FX Forecasts

Desjardins Economic Studies
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The recent budget deal in the United States didn't mark a turning point in currency trends

HIGHLIGHTS

- The budget uncertainty that is resurfacing in the United States lends credibility to the scenario where the Federal Reserve (Fed) would wait until its meeting in March to announce that it is winding down its purchasing program. This scenario is not favourable to a quick turnaround for the U.S. dollar.
- The expected weakness in Canada's domestic demand is not consistent with any quick return to parity with the U.S. dollar. The loonie's value could slip slightly in the short term, fuelled by concerns regarding the statistics in Canada and global demand.
- The emerging currencies that are sensitive to rising bond yields remain at risk over the next few months. Even if the Fed decides to wait until March, bond yields could be under increasing pressure as 2014 begins.
- Recent euro gains will be difficult to sustain since they could seriously threaten the fragile economic recovery in the Eurozone. This could trigger an European Central Bank response.

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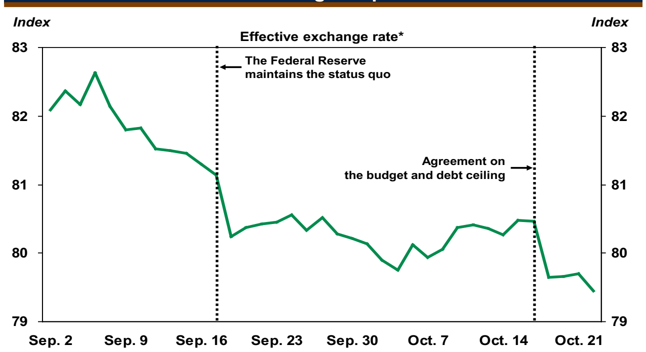
Editorial

The budget impasse in the United States kept the U.S. dollar under pressure compared to several other major currencies. The losses were less steep, however, than in September after the Federal Reserve (Fed) released its surprise decision not to wind down the pace of its securities purchases. The greenback even firmed up a bit during the second week of October when an agreement between the Republicans and Democrats looked near. Now that the problem is solved, the U.S. dollar could be expected to rise. But this is not what we are seeing (graph 1). Why is that?

Graph 1 – The U.S. dollar is slipping despite the end of the budget impasse



* 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

THE WATER TORTURE TEST

The agreement reached on October 16 does not eliminate all the concerns about the U.S. government's capacity to function properly and meet its financial obligations. Like a death by a thousand cuts, the Republicans and Democrats will have to butt heads once again on adopting budget allocations and raising the debt ceiling. An agreement has to be reached by January 15, 2014, to prevent another government shutdown. The debt ceiling has been suspended

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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.

until February 7, a deadline the Treasury can elect to extend by a few months by instituting special measures.

The U.S. government may have avoided the worst in the short term, but now it has to demonstrate beyond a doubt that it can find a longer term solution. The next round of negotiations could actually wind up with another short-term agreement. However, the mid-term elections should prompt both camps to roll up their sleeves and come up with a solution that would last long enough to spare the election campaigns.

IMPACT ON THE FED'S NEXT DECISIONS

The budget uncertainty that is resurfacing in the United States could influence the Fed's upcoming decisions. We now seriously doubt that the Fed will start cutting back on its asset purchases before the end of the year. The Fed acted prudently in September and this strategy could very well be repeated. If a new shutdown takes place in January, it lends credibility to the scenario where the Fed would wait until later in the winter or spring to announce that it is winding down its purchasing program. This scenario is not favourable to a quick turnaround for the U.S. dollar.

Economic data will also play an important role in the Fed's future decisions. The government shutdown in October is likely to have caused economic losses that will also argue in favour of acting with extreme caution. We can thus assume that quarterly annualized real GDP growth was trimmed by 0.3 to 0.5 of a percentage point in the fourth quarter. Our most recent scenarios, which called for 2.2% growth for the quarter, already include this bite. It remains to be seen if households, businesses and investors were more heavily affected than expected, and for a longer period of time. As a result, the U.S. dollar could be fairly sensitive to post-shutdown statistics.

