FX Forecasts

Desjardins Economic Studies
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The U.S. dollar stumbles at the Federal Reserve's hesitation

HIGHLIGHTS

- The DXY index for the U.S. exchange rate has now completely wiped out the gains it made in spring and early summer.
- The context should become favourable to the U.S. dollar by the end of the year. Gains should be limited, however.
- Several emerging currencies could remain highly volatile, especially since bond yields could increase again in the United States and in other advanced nations.
- The postponement of the next key rate hike in Canada to mid-2015 means we have downgraded our forecast for the Canadian dollar. Return to parity now seems much more difficult for 2014.
- The improvement to the economic outlooks for the euro zone should allow the euro to hold above the US$1.30 mark in the coming quarters, especially as it has sharply reduced the chances that the European Central Bank will drop its key rates again.

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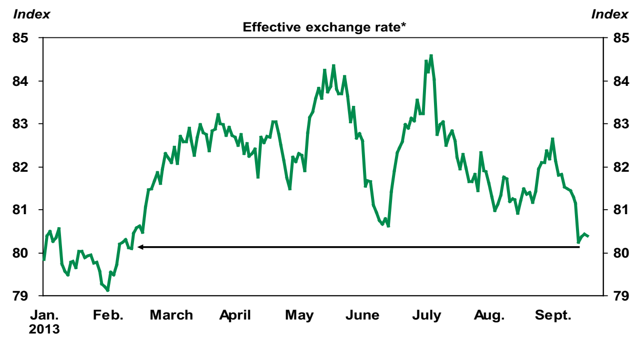
Editorial

Substantial exchange rate movements have been seen in recent months, in tandem with changing expectations for U.S. monetary policy. A new chapter was written after the Federal Reserve (Fed) once again decided to hold off tapering its asset purchases. In the wake of this unexpected decision, the U.S. dollar plunged against most currencies. The DXY index for the U.S. exchange rate has now completely wiped out the gains it made in spring and early summer (graph 1).

Graph 1 – The U.S. dollar is at its lowest level since February



* Weighted average of the U.S. dollar against the euro, yen, pound, Canadian dollar, Swedish krona and Swiss franc.
Sources: Bloomberg and Desjardins, Economic Studies

YET EXPECTATIONS WERE MODEST

Expectations for U.S. monetary policy have changed considerably over the last few months. The U.S. dollar initially shot up last spring on the possibility that the Fed would greatly reduce its asset purchases starting in early summer. Gradually, a broad consensus developed in the financial markets that the Fed needed to reduce its asset purchases more slowly, which contributed to the U.S. dollar's retreat. The consensus forecast for the Fed meeting on September 18 was a US$5B cut to its Treasuries purchases. In the end, the Fed chose to keep its monthly

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Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

purchases at US$40B in mortgage-backed securities (MBS) and US$45B in Treasuries.

Proportionately, the effect on the U.S. dollar may seem exaggerated. No foreign exchange intervention in the order of US$5B would have ever had such a large impact. Nevertheless, the Fed's decision created a lot of uncertainty among investors with regard to the future trajectory of its monetary policy.

ONLY A POSTPONEMENT

We think the Fed will start tapering its asset purchases before the end of the year. However, the improvement to the economy will have to be more convincing. Among other things, the Fed is worried about the impacts of the increase in market interest rates. The next figures for employment and the real estate market will be especially important. There are also economic and financial risks associated with the emerging budgetary impasse in the United States. Without a new budget, a part of the public apparatus could shutdown in October. The government could also become short on cash if the debt ceiling is not raised soon. That being said, a solution at the eleventh hour, as has often happened in the last few years, will probably keep the situation from deteriorating.

