FX Forecasts

Desjardins Economic Studies
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The U.S. dollar has already begun to appreciate

HIGHLIGHTS

- The U.S. dollar is expected to make further gains in the short term, given the solid economic data coming from the United States and the eventual start to tapering.
- Canada's economic difficulties argue less and less for a rapid comeback by the loonie, which could dip again slightly in the short term, though it should show a general trend towards stabilizing around US$0.94. The currency may however end 2014 on a more positive note if fears for Canada's economy fade, supported by an improvement in the global economy.
- The euro should pull back over the next few months amid the upcoming decrease of asset purchases by the Federal Reserve. The euro zone's weak economy and fears of deflation may also harm the euro.
- The pound could edge down against the U.S. dollar in the near term, but the British economy's solid performance and a less dovish central bank will continue to support the currency.
- The currencies of several emerging economies are expected to remain very volatile in the coming months due to their sensitivity to U.S. interest rates.

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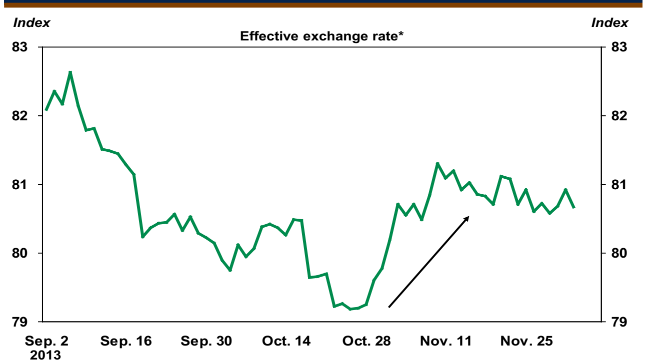
Editorial

The U.S. dollar's soft patch has been short-lived. After the negative effects of the delay to Federal Reserve (Fed) tapering (decrease of securities purchases) in September and the budget impasse in October, more favourable winds have blown on the greenback. It appreciated in late October and early November, and has stabilized more recently (graph 1). The U.S. dollar is still expected to make further gains in the short term, given the solid economic data coming from the United States and the eventual start to tapering.

Graph 1 – The U.S. dollar erased some of its earlier losses



* 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

GOOD ECONOMIC FIGURES IN THE UNITED STATES

Many of the statistics released in the United States since the end of October have beat expectations, including real GDP growth, which stood at an annualized 2.8% in the third quarter. Employment also performed well. Despite the U.S. government shutdown, 204,000 jobs were created in October in the United States, including 212,000 in the private sector. After the revisions, the average for job creation over the last few months has returned to a more comfortable level, at around 200,000 jobs per month (graph 2 on page 2). Finally, businesses don't seem to have been too shaken by

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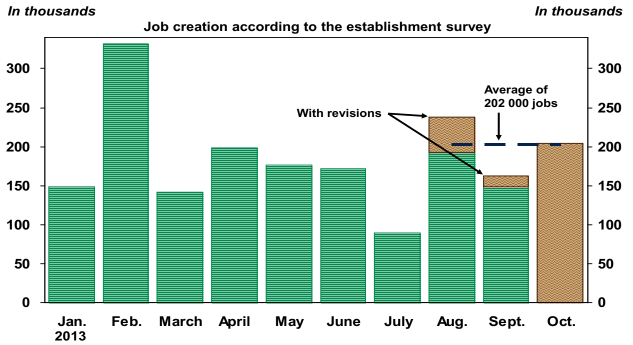
Graph 2 – The latest figures on U.S. employment have been very encouraging



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

the shutdown, as the ISM indexes continued to advance. In November, the manufacturing index reached its highest point since April 2011, at 57.3.

These good figures bring back to the forefront the possibility that the Fed may reduce its asset purchases soon, a situation that favours the U.S. dollar, as it did earlier last spring. The greenback is benefiting from higher longer-term yields, as well as the fact that many see the reduction of Fed asset purchases as the first step towards monetary firming in the United States.

