FX Forecasts

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# 2014: Year of the greenback?

### HIGHLIGHTS

- Only in December did the Federal Reserve (Fed) announce a reduction to its securities purchases, but several factors seem to have lessened its impact on the U.S. dollar.
- Despite numerous headwinds, the U.S. dollar could still appreciate against several currencies. The Fed might not be in firming mode yet, but it will probably get there before most of the other major central banks, which will help the greenback.
- With the European Central Bank remaining in easing mode and probably keeping its key rates low longer than most other central banks, and given the major problems in the euro zone, the euro should slide over the coming months.
- There is not much to justify rapid appreciation by the loonie in the short term. It could even pull back further if negative sentiments about it persist, or if the market continues to believe in the possibility of monetary easing in Canada. Eventually, however, attention should be paid to more favourable aspects.

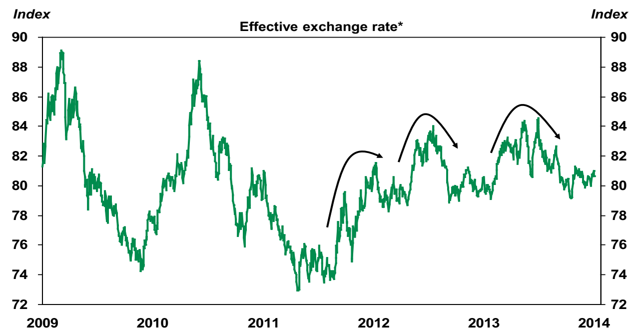
### Contents



## Editorial

After several years of hesitation, could the U.S. dollar finally be on a lasting uptrend (graph 1)? The improved economic situation in the United States and tapered securities purchases by the Federal Reserve (Fed) could mean yes. However, only a slight increase of the greenback has been recently observed. What does that mean?

Graph 1 – The U.S. dollar had some false starts in recent years




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

### LIMITED APPRECIATION AFTER THE FED'S DECISION

Last spring, the general view that the Fed would soon be reducing its securities purchases strongly pushed bond yields and the U.S. dollar upwards. Tapering of the purchases was seen as a first step in monetary firming. However, the Fed did not lower its level of intervention in the summer or in the fall, leading to further weakening by the greenback. Only in December did it announce a reduction to its securities purchases, but several factors seem to have lessened its impact on the U.S. dollar.

Firstly, when the possibility of tapered purchases made the news last spring, the pace was not supposed to be this gradual. The Fed only announced a US$10B cut to its

**François Dupuis**
Vice-President and Chief Economist

**Yves St-Maurice**
Senior Director and Deputy Chief Economist

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

**Mathieu D'Anjou**
Senior Economist

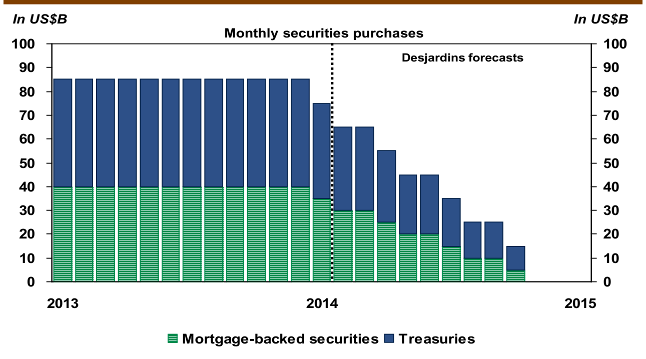
**Jimmy Jean**
Senior Economist

**Hendrix Vachon**
Senior Economist

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

monthly purchases, which were previously at US$85B. At this rate, the Fed's quantitative easing program might not really end until November (graph 2). For 2014, the Fed's balance sheet should therefore grow by US$450B according to our estimates.

**Graph 2 – The Federal Reserve's cuts to securities purchases will be staggered over almost the entire year**




Sources: Federal Reserve and Desjardins, Economic Studies

The fact that the balance sheet will continue to expand means that true monetary firming has not yet begun. The view that a cut to purchases is equivalent to a monetary firming measure is therefore mistaken, and a larger number of investors may have understood that. In practice, 2014 should not feature any less excess liquidity than 2013, a fact inconsistent with strong appreciation by the U.S. dollar.

