FX Forecasts

Desjardins Economic Studies
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Mother Nature’s whims also affect currencies

HIGHLIGHTS

- The tapering of the U.S. Federal Reserve securities purchases does not really constitute monetary firming. We will have to wait until later this year for the U.S. dollar to be more stimulated by speculation about an eventual hike in key interest rates.
- A resurgence of concerns in emerging nations and in Europe is very probable in the short term, and this could benefit the U.S. dollar in the next few months.
- The loonie’s downward trend is unlikely to reverse itself in the short term. Due to weak inflation, the Bank of Canada will remain concerned for many months to come, a situation that will probably keep the Canadian dollar below US$0.90.
- Outlooks for economic growth and inflation are still definitely bleaker in the euro zone than in the other advanced countries, and this encourages us to keep banking on a gradual decline of the euro.
- The pound could lose ground in the short term, since monetary firming in 2014 is not very likely.

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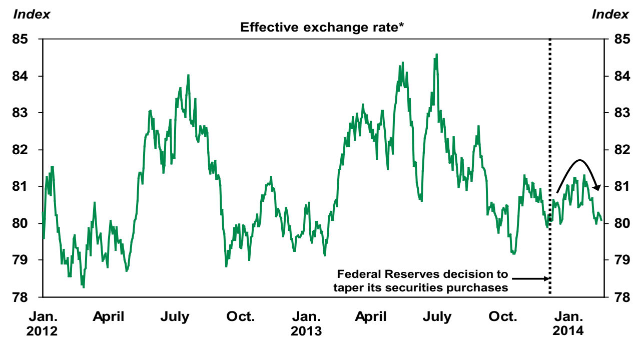
Editorial

The U.S. dollar started off the year on a slightly positive note, but then a string of lacklustre data released in the United States over the past few weeks wiped out the small gains that had been achieved (graph 1). The weather seems to have had a considerable influence over these results. Meanwhile, the European currencies are still strong, and the emerging currencies seem to be stabilizing once more. Not to be outdone, the commodity currencies are benefiting from the weakness of the U.S. dollar and the subsiding risks in the emerging countries.

Graph 1 – The U.S. dollar is still struggling to appreciate



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

THE DISAPPOINTMENTS IN THE UNITED STATES SHOULD BE MERELY TEMPORARY

The latest U.S. economic data are considerably less encouraging than the previous ones, indicating a significant decline in economic growth in the first quarter. The statistics that were released in February on employment, the manufacturing ISM, retail sales, manufacturing output and housing starts all fell short of expectations, in many cases by a large margin.

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Weather seems to be the main reason for these results. Many parts of the United States were affected by intense cold snaps or higher-than-average snowfall accumulations. This bad weather continued into February, suggesting that the statistics to be released in March will again be disappointing. If the weather is indeed the main culprit, economic conditions should improve with the arrival of spring. We predict that U.S. real GDP growth will come in at 1.7% in the first quarter, and then return closer to 3% thereafter.

THE FEDERAL RESERVE STAYS THE COURSE

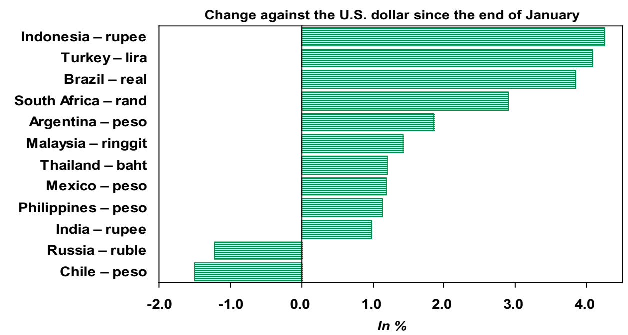
The Federal Reserve (Fed) does not seem too concerned about the recent economic slowdown. It announced a second US$10B reduction of its securities purchases, and seems set to continue in this direction at future monetary policy meetings. The Fed's new President, Janet Yellen, also reassured the markets after her appearances before a committee of the Congress. Her vision on supporting the economy is in line with that of her predecessor, Ben Bernanke. Moreover, she is not perceived to be a leader who would wish to rush into interest rate hikes.