SOME OBSTACLES ALL THE SAME

However, the U.S. economic picture is not entirely rosy. Real GDP's solid performance in the third quarter was chiefly caused by a faster rise by business inventories, something we cannot count on in the coming quarters. Furthermore, consumption growth slowed again over the summer, and business investment did not meet the expectations set by ISM index growth.

It would be astonishing if the U.S. economy were to accelerate again in Q4 2013. On its own, the 16-day U.S. government shutdown should take a 0.3 to 0.5 percentage point bite out of annualized growth. Confidence is still struggling, painting a rather worrisome picture for the holiday shopping season.

Faced with these obstacles, it would be surprising if tapering was announced soon. We must also keep in mind that the latest agreements on the U.S. budget and debt ceiling expire on January 15 and February 7 respectively. Even if the economic data remains surprisingly high, some caution will still be required until at least February. Our scenario calls for a Fed announcement in March, with asset purchases starting to wind down in April. This reduction should be quite gradual, lasting until the end of the year.

THE COMING MONTHS LOOK PROMISING FOR THE U.S. DOLLAR

The presence of some obstacles in the U.S. economy may slow the greenback's appreciation, but it cannot stop it. It will only be a matter of months—or weeks—before the onset of tapering once again dictates the direction of several financial variables, including the U.S. dollar.

However, it is unlikely that the DXY U.S. exchange rate index will climb back to the highs reached last spring, at least not in the next year. First of all, yields should not rise as steeply this time, given where they are now. Second, the Fed is likely to work hard to convince the markets that real monetary firming (key rate increases and a reduction of its balance sheet) will not start until much later and will be very gradual. Finally, we must also look at movement by the other major currencies. The euro zone's return to economic growth reduces the likelihood that the euro will fall back below US$1.30 in the short term. The pound's potential for depreciation is also limited, as Britain's economy is doing well and expectations of eventual monetary firming in the United Kingdom have been brought closer compared with last spring.

After tapering starts in April, the markets should focus less on this aspect in setting the direction to take, and the U.S. dollar could then lose its momentum. What's more, the expected improvements to the global economy in 2014 will reduce demand for safe-haven securities, a situation that could hurt the greenback. The euro and the pound could make some gains, provided financial strains don't resurface in Europe. Finally, commodity currencies are also expected to rebound slightly.

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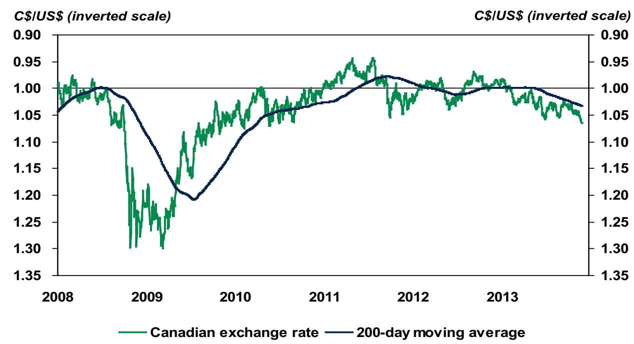
CANADIAN DOLLAR (CAD)

The Bank of Canada is more fearful

- The Canadian dollar has started depreciating against the greenback again. One significant element was the Bank of Canada (BoC) meeting on October 23, after which the comment about eventual key rate hikes was removed from the official statement. Added to this are the lingering concerns over the outlook for Canada's economy.
- From a technical standpoint, the Canadian dollar has already been trending down for several quarters, according to the movement by its 200-day moving average. Its momentum has improved, but that largely reflects the fact that Canada's dollar has dropped back to the same low point that it was at three months ago. The balance of speculative positions against the loonie had improved in September and early October, but then deteriorated again. Investor sentiment remains negative, although there has not been any race to the bottom.
- Fundamentally, even though GDP growth was sustained in the third quarter, this will not get rid of the worries about Canada's economy. On one hand, the third-quarter rebound by growth mainly reflects catch-up from the second quarter, which was affected by floods in Alberta and a construction strike in Quebec. On the other, outlooks for the coming quarters remain strewn with obstacles, including uncertainty about global growth, under-investment by Canadian businesses, and competitiveness problems in Canada. Weaker job creation and high debt loads for Canadians have also reduced potential increases by consumption and residential investment.
- In this context, it is clear why the BoC chose to adopt a more cautious tone. It should remain on the sidelines for several more quarters, especially since inflation is in no way threatening. The likelihood that key rates will be dropped seems quite low, however, given that it could further delay the needed adjustments to household balance sheets.