That being said, the reduction to purchases will be followed by interest rate hikes, and the real question is this: How long will the Fed wait? In its statements, the Fed is putting more and more emphasis on this waiting period. Though the target for the jobless rate may be reached more quickly than expected, the Fed has affirmed that it will wait much longer before bringing rates up. Weak inflation is adding a lot of credibility to these words. Investor anticipations currently seem to be taking the Fed's message into account, thus leading to a modest recovery by bond yields and less appreciation by the U.S. dollar.

Furthermore, evolving demand for safe-haven securities has also an impact on exchange rate movements. The U.S. dollar is known to appreciate when demand for safe-haven securities is high and depreciate when the opposite occurs. Since last spring, worries about China and Europe have eased substantially. Investors still seem skittish about some emerging nations but, on the whole, demand for safe-haven securities has dropped.

## THE U.S. DOLLAR WILL STILL HAVE AN EDGE OVER SEVERAL CURRENCIES

Despite numerous headwinds, the U.S. dollar could still appreciate against several currencies. The Fed might not be in firming mode yet, but it will probably get there before most of the other major central banks. In 2014, the Bank of Japan will maintain the pace of its securities purchases and could also announce new measures. The European Central Bank could announce another cut to key rates and inject liquidity into Europe's financial system. Divergent monetary policies will benefit the U.S. dollar, at least against the euro and the yen.

The U.S. dollar is also showing strength against currencies of several emerging nations (e.g. Indonesia, Turkey, Brazil, Argentina). Low growth rates, current account deficits and precarious public finances are all issues that are fuelling concerns about these countries. These problems cannot be solved quickly. It will probably take a few more quarters for investor confidence to recover. In the meantime, the U.S. dollar will benefit.

Other regions of the world will also be watched in 2014. While the situation in Europe has settled down over the last year, there are still obstacles on the horizon. The economic recovery lacks strength, and while the jobless rate has stopped rising, it is not coming down quickly. Financially speaking, the fragmented credit market and indebted public administrations are still problematic. Finally, the political aspect is not much better, with slow progress on improving the euro zone's functioning and strengthening its financial system. In this context, we maintain our assumption that worries will increase in Europe, giving the greenback another boost.

**François Dupuis**
Vice-President and Chief Economist

**Hendrix Vachon**
Senior Economist

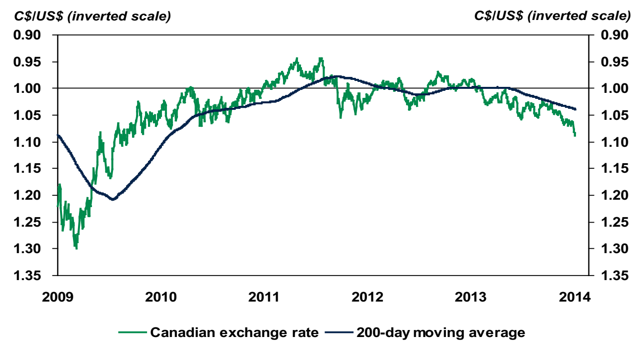
# CANADIAN DOLLAR (CAD)

## The Bank of Canada's dovish tone drags the currency down

- The Canadian dollar seems short on support. The currency recently hit its lowest point in four years, US$0.9138. Despite some more encouraging signs, investors remain worried about Canada's economy and are attaching a lot of importance to the possibility that the Bank of Canada (BoC) could cut its key rates.
- Technically speaking, the Canadian dollar has been trending down for around one year. Its momentum has deteriorated in recent months, after a short-lived improvement in early fall. The balance of speculative positions is quite negative. These levels indicate considerable pessimism, which could prompt a substantial upward correction by the loonie when the situation gets back to normal.
- Some fundamental factors are helping to maintain strong pessimism. The BoC's October 23 meeting was a key element in the Canadian dollar's depreciation over recent months. By striking the mention of an eventual key rate hike from its official statement, the BoC helped to modify monetary policy expectations. There is a widespread belief that the BoC will not start raising its key rates before the Federal Reserve does.
- Even worse for the loonie is the fact that, in conjunction with soft inflation, the BoC's more dovish tone suggests that interest rates will be cut in 2014. Currently, investors are attaching a lot of importance to this possibility and very little to recent good news. Among other things, some economic indicators in Canada are pointing to fairly robust growth and, on the other side of the border, the situation is also improving further. In this context, a Canadian key rate cut would be surprising. Dropping rates could also further slow the needed adjustment to household debt, which has risen recently.