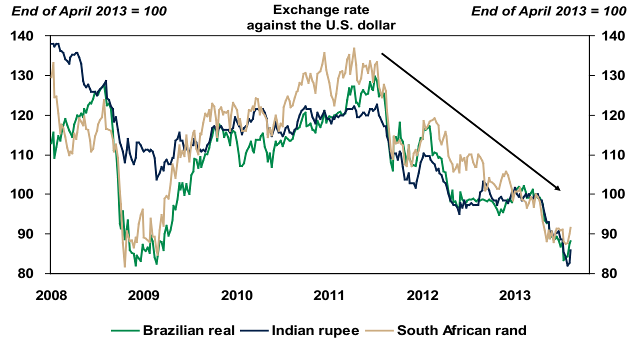
The context should therefore become favourable to the U.S. dollar by the end of the year. Gains should be limited, however. In fact, the Fed will remain in easing mode for several more quarters. Its balance sheet will likely continue to expand until the end of 2014. Monetary firming will only start in the second half of 2015, when the Fed begins to raise key rates or reduce its balance sheet. The U.S. dollar will only appreciate in a more lasting fashion when true monetary firming is on the horizon. The movement could be amplified by the feeling that other major central banks will not be able to do as much as the Fed.

THE PRESSURE ON EMERGING CURRENCIES EASED UP

Currencies from emerging countries have fluctuated wildly recently. These currencies are vulnerable to increasing bond yields in the United States and other industrialized nations. Relatively speaking, this makes the returns offered in emerging countries less appealing. The Fed's status quo was therefore good news for emerging countries, as it had a downside effect on bond yields.

However, yield movements do not explain everything. Several currencies were trending down well before rates picked up. The Brazilian real, the Indian rupee and the South African rand have been depreciating since 2011 (graph 2). The weaker economic growth in these countries

Graph 2 – The real, the rupee and the rand have been trending down since 2011



Sources: Datastream and Desjardins, Economic Studies

and current account deficits are behind this trend. Their dependence on foreign capital to finance economic development makes them even more vulnerable to interest rate movements.

A vicious cycle can set in when interest rates are raised to attract capital. This can weaken growth and translate into renewed exchange rate depreciation. Dropping interest rates to stimulate growth is not a better solution. Inflation, already high in these countries, could accelerate, further accentuating exchange losses. It then becomes more difficult to repay foreign debt and the risk of a financial crisis increases.

The recent improvement to Brazil's growth helped to ease investor fears. Moreover, the exchange rate depreciation seen to date should help boost the pace of growth in struggling economies. However, structural reforms will also be needed, suggesting fears will linger for several more quarters. Several emerging currencies could remain highly volatile, especially since bond yields could increase again in the United States and in other advanced nations.

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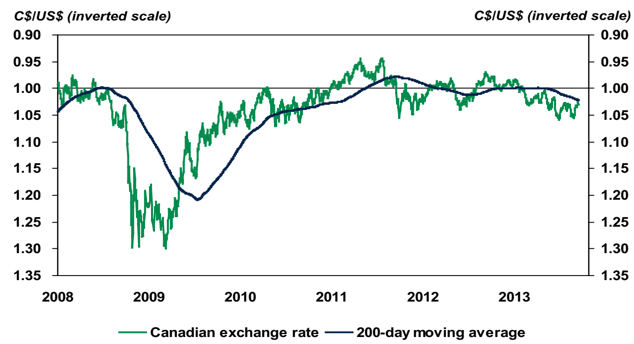
CANADIAN DOLLAR (CAD)

Parity will be harder to reach

- The Canadian dollar is currently oscillating close to US$0.97. It had dropped to US$0.95 in August, due to the strong U.S. dollar and fears over demand from emerging countries. Canada's economic outlook seems more uncertain when demand for commodities is threatened. However, other currencies vulnerable to demand for commodities reacted more dramatically than the Canadian dollar. Proximity to the U.S. market, where economic signals have been fairly encouraging, remains an advantage.
- Technically, the Canadian dollar has been trending down for around three quarters. Market indicators do not suggest that its trajectory is exaggerated. Investor sentiment toward the currency has improved, but there are still more short than long positions. This could be a reflection of concerns about demand for commodities.
- The release of strong employment figures in Canada—and disappointing ones in the United States—gave the loonie a boost in early September. More encouraging statistics from some emerging countries also helped. Nothing can be taken for granted, however. Internationally, economic data could deteriorate again in emerging countries. The situation in the Middle East and budget negotiations in the United States could add to the concern. Locally, the next figures for employment should be less astonishing. Businesses could still be hesitant to invest, and the housing market should slow somewhat.
- In its most recent statement, the Bank of Canada acknowledged that the Canadian economy was taking longer than expected to shift toward exports and that investment was slower than anticipated. As long-term interest rates have already risen substantially and economic growth is looking a little weaker, we now predict that the target for the overnight rate could stay at 1.00% until spring 2015.