Forecasts: Canada's economic difficulties argue less and less for a rapid comeback by the loonie, which could dip again slightly in the short term, though it should show a general trend towards stabilizing around US$0.94. The currency may however end 2014 on a more positive note if fears for Canada's economy fade, supported by an improvement in the global economy.

Canadian dollar and trend

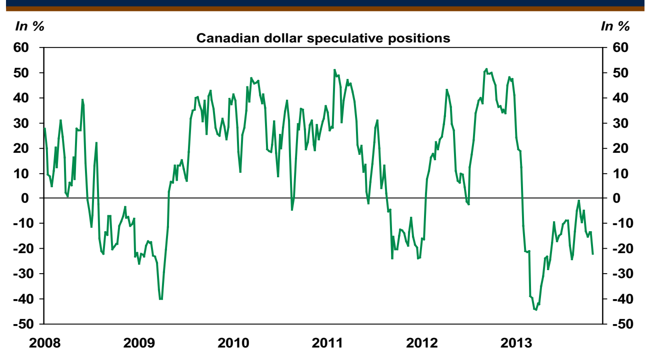


Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum

Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

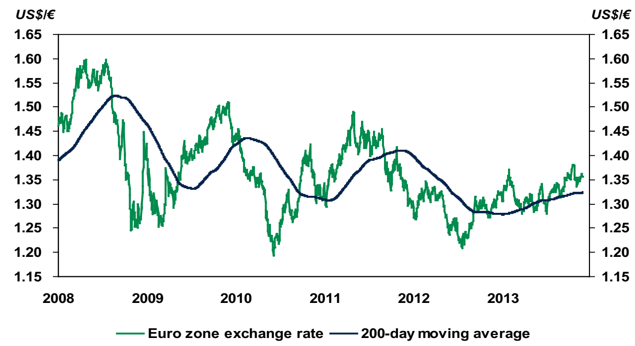
EURO (EUR)

The European Central Bank reins in the euro

- The euro jumped in October, reaching US$1.38 near the end of the month. The release of very weak inflation figures for the euro zone and a surprise key rate cut by the European Central Bank (ECB), however, put an end to this surge and brought the euro back to around US$1.33. Technical factors may also have magnified the euro's pullback, as net speculative positions were quite high at the end of October. Subsequently, the euro came back somewhat, reaching US$1.36 on the news of a deal to form a new German government.
- The latest economic data has helped limit upside pressure on the euro. After real GDP rose by an annualized 1.1% in the second quarter, the euro zone's economy grew just 0.4% in the third quarter, while the trade balance deteriorated. Several countries posted disappointing results, especially France and Italy, whose real GDPs contracted. The latest figures on foreign trade were a bit more encouraging but, as a whole, leading indicators suggest that economic growth will remain soft in the coming quarters.
- In this context, the ECB could not ignore the sharp drop by inflation, which went from 1.1% in September to just 0.7% in October, especially since core inflation dropped to 0.8%, its lowest point since the euro's creation. The ECB reacted quickly, lowering the interest rate for the Eurosystem's main refinancing operations to 0.25% on November 7. The interest rate for the marginal lending facility was reduced by 25 basis points, to 0.75%, while the interest rate for the deposit facility remained unchanged at 0.00%. The ECB has clearly stated that it could reduce its key rates again—by bringing the deposit rate into negative territory, among other things—and that it was still planning other actions, including new long-term loans to the banking sector. It should be noted, however, that the decision to cut key rates was not unanimous, and that representatives from Germany seem increasingly uncomfortable with ECB actions.

