business-related indicators are also on positive ground, and the initial estimates of GDP for the second quarter of 2013 are quite strong. The signs are less encouraging for consumption, however. Inflation was down in April, but at 2.4% it is still above the Bank of England's (BoE) 2.0% target. In these circumstances, the BoE is unlikely to change its monetary policy in the months to come, although we should watch to see what effect Mark Carney's arrival will have on the BoE's internal discussions and its communications. **The pound should continue to gradually appreciate in the next few quarters.**

British pound and trend



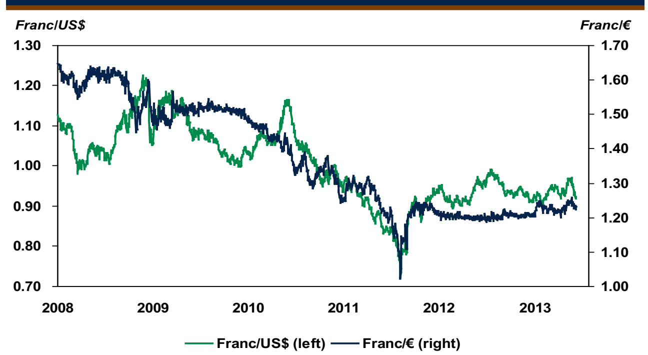
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

The franc reverses its May losses

- After a troubled time in May, the Swiss franc has firmed up in recent weeks. The USD/CHF pair, which had reached 0.98 franc in the last weeks of May, has now fallen back below 0.93 franc. The franc has also appreciated slightly against the euro, with the EUR/CHF pair falling back to around 1.23 franc.
- Apart from the general depreciation of the greenback, the release of positive economic data has contributed to the Swiss franc's good performance. The Swiss economy expanded 0.6% in the first quarter of 2013, more than double what analysts were expecting. Household consumption is still rising at a good pace. Most of the indicators hint that growth will continue in the second quarter. Deflation still prevails, however, and the president of the Swiss National Bank recently reaffirmed the importance of maintaining a floor of 1.20 Swiss franc/€. He even opened the door to negative interest rates, should the situation require it. **The probable resurgence of some concerns about the euro zone could intensify the upwards pressure on the Swiss franc in the months ahead.**

Swiss franc and trend



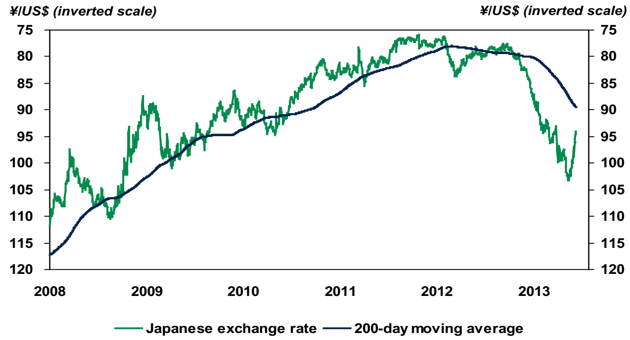
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

The level of ¥100/US$ appears to be difficult to sustain

- The break through the psychological barrier of ¥100/US$ in May proved to be temporary. The Japanese exchange rate fell back to ¥94/US$ and is now struggling to resume an upwards trend. The yen's appreciation is consistent with the general decline of the U.S. dollar, but that is not the only explanation. Concerns have recently been expressed regarding Japanese monetary policy. Among other things, analysts are worried about the surge in bond yields and the effects of excessive depreciation of the yen. Some were expecting the Bank of Japan (BoJ) to announce measures on June 11 to attempt to reduce the volatility in the markets, but that did not happen. Instead, the BoJ rejoiced in the rally observed in the Japanese economy and the upturn in expectations of inflation.
- The BoJ is staying the course on its goal to raise the inflation rate to 2% by the end of 2014, and it may adjust its interventions according to the amount of progress achieved. **The BoJ will probably remain more interventionist than the other central banks, which should cause the yen to depreciate further.** The exchange rate should settle sustainably above ¥100/US$ in the upcoming quarters.

