FX Forecasts

Desjardins Economic Studies
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A last false start by the U.S. dollar?

HIGHLIGHTS

- The arrival of spring could help the U.S. dollar's cause considerably. The unusual weather dragged several indicators down over the winter, which fuelled doubts about the solidity of the U.S. economy, and probably prompted some Federal Reserve leaders to choose their words carefully.
- With the global and Canadian economies expected to firm up, and inflation to rise, the loonie should gain slightly against the U.S. dollar. Our target for the end of the year is US$0.925 (C$1.081/US$).
- The European Central Bank seems determined to keep the euro from rising further. However, words may not be enough, and it should soon announce additional monetary easing, which should take the euro close to US$1.35 within a few months.
- Following a run of spectacular gains, the pound could edge back in the coming months, then start to trend up again next year.

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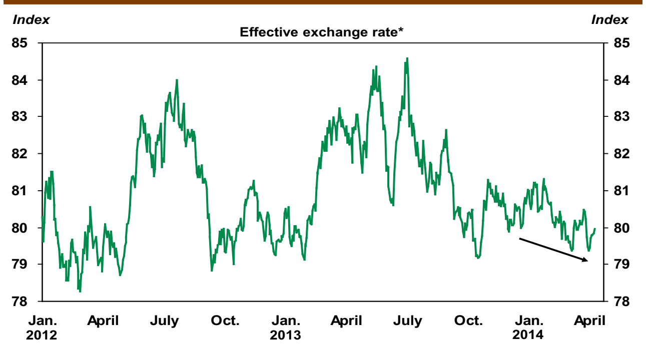
Editorial

It may seem increasingly difficult to believe in a sustainable rise by the U.S. dollar. Another false start occurred in March after the Federal Open Market Committee (FOMC) meeting. In opening the door for key interest rates to start increasing six months after the upcoming end to securities purchases, Janet Yellen took the markets by surprise—they still seemed quite short-sighted about the future trajectory of key rates. The wake-up call was short-lived, however. The release of the minutes of the March FOMC meeting and the accommodating tone of messages from Federal Reserve (Fed) leaders tempered expectations and wiped out the greenback's recent gains. The DXY U.S. exchange rate index is about where it was at the start of the year (graph 1), but we still foresee some appreciation by the greenback over the coming quarters.

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



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

A LIVELY SPRING!

The arrival of spring could help the U.S. dollar's cause considerably. The unusual weather dragged several indicators down over the winter, which fuelled doubts about the solidity of the U.S. economy, and probably prompted

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

some Fed leaders to choose their words carefully. Stronger confidence in the U.S. economy and a Fed that is more inclined to preparing the markets for interest rate hikes would help the greenback appreciate.

The economic numbers for March already offer some encouraging signs. The ISM manufacturing and non-manufacturing indexes are on the rise again after nearing the psychological threshold of 50. Hours worked are also up, reflecting the many employees who are back at work full time after having had to work part time because of the poor weather in previous months. Finally, retail sales and industrial production posted major rebounds.

There are some lingering concerns for housing, however, with starts coming in below expectations for March, among other things. It will likely take several more months to get a clearer picture of the situation, especially since the unusual weather patterns probably still had some influence on March's data. In the very near term, some indicators could even be inflated by temporary rebounds, amid some pent-up demand from previous months. In this context, we should not be surprised if the recent good news has not been enough to reassure the Fed and the markets, and support the U.S. dollar's appreciation.

THE EURO AND THE YEN WILL DEPRECIATE

The U.S. exchange rate is not only affected by the U.S. economy—it is also influenced by the other major currencies. For example, outlooks remain negative for the euro and the yen, which will be enough to turn around the many exchange rate indexes calculated for the greenback. The euro and the yen account for just over 70% of the DXY index.