The weak inflation in the United States lends great credibility to a scenario in which the Fed will bide its time. Investors' expectations currently seem to be aligned along that road, even if the jobless rate falls faster than expected. This will have implications for the U.S. dollar in the future. Despite economic data that should improve in the spring, the greenback's appreciation could continue to be held in check by the low potential for monetary firming in the short term. Since the Fed's balance sheet is still expanding, the tapering of the securities purchases does not really constitute monetary firming. We will have to wait until later this year for the U.S. dollar to be more stimulated by speculation about an eventual hike in key interest rates.

At least two other factors are currently playing against the U.S. dollar, starting with the strength of the European currencies. While the appreciation of the pound sterling appears more justified, given the healthy progress observed in the British economy, the same cannot be said for the euro. The euro zone has indeed emerged from recession, but the pace of growth is still slow, and many challenges are still hanging over the region. The substantial surplus in the euro zone's current account cannot by itself justify a strong euro. That surplus is actually a reflection of weak domestic demand. Sooner or later, the euro should fall; but in the meantime, it is making the greenback look bad. A possible intervention by the European Central Bank could be a turning point.

The other factor playing against the U.S. dollar is its safe-haven status. When concerns dissipate, the U.S. dollar depreciates. Concerns about the emerging countries were reawakened at the beginning of the year, but already we can feel some alleviation, as shown by the re-appreciation of several emerging currencies (graph 2). Concerns about the euro zone are also very small.

Graph 2 – A respite for emerging currencies



Sources: Datastream and Desjardins, Economic Studies

A LIKELY RESURGENCE OF CONCERNS

In the long term, demand for safe-haven currencies should continue to wane as the global economy strengthens; this will wipe out a portion of the gains expected for the U.S. dollar. However, a resurgence of concerns is very probable in the short term, and the U.S. dollar could temporarily enjoy additional support in the next few months.

Indeed, it appears that the emerging countries are not out of the woods yet. While the raising of key interest rates by certain central banks did help stabilize the situation, it is now threatening to stifle economic growth. Brazil is already experiencing this type of reaction. The problem of current account deficits is also still unresolved in many emerging countries. We should keep in mind, too, that the current calm state of affairs in Europe seems fragile.

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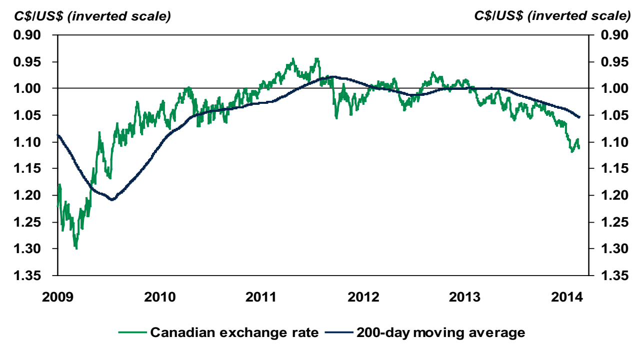
CANADIAN DOLLAR (CAD)

