FX Forecasts

Desjardins Economic Studies
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Greater volatility ahead for currencies

HIGHLIGHTS

- The developments we expect from the economy, bond yields and the monetary policies of the major central banks suggest that many currencies will soon show increased volatility.
- An expected rebound in the U.S. dollar and the Bank of Canada's worried tone will limit the loonie's appreciation for a few more months. The currency could even edge back in the short term.
- The next date to watch for the euro is June 5, when the European Central Bank (ECB) meeting takes place. If the ECB takes decisive action, the euro's new downtrend should be confirmed, and the currency could end 2014 at around US$1.32.
- After considerable gains, the pound should be fairly stable against the greenback over the coming months, though it should continue to appreciate against the euro.
- The calmer environment for emerging currencies is closely tied to the pullback in U.S. bond yields. A rebound in yields could quickly encourage investors to pull their money out of emerging nations.

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Editorial

Several of the major currencies in advanced and emerging nations have recently been quite stable. However, the developments we expect from the economy, bond yields and the monetary policies of the major central banks suggest that many currencies will soon show increased volatility. This phenomenon is already being seen with the euro, which began to fall. The U.S. dollar, the yen and several emerging currencies will also bear watching.

THE U.S. ECONOMY SHOWS SIGNS OF REBOUNDING

The weather was very bad for the U.S. economy in the first quarter, which led to weak 0.1% real GDP growth. This result was even below expectations, which had called for an increase of just over 1%. The prevailing economic uncertainty forced the Federal Reserve (Fed) to remain cautious in conducting its monetary policy, especially with regard to its communications.

However, much of the recent data is more encouraging and suggests that the U.S. economy will bounce back in the second quarter. The April figures from the housing market are especially reassuring, although a more sustained trend would be nice. Several indicators had bounced back in March, but not housing. It now remains to be seen if this will last, as it is an important component of the U.S. economy.

This is not enough, however, to dispel all investor concerns and make the U.S. dollar appreciate. April's data was occasionally mixed. Retail sales and industrial production disappointed. However, after March's rebound in these key figures, it was likely that some pullback would occur in April. It will probably take another month or two to be completely reassured on that head. The movement in employment, as well as the household and business confidence indicators, augur well.

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

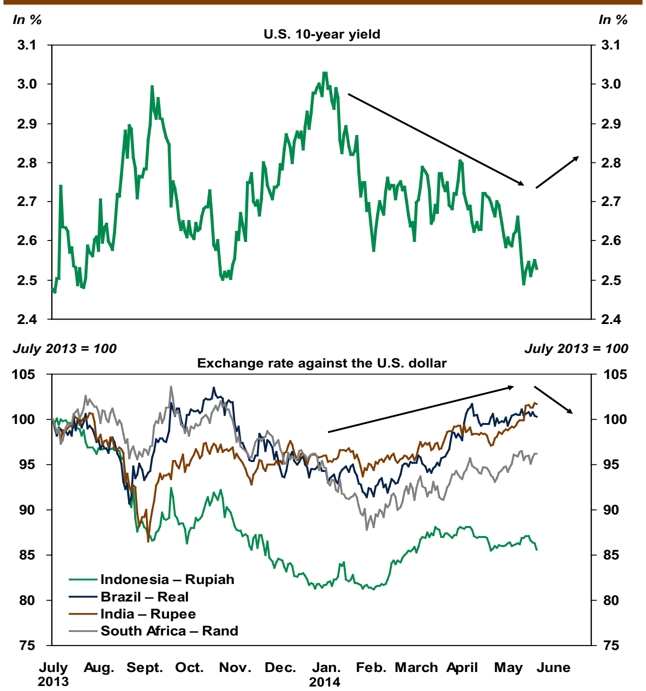
Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

BOND YIELDS COULD SHOOT UP

The improved U.S. economic situation should favour a climb in bond yields, especially if the Fed seems less worried in its communications. Note that in spring 2013, bond yields went up abruptly when investor attention was focused on the looming reduction to the Fed's securities purchases. For now, the issue is not the tapering, but rather the onset of true monetary firming, which should have a sizable positive impact on the U.S. dollar.