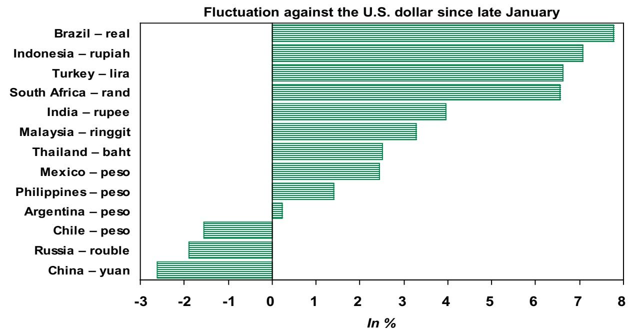
The strength of the euro and yen since the start of the year may raise some doubts about these forecasts. For now, some factors are supporting these currencies, but that should not persist. For example, the yen is benefiting from a safe haven effect which should wane as the U.S. and global economies improve. The euro is profiting from renewed enthusiasm for the peripheral euro zone nations, but the smallest shock or disappointment could cause the currency to falter.

The fact that the European Central Bank (ECB) and Bank of Japan (BoJ) are hesitant to announce new easing measures also explains the current behaviour of the euro and yen. The weak European economic recovery and, above all, the worrying trend for inflation lead us to believe that future easing is in the works. Already, a change of stance can be perceived in ECB communications and the remarks from its leaders. As for the BoJ, even if it does not increase its securities purchases this year, it should at least confirm that it will be extending its current policy in 2015.

RECENT APPRECIATION BY EMERGING CURRENCIES SEEMS PREMATURE

Lastly, the U.S. dollar could also gain against several emerging currencies in the short term. Most emerging currencies have appreciated against the U.S. dollar since the end of January, with some showing substantial advances (graph 2). This rebound was supported by easing fears in many emerging nations, as well as low U.S. bond yields.

Graph 2 – The break continues for several emerging market currencies



Sources: Datastream and Desjardins, Economic Studies

From the perspective that U.S. bond yields should rise in the coming quarters, we can expect a lot of volatility from emerging currencies. Furthermore, the presence of many imbalances and unresolved structural problems mean we cannot expect fears about emerging nations to subside quickly. We recently published an *Economic Viewpoint*[1] on this subject.

François Dupuis
Vice-President and Chief Economist

Hendrix Vachon
Senior Economist

[1] Desjardins, Economic Studies, *Economic Viewpoint*, "Risk of financial crisis in emerging countries – Despite the recent lull, concerns persist", Avril 9, 2014, www.desjardins.com/ressources/pdf/pv140409-e.pdf?resVer=1397061445000.

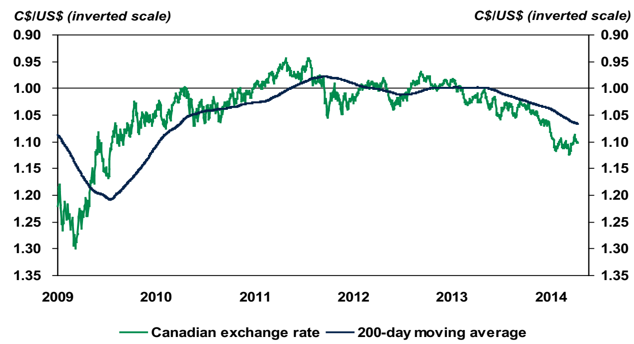
CANADIAN DOLLAR (CAD)

