FX Forecasts

Desjardins Economic Studies
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The Federal Reserve had trouble making itself understood; result: mayhem!

HIGHLIGHTS

- During the two previous quantitative easing programs, the U.S. dollar had appreciated later than what is currently being observed.
- The appreciation of the U.S. dollar can also be supported by other factors, which are often specific to the other currencies. For example, the radical shift in Japanese monetary policy, concerns about emerging countries, and the situation in Europe.
- Prospects of monetary tightening in Canada in the fall of 2014, and the expected alleviation of concerns about global demand for commodities will help the loonie pick up steam.
- The challenging economic and political conditions and the increasing possibility of further monetary easing in the euro zone should keep the euro fairly close to US$1.30 in the months to come.
- The Bank of Japan will remain more interventionist than the other central banks, which is likely to keep weakening the yen in the coming quarters.

Contents

Editorial

Exchange rates have been strongly affected by changing expectations regarding U.S. monetary policy. The U.S. dollar jumped on June 19, after Ben Bernanke mentioned that the Federal Reserve (Fed) might scale back its bond purchases by the end of this year. Subsequently, Fed officials, including Mr. Bernanke, endeavoured to temper market sentiment by making some remarks considered more dovish. As a result, the greenback surrendered some of its earlier gains. Some more disappointing U.S. data also contributed to that depreciation.

THE FED'S MESSAGE

People mainly focused their attention on the future winding down of asset purchases, and not so much on the rest of the Fed's message. At least three other important points slipped under the radar. First of all, the Fed will continue a monetary policy that will support the U.S. economy for a long time to come. Reducing the pace of asset purchases should not be confused with starting monetary tightening. Next, the scenario for tapering off bond purchases will be strictly contingent on the economy and inflation unfolding according to the Fed's expectations. Therefore, the release of disappointing data could change the rules of the game. Finally, a faster decline in the unemployment rate would not be enough to justify a hastier tightening of monetary policy. The monetary authorities would have to be confident that the economic recovery would continue, that inflation would increase, and that the job market would keep improving, before it would scale back its interventions.

If the Fed's message had been better understood in the first place, the volatility probably would have been less pronounced. In any event, the remarks by Mr. Bernanke and other officials did clarify the message.

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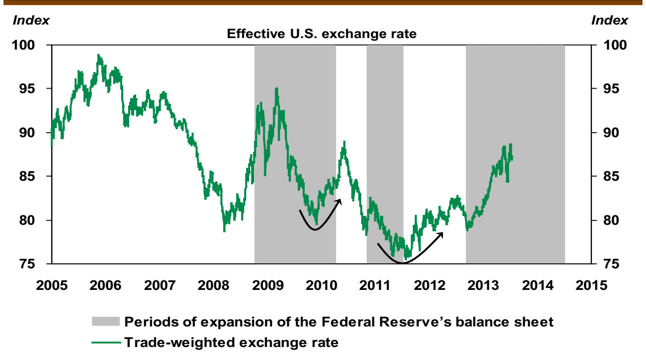
A SHARP REACTION BY THE U.S. DOLLAR

The greenback reacted sharply to market expectations about U.S. monetary policy. However, the logic behind the appreciation of the U.S. dollar in a situation of the Fed slowing its pace of asset purchases is open to question.

The U.S. dollar depreciated during the first two quantitative easing programs. Actually, in the case of the first program, the greenback initially appreciated due to its safe haven status. It should also be noted that the beginning of the first program was not clearly announced. The Fed had started making purchases in the fall of 2008, but it did not clarify its intervention until March 2009. Nevertheless, the U.S. dollar's return to an upwards trend did not occur until near the end of the two previous easing programs (graph 1). The current trajectory appears quite different, especially when we consider that the purchases are not likely to cease completely until the middle of 2014.