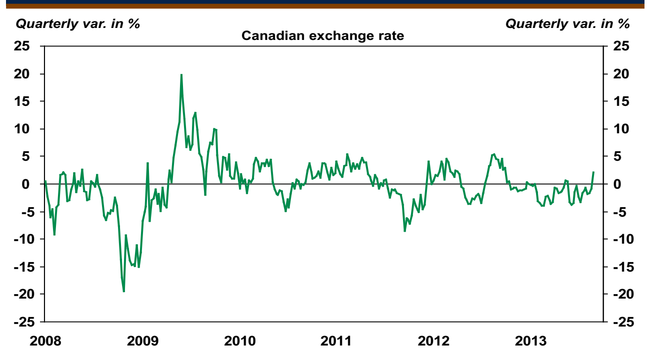
Forecasts: The postponement of the next key rate hike in Canada to mid-2015 means we have downgraded our forecast for the Canadian dollar. Return to parity now seems much more difficult for 2014. What's more, fears about global demand for commodities may linger for several more quarters, and more disappointing data could be released for Canada's economy in the short term. The loonie could fall back to US$0.95 before the end of the year, then begin a more lasting upswing.

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

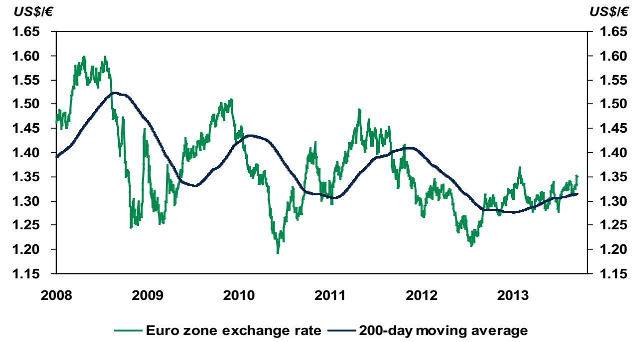
EURO (EUR)

The situation is improving... slowly

- After fluctuating wildly at the start of the summer, the euro has stabilized in the neighbourhood of US$1.32–1.33 since the end of July. The release of encouraging economic statistics is helping the euro hold above US$1.30. It jumped to US$1.30 after the Fed September meeting. Investors also seem fairly optimistic about the euro, as net speculative positions on this currency have climbed back into positive territory.
- The most important recent development for the euro is the improvement in European economic outlooks. The lengthy recession that began in fall 2011 finally ended last spring, when solid performances by Germany and France helped the euro zone's real GDP grow by an annualized 1.2%. While some figures, especially for industrial output, weakened in July, the leading activity indexes are still on the rise, suggesting that the economy will keep growing in the coming quarters. Fears of seeing the growth gaps between the United States and Europe widen, fostering a drop by European currencies, have thus waned substantially.
- However, we must not assume that all of the problems in the euro zone have been solved. Financial strains have eased significantly in the last year, but several countries' public finances remain in problematic situations. It also seems more and more likely that a third bailout plan will have to be announced for Greece. European financial institutions also remain fragile, and it is taking a long time to establish a banking union. We therefore understand why the European Central Bank (ECB) has been keeping its dovish tone, stressing that the unemployment rate remains high and the risks surrounding the economic outlooks are tilted to the downside. Everything suggests that, for several more months, the ECB will maintain its guidance that key rates will remain at or below current levels for a longer period of time. The ECB also says it is ready to respond if surplus liquidity reaches a level it deems too low.

Forecasts: The improvement to the economic outlooks for the euro zone should allow the euro to hold above the US$1.30 mark in the coming quarters, especially as it has sharply reduced the chances that the ECB will drop its key rates again. However, persisting risks to Euroland's economy and the fragility of the budding recovery are limiting the probability of significant, lasting appreciation by the euro.