The grey clouds are slowly dissipating

- The Canadian dollar is currently worth just over US$0.90. The currency's greater stability over the last two months seems to confirm that the worst of the depreciation is over. However, while the main determinants that weakened from October to January have settled down, the conditions for a lasting upswing are not yet in place.
- From a technical standpoint, the stability seen in the last two months has not yet softened the trend for Canada's exchange rate, as shown by its 200-day moving average. Furthermore, investor sentiment toward the currency remains firmly anchored in negative territory, even though some improvement has been seen there. Investors seem to be waiting for better signals from fundamental variables before reversing their position more significantly.
- Inflation and the Bank of Canada's (BoC) fearful tone were the most punishing determinants for the loonie between October and January. Now that inflation seems to be climbing faster than expected, the chances of an interest rate cut in Canada have waned, and the Canadian dollar is less penalized by this outlook. All the same, the BoC has refrained from completely closing the door on easing. It maintains that many risks are threatening the economy, and that, unlike total inflation, core inflation (excluding eight volatile components) will remain below 2% for several more quarters.
- An important issue for the Canadian economy is the rebalancing of growth toward exports and non-residential investment. Without that shift, it will be hard for growth to stay on track, given that governments are still working on deficit reduction and households need to be more frugal. The improvements forecast for the global economy should help work this transition, but Canadian exporters will still need the currency's help to remain competitive.

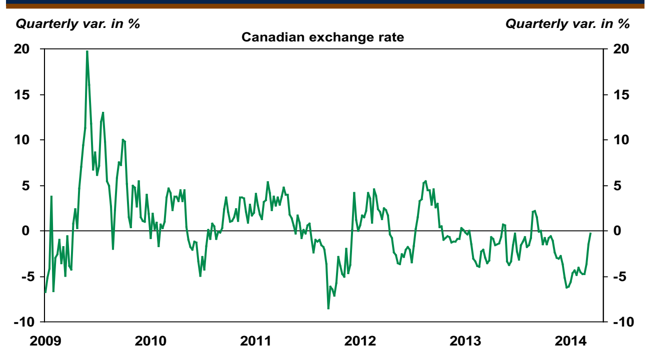
Forecasts: The Canadian dollar will remain highly sensitive to shifts in economic data, especially inflation, and BoC signals. It should remain close to current levels for several more months. After that, with the global and Canadian economies expected to firm up, and inflation to rise, the loonie should gain slightly against the U.S. dollar. Our target for the end of the year is US$0.925 (C$1.081/US$).

Canadian dollar and trend



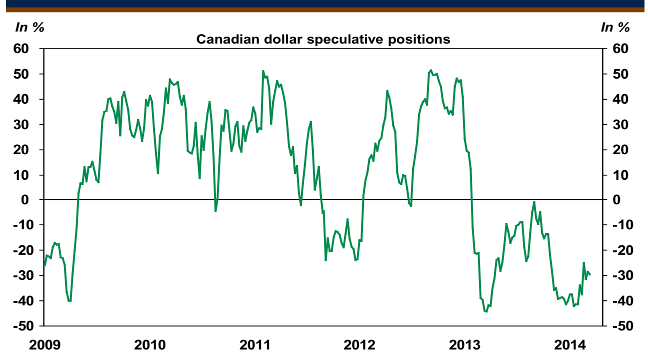
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

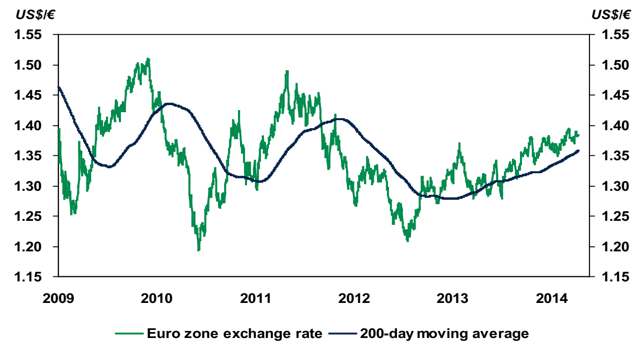
EURO (EUR)