The slide comes to a halt in February

- The Canadian dollar had a rough ride in January: its value against the greenback dropped by 5%. It even reached a four-and-a-half-year low, at US$0.8910. The first half of February was much quieter, and the loonie re-appreciated to nearly US$0.92. However, disappointing data on the Canadian economy quickly drove it back to around US$0.90.
- From a technical standpoint, it will take more than a lull of a few weeks to really break the loonie's downward trend. Its momentum is still firmly anchored in negative territory, and investor sentiment is still clearly pessimistic, as may be seen from the very low balance of speculative positions. Apparently, the Canadian dollar is still oversold.
- Fundamentally, the main source of the Canadian dollar's weakness seems to be the change of tone adopted by the Bank of Canada (BoC) since October. It was from that point onwards that the loonie's decline accelerated. It got another jolt in January, when the BoC opened the door further to a lowering of key interest rates, by mentioning that the downside risk for inflation had increased. Inflation is in fact languishing around the bottom end of the BoC's target range. It could sink further in the short term, a situation that would certainly fuel speculations about monetary easing.
- Concerns about Canadian economic growth are exacerbating the loonie's weakness. The uncertain situation in some emerging countries is raising doubt about demand for commodities and, in turn, for Canadian exports. But commodity exports are not the only source of worry. Canada did not benefit much from the global economic recovery in 2013. Competitiveness issues seem to be the reason why Canada is losing market share abroad, justifying an adjustment to the currency.

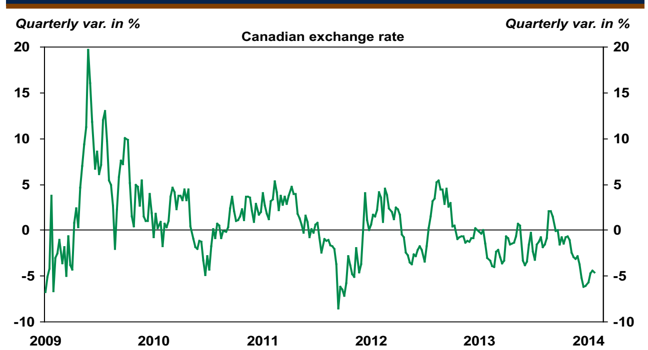
Forecasts: The loonie's downward trend is unlikely to reverse itself in the short term. Due to weak inflation, the BoC will remain concerned for many months to come, a situation that will probably keep the Canadian dollar below US$0.90. We do not think that key interest rates will be lowered, however. The loonie should do better in the second half of the year, once concerns about inflation dissipate. Global economic conditions should also be less uncertain by then.

Canadian dollar and trend



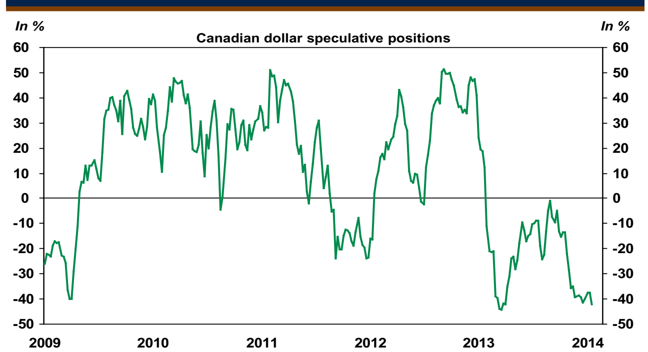
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

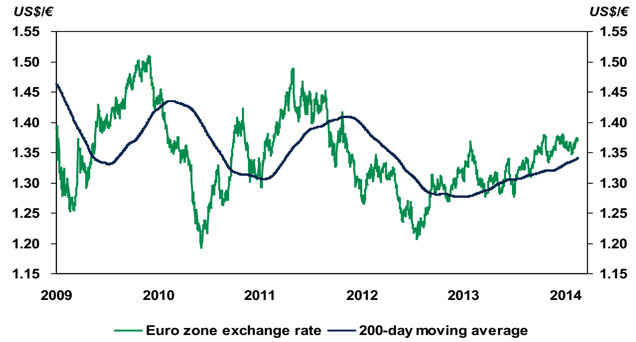
EURO (EUR)