Yen and trend



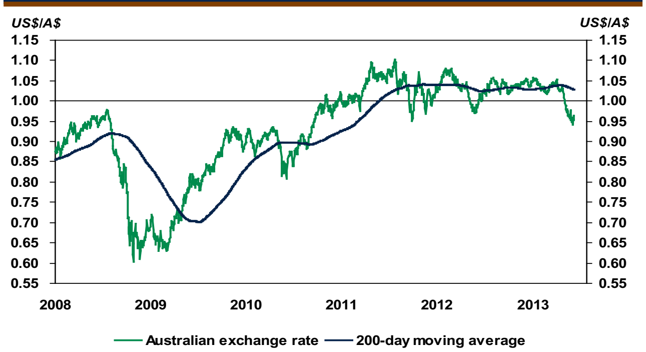
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

A 33-month low

- The Australian dollar has continued its descent, and a 33-month low was recently reached, at US$0.9325. This trend is due, in particular, to concerns about growth in China and other parts of the world. Australia is a major exporter of commodities, and its growth is highly dependent on global demand. There are also concerns that investments in the resource sector may be levelling off. Without such support, the Australian economy will be less robust. In fact, the latest GDP data show a slight pullback in growth, negatively impacted by investment. The Reserve Bank of Australia did not budge in June, but left the door open for further interest rate cuts. It is hoping that other sectors may step in and pick up the slack from the natural resources sector.
- While the Australian dollar's depreciation is supported by fundamental factors, it nevertheless appears to be too quick to last. Moreover, some technical factors have intensified this downwards movement. **An alleviation of concerns about demand for commodities should help the currency stabilize, and even win back a few cents.**

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

Concerns about economic growth weigh down emerging currencies

CHINESE YUAN (CNY)

- In recent weeks, the Chinese exchange rate has stabilized at around 6.13 yuans/US$. The yuan stood alone at the beginning of May in appreciating against the U.S. dollar, while most of the other currencies lost ground. The current pause may seem well deserved, especially since the latest data have not allayed the worries about the Chinese economy. The yuan is nevertheless faring better than many other emerging currencies, which recently depreciated further.
- While this pause could last for some time, **the 6.00 yuans/US$ mark is still achievable by the end of this year**. The scenario of a soft landing of the Chinese economy is still credible. The concerns should gradually fade away.

Chinese yuan and trend

Sources: Datastream and Desjardins, Economic Studies

MEXICAN PESO (MXN)

- The Mexican peso's climb suddenly reversed itself in recent weeks. The USD/MXN pair recently rose to over 12.80 pesos, a loss of approximately 8% in the space of a month.
- Initially, the peso's decline seemed to mainly reflect the greenback's surge against all currencies. But the correction of the peso, like that of many other emerging currencies, has accelerated in early June. Economic statistics showing decelerating growth in Mexico are partly accountable for this pullback. The increased volatility in the markets and a possible tapering off of quantitative purchases by the Federal Reserve are also triggering concerns about a reversal of the capital flows that have been benefiting the peso in recent quarters. **The peso is likely to remain volatile in the months ahead.**

Mexican peso and trend

Sources: Datastream and Desjardins, Economic Studies

BRAZILIAN REAL (BRL)

- The real has continued to depreciate despite the fact that the Central Bank of Brazil has once again raised its main key interest rate. The exchange rate is currently hovering near the 2.15 reals/US$ mark. The monetary tightening is in response to high inflation, but on the flip side, economic growth is likely to have even more trouble picking up steam. In fact, Brazil's first quarter GDP data were disappointing. Although expectations were for improvement compared to the previous quarter, what happened was the opposite.
- **Concerns about the Brazilian economy will make it difficult for the exchange rate to get back below 2.00 reals/US$ in the short term.** But the trend should shift back towards appreciation in anticipation of future improvement in economic conditions.