The European Central Bank will have to rein in the euro

- The euro's strength moderated somewhat after the March 19 Federal Reserve (Fed) meeting. In light of the Fed's more hawkish tone, the euro dropped from around US$1.39 to just under US$1.38. However, the common currency climbed to nearly US$1.39 in early April on the European Central Bank's decision to keep its monetary policy unchanged, while various factors (the drop by the NASDAQ, publication of the minutes from the last Fed meeting) harmed the greenback.
- The sharp turnaround in investor sentiment toward peripheral euro zone nations helped boost the euro. Not only have financing rates for countries like Italy and Spain continued to fall, but even Greece was recently able to issue five-year bonds at less than 5%. The popularity of bonds from euro zone countries whose economic and financial situations remain quite precarious seems to reflect a frenzied search for yields on a global scale.[1] As worries continue to grow over the situation in China and the Ukraine, European securities even seem to be acting as safe havens.
- The high value of the euro may, however, worsen the already weak economic outlooks for the euro zone. Purchasing manager indexes continue to suggest modest economic growth for Euroland, but some confidence indexes have dropped, including Germany's. The conflict in the Ukraine, which could curb growth in Eastern Europe, could have negative consequences for the euro zone. Beyond the subdued growth outlooks, weak inflation is garnering a lot of attention. The annual inflation rate dropped to 0.5% in March, and core inflation did not fare any better, at just 0.7%. Inflation has been well below 2% for a long time, which is a serious risk to the ECB's credibility. In early April, the ECB did not relax its monetary policy, but it did open the door to future actions. President Mario Draghi went even further over the last few days, asserting that "the strengthening of the exchange rate requires further monetary stimulus."

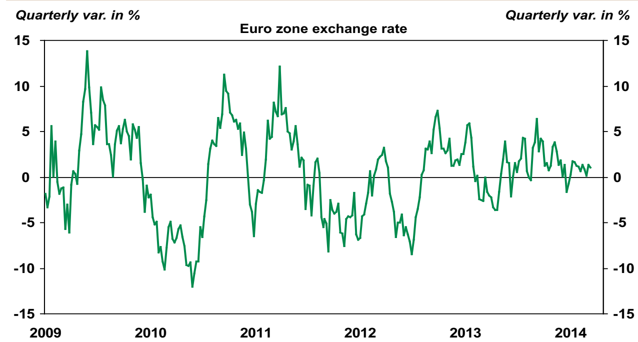
Forecasts: The ECB seems determined to keep the euro from rising further. However, words may not be enough, and it should soon announce additional monetary easing, which should take the euro close to US$1.35 within a few months.

Euro and trend



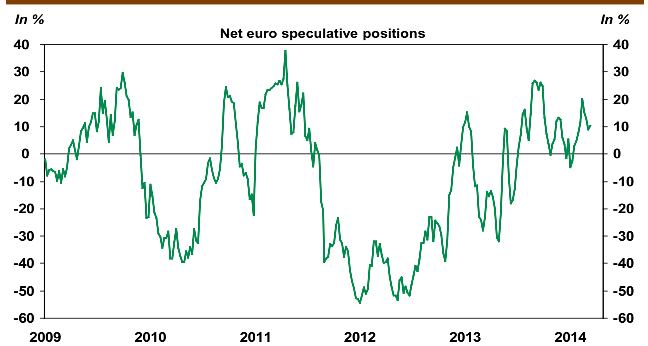
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

[1] Desjardins, Economic Studies, *Economic News*, "Are low yields justified in Europe?", April 3, 2014, www.desjardins.com/ressources/pdf/nf140403-e.pdf?resVer=1396539199000.