Uncertainty about monetary policy could keep the euro volatile

- The euro faltered somewhat in mid-January, but it quickly climbed back to around US$1.37 after an encouraging upturn in purchasing managers' indexes. Subsequently, a surge in investor concern about conditions in emerging countries and another drop in inflation drove the euro down to around US$1.35 at the end of January. The European Central Bank's (ECB) decision to opt for the status quo in February sent the euro back on an upward path; it also took advantage of the greenback's weakness to return close to US$1.38.
- The euro's recent fluctuations show that this currency is still sensitive to any surge in international financial tensions. When investors' concerns deepen, as they did at the end of January, they turn to safe-haven currencies such as the yen, the U.S. dollar or the Swiss franc, at the expense of the other currencies. In recent weeks, investors' concerns have subsided, favouring a rebound of the euro. Conditions in Europe are fairly calm, and a change of government appears to be happening in orderly fashion in Italy. However, the issue of the weakness of the European banking sector is still a significant risk for the euro, as the ECB's stress tests near.
- In the short term, the euro's movements are likely to reflect, to a large extent, monetary policy trends on both sides of the Atlantic. Recently, the euro benefited from the fact that the economic data from the euro zone have been less disappointing than in the U.S.; this could pave the way for a pause in the Federal Reserve's tapering of its securities purchases. This trend could quickly reverse itself, however. The ECB has clearly indicated that it could ease its monetary policy as early as March, especially if new economic outlooks suggest that inflation will remain too low for too long. Furthermore, although growth was slightly stronger than expected in the last quarter of 2013, risks of deflation are still much higher in the euro zone (where annual inflation fell back to 0.7% in January) than in most of the advanced economies. It is therefore to be expected that monetary policy will remain very accommodative for much longer in the euro zone, putting the euro at a disadvantage in the medium and long term.

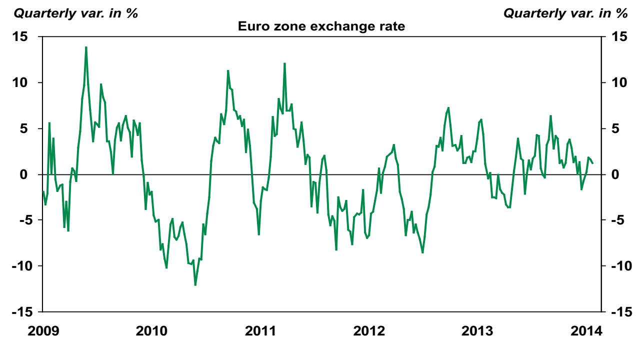
Forecasts: Outlooks for economic growth and inflation are still definitely bleaker in the euro zone than in the other advanced countries, and this encourages us to keep banking on a gradual decline of the euro. The euro's sensitivity to any increase in financial tensions is another reason to bet against this currency in the current climate.

Euro and trend



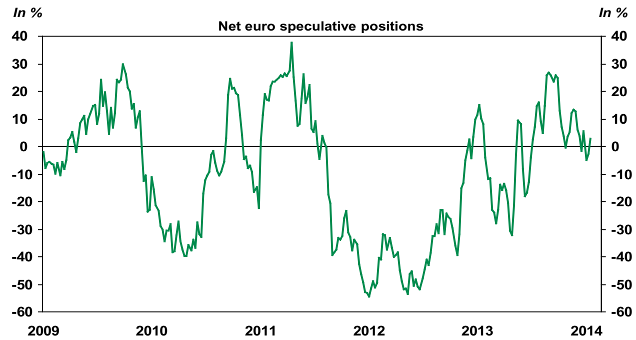
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



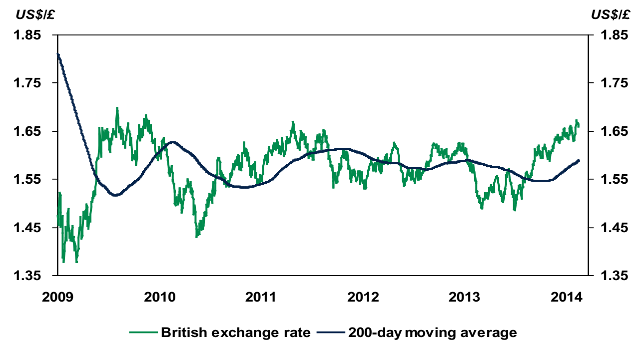
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

No rate hike in 2014, but...