Euro and trend



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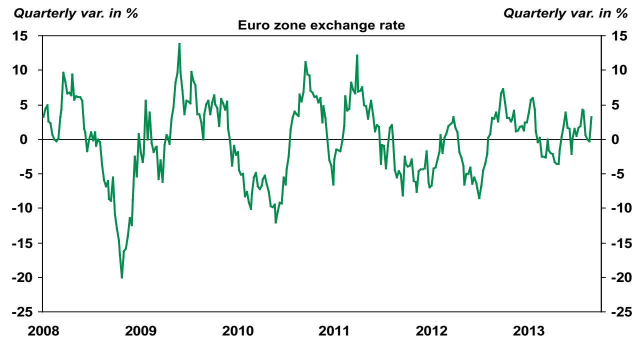
Euro: momentum



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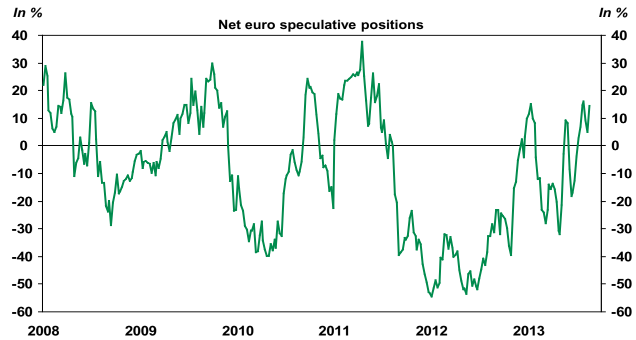
Euro: net speculative positions



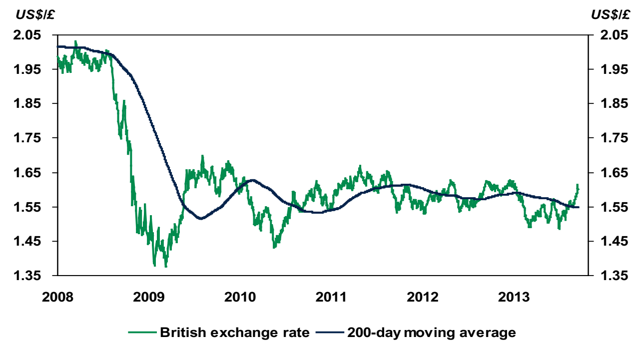
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

The pound is back above US$1.60

- The pound sterling shot up over the last few months, going from under US$1.49 on July 9 to over US$1.60, a gain of more than 7%.
- Two factors are primarily responsible for the pound's rebound after a rough first half of 2013. First of all, the data shows clear improvements to the economic situation in the United Kingdom, as real GDP advanced an annualized 2.9% in the second quarter and purchasing manager indexes jumped to their highest levels in recent years. Secondly, the view that the Bank of England (BoE) would become very dovish with Mark Carney at the helm was quickly dispelled. Fears that a credit bubble would force the BoE to raise its key rate in 2014 seem exaggerated, however. **Although the pound's recent rise seems largely justified, a slight dip is expected in the coming months, as the Federal Reserve should finally begin to taper its asset purchases, and anticipations of monetary firming in the United Kingdom should be pushed back.**

British pound and trend



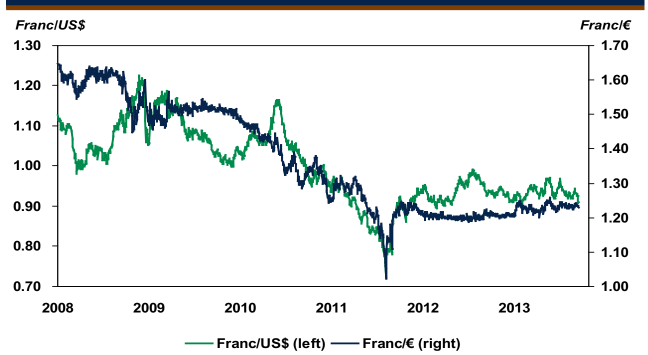
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