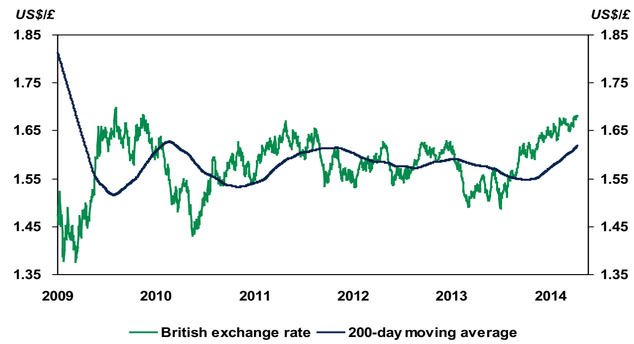
Desjardins Economic Studies

BRITISH POUND (GBP)

New signs of strength in the United Kingdom

- The pound sterling appreciated further in the last few weeks, rising to US$1.68, close to its highest point since 2009. The pound has made a spectacular advance of more than 10% in the last nine months. It also recently rose against the euro, with the EUR/GBP pair sliding back to around £0.82/€.
- Aside from the U.S. dollar's retreat, the pound's latest gains once again reflect the release of encouraging economic figures that seem to be opening the door to an earlier monetary firming. Industrial production jumped 0.9% in February, and a coincident activity indicator suggests economic growth of about 3.5% (annualized) for the first quarter of 2014. The latest numbers on jobs were also excellent and the jobless rate fell to 6.9% in February, crossing below the 7.0% threshold the Bank of England (BoE) established for starting to contemplate monetary firming. On the other hand, inflation retreated to 1.6% in March, its lowest point since October 2009, which will allow the BoE to wait a little longer than the market anticipates before starting to raise its key rates. **Following a run of spectacular gains, the pound could thus edge back in the coming months, then start to trend up again next year.**

British pound and trend



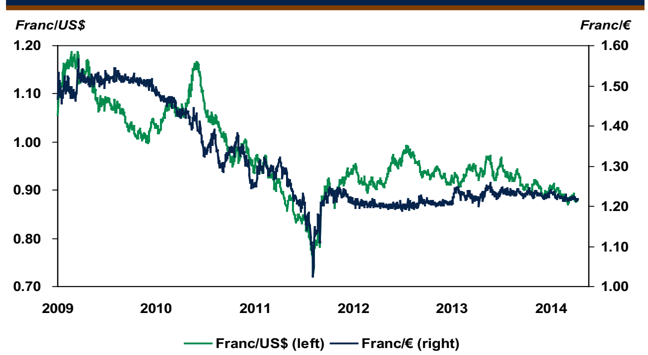
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

The franc's movements will remain limited

- The Swiss franc retreated during the last weeks of March. The Federal Reserve's fairly hawkish comments, encouraging economic data from the United States and some stabilization of the situation in the Ukraine took the USD/CHF pair from 0.970 francs in mid-March to nearly 0.895 francs in early April. However, this movement has largely reversed over the last few days, on a surge in tension in the Ukraine and a substantial slide by the big stock exchanges. The franc's evolution against the euro was similar, with the EUR/CHF pair climbing to around 1.224 francs in early April before returning to around 1.215 francs. Switzerland's most recent economic data is not sending any clear signals, and inflation remains extremely low. **Developments in Ukraine will continue to have considerable influence over the movements by the franc, which should not stray too far from the 1.200 franc ceiling set by the Swiss National Bank as long as international tension remains high.**

Swiss franc



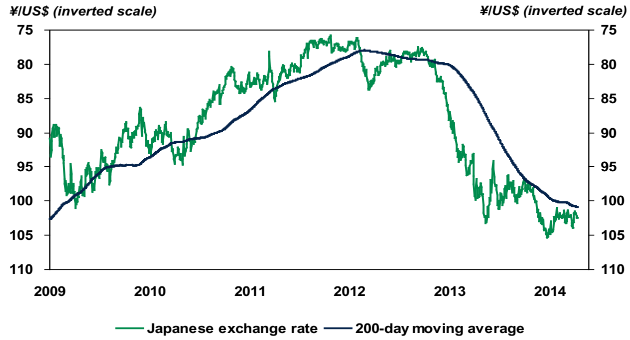
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