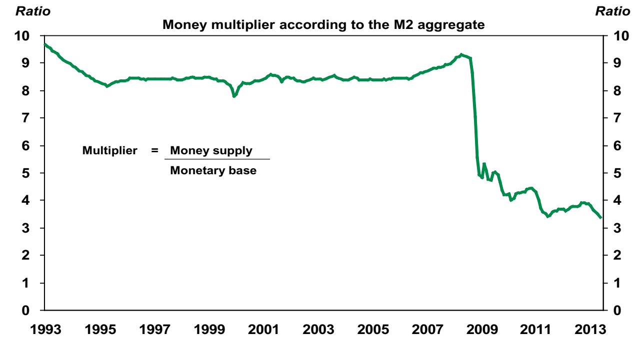
Graph 1 – The U.S. dollar did not appreciate as early during the previous easing programs



Sources: Datastream and Desjardins, Economic Studies

Generally speaking, a currency appreciates when the monetary policy becomes more restrictive. It is all a question of supply and demand. A less accommodative policy normally shrinks the money supply, which puts upwards pressure on its value. In this case, even if the Fed reduces its purchases, the size of its balance sheet and the quantity of liquidity injected into the financial system will keep increasing for several more months. After that, the amount of liquidity will be maintained, probably until the second half of 2015, at which point we believe the Fed will truly begin its tightening. In the meantime, the money supply could still expand quickly if the credit market returned to normal and if the money multiplier rose (graph 2). The money multiplier provides an indication about the quantity of money created by the liquidity that was initially injected by the central bank. In short, nothing suggests that the supply of U.S. dollars will diminish in the short term. In these circumstances, the currency should not appreciate.

Graph 2 – The money multiplier is still low, but it could increase



Sources: Datastream and Desjardins, Economic Studies

OTHER FACTORS COME INTO PLAY

The appreciation of the U.S. dollar can also be supported by other factors, which are often specific to the other currencies. For example, the yen has fallen sharply since the fall of 2012 due to a radical shift in Japanese monetary policy. The yen carries significant weight in the effective exchange rate indexes that are calculated for the U.S. dollar.

Concerns about emerging countries are also playing in the greenback's favour. These concerns have intensified in recent months, due to disappointments in data from China, Brazil and India, among other things. The currencies of emerging countries are not the only ones affected; so are those of countries that export commodities, demand for which is tied to global economic growth. The situation is expected to improve soon, however, which should partly reverse the effects on exchange rates.

Finally, the situation in Europe is still worrisome, and the central banks are leaving the door open to further interventions. To a relative extent, this could benefit the U.S. dollar; on the other hand, these actions will probably be limited compared to what the Fed does. Trends in economic statistics could also become a bit less favourable to the greenback if the recession were to end in the euro zone and U.S. data were to stay mixed for a while longer.

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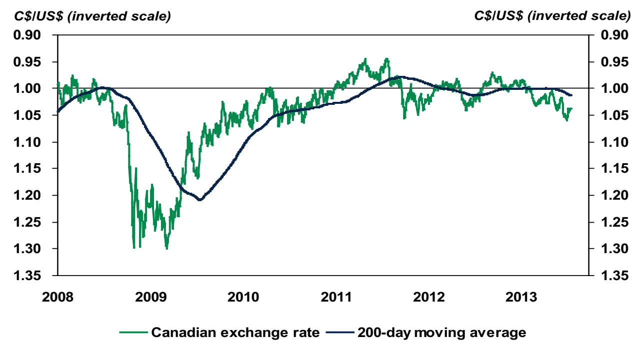
CANADIAN DOLLAR (CAD)

Getting back to parity will take longer than previously thought

- After surpassing US$0.9800 at the beginning of June, the Canadian dollar has fallen back in July to a 21-month low, at US$0.9428. The slump was mainly due to the U.S. dollar being stimulated by expectations of less accommodative monetary policy in the United States. Concerns about growth in emerging countries and demand for commodities also affected the loonie. The losses were partly recovered during the past two weeks, when Ben Bernanke tried to temper investors' expectations, which weakened the U.S. dollar. The loonie is currently trading above US$0.9600.
- From a technical viewpoint, the momentum has moved back into negative territory. Speculative positions still show little enthusiasm for the Canadian dollar, although the outlook has improved in recent months. The loonie seems to have good potential for appreciating, if only speculator sentiment would get closer to normal.
- In terms of fundamentals, the latest data have been less surprising. Job creation was zero in June, after the amazing rebound recorded in May. Retail sales were slightly disappointing, and manufacturing sales improved as expected. On the other hand, housing starts gave an astonishing performance in June, maintaining a pace of nearly 200,000 units.
- Several concerns persist, however. The slump in commodity prices is threatening to discourage investments. On another front, the Keystone XL pipeline project has yet to receive official approval. This project would make it possible to expand oil exports to the United States, and to obtain higher prices for that resource. Finally, Canadians seem to be showing greater caution about debt, which is reining in some consumer spending, and government spending is hobbled by the fight against budget deficits.
- The Bank of Canada still estimates that the economy will grow faster than its potential, so the surplus production capacity will diminish. The arrival of Stephen Poloz has led to a rewording of the central bank's press release, but the message is still pretty much the same as far as the future path of interest rates is concerned.