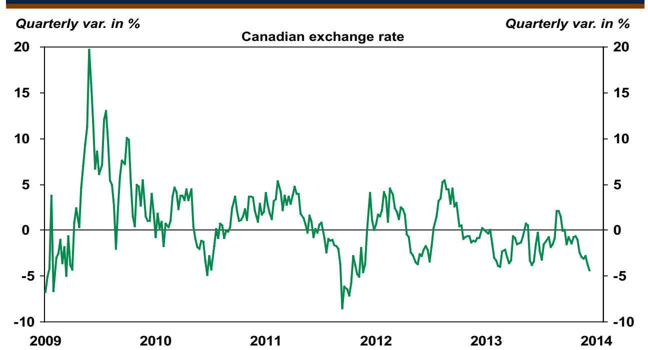
**Forecasts:** There is not much to justify rapid appreciation by the loonie in the short term. It could even pull back further if negative sentiments about it persist, or if the market continues to believe in the possibility of monetary easing in Canada. Eventually, however, attention should be paid to more favourable aspects. The expected rise by inflation in 2014 and the improved economic situation overall should allow the loonie to buck its downtrend and bring it closer to US$0.94.

**Canadian dollar and trend**



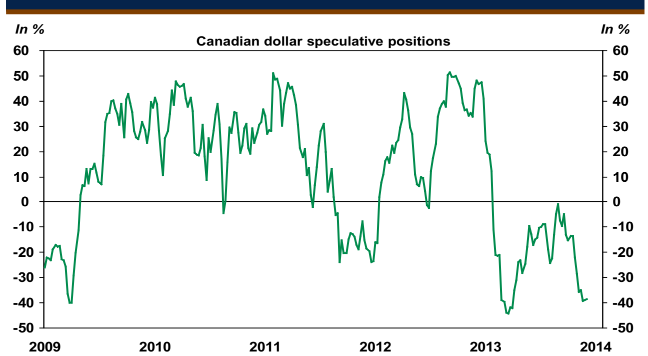

Sources: Datastream and Desjardins, Economic Studies

**Canadian dollar: momentum**




Sources: Datastream and Desjardins, Economic Studies

**Canadian dollar: net speculative positions**




Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

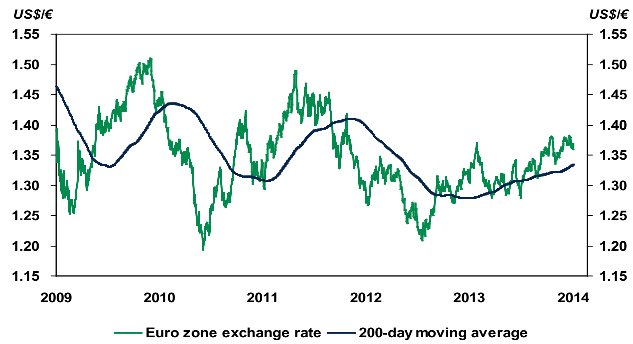
# EURO (EUR)

## Many obstacles remain

- Despite the Federal Reserve's decision to start tapering its bond purchases, the euro has held strong. Euroland's currency is currently oscillating around US$1.37 and even flirted with US$1.39 in late December. Growing investor optimism over the global economy is partially responsible for the euro's solid performance, as net speculative positions for this currency are staying in positive territory.
- While the global economy may continue to favour the euro in 2014, serious problems with Europe's economy should put downside pressure on the currency. Although some confidence indexes have risen, the euro zone's economic situation and growth outlook are still quite weak, while notable improvements have recently occurred in the United Kingdom and United States. The jobless rate for the euro zone as a whole is above 12%, and nothing points to a sharp drop as real GDP growth will struggle to hit 1% in 2014. The banking sector is also a major source of concern. The European Central Bank (ECB) will conduct major stress tests this year and, without a shared mechanism for bailing out struggling institutions, bank shareholders, their creditors and national governments may have to swallow considerable losses.
- Given the fragile economic situation and banking system in the euro zone, we can understand why the ECB is worried about soft inflation. The euro zone's annual inflation rate dropped back to 0.8% in December, and core inflation hit a historic low of 0.7%. Everything suggests that inflation will remain far below the target of "below, but close to 2%" for several more months. The ECB did not announce any monetary policy changes at its January meeting, but it modified its statement to more clearly indicate that its key rates will remain at or below current levels for an extended period of time. It also emphasized that it was ready to use every instrument at its disposal if inflation outlooks were to deteriorate or if it were to see unwarranted tightening of financial conditions.