- The pound sterling continued its upward trajectory in recent weeks, even surpassing US$1.68 in mid-February, a high not seen in more than four years. These gains are directly linked to strong performance by the British economy and the spectacular plunge in the unemployment rate, which both encourage investors to bet on an interest rate hike as early as soon as Q4 2014.
- With the unemployment rate quickly nearing the 7% threshold, Bank of England (BoE) leaders have adjusted their guidance about how monetary policy will evolve in the coming quarters. Rather than basing decisions on one specific economic indicator, once the unemployment rate reaches 7%, the BoE will consider several factors, including the degree of spare capacity in the economy, the strength of the economic recovery and inflationary pressures. While the BoE is counting on a favourable economic scenario, it is telling us that key interest rates will remain at floor level for a while longer, and that monetary firming will be gradual. **The pound could lose ground in the short term, since monetary firming in 2014 is not very likely. It should appreciate in 2015, however, as the BoE will probably raise its key interest rate earlier than the other major central banks.**

British pound and trend



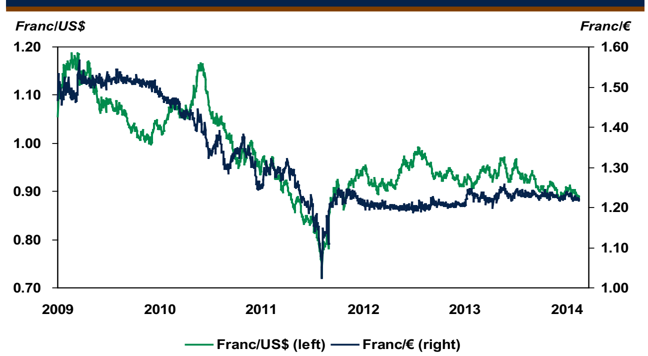
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

The floor-level exchange rate is still necessary

- The surge in investor concern at the end of January benefited the safe-haven currencies, including the Swiss franc. As a result, the USD/CHF pair fell from over 0.91 francs to less than 0.89 francs, while the EUR/CHF pair fell back close to 1.22 francs. This recent reaction by the franc will strengthen the Swiss National Bank's (SNB) resolve to maintain its floor-level exchange rate of 1.20 francs per euro for a good while longer, especially since Swiss inflation is close to zero. However, the SNB is still concerned about the risk of overheating in the real estate market, so it has raised the amount of capital that Swiss financial institutions are required to hold to underpin their mortgage lending. **The fluctuations of the Swiss franc will mainly reflect changes in international risks in the short term. A gradual depreciation should begin in the second half of 2014.**

Swiss franc and trend



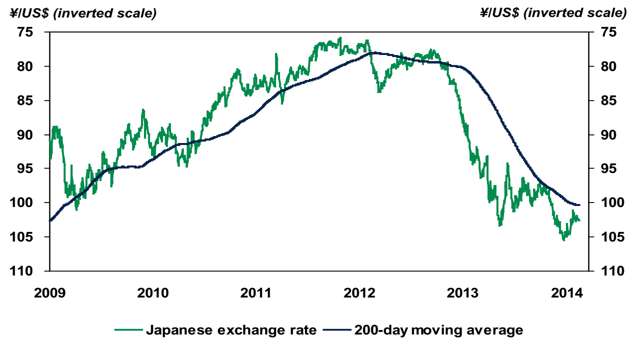
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

Temporary re-appreciation

- The yen has appreciated slightly since the beginning of the year. A few temporary factors have played in its favour, including concerns about some emerging countries and the weakness of the U.S. dollar. But this is not enough to reverse the currency's downward trend. **The majority of the fundamental variables still support depreciation of the yen, so the exchange rate will probably reach ¥110/$US by the end of the year.**
- Japan's economic growth fell short of expectations in the last quarter, with annualized growth of barely 1%. An increase in imports wiped out a large portion of the gains in consumer spending and investment. Thus the yen's depreciation is still taking time to produce an impact on economic growth. The sales tax hike in April will likely hold the Japanese economy in check, suggesting that the Bank of Japan will maintain its highly interventionist approach. In fact, in February it announced the extension of its lending programs. We are still expecting its securities purchases to continue into 2015; this will be a determining factor for the continuation of the yen's depreciation.