Brazilian real and trend

Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

Country – Currency*	*Spot price* June 17	*Percentage return since* 1 month	3 months	6 months	1 year	*Last 52 weeks* Higher	Average	Lower
Americas								
Argentina – peso	5.3363	1.9584	4.8122	9.2654	18.7483	5.3363	4.8810	4.4932
Brazil – real	2.1527	5.8046	8.9644	2.7983	5.2974	2.1578	2.0327	1.9490
Canada – dollar	1.0170	-1.0074	-0.2110	3.3064	-0.6302	1.0396	1.0042	0.9685
Canada – (CAD/USD)	0.9833	1.0177	0.2114	-3.2006	0.6342	1.0325	0.9958	0.9619
Mexico – peso	12.7123	3.2597	2.2185	-0.4047	-8.6393	13.9587	12.8379	11.9901
Asia and South Pacific								
Australia – (AUD/USD)	0.9547	-1.8522	-8.3063	-9.5045	-5.3036	1.0593	1.0291	0.9426
China – yuan renminbi	6.1250	-0.2646	-1.4243	-1.7926	-3.7797	6.3885	6.2520	6.1212
Hong Kong – dollar	7.7596	-0.0444	-0.0187	0.1239	-0.0013	7.7647	7.7561	7.7500
India – rupee	58.1100	5.8566	7.5514	5.9338	4.9012	58.3400	54.7264	51.7450
Japan – yen	94.5100	-8.4294	-0.8029	12.6662	20.0661	103.2100	86.9979	77.4900
New Zeland – (NZD/USD)	0.7996	-0.8635	-3.3741	-5.3330	1.4872	0.8629	0.8219	0.7846
South Korea – won	1,126	0.8733	1.4228	5.0117	-3.3759	1,166	1,108	1,055
Europe								
Denmark – krona	5.5806	-3.8640	-2.1574	-1.5333	-4.8929	6.1688	5.7757	5.4693
Euro zone – (EUR/USD)	1.3347	4.0822	2.1544	1.4131	5.7227	1.3696	1.2912	1.2085
Norway – kroner	5.7239	-2.2174	-0.6285	2.0030	-3.6689	6.1164	5.7640	5.4572
Russia – ruble	31.7652	1.0858	3.7146	2.4667	-2.2684	33.3167	31.2949	29.8739
Sweden – krona	6.4611	-3.4713	1.0392	-2.9297	-7.6003	7.0640	6.6136	6.2899
Switzerland – swiss franc	0.9250	-4.9185	-1.4647	0.7735	-2.7646	0.9938	0.9425	0.9029
United Kingdom – (GBP/USD)	1.5713	3.4294	3.8464	-2.9972	0.4475	1.6284	1.5694	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	Q4	*2013* Q1	Q2f	Q3f	Q4f	*2014* Q1f	Q2f	Q3f	Q4f
American dollar											
Canadian dollar	(USD/CAD)	0.9838	0.9922	1.0175	1.0204	1.0101	1.0000	1.0000	0.9901	0.9901	0.9804
Euro	(EUR/USD)	1.2865	1.3184	1.2841	1.3100	1.3000	1.3200	1.3300	1.3400	1.3500	1.3500
British pound	(GBP/USD)	1.6148	1.6255	1.5185	1.5500	1.5700	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	0.9600	0.9600	0.9600
Yen	(USD/JPY)	77.92	86.75	94.22	97.00	100.00	102.00	105.00	108.00	110.00	110.00
Australian dollar	(AUD/USD)	1.0376	1.0398	1.0419	0.9700	0.9900	1.0000	1.0200	1.0200	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	12.60	12.30	12.10	12.00	11.90	11.70	11.50
Brazilian real	(USD/BRL)	2.0303	2.0432	2.0135	2.1000	2.0400	2.0000	2.0000	1.9900	1.9800	1.9600
Effective dollar*	(1973 = 100)	72.71	73.44	76.23	76.10	76.30	75.90	75.90	75.80	75.80	75.60
Canadian dollar											
American dollar	(CAD/USD)	1.0165	1.0079	0.9828	0.9800	0.9900	1.0000	1.0000	1.0100	1.0100	1.0200
Euro	(EUR/CAD)	1.2657	1.3081	1.3065	1.3367	1.3131	1.3200	1.3300	1.3267	1.3366	1.3235
British pound	(GBP/CAD)	1.5886	1.6128	1.5449	1.5816	1.5859	1.5800	1.5900	1.5842	1.5941	1.5882
Swiss franc	(CAD/CHF)	0.9505	0.9225	0.9332	0.9212	0.9405	0.9500	0.9500	0.9696	0.9696	0.9792
Yen	(CAD/JPY)	79.20	87.43	92.60	95.06	99.00	102.00	105.00	109.08	111.10	112.20
Australian dollar	(AUD/CAD)	1.0208	1.0317	1.0601	0.9898	1.0000	1.0000	1.0200	1.0099	1.0198	1.0098
Chinese yuan	(CAD/CNY)	6.3880	6.2793	6.1043	5.9780	5.9895	6.0000	6.0000	6.0095	5.9590	6.0180
Mexican peso	(CAD/MXN)	13.07	12.97	12.10	12.35	12.18	12.10	12.00	12.02	11.82	11.73
Brazilian real	(CAD/BRL)	2.0637	2.0593	1.9790	2.0580	2.0196	2.0000	2.0000	2.0099	1.9998	1.9992

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