The Swiss National Bank want to keep its floor rate

- Following the general trend for European currencies, the Swiss franc has recently appreciated sharply against the greenback. The USD/CHF pair thus went from 0.97 francs at the start of July to 0.91 francs following the Fed's decision to maintain its pace for asset purchases. However, the franc has not fluctuated much against the euro.
- Economic statistics remain encouraging in Switzerland. Robust second quarter growth convinced the Swiss National Bank (SNB) to upgrade its economic forecasts for 2013. Moreover, deflation seems to have stopped. In spite of this, the SNB is maintaining a very dovish stance; on September 19, it repeated that the floor rate of 1.20 franc/€ would remain crucial. As the bank predicts that Swiss inflation will be just 0.7% for 2015, even if it keeps the three-month LIBOR rate at zero for another three years, it feels that there are no inflation risks for Switzerland. **The franc should continue to hold strong against the euro and the floor rate could be tested if financial strains resurface in Europe.**

Swiss franc and trend



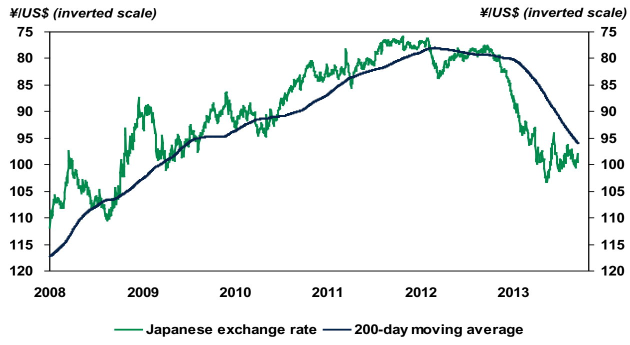
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

The consumption tax is becoming an important issue

- The yen temporarily benefited from the safe-haven effect in August, due to fears about some emerging countries. Japan's exchange rate dropped to ¥96/US$, but climbed back to nearly ¥100/US$ in September. The recent positive economic data for GDP, industrial output and exports from Japan have not prevented further depreciation by the yen.
- Monetary policy continues to dictate the yen's overall trend. The Bank of Japan (BoJ) will continue its asset purchases until the 2% inflation target is reached, which may take some time. The inflation rate remains slightly negative when the variation in food and energy prices is excluded; inflation expectations are increasing at a timid pace. The expected consumption tax increase has also become an important issue in Japan. The BoJ could announce other accommodative measures if this were to hurt the economy and the acceleration of inflation. **The yen should continue to depreciate in 2014.**

Yen and trend



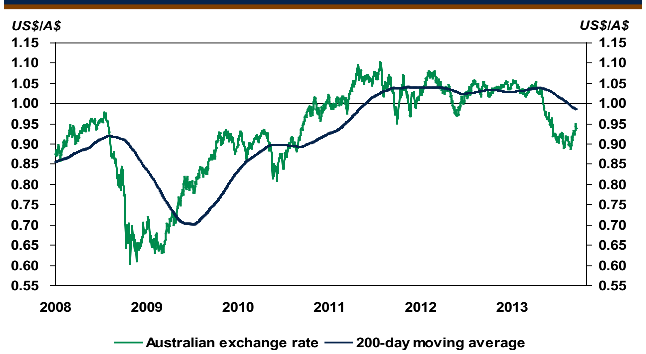
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The tumble seems to have ended

- The Australian dollar declined further over the summer, but at a much slower pace than last spring. It reached a three-year low in August, at US$0.8848, amidst fears about the economic strength of emerging countries. Another key interest rate cut from the Reserve Bank of Australia (RBA) also hurt the currency.
- The wind now seems to be shifting. Australia's dollar has been on the rise since the start of September and is currently around US$0.94. Fears about emerging countries have waned somewhat and Australia's economy has grown a bit faster than expected. The RBA has also taken a less dovish tone; its statement no longer mentions that it has some leeway to lower key rates if necessary. However, other sectors of Australia's economy must take the slack from softer investment in mining. In this context, **the Australian dollar's potential for appreciation will be limited for several quarters.**

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

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EMERGING CURRENCIES

A little break for emerging currencies

CHINESE YUAN (CNY)

- China's exchange rate has not moved much lately, oscillating around 6.12 yuan/US$. The yuan was not affected by the wave of depreciation that hit several emerging currencies. China has the advantage of having a comfortable trade surplus, which is not really compatible with exchange depreciation. Monetary authorities are also keeping a tight grip on the currency. Moreover, **in a context in which demand is not growing as fast in China, exchange rate stability seems like a compromise to keep from aggravating the situation with a pullback by exports**. While the latest economic figures have been a little more encouraging, authorities could opt to wait a few more months before letting the yuan rise further.