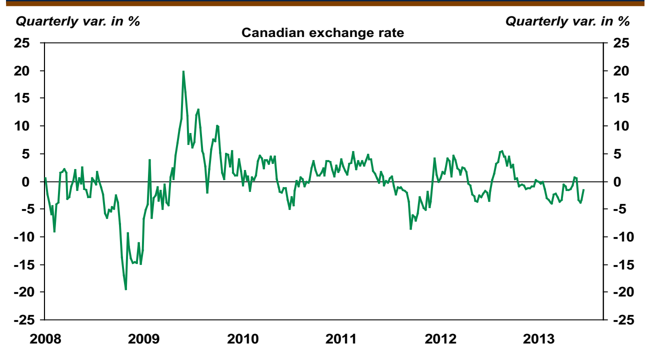
Forecasts: The dollar is likely to keep being buffeted by the volatility generated by changing expectations about U.S. monetary policy. No return to parity is expected before the beginning of 2014. Prospects of monetary tightening in Canada in the fall of 2014, and the expected alleviation of concerns about global demand for commodities will help the loonie pick up steam.

Canadian dollar and trend



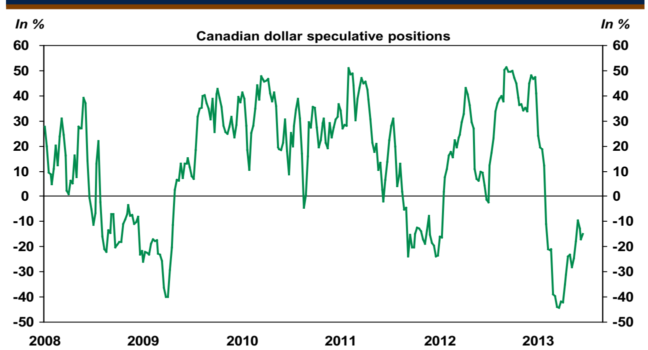
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

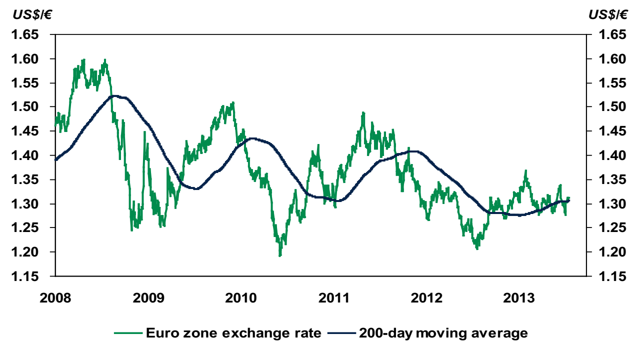
EURO (EUR)

The European central bank felt a need to take new action

- The euro has been highly volatile in recent weeks, moving from around US$1.34 in the middle of June to less than US$1.28 on July 9, before rising again to over US$1.31. These fluctuations mainly reflected comments by the President of the Federal Reserve (Fed). Mr. Bernanke's announcement that the Fed might wind down the pace of its asset purchases later this year, and bring them to a halt around mid-2014, sent the greenback soaring on June 19. His insistence that U.S. monetary policy would remain very accommodative for a long while yet subsequently reassured investors and triggered a rally by many currencies, including the euro, against the U.S. dollar on July 10.
- The euro's see-sawing in recent months has brought it back very close to its 200-day average. The momentum and the speculative positions do not herald any imminent technical movement.
- Economic conditions are still very troubled in the euro zone, with the unemployment rate at a record high, and every indication that the recession is continuing. The latest data on real activity are mixed: retail sales were up in May, but real production and the balance of trade deteriorated. But gradual improvement in several economic and confidence indicators offer some hope that the recession could be over by the end of this year. At the same time, developments in the political arena are worrisome for the euro, since the Greek, Portuguese and Spanish governments are compromised by internal problems, and the European Council meeting at the end of June did not make any significant progress on the issue of the banking union.
- The European Central Bank (ECB) sparked some surprise by stating, at its July 4 meeting, that it expected that its key interest rates would remain at present or lower levels for an extended period. This is a significant change for the ECB, which in the past had always refused to make commitments about its future monetary policy. It was the tightening of financial conditions resulting from the widespread increase in bond yields around the world that pushed the ECB to take this action, and serious consideration was given to another interest rate cut.