We must also consider the effect a rise in U.S. bond yields would have on the other currencies. Over the last year, the trend for several emerging currencies seemed to be directly linked to the trend for bond yields (graph 1). An increase in U.S. yields could once again prompt capital outflows, as there would be less incentive to take risks in emerging nations. The many structural problems in these countries could also take centre stage again.

Graph 1 – Several emerging currencies remain vulnerable to the trend for U.S. bond yields

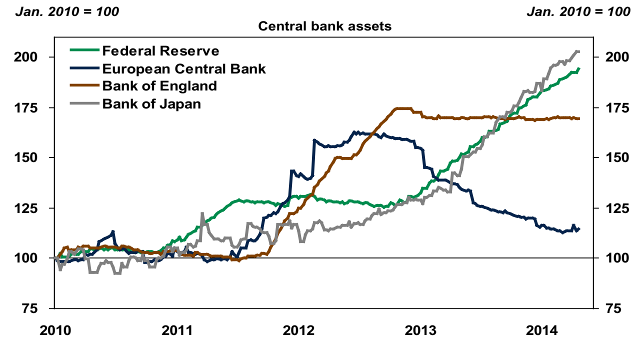


Sources: Bloomberg and Desjardins, Economic Studies

OTHER CHANGES IN SIGHT FOR MONETARY POLICIES

The United States is not the only nation in which monetary policy shifts are expected. The greatest change should take place in Europe, where the European Central Bank (ECB) has clearly opened the door to further easing measures. Remember that in 2013, the ECB stood apart from the other central banks. It was, in fact, the only one to have reduced its balance sheet, which is technically akin to monetary firming (graph 2). The prospect of the ECB is heading into easing mode when the Fed is heading in the opposite direction suggests a steep downtrend for the euro in the coming quarters. It remains to be seen if the ECB will act as determinedly as it recently hinted it would.

Graph 2 – The European Central Bank is currently alone in reducing the size of its balance sheet



Sources: Datastream and Desjardins, Economic Studies

As for the other major central banks, it seems increasingly likely that the Bank of Japan will have to continue its securities purchases past 2014, perhaps even increasing the pace. These actions would obviously hurt the yen. Finally, a very different scenario is expected for the Bank of England. The strength of Britain's economy has raised the chances of early monetary firming, contributing to the pound's recent gains. In contrast with the euro and yen, the pound's trend should be more toward consolidation against the U.S. dollar in the short term.

François Dupuis
Vice-President and Chief Economist

Hendrix Vachon
Senior Economist

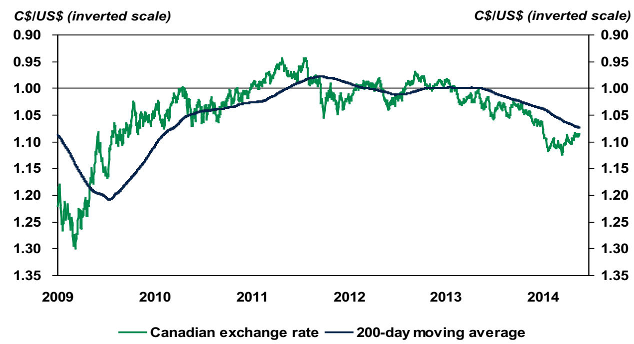
CANADIAN DOLLAR (CAD)

Reappreciation should be limited

- The Canadian dollar is gradually picking up, recently hitting US$0.92 (C$1.087/US$). Canada's relatively good economic performance over the winter, despite the capricious weather, seems to have helped boost investor confidence. Canada's economy is heading for growth of close to 2% for the first quarter, while the U.S. economy stagnated at 0.1%.
- From a technical standpoint, renewed confidence in the Canadian dollar can be seen in net speculative positions. Investors continue to prefer short positions, but less so than before. The Canadian exchange rate's momentum has also improved. However, it will take a few more months before the 200-day moving average stabilizes.
- From a more fundamental point of view, even though the Canadian economy is showing nice resilience, it is not enough to support any significant climb by the currency. The need to shift economic growth toward exports and non-residential investment remains Canada's main issue. The expected improvement in the global economy should help bring about the transition, but without sufficient productivity gains, Canadian businesses will have a difficult time dealing with international competition if the loonie appreciates too much.
- The rise in inflation to its median target of 2% is greatly decreasing the likelihood of an interest rate cut in Canada. However, the Canadian dollar's comeback could be a bit stronger if the Bank of Canada (BoC) was not still tryinig to sow doubt about the future direction of its monetary policy. By instead focusing on core inflation in its statement, the BoC managed to keep its relatively worried tone, therefore leaving the door slightly open for a key rate cut.