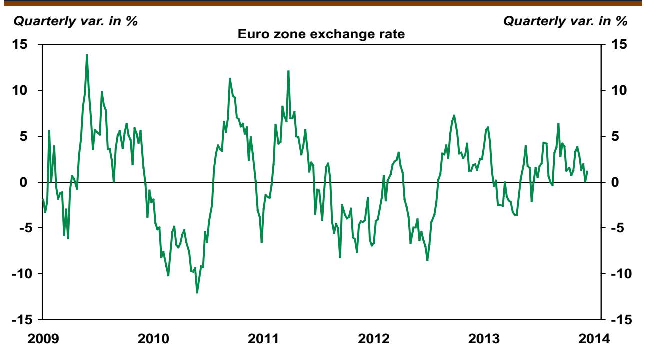
**Forecasts:** With the ECB remaining in easing mode and probably keeping its key rates low longer than most other central banks, and given the major problems in the euro zone, the euro should slide over the coming months. However, the international context, which is relatively good for riskier currencies, should generally keep the euro above US$1.30 in 2014.

**Euro and trend**



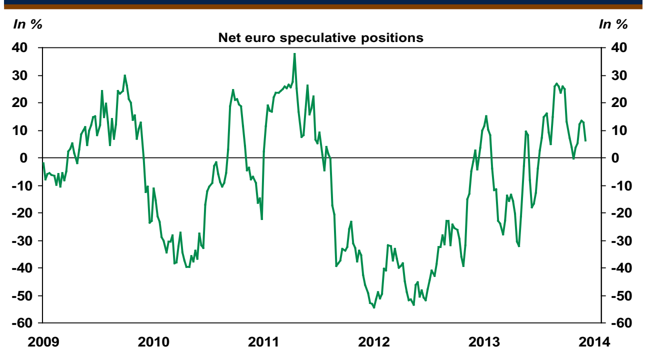

Sources: Datastream and Desjardins, Economic Studies

**Euro: momentum**




Sources: Datastream and Desjardins, Economic Studies

**Euro: net speculative positions**



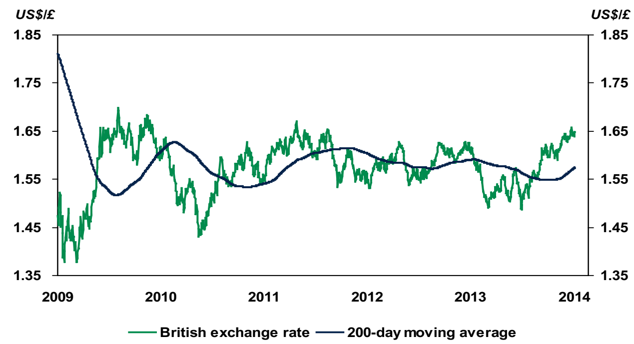

Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

# BRITISH POUND (GBP)

## Heading for consolidation

- Like Britain's economy, the pound sterling posted a remarkable turnaround in 2013. After a difficult first half of the year, which took it below US$1.50, the pound rose sharply, ending 2013 at more than US$1.65, a peak that dates back to spring 2011. The pound is also strong against the euro, with the EUR/GDP pair recently falling below £0.83.
- As the economic recovery seems to be continuing in the United Kingdom, it would be tempting to bank on further gains by the pound. Especially encouraging is that the labour and housing markets have picked up speed, with stagnant home prices giving way to annual growth of over 8% according to several indexes. As inflation has moderated, we still expect the Bank of England (BoE) to clearly signal its intent to keep its key rate at its floor for a long time still, even though the unemployment rate could well hit the 7.0% threshold this year. The BoE will want to avoid overly strong appreciation by the pound, which could stifle recovery. In this context, **the pound should consolidate its recent gains and even pull back slightly against the U.S. dollar in the coming months.**