Forecasts: The challenging economic and political conditions and the increasing possibility of further monetary easing in the euro zone should keep the euro fairly close to US$1.30 in the months to come. Shifts in the Fed discourse could generate more episodes of extreme volatility, however.

Euro and trend



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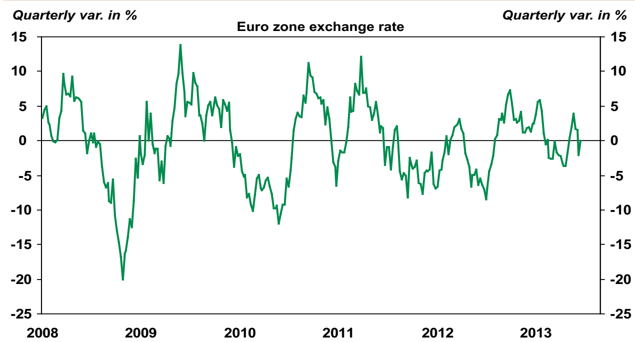
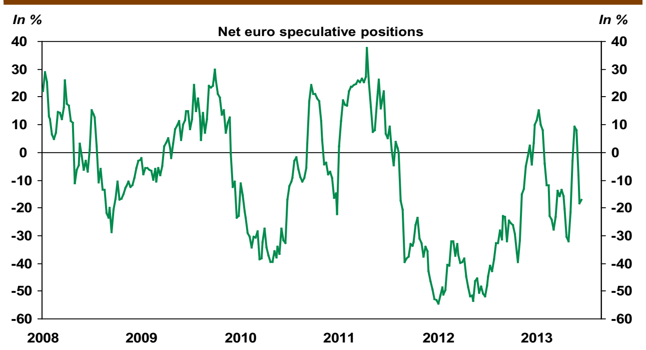
Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



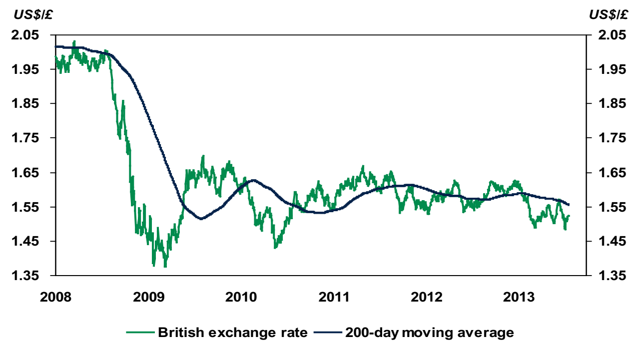
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

Is Carney really more dovish than King was?

- The pound sterling depreciated sharply against the greenback in the last weeks of June. The July 4 meeting of the Bank of England (BoE) also put downwards pressure on the pound. The fact that the BoE is opening the door to forward guidance seemed to confirm a perception on the part of many investors that Mark Carney's arrival signalled an even more accommodative monetary policy in the United Kingdom. Consequently, the pound fell below US$1.49 on July 9 and also depreciated significantly against the euro.
- The pound has got back on track since then, taking advantage of the greenback's weakening. On July 17, the release of the minutes of the last BoE's meeting also helped clarify the situation. BoE officials have a fairly positive view of the recent economic trends in the United Kingdom, but they are concerned about the recent spike in bond yields. A minority of officials wanted to make the monetary policy even more stimulative despite the high inflation, but the option of new quantitative purchases appears less attractive. **The BoE's adoption of forward guidance in the near future could signal the end of the expansion of its balance sheet, which would be favourable to the pound.**

British pound and trend



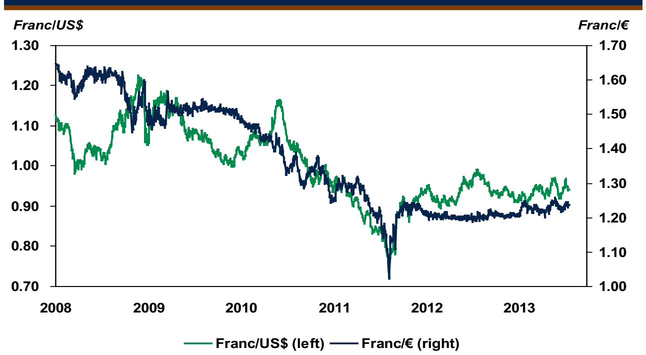
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