U.S. DOLLAR SET TO RISE BY YEAR-END

Recent events reduce—but not fully derail—the greenback's potential to appreciate by the end of the year. Consistent with what happened last spring, expectations about the Fed's actions should kick-start the U.S. dollar a few months before it takes concrete action. In addition, the looming mid-term elections are a major incentive to speed up reaching an agreement. If a new shutdown is avoided on January 15, 2014, and if the economic data are satisfactory, the Fed could opt to announce a first reduction of its asset purchases at its meeting in late January. This possibility will be accounted for in the greenback's movements.

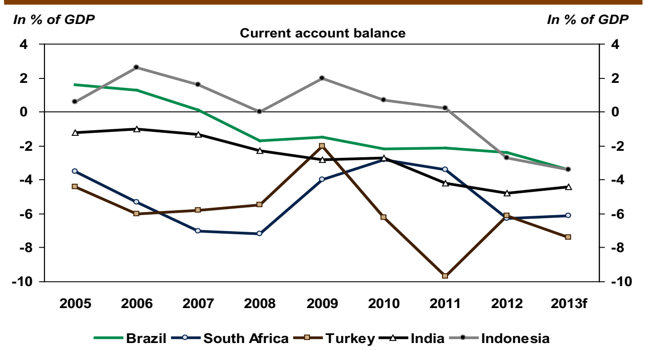
EMERGING CURRENCIES STILL AT RISK

By postponing the easing of its securities purchases, the Fed is putting a lid on interest rate hikes in the short term, which extends the breathing room this provides several emerging currencies. Earlier this year, countries such as India, Indonesia, Brazil and South Africa suffered steep declines in their currency values due to rising interest rates in the United States. This phenomenon squeezes capital inflows to these countries, which reduces the demand for their currencies, among other things.

The emerging currencies that are sensitive to rising bond yields remain at risk over the next few months, however. Even if the Fed decides to wait until March, bond yields could be under increasing pressure as 2014 begins. Statistics on the U.S. economy will also have greater influence over these movements.

To reduce the exposure to shifts in interest rates, the structural problems have to be resolved. In addition to weak economic growth, countries that have volatile currencies often grapple with heavy public debt, current account deficits and inflation (graph 2). Solutions for these types of difficulties can rarely be applied swiftly, which suggests that a prudent approach is in order for certain currencies in emerging countries.

Graph 2 – The current account balance in several emerging countries has deteriorated in recent years



f: forecasts
Sources: International Monetary Fund and Desjardins, Economic Studies

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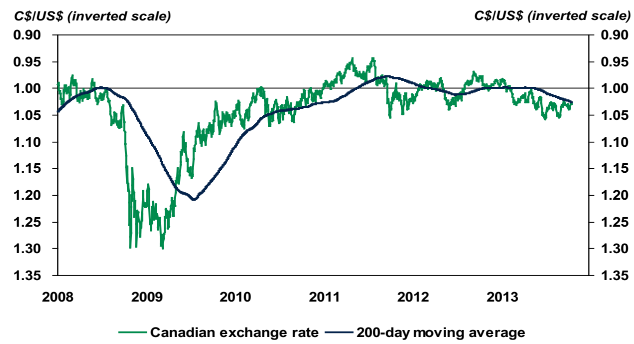
CANADIAN DOLLAR (CAD)

Concerns persist

- The Canadian dollar has shifted between US$0.96 and US$0.97 in recent weeks. An unexpected decline in Canada's trade balance drove temporarily the loonie to the lower end of this range in the second week of October. Worries about the consequences of the budget impasse in the United States also hindered the loonie. This contrasts with the increase in most other major currencies over the same period. The importance of the U.S. market for Canada is likely to have weighed in the balance.
- From a technical standpoint, Canada's currency has been trending downward for a few months now. Its momentum has gained some traction lately and the balance of speculative positions on the currency is less negative. That said, sentiment toward the loonie would still have to strengthen markedly to speak of a sustainable uptrend.
- From a fundamental standpoint, real GDP growth in the third quarter is expected to be sustained. But investors will probably need more to quell their concerns, however. On one hand, the rebound in growth will primarily reflect the narrowing of the gap created in the second quarter, which was impacted by the floods in Alberta and the construction strike in Quebec. On the other, many obstacles continue to cloud the outlooks; among them, the many uncertainties around the globe, which should continue to dampen investment by Canadian businesses. Weaker job creation and Canadians' high debt levels are also eroding the upward potential of consumption and residential investment.
- Faced with weakened domestic demand, all hopes hinge on Canada's exports. This particular situation is not conducive to the loonie's appreciation. Another key point, the Bank of Canada may end up staying on the sidelines for a few more quarters. Weak inflation gives the monetary authorities some additional leeway. The first increase in interest rates is only expected sometime in mid-2015, or only a few months before the Federal Reserve makes its move.