British pound and trend



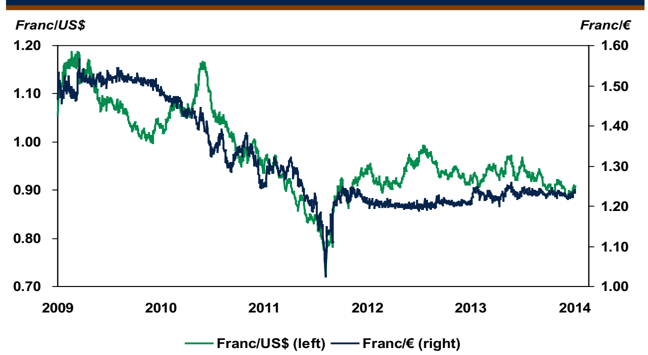

Sources: Datastream and Desjardins, Economic Studies

# SWISS FRANC (CHF)

## Too soon for a sharp depreciation

- The Swiss franc has been fairly stable against the U.S. dollar in recent weeks, with the USD/CHF pair remaining at around 0.90 francs. However, the franc has depreciated slightly against the euro and the EUR/CHF pair neared 1.24 francs, reflecting investors' increased optimism. The economic outlook is rather favourable in Switzerland, but everything indicates that inflation will remain really low this year. The Swiss National Bank therefore repeated its intent to keep its floor rate at 1.20 francs per euro for an extended period of time. **The euro zone's many lingering risks should keep the Swiss franc very strong in the first half of 2014. However, this currency could trend down in the second half of the year, as the global context will be less and less favourable to safe-haven securities.**

Swiss franc and trend

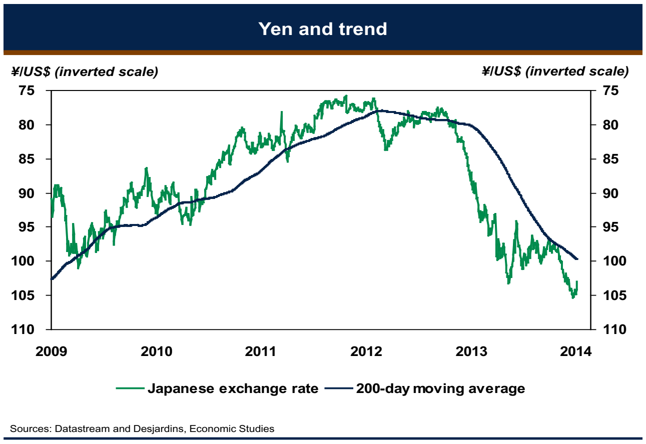



Sources: Datastream and Desjardins, Economic Studies

# YEN (JPY)

## The pace of depreciation will slow in 2014

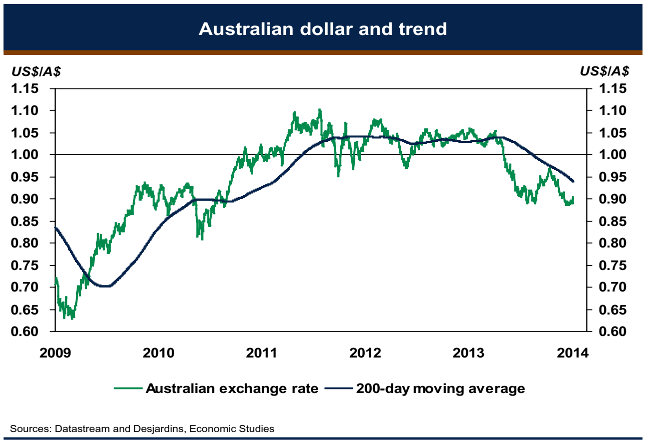
- The yen pulled back 18% against the U.S. dollar in 2013, largely due to the Bank of Japan's (BoJ) incredibly accommodating monetary policy, which will continue through 2014. In order to get the inflation rate up to 2% and keep it there, the BoJ plans to buy around ¥70,000B in assets. The BoJ will be the most interventionist among central banks, a situation that will keep the yen weak. Nevertheless, as these interventions are already expected, their downward impact on the currency should be slighter than last year. In fact, the yen may be more weakened by the possibility that the BoJ will announce additional easing.
- Economic growth slowed in Japan in the third quarter. However, it should bounce back in the short term, before the sales tax hike is implemented in April. After that, growth could once again disappoint and the current reflation could be slow to hit a wide enough range of prices. **Any disappointment from the economy or inflation will increase the likelihood of further intervention by the BoJ, a scenario that should in turn hurt the yen.**