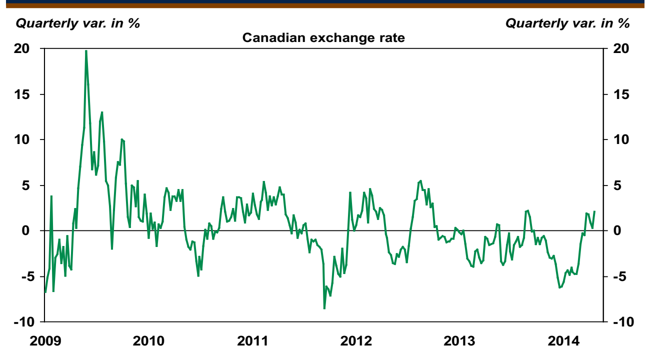
Forecasts: The Canadian dollar is approaching our year-end target, US$0.925 (C$1.081/US$). This level will be difficult to sustain in the short term. An expected rebound in the U.S. dollar and the BoC's worried tone will limit the loonie's appreciation for a few more months. The currency could even edge back in the short term. However, the BoC's stance should adjust to improving economic conditions over the year, which will give the loonie more lasting momentum.

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

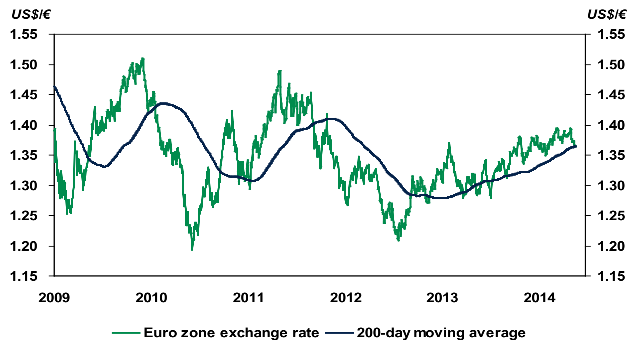
EURO (EUR)

Has the European Central Bank stopped the euro for good?

- The euro ended April on a high, climbing above US$1.393 in the first days of May. However, this uptrend came to an end after the May 8 meeting of the European Central Bank (ECB), when the euro zone's monetary authorities clearly signalled their intention to ease their monetary policy at the June meeting. The euro has moved down ever since, falling back close to US$1.360. Technical indicators confirm the change in attitude toward the euro, as net speculative positions on the currency have recently dropped back into negative territory.
- As the May meeting drew near, most analysts expected the ECB to again opt for the status quo, despite weak inflation and a strong euro. In fact, the ECB did not announce any changes to its monetary policy at this meeting, and barely modified its statement. Initially, the euro benefited from the ECB's inaction, even flirting with US$1.40. During the press conference, though, President Draghi announced that he had a consensus among ECB leaders to go into action at the June meeting, after consulting the new growth and inflation forecasts. He also stated that the ECB was very concerned by the euro's appreciation in a context of ongoing weak inflation and economic activity.
- None of the statistics published since the May meeting should change ECB leaders' views on the need to further ease their monetary policy. The euro zone's real GDP only grew an annualized 0.8% in the first quarter, and disappointing performances from France and Italy are worrying. Stagnating confidence and activity indicators do not augur a sharp acceleration in growth this spring. Persisting serious tensions in Ukraine could also prompt the ECB to act, as they reduce the growth outlooks for Eastern Europe and put upside pressure on the euro. The ECB judges that nearly €160B (US$220B) in funds have been taken out of Russia and put into the euro zone, among others.

Forecasts: The next date to watch for the euro is June 5, when the ECB meeting takes place. A simple key rate cut may not be enough to satisfy the markets, and we will have to see if the ECB will announce more aggressive measures (negative deposit rate, securities purchases, etc.). If the ECB takes decisive action, the euro's new downtrend should be confirmed, and the currency could end 2014 at around US$1.32.