The franc will remain strong against the euro for a while yet

- The Swiss franc also depreciated against the greenback in the last weeks of June and beginning of July, and then rallied. The USD/CHF pair rose from 0.92 franc in the middle of June to over 0.97 franc on July 9, then fell back to around 0.94 franc. The franc was more stable against the euro, with the EUR/CHF pair fluctuating around 1.23 franc.
- Despite strong economic growth in the first quarter and subsiding deflation in June, there is every indication that the Swiss National Bank (SNB) will maintain a highly stimulative monetary policy for a long time to come. At its June meeting, the SNB reaffirmed its determination to defend the floor of 1.20 francs/€ to avoid an inopportune tightening of monetary conditions. The SNB is forecasting a marked slowdown of growth in the second quarter, and ongoing very weak inflation. **Little movement is predicted in the short term, but the Swiss franc will probably lose ground against the euro once the euro zone economy starts growing again.**

Swiss franc and trend



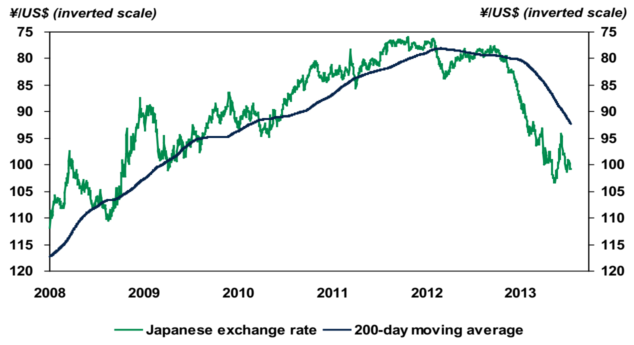
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

A return to ¥100/US$

- The Japanese exchange rate is once again verging on ¥100/US$. The depreciation of the yen resumed around mid-June, in particular due to a stronger U.S. dollar. Better-than-expected Japanese statistics released at the end of June on industrial production, retail sales and housing starts were not enough to slow the yen's decline. Investors are still paying a great deal of attention to the Bank of Japan (BoJ) and its progress in combating deflation. Despite an inflation rate that is taking a long time to move onto positive ground, the status quo was again left in place at the latest monetary policy meeting. The BoJ is continuing its asset purchases at an annual rate of ¥60,000B to ¥70,000B (US$600B to US$700B).
- The BoJ has set a target of a 2% inflation rate by the end of 2014. Excluding the effect of higher consumption taxes, the BoJ officials do not expect that target to be met before fiscal 2015. Further easing may therefore be required. **The BoJ will remain more interventionist than the other central banks, which is likely to keep weakening the yen in the coming quarters.**

Yen and trend



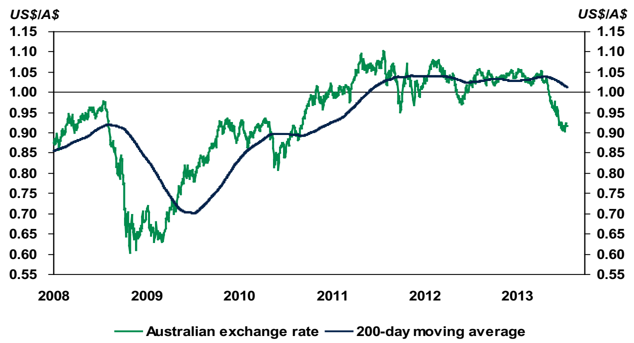
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The downturn deepens

- The Australian dollar recently hit a 34-month low, at US$0.90. The Australian economy is still strongly tied to commodities and to demand from the emerging countries of Asia. The currency is adversely affected by concerns about the emerging economies and natural resources prices. Investments in the commodity sector have also plateaued in Australia, increasing the need for other sectors to pick up the torch to ensure growth. It was against this backdrop that the Reserve Bank of Australia (RBA) lowered its main key interest rate to 2.75%.
- The RBA maintains that it still has room for easing its monetary policy. However, the depreciation of the currency reduces the amount of space available. Inflation could rise more than expected in the medium term due to higher prices of imported goods which would be carried through to retail prices. **More limited potential for monetary easing could help stabilize the Australian dollar between now and the end of the year.** Meanwhile, data from the emerging countries could improve, which would enable the currency to recover some of its losses.