# AUSTRALIAN DOLLAR (AUD)

## Below the US$0.90 mark

- The Australian dollar has mostly fluctuated below the US$0.90 mark for around one month. It had hit this threshold earlier in the year before rising back to US$0.95. **However, a climb like this seems highly unlikely in the short term, as the Reserve Bank of Australia (RBA) has made its preference for a weak currency even more clear.** Following its monetary policy meeting in December, the RBA repeated that it was uncomfortable with the exchange rate, which was then slightly above US$0.90. Subsequently, the RBA's governor indicated that US$0.85 would be a more appropriate level to enable Australia's economy to restructure. This is not an official target, however.
- The RBA is ready to intervene in the foreign exchange market if necessary, although it is aware of the cost. A key rate cut would have a more lasting impact on the currency, but the RBA does not seem ready to go in that direction for now. The economic spinoffs of previous rate cuts have not yet completely materialized in the economy. Another drop by inflation could result in some leeway, however, and help keep the aussie below US$0.90 for several months.



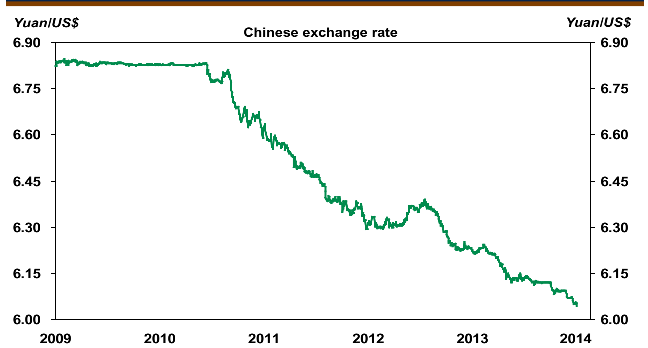
# EMERGING CURRENCIES

## The yuan stands apart

### CHINESE YUAN (CNY)

- In the wake of reforms announced by China to stimulate growth by domestic demand, monetary authorities continued to let the yuan appreciate against the U.S. dollar. The fact that China's economy has improved also facilitates management of the exchange rate. GDP growth accelerated in the third quarter, credit went up and the trade balance improved. The trend for China's currency is therefore diverging from the trend seen for several emerging currencies affected by the Federal Reserve's (Fed) reduced securities purchases and rising bond yields. **However, the yuan's appreciation remains slow and complete liberalization of the exchange rate still seems remote. Our target for the end of 2014 is 5.90 yuan/US$.**

Chinese yuan and trend




Sources: Datastream and Desjardins, Economic Studies

### MEXICAN PESO (MXN)

- After appreciating in early December, the peso depreciated somewhat following the Fed's decision to begin tapering its bond purchases. The USD/MXN pair then climbed slightly above 13 pesos. The peso pulled back much less than we could have feared after the Fed's decision. Note that the improving U.S. economic outlook is good news for Mexico's economy and tends to confirm that the Bank of Mexico will not have to lower its key rate further. Investors also take a positive view of the government's recent decision to move forward with a substantial reform of the energy sector. **After a difficult 2013, the peso could soon resume its appreciation.**