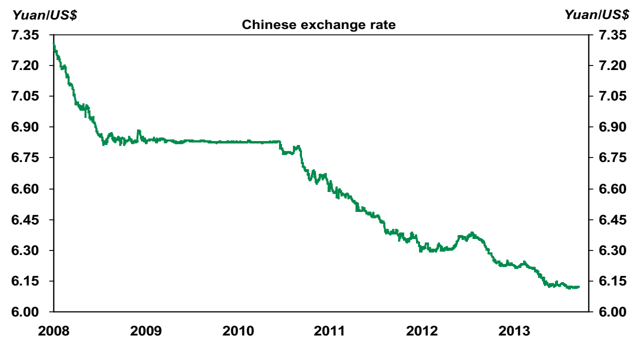
MEXICAN PESO (MXN)

- After dropping to around 12.50 pesos in mid-July, the USD/MXN pair shot up starting in mid-August, returning to 13.40 pesos. Behind the peso's return to depreciation were renewed fears of a possible cut to the Federal Reserve's (Fed) asset purchases and disappointing economic figures, with the Mexican economy posting a contraction in the second quarter.
- The Bank of Mexico's (BoM) surprise decision to cut its key rate as of its September 6 meeting was well received, prompting a rebound by the stock market and Mexico's currency. This decision confirms that the BoM is primarily concerned about the economic situation in Mexico; the BoM is not worried about a collapse by the peso which would kick off a surge in inflation. **Further key rate cuts are possible, but should not keep the peso from appreciating over the next few months.**

BRAZILIAN REAL (BRL)

- In recent months, the real has been one of the currencies under the heaviest pressure. In August, the exchange rate hit a nearly five-year peak at 2.45 reals/US$. The situation improved in September following the release of better than anticipated GDP figures for Brazil and the status quo decided by the Fed. The real also got direct support from Brazil's central bank through foreign exchange swaps. The increase to the key interest rate should, in principle, also support the currency, but it is primarily raising concerns about future economic growth. That said, inflation is starting to come down, which could reduce the need to firm up monetary policy. **In the near term, the economic data could be disappointing again, which would curb the real's appreciation.**