Yen and trend



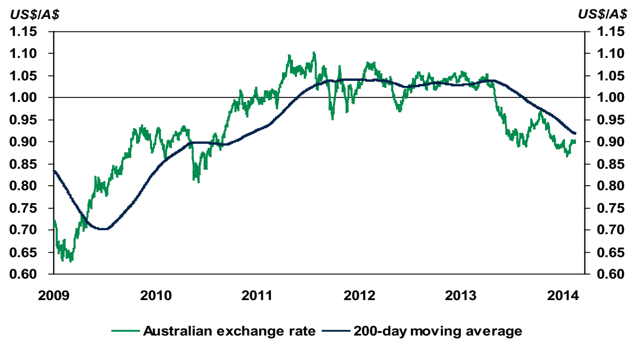
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The currency comes to the economy's rescue

- The Australian dollar hit a three-and-a-half-year low in January, at US$0.8660. It rallied on February 4 after the meeting of the Reserve Bank of Australia (RBA), which adopted a more neutral tone and removed its message about the overvaluation of the aussie. The weakness of the U.S. dollar and some good news stories out of China also helped the Australian dollar to climb back to US$0.90.
- Keep in mind that the RBA has already stated that the equilibrium value of the aussie lies closer to US$0.85 than to US$0.95. The recent appreciation of that currency is out of sync with that vision. The Australian economy needs to restructure, but that takes time. The unemployment rate reached 6% in January, its highest level since 2003. A rebound in inflation is now limiting the RBA's ability to further lower its key interest rates, but it could still attempt to dictate the value of the currency according to its expectations. **What the Australian economy needs is a weak currency, whose value should fluctuate between US$0.85 and US$0.90 in the upcoming quarters.**

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

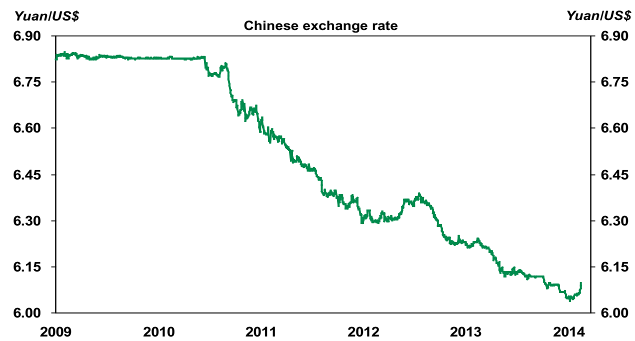
EMERGING CURRENCIES

A slight upturn for most emerging currencies

CHINESE YUAN (CNY)

- The Chinese exchange rate is struggling to move below 6.05 yuan/$US. The positive data on trade and the Chinese credit market for January had no effect on the value of the yuan, nor did the recent weakness of the U.S. dollar which did give a boost to many other currencies. It often happens that the yuan stabilizes around a plateau, before being revalued by the monetary authorities. Weaker growth in the Chinese economy is still leading officials to adopt a cautious approach to their exchange rate policy. The reforms that have been undertaken in China to reduce the country's dependence on exports will take time to produce results. In these circumstances, **the revaluation of the yuan will continue to be very gradual. The exchange rate should be close to US$5.90 by the end of the year.**

Chinese yuan and trend



Sources: Datastream and Desjardins, Economic Studies

MEXICAN PESO (MXN)