Euro and trend



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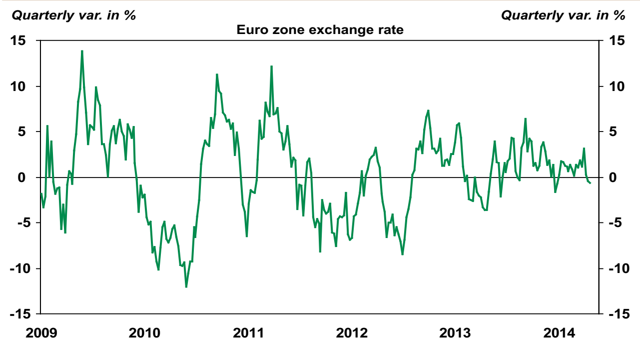
Euro: momentum



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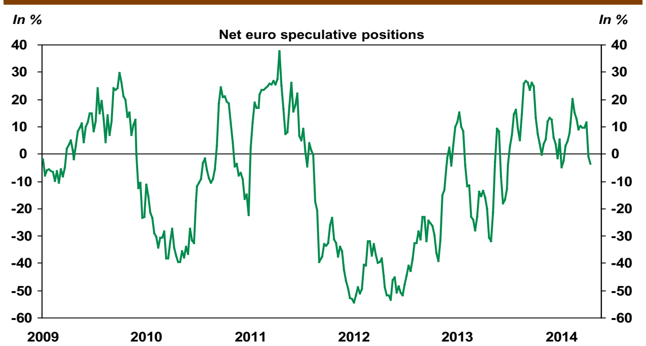
Euro: net speculative positions



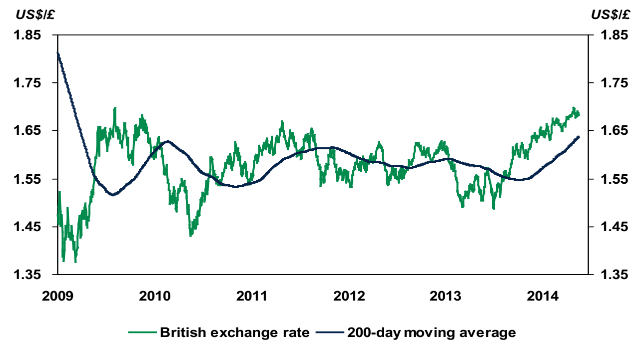
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

Outlooks remain favourable for the pound

- After touching US$1.70 in early May, the pound was dragged down against the greenback by the falling euro. Then, Governor Carney's fairly dovish remarks when he presented the Inflation Report and data showing that wage growth has slowed brought the pound to around US$1.675 in mid-May. Unlike the euro, though, the pound quickly bounced back, as Britain's retail sales and inflation accelerated more than expected in April, with core inflation even returning to the 2% target. The minutes of the last monetary policy committee meeting also revealed a wide range of opinions about the spare capacity of Britain's job market and the appropriate path of monetary policy. The pound thus recently climbed back over US$1.685 and hit its highest point against the euro since the end of 2012.
- We continue to expect Britain's key rates to go up in spring 2015. However, some investors will continue to expect a hike by the end of 2014, which will support the pound. Unlike the European Central Bank, the Bank of England will not fight currency appreciation, which will help subdue inflationary pressures. **After considerable gains, the pound should be fairly stable against the greenback over the coming months, though it should continue to appreciate against the euro.**

British pound and trend



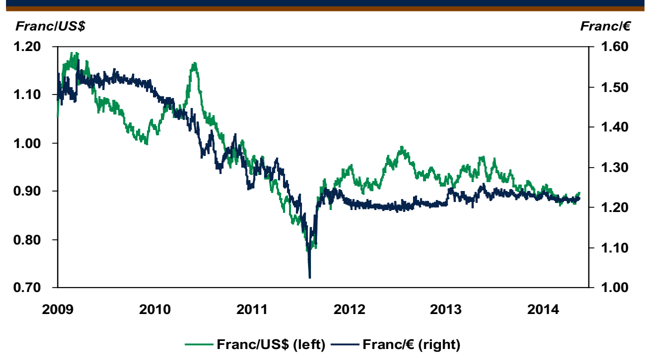
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