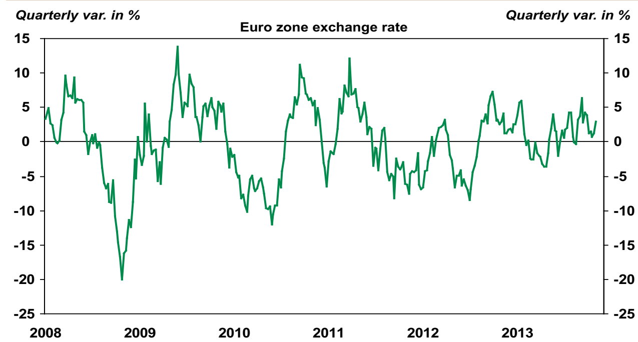
Forecasts: The euro should pull back over the next few months, as the upcoming withdrawal of bond purchases by the Federal Reserve should favour the greenback. The euro zone's weak economy and fears of deflation may also harm the euro. After that, however, the euro could edge up, as the international context should become less favourable to safe-haven securities.

Euro and trend



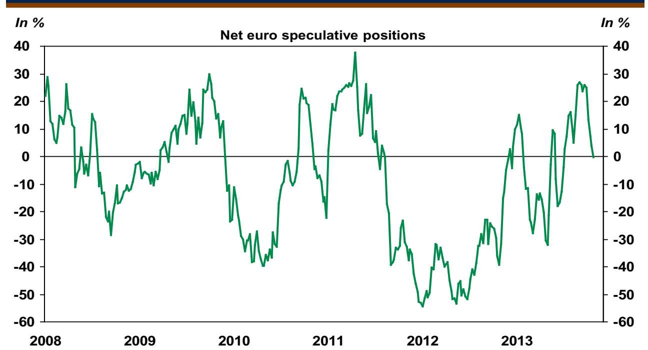
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



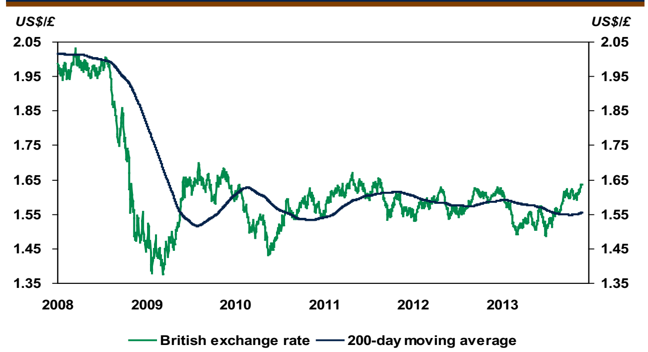
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

Will the Bank of England be able to stick to its commitment much longer?

- The pound sterling remained strong in the last few weeks, even going above US$1.63 recently. The pound appreciated against the euro, with the EUR/GBP pair going from £0.875 this summer to less than £0.830.
- Britain's solid performance continues to contrast with the situation in the euro zone. After last spring's quarterly annualized growth of 2.7%, Britain's economy accelerated further, growing 3.2% in the third quarter. In its latest Inflation Report, the Bank of England (BoE) acknowledged that economic outlooks had improved and that the jobless rate could reach 7.0% in early 2015, much sooner than it had previously anticipated. While inflation outlooks seem a little more favourable, BoE leaders stress that the key rate could remain unchanged until 2016. Markets remain sceptical about this statement, and the BoE could eventually have to open the door to earlier monetary firming. The BoE has already announced that the Funding for Lending Program will no longer apply to consumer loans in 2014. **The pound could edge down against the U.S. dollar in the near term, but the British economy's solid performance and a less dovish central bank will continue to support the currency.**