Mexican peso and trend


Sources: Datastream and Desjardins, Economic Studies

### BRAZILIAN REAL (BRL)

- The exchange rate climbed to around 2.40 reals/US$. The Brazilian real is among currencies mostly affected by the Fed's reduced asset purchases. The economic uncertainty still plaguing Brazil has increased the currency's volatility. The Central Bank of Brazil's key rate increase is only managing to curb depreciation because, in exchange, it also jeopardizes short-term economic growth. The 5.8% inflation rate is still too far over the 4.5% mid-point target, suggesting that monetary firming will continue. **The exchange rate should stay close to 2.40 reals/US$ for several more months, until economic uncertainty wanes further.**

Brazilian real and trend


Sources: Datastream and Desjardins, Economic Studies

## Table 1
## Currency market

| Country – Currency* | Spot price Jan. 13 | Percentage return since 1 month | 3 months | 6 months | 1 year | Last 52 weeks Higher | Average | Lower |
|---|---|---|---|---|---|---|---|---|
| **Americas** | | | | | | | | |
| Argentina – peso | 6.6580 | 5.8295 | 14.1535 | 22.7055 | 34.7228 | 6.6580 | 5.5336 | 4.9420 |
| Brazil – real | 2.3446 | 0.3274 | 7.4989 | 3.5601 | 15.0982 | 2.4513 | 2.1703 | 1.9490 |
| Canada – dollar | 1.0866 | 2.3936 | 4.6218 | 4.5715 | 10.4610 | 1.0923 | 1.0332 | 0.9837 |
| Canada – (CAD/USD) | 0.9203 | -2.3377 | -4.4177 | -4.3716 | -9.4703 | 1.0166 | 0.9679 | 0.9155 |
| Mexico – peso | 12.9745 | 0.1254 | -0.7546 | 1.2711 | 2.6257 | 13.4419 | 12.7759 | 11.9901 |
| **Asia and South Pacific** | | | | | | | | |
| Australia – (AUD/USD) | 0.9053 | 1.0140 | -4.3773 | 0.0588 | -14.0827 | 1.0571 | 0.9597 | 0.8861 |
| China – yuan renminbi | 6.0433 | -0.4604 | -1.2629 | -1.5348 | -2.7799 | 6.2443 | 6.1422 | 6.0433 |
| Hong Kong – dollar | 7.7544 | 0.0064 | 0.0026 | -0.0580 | 0.0323 | 7.7647 | 7.7567 | 7.7516 |
| India – rupee | 61.5250 | -1.0773 | 0.8276 | 2.7283 | 12.1185 | 68.8050 | 58.8035 | 53.0350 |
| Japan – yen | 103.0000 | -0.2131 | 4.4890 | 3.8045 | 15.4967 | 105.3150 | 98.1724 | 88.3900 |
| New Zeland – (NZD/USD) | 0.8377 | 1.3320 | 0.6534 | 7.6652 | 0.0922 | 0.8629 | 0.8196 | 0.7708 |
| South Korea – won | 1,057 | 0.3752 | -1.3767 | -6.0338 | 0.1849 | 1,161 | 1,094 | 1,050 |
| **Europe** | | | | | | | | |
| Denmark – krona | 5.4583 | 0.5351 | -0.8942 | -4.3587 | -2.4058 | 5.8361 | 5.6092 | 5.4044 |
| Euro zone – (EUR/USD) | 1.3654 | -0.5608 | 0.6710 | 4.5965 | 2.3079 | 1.3815 | 1.3298 | 1.2781 |
| Norway – kroner | 6.1170 | -1.0186 | 1.9492 | 0.8000 | 10.6129 | 6.2499 | 5.8966 | 5.4572 |
| Russia – ruble | 33.2660 | 1.2057 | 3.0268 | 1.8870 | 9.5195 | 33.4900 | 31.9543 | 29.8739 |
| Sweden – krona | 6.5032 | -1.0672 | 0.4332 | -2.4079 | 0.5885 | 6.7935 | 6.5131 | 6.2899 |