A calmer Ukraine could hurt the Swiss franc

- Like the euro, the Swiss franc appreciated against the dollar in late April and early May before retreating more than 2% after the European Central Bank meeting. The USD/CHF pair therefore went from around 0.875 francs in early May to nearly 0.895 francs recently. Although this movement is largely attributable to the euro's, note that the Swiss franc also edged back against the common currency, with the EUR/CHF pair climbing above 1.22 francs. As the Swiss National Bank expects the economy to grow about 2% this year and zero inflation, nothing suggests that its monetary policy will change. **Like the euro, the Swiss franc should continue to retreat against the greenback over coming quarters. Further developments in Ukraine following the election will have a considerable influence on the EUR/CHF pair.**

Swiss franc

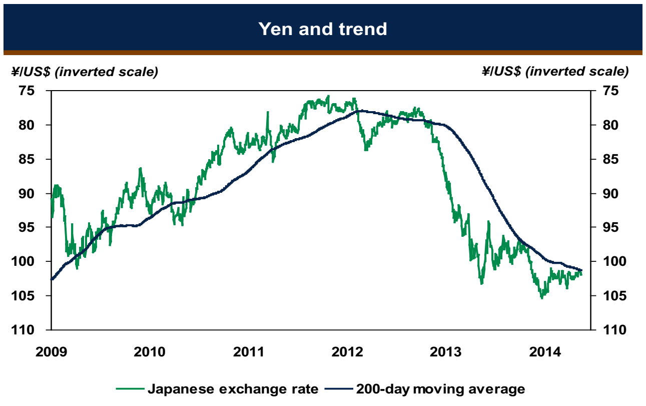


Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

Japan’s economy will still need the Bank of Japan

- The yen continues to stagnate. For now, a safe haven effect is preventing it from depreciating further. What’s more, economic data is generally better in Japan than in other advanced nations, with Japan posting very strong economic growth in the first quarter. Real GDP grew an annualized 5.9%, mainly driven by an 8.5% jump in consumer spending. However, this good result is associated with a temporary phenomenon. April’s sales tax hike prompted consumers to move up some purchases, which means some pullback can be expected in the second quarter.
- The next economic data from Japan should therefore show less strength, while some improvements are expected for the other advanced economies. This context will be conducive to further depreciation by the yen. We can also expect the Bank of Japan to continue its security purchases in 2015, possibly accelerating the pace. **Japan’s exchange rate should approach ¥110/US$ by year’s end.**

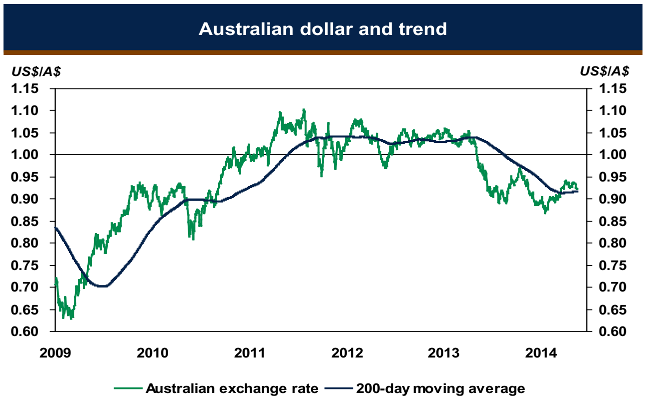


Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The currency remains overvalued

- The Australian dollar has been oscillating between US$0.92 and US$0.94 since the end of March. The Reserve Bank of Australia (RBA) no longer seems willing to further relax its monetary policy, which is lending some support to the currency. The job market’s recent performance and the lively real estate sector are other strong points.
- Australia’s currency remains quite vulnerable to headwinds, though. For example, it depreciated abruptly in April following the release of weaker-than-expected inflation figures and the publication of the minutes from the latest monetary policy meeting. The minutes contained a warning about Australia’s economic growth, among other things. The RBA believes that growth will remain below potential over the coming quarters, due to soft exports, weaker mining investments and the budget consolidation announced by the government. **These economic outlooks do not mesh with a strong currency, prompting us to expect levels close to US$0.90 for the coming quarters.**