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

The emerging countries continue a rough ride

CHINESE YUAN (CNY)

- The Chinese exchange rate has been holding steady at around 6.13 yuans/US$ for around two months now. The general appreciation of the U.S. dollar probably led the Chinese authorities to slow the pace of the yuan's appreciation, especially since many emerging currencies have suffered significant downturns. Some disappointing data may also have influenced this decision. Economic growth has fallen to 7.5%, and exports are down compared with last year.
- **The 6.00 yuans/US$ mark will be more difficult to reach between now and the end of the year if the exchange rate remains stable for many more months.** The scenario of a soft landing for the Chinese economy is still credible, however, and concerns should gradually dissipate.

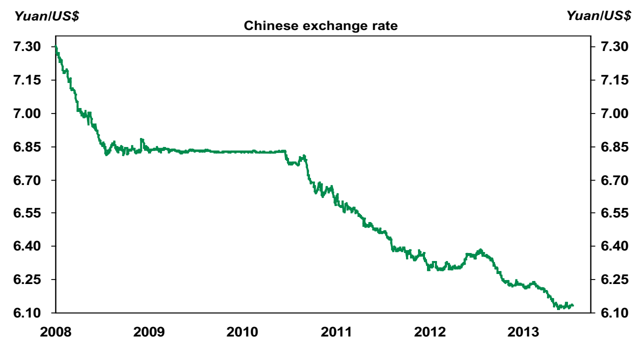
MEXICAN PESO (MXN)

- The USD/MXN pair surged to over 13.40 pesos after the June meeting of the Federal Reserve, reaching its highest level in nearly a year. Compared to where it stood at the beginning of May, the peso had lost nearly 13%.
- This drop by the peso mainly reflected a general correction in emerging currencies. Signs of weakness in the Mexican economy and the possibility of another cut in key interest rates also did damage to the peso. The USD/MXN pair nevertheless returned to around 12.50 pesos recently, when fears of hasty monetary tightening in the United States subsided, and some Mexican economic data firmed up. **The peso should gradually appreciate over the next few quarters.**

BRAZILIAN REAL (BRL)

- The Brazilian real is one of the currencies that has struggled the most against the U.S. dollar. The Brazilian exchange rate has reached its peak of 2009, at close to 2.30 reals/US$. The interest rate hikes decreed by the Central Bank of Brazil did not succeed in stirring up more enthusiasm for the currency. This monetary tightening is in response to an inflation rate that is above target. However, the impact that this tightening could have on economic growth, which is already considered disappointing, is arousing concerns. The situation is aggravated by riots in Brazil and by the worries that have spread to other emerging countries, leading investors to repatriate their funds to safer havens. **More encouraging economic data in Brazil and in the other emerging countries should bolster the real between now and 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* July 22	*Percentage return since* 1 month	3 months	6 months	1 year	*Last 52 weeks* Higher	Average	Lower
Americas								
Argentina – peso	5.4613	2.1176	5.7050	10.1336	19.7971	5.4613	4.9645	4.5588
Brazil – real	2.2412	-0.9130	11.0497	9.4205	10.6823	2.2707	2.0517	1.9490
Canada – dollar	1.0340	-1.2322	0.6963	4.0817	2.3509	1.0588	1.0066	0.9685
Canada – (CAD/USD)	0.9671	1.2476	-0.6915	-3.9217	-2.2969	1.0325	0.9935	0.9445
Mexico – peso	12.5229	-6.3806	1.4826	-1.2565	-5.7394	13.6870	12.7808	11.9901
Asia and South Pacific								
Australia – (AUD/USD)	0.9249	0.3284	-9.9801	-12.4682	-10.8773	1.0593	1.0186	0.9048
China – yuan renminbi	6.1409	0.1223	-0.6745	-1.2685	-3.6525	6.3885	6.2303	6.1212
Hong Kong – dollar	7.7588	0.0052	-0.0676	0.0645	0.0322	7.7647	7.7561	7.7500
India – rupee	59.7250	0.7592	10.1734	11.1680	7.9530	60.7200	55.1112	51.7450
Japan – yen	99.6650	1.8029	0.4434	12.3492	26.9780	103.2100	88.8758	77.4900
New Zeland – (NZD/USD)	0.7970	2.7736	-5.3877	-5.2283	-0.3347	0.8629	0.8205	0.7708
South Korea – won	1,119	-2.8922	-0.0045	5.3354	-1.9519	1,161	1,107	1,055
Europe								
Denmark – krona	5.6564	-0.4952	-0.8501	0.9720	-7.5767	6.1688	5.7501	5.4693
Euro zone – (EUR/USD)	1.3193	0.4339	1.2509	-0.7000	8.4323	1.3696	1.2971	1.2085
Norway – kroner	5.9338	-2.0672	1.5227	6.3777	-2.1366	6.2499	5.7659	5.4572
Russia – ruble	32.3310	-1.5760	2.1007	6.8475	0.9319	33.3212	31.3040	29.8739
Sweden – krona	6.4884	-2.7882	-0.6340	-0.3303	-6.5651	6.9793	6.5817	6.2899
Switzerland – swiss franc	0.9352	0.0481	-0.0961	0.6078	-5.2434	0.9938	0.9405	0.9029
United Kingdom – (GBP/USD)	1.5370	-0.1300	0.8233	-3.1385	-1.6824	1.6284	1.5657	1.4831