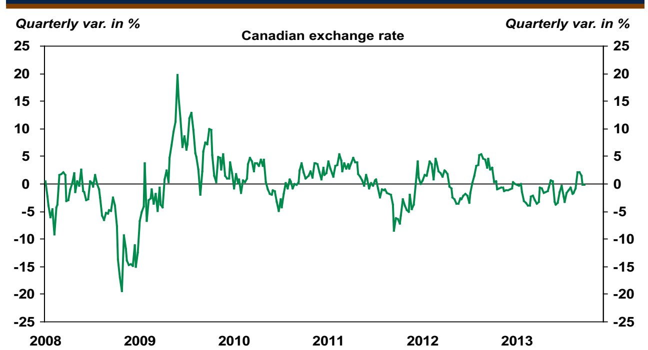
Forecasts: The expected weakness in Canada's domestic demand is not consistent with any quick return to parity with the U.S. dollar. The loonie's value could slip slightly in the short term, fuelled by concerns regarding the statistics in Canada and global demand. After that, the loonie should once again be able to soar, provided that the economic situation improves gradually throughout 2014.

Canadian dollar and trend



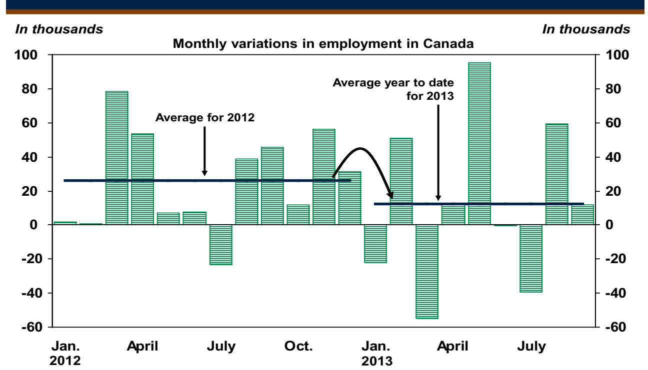
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: employment growth slowed



Sources: Statistics Canada and Desjardins, Economic Studies

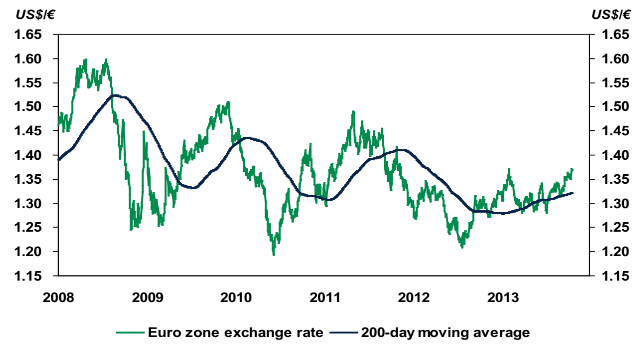
EURO (EUR)

Events in the United States favour the euro

- After rebounding to US$1.35 on September 19, following the Federal Reserve's (Fed) decision to not ease its bond purchases, the euro continued to climb. The political impasse and disappointing data in the United States recently pushed the euro to more than US$1.37, a peak since November 2011.
- After several years of crisis and doubts about the euro's survival, the euro's role as a safe haven amid swirling concerns about a U.S. government default is somewhat ironic. This mostly reflects two main facts: 1) there are few major currencies and 2) they cannot all depreciate at the same time. Beyond the risk of a new financial crisis originating in the United States, the U.S. government shutdown tilts in favour of the euro against the greenback—by cutting U.S. growth outlooks and by increasing the chances that the Fed will continue to buy up massive amounts of bonds for some time. The euro held firm following the agreement to reopen the federal government, since the possibility of a new shutdown in early 2014 is another reason for the Fed to keep purchasing bonds.
- However, the euro zone is still grappling with serious problems that are limiting the euro's potential to appreciate. The most recent economic statistics were relatively mixed and all signs indicate that growth in the euroland economy will remain very weak in the coming quarters. Credit evolution is particularly worrisome, with loans to non-financial businesses posting a 2.9% decline (annual) in August. With the annual inflation rate falling to only 1.1% in September, the European Central Bank (ECB) has the leeway it needs to reiterate that key rates will remain at their current levels—or lower—for an extended period.
- While another reduction in key rates seems unlikely now that the recession is over, the ECB could soon announce its intentions to offer long-term loans to the banking sector. The president, Mario Draghi, clearly left the door wide open on this issue by stating that the ECB will be particularly attentive to shifts in the situation on monetary markets and confirming its readiness to deploy all the instruments in its arsenal to maintain favourable conditions.