- The Mexican peso was not entirely spared by the surge of concern about emerging countries; the USD/MXN pair jumped to around 13.60 pesos at the end of January, its highest level since the summer of 2012. But the peso's depreciation is actually quite limited compared to what was observed for other emerging currencies, a sign that this country is deemed to present relatively low risk. The most recent Mexican economic data are fairly mixed, but we note a surge in inflation, which hit 4.5% in January. The Bank of Mexico predicts that inflation will moderate, but it will keep a close eye on upward pressure on prices, especially the possibility of new financial tensions that might affect the peso. **The outlook for the peso in the medium term is still favourable.**

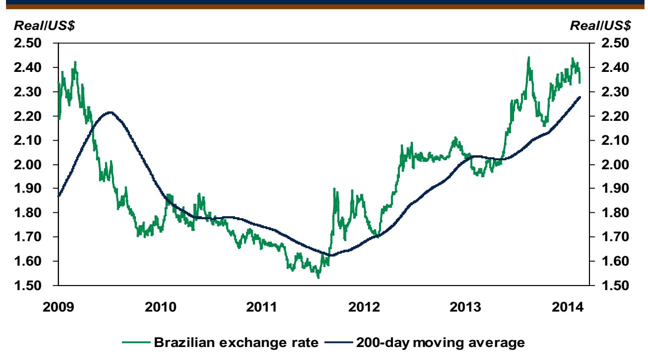
Mexican peso and trend

Sources: Datastream and Desjardins, Economic Studies

BRAZILIAN REAL (BRL)

- The Brazilian economy is continuing to arouse concern, and the exchange rate reached a five-year peak at the beginning of February, at nearly 2.48 reals/US$. The recent weakness of the U.S. dollar drove the exchange rate back below 2.40 reals/US$, but the trend will likely remain towards depreciation in the short term. The real GDP data for the end of 2013 will be announced at the end of February, but an economic index produced by the Central Bank of Brazil (CBB) suggests that the economy lost ground for a second quarter in a row. **Economic challenges are likely to adversely affect the real for a few more quarters.** It is taking time for the interest rate hikes ordered by the CBB to support the currency, as they are doing further damage to the economy.