* 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	Q2	Q3f	Q4f	*2014* Q1f	Q2f	Q3f	Q4f
American dollar											
Canadian dollar	(USD/CAD)	0.9838	0.9922	1.0175	1.0520	1.0417	1.0204	1.0101	1.0000	0.9901	0.9804
Euro	(EUR/USD)	1.2865	1.3184	1.2841	1.2999	1.3000	1.3100	1.3200	1.3300	1.3300	1.3400
British pound	(GBP/USD)	1.6148	1.6255	1.5185	1.5167	1.5300	1.5500	1.5700	1.5800	1.5900	1.6000
Swiss franc	(USD/CHF)	0.9351	0.9153	0.9495	0.9463	0.9500	0.9500	0.9600	0.9600	0.9700	0.9700
Yen	(USD/JPY)	77.92	86.75	94.22	99.14	100.00	102.00	105.00	107.00	109.00	110.00
Australian dollar	(AUD/USD)	1.0376	1.0398	1.0419	0.9141	0.9200	0.9400	0.9400	0.9500	0.9500	0.9600
Chinese yuan	(USD/CNY)	6.2845	6.2303	6.2108	6.1376	6.1000	6.0500	6.0000	5.9500	5.9000	5.9000
Mexican peso	(USD/MXN)	12.86	12.87	12.32	12.95	12.50	12.30	12.10	12.00	11.90	11.70
Brazilian real	(USD/BRL)	2.0303	2.0432	2.0135	2.2153	2.1700	2.1200	2.0500	2.0000	2.0000	2.0000
Effective dollar*	(1973 = 100)	72.71	73.44	76.23	77.55	77.40	76.80	76.70	76.50	76.50	76.10
Canadian dollar											
American dollar	(CAD/USD)	1.0165	1.0079	0.9828	0.9506	0.9600	0.9800	0.9900	1.0000	1.0100	1.0200
Euro	(EUR/CAD)	1.2657	1.3081	1.3065	1.3674	1.3542	1.3367	1.3333	1.3300	1.3168	1.3137
British pound	(GBP/CAD)	1.5886	1.6128	1.5449	1.5955	1.5938	1.5816	1.5859	1.5800	1.5743	1.5686
Swiss franc	(CAD/CHF)	0.9505	0.9225	0.9332	0.8996	0.9120	0.9310	0.9504	0.9600	0.9797	0.9894
Yen	(CAD/JPY)	79.20	87.43	92.60	94.24	96.00	99.96	103.95	107.00	110.09	112.20
Australian dollar	(AUD/CAD)	1.0208	1.0317	1.0601	0.9616	0.9583	0.9592	0.9495	0.9500	0.9406	0.9412
Chinese yuan	(CAD/CNY)	6.3880	6.2793	6.1043	5.8345	5.8560	5.9290	5.9400	5.9500	5.9590	6.0180
Mexican peso	(CAD/MXN)	13.07	12.97	12.10	12.31	12.00	12.05	11.98	12.00	12.02	11.93
Brazilian real	(CAD/BRL)	2.0637	2.0593	1.9790	2.1059	2.0832	2.0776	2.0295	2.0000	2.0200	2.0400

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