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 Sep. 23	Percentage return since 1 month	3 months	6 months	1 year	Last 52 weeks Higher	Average	Lower
Americas								
Argentina – peso	5.7725	2.6907	7.9375	12.9924	23.2453	5.7725	5.1359	4.6838
Brazil – real	2.2008	-7.6111	-2.6992	9.1398	8.7327	2.4513	2.0994	1.9490
Canada – dollar	1.0296	-2.1711	-1.6525	0.6993	5.4648	1.0588	1.0145	0.9756
Canada – (CAD/USD)	0.9713	2.2193	1.6803	-0.6944	-5.1816	1.0251	0.9857	0.9445
Mexico – peso	12.7808	-1.4831	-4.4530	3.3026	-0.3749	13.4419	12.7421	11.9901
Asia and South Pacific								
Australia – (AUD/USD)	0.9431	4.4987	2.3012	-9.6812	-9.8463	1.0593	0.9950	0.8900
China – yuan renminbi	6.1210	0.0000	-0.2022	-1.4681	-2.9229	6.3093	6.1906	6.1125
Hong Kong – dollar	7.7534	-0.0200	-0.0644	-0.1352	-0.0026	7.7647	7.7560	7.7500
India – rupee	62.6050	-0.9493	5.6179	15.1886	17.3147	68.8050	56.3962	51.7450
Japan – yen	98.8450	0.1013	0.9653	4.5813	26.4569	103.2100	92.3158	77.6050
New Zeland – (NZD/USD)	0.8374	7.3355	7.9802	0.1424	1.0300	0.8629	0.8187	0.7708
South Korea – won	1,074	-3.8498	-6.7954	-4.0559	-4.0538	1,161	1,103	1,055
Europe								
Denmark – krona	5.5274	-0.8280	-2.7654	-3.6669	-3.7868	5.8705	5.6898	5.4693
Euro zone – (EUR/USD)	1.3493	0.6641	2.7101	3.8124	3.8764	1.3696	1.3106	1.2706
Norway – kroner	5.9185	-1.6713	-2.3189	1.9868	3.1151	6.2499	5.7781	5.4572
Russia – ruble	31.7992	-3.5777	-3.1950	3.1638	2.4690	33.4900	31.4704	29.8739
Sweden – krona	6.3869	-1.5954	-4.3097	-1.6712	-2.7270	6.7935	6.5516	6.2899
Switzerland – swiss franc	0.9111	-0.9028	-2.5354	-3.1004	-2.3160	0.9796	0.9347	0.9029
United Kingdom – (GBP/USD)	1.6033	2.8153	4.1782	5.2070	-1.3658	1.6284	1.5617	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	1.0309	1.0526	1.0417	1.0309	1.0204	1.0101
Euro	(EUR/USD)	1.2865	1.3184	1.2841	1.2999	1.3400	1.3200	1.3300	1.3400	1.3500	1.3400
British pound	(GBP/USD)	1.6148	1.6255	1.5185	1.5167	1.6000	1.5800	1.5900	1.6100	1.6200	1.6100
Swiss franc	(USD/CHF)	0.9351	0.9153	0.9495	0.9463	0.9200	0.9300	0.9300	0.9400	0.9500	0.9600
Yen	(USD/JPY)	77.92	86.75	94.22	99.14	100.00	101.00	103.00	105.00	108.00	110.00
Australian dollar	(AUD/USD)	1.0376	1.0398	1.0419	0.9141	0.9400	0.9200	0.9300	0.9400	0.9500	0.9500
Chinese yuan	(USD/CNY)	6.2845	6.2303	6.2108	6.1376	6.1200	6.1000	6.0500	6.0000	5.9500	5.9000
Mexican peso	(USD/MXN)	12.86	12.87	12.32	12.95	12.90	12.80	12.50	12.20	12.10	12.00
Brazilian real	(USD/BRL)	2.0303	2.0432	2.0135	2.2153	2.2500	2.2000	2.1500	2.1500	2.1000	2.0500
Effective dollar*	(1973 = 100)	72.71	73.44	76.23	77.55	75.80	76.90	76.70	76.50	76.40	76.70
Canadian dollar											
American dollar	(CAD/USD)	1.0165	1.0079	0.9828	0.9506	0.9700	0.9500	0.9600	0.9700	0.9800	0.9900
Euro	(EUR/CAD)	1.2657	1.3081	1.3065	1.3674	1.3814	1.3895	1.3854	1.3814	1.3776	1.3535
British pound	(GBP/CAD)	1.5886	1.6128	1.5449	1.5955	1.6495	1.6632	1.6563	1.6598	1.6531	1.6263
Swiss franc	(CAD/CHF)	0.9505	0.9225	0.9332	0.8996	0.8924	0.8835	0.8928	0.9118	0.9310	0.9504
Yen	(CAD/JPY)	79.20	87.43	92.60	94.24	97.00	95.95	98.88	101.85	105.84	108.90
Australian dollar	(AUD/CAD)	1.0208	1.0317	1.0601	0.9616	0.9691	0.9684	0.9688	0.9691	0.9694	0.9596
Chinese yuan	(CAD/CNY)	6.3880	6.2793	6.1043	5.8345	5.9364	5.7950	5.8080	5.8200	5.8310	5.8410
Mexican peso	(CAD/MXN)	13.07	12.97	12.10	12.31	12.51	12.16	12.00	11.83	11.86	11.88
Brazilian real	(CAD/BRL)	2.0637	2.0593	1.9790	2.1059	2.1825	2.0900	2.0640	2.0855	2.0580	2.0295

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