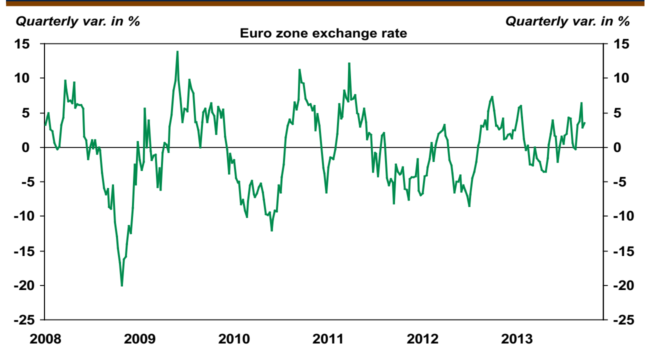
Forecasts: Recent euro gains will be difficult to sustain since they could seriously threaten the fragile economic recovery in the Eurozone. This could trigger an ECB response. Nonetheless, the possibility of new political impasses in the United States could keep the euro relatively strong.

Euro and trend



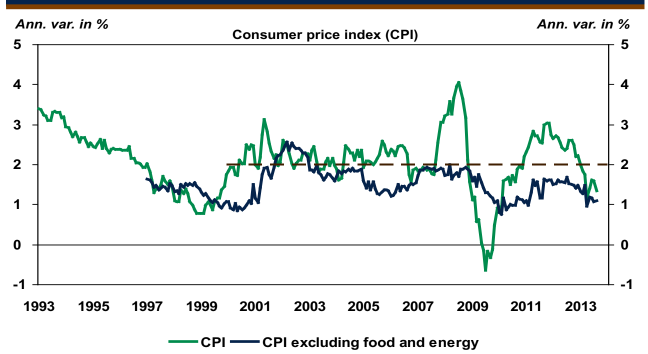
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: the euro zone's inflation rate is low



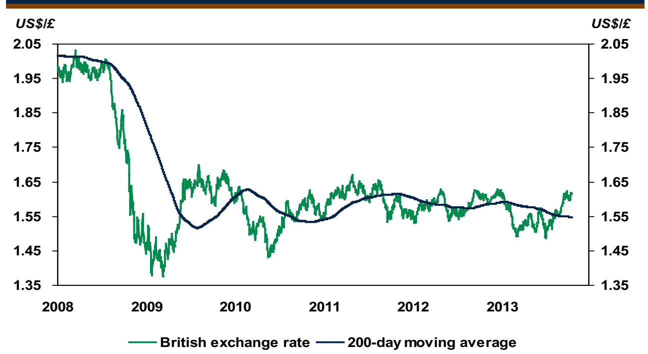
Sources: Datastream and Desjardins, Economic Studies

BRITISH POUND (GBP)

The economic recovery is taking hold

- Like the euro, the recent political impasse and the Federal Reserve's (Fed) subsequent decision lifted the pound sterling. Britain's currency thus reached US$1.626 in early October, a gain of almost 10% vs. the level posted in early July.
- Sharp improvements in the economic outlooks continue to favour the pound. After posting solid growth of 2.7% (annualized) in the second quarter, all signs indicate that the British economy continued to gain momentum over the summer. The governor of the Bank of England (BoE) recently stated that he saw no case for quantitative easing now that the economic recovery has strengthened and broadened. Even though concerns are growing about the possibility of a real estate bubble, the BoE's leaders believe that it is far too early to consider monetary tightening, repeating that such actions will not even be considered as long as the unemployment rate remains above 7.0%. **The extension of the Fed's bond purchases will help the pound remain around US$1.60 for the next few months.**