British pound and trend



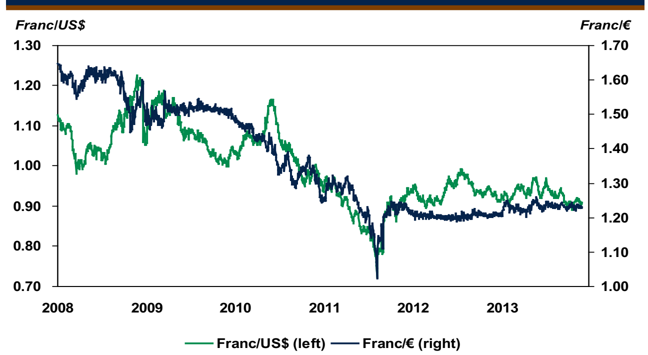
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

Following the euro for a while longer

- The Swiss franc continues to dog the euro's movements, with the EUR/CHF pair fluctuating around 1.23 francs. The franc therefore depreciated against the U.S. dollar in early November, but the USD/CHF pair returned to around 0.90 franc. Economic data remains encouraging in Switzerland, where the economy grew an annualized 2.1% in the third quarter, and some leading indicators have recently hit peaks that date back several years. Despite the Swiss franc's strength and the difficulties in the euro zone, foreign trade is also showing some encouraging signs. This could normally justify some appreciation by the franc against the euro. However, nothing suggests that the Swiss National Bank will be withdrawing its floor rate of 1.20 francs soon, especially since the recent data on prices show that the deflation problem has not been solved. Consequently, **the franc should continue to move in tandem with the euro over the coming months**.

Swiss franc and trend



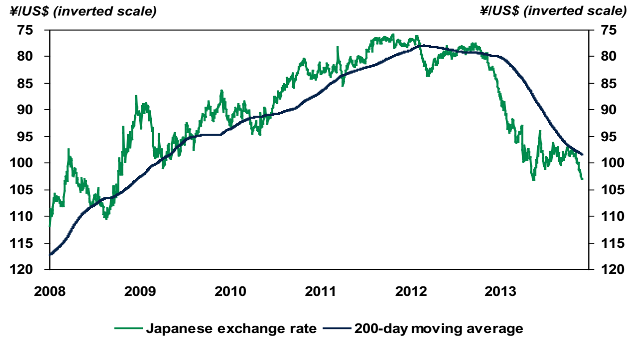
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

Renewed depreciation movement

- Japan's exchange rate recently reached ¥103/US$, a threshold not crossed since last May. The yen's depreciation had slowed for several months, as the currency had benefited from Japan's solid economic data, as well as the U.S. dollar's weakness during the budget impasse in the United States.
- Faced with a U.S. dollar that is appreciating again and more lacklustre economic data from Japan, it is now more difficult for the yen to avoid depreciation. Real GDP growth dropped by an half between the second and third quarters, and the picture would have been much worse without the major contribution from business inventories. This raises concerns, especially with regard to hitting the inflation target. If the economy does not perform adequately, this will increase the chances that the Bank of Japan's bond buying policy will be extended past 2014. Already, weak core inflation growth suggests that the 2% target will not be reached next year. In this context, **we are maintaining our target of ¥110/US$**.

Yen and trend



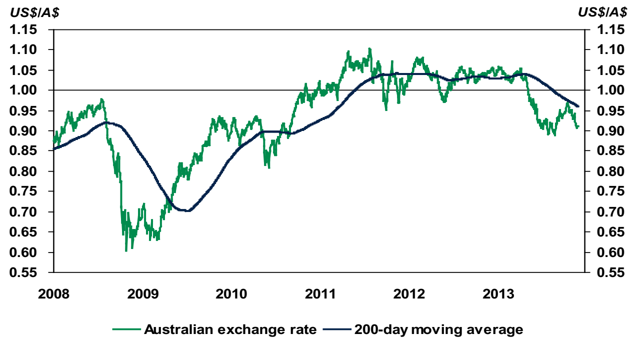
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