Depreciation will start back up later in the year

- Depreciation by the yen has been slow to gather new momentum. The exchange rate started April at around ¥104/US$, but it dropped back to around ¥102/US$. The yen's resilience is largely due to its role as a safe haven, fuelled recently by falling stock markets and rising tensions between Russia and the West. Investors also seemed surprised that the Bank of Japan (BoJ) did not announce any new measures on April 8.
- The factors supporting the yen could remain in place for some time, but we expect it to start to depreciate again at some point. The safe haven effect will dissipate with the expected improvement to the global economic situation. Then, even though the BoJ does not seem eager to announce new measures, it will still be the most interventionist central bank for several more quarters. **At a minimum, the BoJ should extend its securities purchases to 2015 to reach its inflation goal. Our target of ¥110/ US$ at the end of 2014 still seems credible.**

Yen and trend



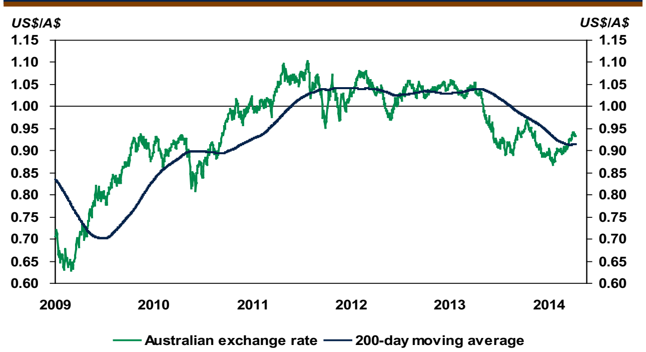
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The upswing seems exaggerated

- The Australian dollar gained just over four cents between mid-March and mid-April, bringing it to US$0.94. This climb is primarily supported by improved economic data for Australia. Job creation has been sustained since the start of the year, and credit seems to be accelerating. At a discussion panel in late March, the governor of the Reserve Bank of Australia (RBA) also mentioned that Australia's economy was showing encouraging signs in terms of domestic demand.
- However, other factors still justify a lower exchange rate. The RBA continues to state that the exchange rate is high from a historical standpoint. In early April, it also added that Australia's economy would not adjust as much as expected due to the currency's recent appreciation. At that time, the exchange rate was US$0.92, so we can assume that the RBA could still toughen its stance if the Australian dollar remains strong between now and its next monetary policy meeting in May. **An exchange rate close to US$0.90 would be much more compatible with required adjustment by the Australian economy, which must offset the drop in natural resources investment, among other things.**

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

China remains worrisome

CHINESE YUAN (CNY)

- Fears about China's economy intensified after the release of several rather disappointing indicators, including international trade and industrial production. Economic growth also retreated to 7.4% (year-on-year) in the first quarter. In this context, the yuan's slide may seem justified. However, note that this currency had still been considered substantially undervalued before China's data deteriorated. Furthermore, it is still headed for a soft landing due to the drive by Chinese leaders to curb some risky sectors of the economy, such as residential real estate. We can therefore remain confident that yuan revaluation will begin again shortly. **Our forecast for the end of 2014 was revised to 6 yuan/US$ last month.**

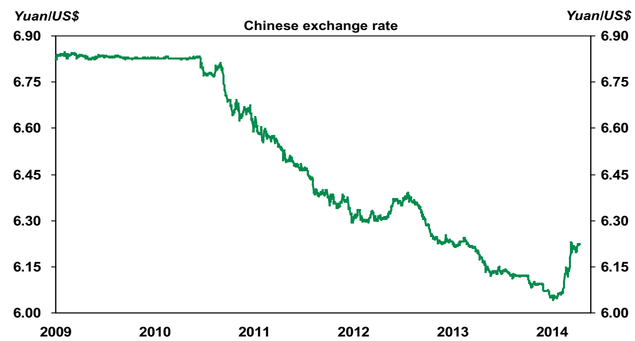
MEXICAN PESO (MXN)