British pound and trend



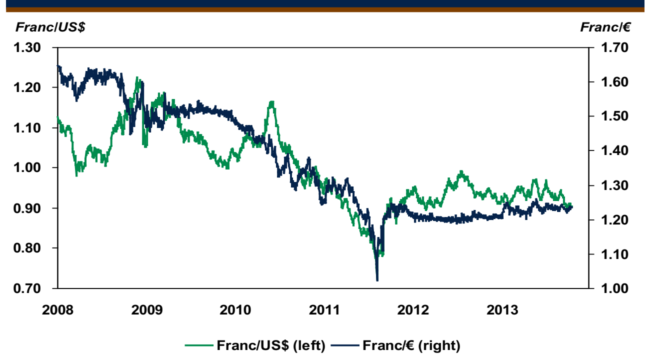
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

The Swiss franc set to move in line with the euro in the short term

- The Swiss franc has also increased in value vs. the greenback in recent weeks, with the USD/CHF pair thus declining to about 0.900 francs per USD. The franc's gains were somewhat more limited compared to the euro's gains, with the EUR/CHF pair climbing to approximately 1.235 francs, shifting away from the floor price of 1.200 francs set by the Swiss National Bank (SNB).
- Switzerland is another country where the economic outlooks have improved significantly in the past few months. Although domestic demand continues to show encouraging signs, the external sector is still an issue given the strong franc and weak demand in the euro zone. While inflation remains very weak, the SNB has signalled that it will keep its exchange rate floor for some time to come. **The Swiss franc should move in line with the euro in the coming months. It should decline against most major currencies over the medium and long terms however, as its status as a safe haven becomes less sought after.**

Swiss franc and trend



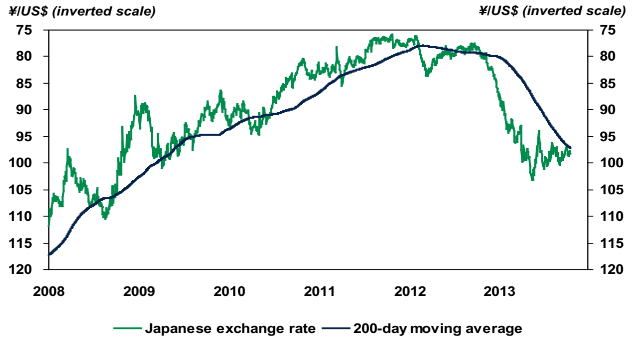
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

The haven effect holds the depreciation at bay

- Japan's exchange rate is holding its own below the symbolic ¥100/$US mark. It recently declined to ¥97/$US. The safe-haven effect is delaying the yen's further depreciation. In summer 2013, Japan's currency capitalized on concerns about some of the emerging countries, and more recently, the yen was a back-up option vs. the greenback due to the budget impasse in the United States and the risk of a sovereign default.
- Economic growth in the first half of the year in Japan was sustained, but the statistics released for Q3 point to a more moderate pace at this time. The increase in the sales tax expected in April is also threatening to slow the economy down. The government has put an economic stimulus plan in place, but it could complicate reducing Japan's substantial public deficit. **A weak yen will be required to sustain Japan's economy. Continued purchases of securities by the Bank of Japan in 2014 and possibly in 2015, will maintain downward pressure on the currency.** The ¥110/$US mark appears achievable within a one-year horizon.

Yen and trend



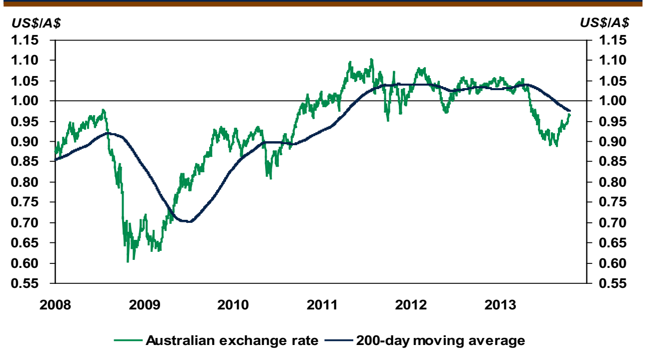
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