Short on support

- The Australian dollar resumed its downtrend in late October, nearing the low points reached earlier this year. Very few factors are currently supporting Australia's currency. Commodity prices are struggling to rise, so the Australian economy must find new drivers to offset weakness in the resources sector, and the Reserve Bank of Australia (RBA) remains in easing mode. The spreads with the yields of other advanced nations have also narrowed considerably, reducing the aussie's appeal for carry trade. Finally, the RBA has openly stated that it prefers a weak currency, leaving the door open to exchange interventions.
- At close to US$0.90, however, there is very little possibility of an exchange intervention. The RBA is aware of the costs of such intervention and seems more uncomfortable when the exchange rate exceeds US$0.95. **The aussie should remain weak for several more months, after which the situation could become more favourable if global growth accelerates and commodity prices rise.**

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

Several currencies remain vulnerable to U.S. interest rates

CHINESE YUAN (CNY)

- After appreciating for a short time in October, a new plateau now seems to be forming at around 6.09 yuan/US$. Yet, China's economic growth accelerated in the third quarter, and most of the recent figures do not point to any flagging in the fourth quarter. Monetary authorities probably prefer to remain cautious. The U.S. dollar is expected to appreciate in the coming months, a situation that, among other things, will prompt the yuan to rise against several currencies, including those from competing emerging nations. **We will likely have to wait for the situation to stabilize for emerging currencies before the yuan starts to appreciate again.**

MEXICAN PESO (MXN)

- The Mexican peso remained volatile, with the USD/MXN pair nearing 13.30 pesos in early November before quickly falling back below 12.90 pesos and finally returning to around 13.20 pesos. Positive U.S. statistics are currently hurting the peso, since they increase the likelihood that the Federal Reserve (Fed) will taper its securities purchases. After several months of disappointing figures, Mexico's economy bounced back more than anticipated in the third quarter. Even though it downgraded its growth scenarios, the Bank of Mexico is signalling that it will not lower its key rate further, as the economy should continue to recover. **The peso may remain weak over the coming months, as investors prepare for reduced purchases from the Fed.**

BRAZILIAN REAL (BRL)

- The recovery by bond yields in several advanced nations at the end of October and start of November caused the real to temporarily depreciate to nearly US$2.35. **Brazil's exchange rate should remain quite volatile over the coming months, until the Fed finally begins to taper its securities purchases.** The sensitivity to rate movements could decrease if the Brazilian economy posts more encouraging outlooks, but this may not occur in the short term. Second-quarter economic growth showed a surprise increase, but the third quarter does not look very good, with the drop recorded by industrial production. Furthermore, faced with an overly high inflation rate, Brazil's central bank has little leeway to support the economy, and continues to gradually raise its main key rate.