Sources: Datastream and Desjardins, Economic Studies

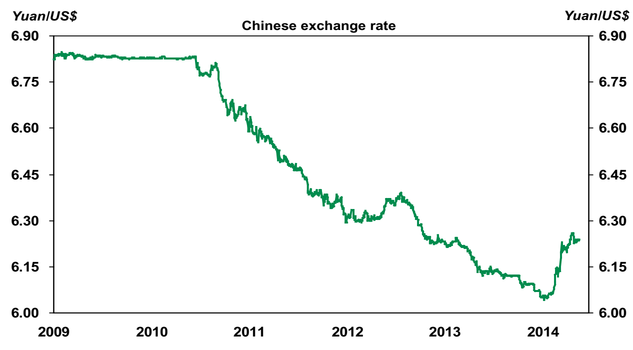
EMERGING CURRENCIES

Weak U.S. bond yields contribute to the lull

CHINESE YUAN (CNY)

- The yuan continued to depreciate, and the gains made since the start of 2013 have been erased. Monetary authorities wish to put an end to capital inflows speculating on the yen's continued revaluation. The timing of currency depreciation coincides with a deceleration by the Chinese economy, which may make this movement more believable. However, from a fundamental point of view, the yuan is still clearly overvalued. The fact that China's foreign currency reserves are rising more quickly than they did last year reflects the increased efforts by monetary authorities to control the exchange rate. **We still believe that revaluation will resume this year, but the 6.00 yuan/US$ mark seems more difficult to reach.**

Chinese yuan and trend

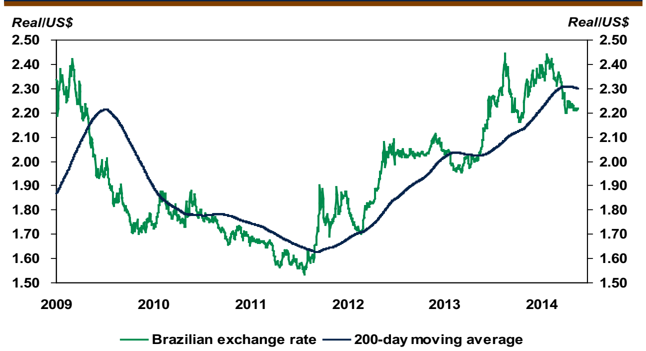


Sources: Datastream and Desjardins, Economic Studies

BRAZILIAN REAL (BRL)

- Brazil's exchange rate stabilized at close to 2.20 reals/US$ in April, when fears about several emerging nations eased considerably. The calmer environment for emerging currencies is, however, closely tied to the pullback in U.S. bond yields. A rebound in yields could quickly encourage investors to pull their money out of emerging nations. From a fundamental point of view, the real does not have many pillars. Economic growth remains fragile, inflation is high, and the current account is in deficit. **A depreciation of Brazil's exchange rate seems likely in the short term, returning close to 2.30 reals/US$.**

Brazilian real and trend



Sources: Datastream and Desjardins, Economic Studies

MEXICAN PESO (MXN)

- The Mexican peso has done well recently, appreciating by nearly 2% against the U.S. dollar since the beginning of May, with the USD/MXN pair dropping back below 12.90 pesos. In addition to the renewed calm in the financial markets, the peso is clearly benefiting from signs of a springtime rebound in the U.S. economy. Recently, the Bank of Mexico considerably downgraded its economic growth forecast for the year, although it noted that the Mexican economy showed signs of picking up. As inflation seems to be under control, nothing points to future changes in Mexico's monetary policy. **The peso will remain vulnerable to evolving international tensions, but the Mexican economy's better position should continue to favour the currency over those of other emerging economies.**