A too-quick recovery

- The Australian dollar has been on an upswing since the beginning of September—it recently reached a four-month peak of US$0.97. Much like other currencies, the decision by the Federal Reserve to maintain its securities purchases bodes well for the Australian dollar. Signs of stabilization in China's economy gave the Australian dollar a bit of a boost, given China's status as Australia's biggest export market.
- The health of Australia's economy is still relatively precarious, with investments in the resource sector slowing down and weak potential for improvement in terms of trade. Other growth engines have to pick up the slack, which prompted the Reserve Bank of Australia to gradually cut its key interest rate over the past two years. The minutes of the latest monetary policy meeting leave room for further reductions. In this context, **the Australian dollar appears to be recovering too quickly and a depreciation seems probable in the short term**. More volatility could be in the cards amid new concerns about global demand for commodities.

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

Volatility remains in store

CHINESE YUAN (CNY)

- The exchange rate recently rose to below 6.10 yuan/$US. This change breaks the trend toward stabilization that has set in in recent months. Data on the foreign currency reserves held by China showed that reserves were much higher than expected, indicating that the yuan did not suffer from the downside pressures that affected several other emerging currencies this summer. The fact remains that the monetary authorities probably do not want the yuan to climb too quickly. Exports have posted slim advances for a year now and economic growth in China remains moderate due to slower advances in domestic demand. **The exchange rate could therefore stabilize once again as it edges closer to 6.00 yuan/$US.**

MEXICAN PESO (MXN)

- After rebounding in mid-September, buoyed by the Federal Reserve's (Fed) decision to maintain its stimulus, the peso quickly retreated due to investors' worries about the political impasse in the United States. The USD/MXN pair, which had fallen to about 12.60 pesos/$US on September 19, quickly climbed back up to above 13 pesos. The last-minute agreement reached to prevent a default in the United States pushed the peso back temporarily to about 12.75 pesos/$US. The difficulties in the Mexican economy continue to hinder the peso while the International Monetary Fund recently downgraded its real GDP growth outlooks for Mexico from 2.9% to 1.2% for 2013. **The peso could remain relatively weak in the coming months and will continue to react strongly to the changes in the political and economic landscape in the United States.**

BRAZILIAN REAL (BRL)

- Brazil's real is gradually recovering after it experienced a difficult phase earlier this year. Currency swap and the selloff of U.S. dollars by the Central Bank of Brazil seem to be effective. These operations are expected to wind down by the end of December, however. The Fed's decision to delay any cuts to its securities purchases and the drop in international bond yields are also providing Brazil's currency with support. The situation could change in a few months, when the Fed's policy is once again up for debate. **The real could experience a period of sharp volatility in the short term.** Ongoing monetary tightening to reduce inflation in Brazil should prop up the currency somewhat, as long as the economy stays on track.