| Switzerland – swiss franc | 0.9026 | 1.3303 | -0.8023 | -4.7740 | -1.0578 | 0.9796 | 0.9263 | 0.8858 |
| United Kingdom – (GBP/USD) | 1.6383 | 0.6450 | 2.7373 | 8.3711 | 1.6032 | 1.6563 | 1.5659 | 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 | | 2013 Q3 | Q4 | 2014 Q1f | Q2f | Q3f | Q4f | 2015 Q1f | Q2f | Q3f | Q4f |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **American dollar** | | | | | | | | | | | |
| Canadian dollar | (USD/CAD) | 1.0310 | 1.0623 | 1.0870 | 1.0753 | 1.0638 | 1.0638 | 1.0526 | 1.0417 | 1.0309 | 1.0204 |
| Euro | (EUR/USD) | 1.3536 | 1.3780 | 1.3500 | 1.3200 | 1.3300 | 1.3200 | 1.3100 | 1.3000 | 1.2900 | 1.2800 |
| British pound | (GBP/USD) | 1.6194 | 1.6563 | 1.6300 | 1.6200 | 1.6300 | 1.6400 | 1.6400 | 1.6500 | 1.6600 | 1.6800 |
| Swiss franc | (USD/CHF) | 0.9052 | 0.8908 | 0.9000 | 0.9200 | 0.9300 | 0.9500 | 0.9800 | 0.9900 | 1.0000 | 1.0200 |
| Yen | (USD/JPY) | 98.23 | 105.32 | 105.00 | 107.00 | 110.00 | 112.00 | 113.00 | 114.00 | 115.00 | 115.00 |
| Australian dollar | (AUD/USD) | 0.9317 | 0.8918 | 0.8900 | 0.9000 | 0.9000 | 0.9100 | 0.9200 | 0.9200 | 0.9300 | 0.9300 |
| Chinese yuan | (USD/CNY) | 6.1215 | 6.0540 | 6.0000 | 6.0000 | 5.9500 | 5.9000 | 5.9000 | 5.8500 | 5.8000 | 5.8000 |
| Mexican peso | (USD/MXN) | 13.09 | 13.04 | 13.10 | 12.85 | 12.60 | 12.40 | 12.20 | 12.00 | 11.90 | 11.80 |
| Brazilian real | (USD/BRL) | 2.2297 | 2.3423 | 2.4000 | 2.3500 | 2.3000 | 2.2500 | 2.2000 | 2.1000 | 2.1000 | 2.0500 |
| Effective dollar* | (1973 = 100) | 75.19 | 76.44 | 77.50 | 78.30 | 78.30 | 78.70 | 78.90 | 79.10 | 79.20 | 79.20 |
| **Canadian dollar** | | | | | | | | | | | |
| American dollar | (CAD/USD) | 0.9700 | 0.9414 | 0.9200 | 0.9300 | 0.9400 | 0.9400 | 0.9500 | 0.9600 | 0.9700 | 0.9800 |
| Euro | (EUR/CAD) | 1.3955 | 1.4638 | 1.4674 | 1.4194 | 1.4149 | 1.4043 | 1.3789 | 1.3542 | 1.3299 | 1.3061 |
| British pound | (GBP/CAD) | 1.6695 | 1.7594 | 1.7717 | 1.7419 | 1.7340 | 1.7447 | 1.7263 | 1.7188 | 1.7113 | 1.7143 |
| Swiss franc | (CAD/CHF) | 0.8780 | 0.8386 | 0.8280 | 0.8556 | 0.8742 | 0.8930 | 0.9310 | 0.9504 | 0.9700 | 0.9996 |
| Yen | (CAD/JPY) | 95.28 | 99.14 | 96.60 | 99.51 | 103.40 | 105.28 | 107.35 | 109.44 | 111.55 | 112.70 |
| Australian dollar | (AUD/CAD) | 0.9605 | 0.9473 | 0.9674 | 0.9677 | 0.9574 | 0.9681 | 0.9684 | 0.9583 | 0.9588 | 0.9490 |
| Chinese yuan | (CAD/CNY) | 5.9377 | 5.6989 | 5.5200 | 5.5800 | 5.5930 | 5.5460 | 5.6050 | 5.6160 | 5.6260 | 5.6840 |
| Mexican peso | (CAD/MXN) | 12.70 | 12.27 | 12.05 | 11.95 | 11.84 | 11.66 | 11.59 | 11.52 | 11.54 | 11.56 |
| Brazilian real | (CAD/BRL) | 2.1628 | 2.2049 | 2.2080 | 2.1855 | 2.1620 | 2.1150 | 2.0900 | 2.0160 | 2.0370 | 2.0090 |

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