Mexican peso and trend

Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

	Spot price	*Percentage return since*				*Last 52 weeks*		
Country – Currency*	May 26	1 month	3 months	6 months	1 year	Higher	Average	Lower
Americas								
Argentina – peso	8.0638	0.7811	2.2799	32.2739	53.0559	8.0700	6.5397	5.2663
Brazil – real	2.2208	-0.6242	-5.3327	-3.5211	8.3925	2.4513	2.2813	2.0489
Canada – dollar	1.0855	-1.5867	-2.2777	2.9790	5.1334	1.1252	1.0651	1.0167
Canada – (CAD/USD)	0.9213	1.6122	2.3308	-2.8928	-4.8828	0.9836	0.9389	0.8888
Mexico – peso	12.8603	-2.1029	-3.2649	-1.7063	2.8902	13.5050	13.0312	12.4578
Asia and South Pacific								
Australia – (AUD/USD)	0.9237	-0.4156	2.9973	1.1869	-4.2581	0.9773	0.9191	0.8684
China – yuan renminbi	6.2395	-0.2271	1.8719	2.4086	1.7589	6.2594	6.1274	6.0412
Hong Kong – dollar	7.7535	0.0006	-0.1005	0.0142	-0.1230	7.7673	7.7562	7.7516
India – rupee	58.7150	-3.1825	-5.2755	-6.0710	5.1863	68.8050	61.2350	55.5725
Japan – yen	101.9550	-0.2104	-0.4103	0.6466	0.6565	105.3150	100.6883	94.0850
New Zeland – (NZD/USD)	0.8549	-0.3249	2.8298	4.3344	5.5912	0.8742	0.8235	0.7708
South Korea – won	1,024	-1.6947	-3.8909	-3.4058	-9.1728	1,161	1,079	1,022
Europe								
Denmark – krona	5.4696	1.3602	0.3164	-0.4767	-5.0714	5.8361	5.5180	5.3568
Euro zone – (EUR/USD)	1.3651	-1.3442	-0.1134	0.6710	5.5759	1.3933	1.3522	1.2786
Norway – kroner	5.9573	-1.0399	-1.6135	-2.2448	2.1397	6.2863	6.0143	5.7167
Russia – ruble	34.1780	-5.1349	-5.0395	3.7261	9.0938	36.6510	33.6031	31.3290
Sweden – krona	6.6218	0.5001	1.6424	0.7164	-0.2816	6.7935	6.5223	6.3189
Switzerland – swiss franc	0.8942	1.4926	0.2467	-1.5253	-6.9369	0.9760	0.9088	0.8712
United Kingdom – (GBP/USD)	1.6846	0.2052	1.2532	4.1033	11.2755	1.6993	1.6121	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

		2013		*2014*				*2015*			
End of period		Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
American dollar											
Canadian dollar	(USD/CAD)	1.0310	1.0623	1.1050	1.0929	1.0870	1.0811	1.0753	1.0753	1.0695	1.0638
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	1.6800	1.6800	1.6900	1.7000	1.7000	1.6900	1.6800
Swiss franc	(USD/CHF)	0.9052	0.8908	0.8869	0.9000	0.9200	0.9300	0.9500	0.9600	0.9700	0.9800
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	6.1000	6.0500	6.0000	6.0000	5.9500	5.9000
Mexican peso	(USD/MXN)	13.09	13.04	13.06	13.00	12.95	12.75	12.65	12.50	12.40	12.30
Brazilian real	(USD/BRL)	2.2297	2.3423	2.2627	2.2800	2.3000	2.2800	2.2500	2.2000	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	0.9150	0.9200	0.9250	0.9300	0.9300	0.9350	0.9400
Euro	(EUR/CAD)	1.3955	1.4638	1.5229	1.4754	1.4457	1.4270	1.4086	1.3978	1.3797	1.3617
British pound	(GBP/CAD)	1.6695	1.7594	1.8421	1.8361	1.8261	1.8270	1.8280	1.8280	1.8075	1.7872
Swiss franc	(CAD/CHF)	0.8780	0.8386	0.8027	0.8235	0.8464	0.8603	0.8835	0.8928	0.9070	0.9212
Yen	(CAD/JPY)	95.28	99.14	93.41	95.16	98.44	101.75	104.16	105.09	106.59	108.10
Australian dollar	(AUD/CAD)	0.9605	0.9473	1.0237	0.9945	0.9783	0.9730	0.9785	0.9785	0.9840	0.9894
Chinese yuan	(CAD/CNY)	5.9377	5.6989	5.6267	5.6273	5.6120	5.5963	5.5800	5.5800	5.5633	5.5460
Mexican peso	(CAD/MXN)	12.70	12.27	11.82	11.90	11.91	11.79	11.76	11.63	11.59	11.56
Brazilian real	(CAD/BRL)	2.1628	2.2049	2.0478	2.0862	2.1160	2.1090	2.0925	2.0460	2.0570	2.0210

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