- The USD/MXN pair dropped to around 12.90 pesos on April 8, its lowest point since January 24, before moving back to around 13.00 pesos. This movement confirms that fears of a widespread financial crisis in emerging nations have lessened substantially. The latest figures from Mexico remain fairly mixed, but clear signs of a springtime rebound by the U.S. economy are a very positive development for Mexican exporters. March statistics on Mexican auto production and exports are also encouraging. As inflation has edged slightly below the Bank of Mexico's target, nothing points to any changes in its monetary policy. **Lingering concerns about emerging countries should keep the USD/MXN pair near 13.00 pesos for a while.**

BRAZILIAN REAL (BRL)

- The real has continued to rise and is now close to 2.20 real/US$. Like other emerging currencies, the real benefited from falling U.S. interest rates and a larger appetite for securities from emerging nations. The real also profited from the Brazilian government's move to relax budget targets, which could help the country's economic growth. A slower pace for monetary firming in Brazil also allows for a bit more optimism about economic growth, provided inflation keeps coming down. That being said, **many obstacles could still harm emerging currencies in the coming quarters, which means we cannot expect the real's comeback to last. The exchange rate could easily climb above 2.30 real/US$ in the short term.**

Chinese yuan and trend

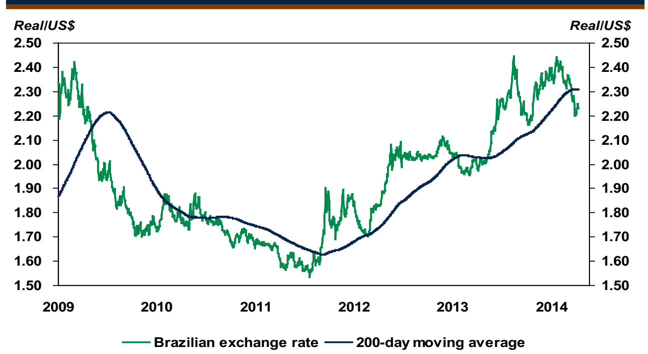


Sources: Datastream and Desjardins, Economic Studies

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 April 21	Percentage return since 1 month	3 months	6 months	1 year	Last 52 weeks Higher	Average	Lower
Americas								
Argentina – peso	8.0050	0.4707	16.2250	36.8189	55.0981	8.0400	6.2711	5.1613
Brazil – real	2.2362	-3.6847	-5.2959	2.9061	11.6119	2.4513	2.2616	1.9992
Canada – dollar	1.1018	-1.5591	0.3598	7.0280	7.3931	1.1252	1.0579	1.0024
Canada – (CAD/USD)	0.9076	1.5838	-0.3585	-6.5665	-6.8842	0.9977	0.9453	0.8888
Mexico – peso	13.0363	-1.3993	-2.0817	0.7980	6.6460	13.5050	12.9557	11.9901
Asia and South Pacific								
Australia – (AUD/USD)	0.9328	2.7146	5.9375	-3.3629	-9.2257	1.0371	0.9259	0.8684
China – yuan renminbi	6.2274	0.0378	2.9229	2.2125	0.8061	6.2276	6.1192	6.0412
Hong Kong – dollar	7.7539	-0.0535	-0.0419	0.0200	-0.1294	7.7673	7.7570	7.7516
India – rupee	60.5950	-0.5008	-2.0845	-1.5995	12.3378	68.8050	60.7310	53.6650
Japan – yen	102.6200	0.3471	-1.6296	4.5117	3.1150	105.3150	100.5201	94.0850