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 Dec. 2	Percentage return since 1 month	3 months	6 months	1 year	Last 52 weeks Higher	Average	Lower
Americas								
Argentina – peso	6.1555	3.9517	8.4670	16.5263	27.3442	6.1555	5.3585	4.8338
Brazil – real	2.3560	4.2639	-0.6955	10.4781	11.7647	2.4513	2.1373	1.9490
Canada – dollar	1.0638	1.8576	0.8963	2.9220	7.0871	1.0638	1.0243	0.9837
Canada – (CAD/USD)	0.9401	-1.8237	-0.8884	-2.8390	-6.6181	1.0166	0.9763	0.9401
Mexico – peso	13.2060	0.9517	-0.9451	2.9254	2.1990	13.4419	12.7559	11.9901
Asia and South Pacific								
Australia – (AUD/USD)	0.9105	-3.5236	1.4158	-4.8848	-12.7561	1.0593	0.9770	0.8900
China – yuan renminbi	6.0930	-0.1074	-0.4355	-0.6814	-2.1480	6.2513	6.1610	6.0820
Hong Kong – dollar	7.7520	-0.0006	-0.0316	-0.1372	0.0226	7.7647	7.7563	7.7500
India – rupee	62.3250	0.9312	-5.5753	10.1538	14.8530	68.8050	57.9756	53.0350
Japan – yen	102.9550	4.3216	3.6442	2.4581	24.8242	103.2100	95.9915	81.8950
New Zeland – (NZD/USD)	0.8186	-0.9905	4.8215	3.1107	-0.2865	0.8629	0.8205	0.7708
South Korea – won	1,057	-0.3347	-3.9302	-6.4176	-2.3687	1,161	1,096	1,055
Europe								
Denmark – krona	5.5088	-0.3870	-2.5733	-3.9718	-4.1122	5.8361	5.6362	5.4045
Euro zone – (EUR/USD)	1.3557	0.5117	2.7903	4.6026	4.2327	1.3803	1.3233	1.2781
Norway – kroner	6.1199	2.4448	0.6141	4.2688	7.9605	6.2499	5.8351	5.4572
Russia – ruble	33.2487	2.6505	-0.3680	4.1098	7.5533	33.4900	31.6895	29.8739
Sweden – krona	6.5653	0.4298	-0.6131	-0.8023	-1.4463	6.7935	6.5185	6.2899
Switzerland – swiss franc	0.9073	-0.5644	-2.8899	-5.4502	-2.0617	0.9796	0.9292	0.8918
United Kingdom – (GBP/USD)	1.6366	2.7887	5.1497	7.9447	2.1152	1.6381	1.5629	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	1.0638	1.0753	1.0638	1.0526	1.0417
Euro	(EUR/USD)	1.2865	1.3184	1.2841	1.2999	1.3536	1.3300	1.3100	1.3200	1.3300	1.3200
British pound	(GBP/USD)	1.6148	1.6255	1.5185	1.5167	1.6194	1.6100	1.6000	1.6100	1.6200	1.6200
Swiss franc	(USD/CHF)	0.9351	0.9153	0.9495	0.9463	0.9052	0.9200	0.9300	0.9400	0.9500	0.9700
Yen	(USD/JPY)	77.92	86.75	94.22	99.14	98.23	101.00	103.00	105.00	108.00	110.00
Australian dollar	(AUD/USD)	1.0376	1.0398	1.0419	0.9141	0.9317	0.9100	0.9000	0.9100	0.9200	0.9300
Chinese yuan	(USD/CNY)	6.2845	6.2303	6.2108	6.1376	6.1215	6.0900	6.0900	6.0500	6.0000	5.9500
Mexican peso	(USD/MXN)	12.86	12.87	12.32	12.95	13.09	13.20	13.30	12.80	12.60	12.40
Brazilian real	(USD/BRL)	2.0303	2.0432	2.0135	2.2153	2.2297	2.3500	2.4000	2.2500	2.1500	2.1000
Effective dollar*	(1973 = 100)	72.71	73.44	76.23	77.55	75.19	77.00	78.00	77.80	77.70	78.00
Canadian dollar											
American dollar	(CAD/USD)	1.0165	1.0079	0.9828	0.9506	0.9700	0.9400	0.9300	0.9400	0.9500	0.9600
Euro	(EUR/CAD)	1.2657	1.3081	1.3065	1.3674	1.3955	1.4149	1.4086	1.4043	1.4000	1.3750
British pound	(GBP/CAD)	1.5886	1.6128	1.5449	1.5955	1.6695	1.7128	1.7204	1.7128	1.7053	1.6875
Swiss franc	(CAD/CHF)	0.9505	0.9225	0.9332	0.8996	0.8780	0.8648	0.8649	0.8836	0.9025	0.9312
Yen	(CAD/JPY)	79.20	87.43	92.60	94.24	95.28	94.94	95.79	98.70	102.60	105.60
Australian dollar	(AUD/CAD)	1.0208	1.0317	1.0601	0.9616	0.9605	0.9681	0.9677	0.9681	0.9684	0.9688
Chinese yuan	(CAD/CNY)	6.3880	6.2793	6.1043	5.8345	5.9377	5.7246	5.6637	5.6870	5.7000	5.7120
Mexican peso	(CAD/MXN)	13.07	12.97	12.10	12.31	12.70	12.41	12.37	12.03	11.97	11.90
Brazilian real	(CAD/BRL)	2.0637	2.0593	1.9790	2.1059	2.1628	2.2090	2.2320	2.1150	2.0425	2.0160

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