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* Oct. 21	*Percentage return since* 1 month	3 months	6 months	1 year	*Last 52 weeks* Higher	Average	Lower
Americas								
Argentina – peso	5.8508	1.5852	7.2312	13.3601	23.5323	5.8513	5.2208	4.7363
Brazil – real	2.1731	-1.5450	-2.8109	8.4600	7.1947	2.4513	2.1123	1.9490
Canada – dollar	1.0295	0.0778	-0.7520	0.3411	3.9009	1.0588	1.0185	0.9837
Canada – (CAD/USD)	0.9714	-0.0777	0.7577	-0.3400	-3.7544	1.0166	0.9819	0.9445
Mexico – peso	12.9331	1.1976	3.2393	5.8018	0.6193	13.4419	12.7576	11.9901
Asia and South Pacific								
Australia – (AUD/USD)	0.9653	2.7559	5.2367	-6.0669	-6.5592	1.0593	0.9884	0.8900
China – yuan renminbi	6.0926	-0.4672	-0.7380	-1.3759	-2.5776	6.2546	6.1777	6.0926
Hong Kong – dollar	7.7524	-0.0103	-0.0741	-0.1494	0.0303	7.7647	7.7561	7.7500
India – rupee	61.5800	-1.0525	3.7749	14.1639	14.3653	68.8050	57.0884	53.0350
Japan – yen	98.1900	-1.1328	-2.4441	-1.3364	23.7897	103.2100	93.8179	79.3200
New Zeland – (NZD/USD)	0.8455	1.0400	6.5866	0.3974	3.5935	0.8629	0.8196	0.7708
South Korea – won	1,062	-2.0110	-5.3064	-4.8399	-3.7295	1,161	1,099	1,055
Europe								
Denmark – krona	5.4522	-1.1208	-3.9141	-4.5333	-4.7950	5.8705	5.6701	5.4498
Euro zone – (EUR/USD)	1.3676	1.2288	4.0793	4.5408	4.9459	1.3696	1.3153	1.2706
Norway – kroner	5.9210	-0.2308	-0.8258	1.7004	4.6002	6.2499	5.7987	5.4572
Russia – ruble	31.9025	0.2593	-1.4479	1.1317	3.4087	33.4900	31.5560	29.8739
Sweden – krona	6.3947	0.5448	-2.1596	-2.1746	-2.8331	6.7935	6.5372	6.2899
Switzerland – swiss franc	0.9017	-1.0860	-4.1357	-3.1055	-2.8183	0.9796	0.9326	0.9000
United Kingdom – (GBP/USD)	1.6159	0.9875	5.8914	5.9088	0.8457	1.6284	1.5613	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	Q3	Q4f	*2014* Q1f	Q2f	Q3f	Q4f
American dollar											
Canadian dollar	(USD/CAD)	0.9838	0.9922	1.0175	1.0520	1.0310	1.0417	1.0417	1.0309	1.0204	1.0101
Euro	(EUR/USD)	1.2865	1.3184	1.2841	1.2999	1.3536	1.3300	1.3100	1.3200	1.3400	1.3300
British pound	(GBP/USD)	1.6148	1.6255	1.5185	1.5167	1.6194	1.6000	1.5800	1.5900	1.6100	1.6000
Swiss franc	(USD/CHF)	0.9351	0.9153	0.9495	0.9463	0.9052	0.9200	0.9300	0.9300	0.9300	0.9500
Yen	(USD/JPY)	77.92	86.75	94.22	99.14	98.23	99.00	102.00	105.00	108.00	110.00
Australian dollar	(AUD/USD)	1.0376	1.0398	1.0419	0.9141	0.9317	0.9300	0.9200	0.9300	0.9400	0.9500
Chinese yuan	(USD/CNY)	6.2845	6.2303	6.2108	6.1376	6.1215	6.1000	6.0500	6.0000	5.9500	5.9000
Mexican peso	(USD/MXN)	12.86	12.87	12.32	12.95	13.09	12.90	13.00	12.75	12.50	12.40
Brazilian real	(USD/BRL)	2.0303	2.0432	2.0135	2.2153	2.2297	2.2000	2.2500	2.1500	2.1000	2.1000
Effective dollar*	(1973 = 100)	72.71	73.44	76.23	77.55	75.19	76.10	77.20	77.00	76.60	77.00
Canadian dollar											
American dollar	(CAD/USD)	1.0165	1.0079	0.9828	0.9506	0.9700	0.9600	0.9600	0.9700	0.9800	0.9900
Euro	(EUR/CAD)	1.2657	1.3081	1.3065	1.3674	1.3955	1.3854	1.3646	1.3608	1.3673	1.3434
British pound	(GBP/CAD)	1.5886	1.6128	1.5449	1.5955	1.6695	1.6667	1.6458	1.6392	1.6429	1.6162
Swiss franc	(CAD/CHF)	0.9505	0.9225	0.9332	0.8996	0.8780	0.8832	0.8928	0.9021	0.9114	0.9405
Yen	(CAD/JPY)	79.20	87.43	92.60	94.24	95.28	95.04	97.92	101.85	105.84	108.90
Australian dollar	(AUD/CAD)	1.0208	1.0317	1.0601	0.9616	0.9605	0.9688	0.9583	0.9588	0.9592	0.9596
Chinese yuan	(CAD/CNY)	6.3880	6.2793	6.1043	5.8345	5.9377	5.8560	5.8080	5.8200	5.8310	5.8410
Mexican peso	(CAD/MXN)	13.07	12.97	12.10	12.31	12.70	12.38	12.48	12.37	12.25	12.28
Brazilian real	(CAD/BRL)	2.0637	2.0593	1.9790	2.1059	2.1628	2.1120	2.1600	2.0855	2.0580	2.0790

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