New Zeland – (NZD/USD)	0.8573	0.4286	3.0604	1.3888	1.7917	0.8713	0.8212	0.7708
South Korea – won	1,039	-3.8186	-2.4688	-2.1864	-6.9205	1,161	1,086	1,035
Europe								
Denmark – krona	5.4132	0.0249	-1.6238	-0.7162	-5.2170	5.8361	5.5479	5.3568
Euro zone – (EUR/USD)	1.3804	0.1561	1.9160	0.9396	5.5231	1.3928	1.3448	1.2786
Norway – kroner	5.9985	-0.8627	-2.7717	1.3089	3.0316	6.2863	6.0021	5.7167
Russia – ruble	35.6858	-1.5169	5.1630	11.8588	13.1247	36.6510	33.2359	30.9213
Sweden – krona	6.6136	2.9314	2.1003	3.4232	1.1741	6.7935	6.5247	6.3189
Switzerland – swiss franc	0.8837	-0.0057	-3.0233	-1.9962	-5.0398	0.9796	0.9149	0.8712
United Kingdom – (GBP/USD)	1.6804	1.8734	2.0652	3.9917	10.1363	1.6809	1.5978	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 Q1	Q2f	Q3f	Q4f	2015 Q1f	Q2f	Q3f	Q4f
American dollar											
Canadian dollar	(USD/CAD)	1.0310	1.0623	1.1050	1.0989	1.0870	1.0811	1.0753	1.0753	1.0638	1.0526
Euro	(EUR/USD)	1.3536	1.3780	1.3782	1.3500	1.3300	1.3200	1.3100	1.3000	1.2900	1.2800
British pound	(GBP/USD)	1.6194	1.6563	1.6672	1.6700	1.6700	1.6800	1.6900	1.7000	1.7000	1.6800
Swiss franc	(USD/CHF)	0.9052	0.8908	0.8869	0.9000	0.9200	0.9400	0.9500	0.9600	0.9800	1.0000
Yen	(USD/JPY)	98.23	105.32	103.22	104.00	107.00	110.00	112.00	113.00	114.00	115.00
Australian dollar	(AUD/USD)	0.9317	0.8918	0.9264	0.9100	0.9000	0.9000	0.9100	0.9100	0.9200	0.9300
Chinese yuan	(USD/CNY)	6.1215	6.0540	6.2172	6.1500	6.0500	6.0000	6.0000	5.9500	5.9000	5.8500
Mexican peso	(USD/MXN)	13.09	13.04	13.06	13.15	12.95	12.80	12.65	12.50	12.40	12.30
Brazilian real	(USD/BRL)	2.2297	2.3423	2.2627	2.3500	2.3000	2.3000	2.2500	2.2500	2.2000	2.1500
Effective dollar*	(1973 = 100)	75.19	76.44	76.86	77.50	78.20	78.70	79.10	79.40	79.60	79.90
Canadian dollar											
American dollar	(CAD/USD)	0.9700	0.9414	0.9050	0.9100	0.9200	0.9250	0.9300	0.9300	0.9400	0.9500
Euro	(EUR/CAD)	1.3955	1.4638	1.5229	1.4835	1.4457	1.4270	1.4086	1.3978	1.3723	1.3474
British pound	(GBP/CAD)	1.6695	1.7594	1.8421	1.8352	1.8152	1.8162	1.8172	1.8280	1.8085	1.7684
Swiss franc	(CAD/CHF)	0.8780	0.8386	0.8027	0.8190	0.8464	0.8695	0.8835	0.8928	0.9212	0.9500
Yen	(CAD/JPY)	95.28	99.14	93.41	94.64	98.44	101.75	104.16	105.09	107.16	109.25
Australian dollar	(AUD/CAD)	0.9605	0.9473	1.0237	1.0000	0.9783	0.9730	0.9785	0.9785	0.9787	0.9789
Chinese yuan	(CAD/CNY)	5.9377	5.6989	5.6267	5.5965	5.5660	5.5500	5.5800	5.5335	5.5460	5.5575
Mexican peso	(CAD/MXN)	12.70	12.27	11.82	11.97	11.91	11.84	11.76	11.63	11.66	11.69
Brazilian real	(CAD/BRL)	2.1628	2.2049	2.0478	2.1385	2.1160	2.1275	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