Brazilian real and trend



Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

Country – Currency*	Spot price Feb. 24	Percentage return since 1 month	3 months	6 months	1 year	Last 52 weeks Higher	Average	Lower
Americas								
Argentina – peso	7.8738	-2.0678	29.4705	40.0712	56.5591	8.0400	5.8358	5.0293
Brazil – real	2.3322	-3.3286	1.8228	-2.0948	18.2692	2.4513	2.2150	1.9490
Canada – dollar	1.1070	-0.0181	5.1484	5.1784	8.1217	1.1180	1.0451	1.0024
Canada – (CAD/USD)	0.9034	0.0181	-4.8963	-4.9234	-7.5116	0.9977	0.9568	0.8945
Mexico – peso	13.2247	-2.0759	1.4674	1.9386	3.6049	13.5050	12.8469	11.9901
Asia and South Pacific								
Australia – (AUD/USD)	0.9038	4.0759	-1.4550	0.1356	-12.4989	1.0543	0.9427	0.8684
China – yuan renminbi	6.0985	0.8200	0.0788	-0.3684	-2.1916	6.2351	6.1232	6.0412
Hong Kong – dollar	7.7587	-0.0515	0.0716	0.0484	0.0271	7.7673	7.7572	7.7516
India – rupee	62.0750	-0.9889	-1.0489	-1.7878	14.3607	68.8050	59.7564	53.6650
Japan – yen	102.4950	0.1955	1.2046	3.7977	9.7318	105.3150	99.4457	91.8150
New Zeland – (NZD/USD)	0.8330	1.4244	1.6493	6.7722	-0.5498	0.8629	0.8183	0.7708
South Korea – won	1,075	-0.5415	1.3392	-3.8005	-0.9358	1,161	1,094	1,050
Europe								
Denmark – krona	5.4328	-0.4197	-1.2326	-2.5244	-3.9157	5.8361	5.5986	5.4044
Euro zone – (EUR/USD)	1.3726	0.2996	1.4936	2.4098	4.2889	1.3815	1.3324	1.2781
Norway – kroner	6.0341	-1.7783	-0.5078	0.2492	6.5136	6.2863	5.9670	5.6651
Russia – ruble	35.4770	2.4971	8.0874	7.5742	16.5427	35.7055	32.4781	30.3825
Sweden – krona	6.5056	1.0069	-1.0442	0.2334	1.3720	6.7935	6.5212	6.3189
Switzerland – swiss franc	0.8897	-0.5144	-2.1663	-3.2251	-4.4925	0.9796	0.9238	0.8858
United Kingdom – (GBP/USD)	1.6631	0.7756	2.7430	6.6502	8.9382	1.6731	1.5748	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	1.1236	1.1111	1.0989	1.0870	1.0753	1.0753	1.0638	1.0526
Euro	(EUR/USD)	1.3536	1.3780	1.3500	1.3300	1.3200	1.3200	1.3100	1.3000	1.2900	1.2800
British pound	(GBP/USD)	1.6194	1.6563	1.6500	1.6500	1.6600	1.6700	1.6800	1.7000	1.7000	1.6800
Swiss franc	(USD/CHF)	0.9052	0.8908	0.9000	0.9200	0.9300	0.9400	0.9500	0.9700	0.9900	1.0200
Yen	(USD/JPY)	98.23	105.32	104.00	106.00	109.00	112.00	113.00	114.00	115.00	115.00
Australian dollar	(AUD/USD)	0.9317	0.8918	0.8700	0.8800	0.8800	0.8900	0.9000	0.9000	0.9100	0.9200
Chinese yuan	(USD/CNY)	6.1215	6.0540	6.0500	6.0000	5.9500	5.9000	5.9000	5.8500	5.8000	5.8000
Mexican peso	(USD/MXN)	13.09	13.04	13.40	13.20	12.95	12.75	12.60	12.45	12.30	12.20
Brazilian real	(USD/BRL)	2.2297	2.3423	2.4500	2.4000	2.3500	2.3000	2.2500	2.2500	2.2000	2.1500
Effective dollar*	(1973 = 100)	75.19	76.44	78.10	78.70	79.10	79.20	79.30	79.60	79.80	80.00
Canadian dollar											
American dollar	(CAD/USD)	0.9700	0.9414	0.8900	0.9000	0.9100	0.9200	0.9300	0.9300	0.9400	0.9500
Euro	(EUR/CAD)	1.3955	1.4638	1.5169	1.4778	1.4505	1.4348	1.4086	1.3978	1.3723	1.3474
British pound	(GBP/CAD)	1.6695	1.7594	1.8539	1.8333	1.8242	1.8152	1.8065	1.8280	1.8085	1.7684
Swiss franc	(CAD/CHF)	0.8780	0.8386	0.8010	0.8280	0.8463	0.8648	0.8835	0.9021	0.9306	0.9690
Yen	(CAD/JPY)	95.28	99.14	92.56	95.40	99.19	103.04	105.09	106.02	108.10	109.25
Australian dollar	(AUD/CAD)	0.9605	0.9473	0.9775	0.9778	0.9670	0.9674	0.9677	0.9677	0.9681	0.9684
Chinese yuan	(CAD/CNY)	5.9377	5.6989	5.3845	5.4000	5.4145	5.4280	5.4870	5.4405	5.4520	5.5100
Mexican peso	(CAD/MXN)	12.70	12.27	11.93	11.88	11.78	11.73	11.72	11.58	11.56	11.59
Brazilian real	(CAD/BRL)	2.1628	2.2049	2.1805	2.1600	2.1385	2.1160	2.0925	2.0925	2.0680	2.0425

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