FX Forecasts

Desjardins Economic Studies
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The U.S. dollar's rebound is largely due to the euro

HIGHLIGHTS

- The coming monetary firming in the United States should support the U.S. dollar. Appreciation should be more pronounced against the euro and yen, due to more divergent monetary policies.
- Given the Canadian dollar's recent gains, our forecast for the end of the year has been upgraded slightly, to US$0.93 (C$1.075/US$). Expected improvements to the U.S. economy should help gradually ease fears about the future of Canadian economy.
- With its recent actions, the European Central Bank has clearly signalled that it will not tolerate an overly strong euro. This, combined with the widening divergence between Euroland's economy and those of the United States and United Kingdom, should keep the euro on a downtrend.
- The recent slide by inflation should allow the Bank of England to wait until Q1 2015 before initiating monetary firming. In this context, it will probably be early 2015 before we see the pound go over US$1.70 sustainably.

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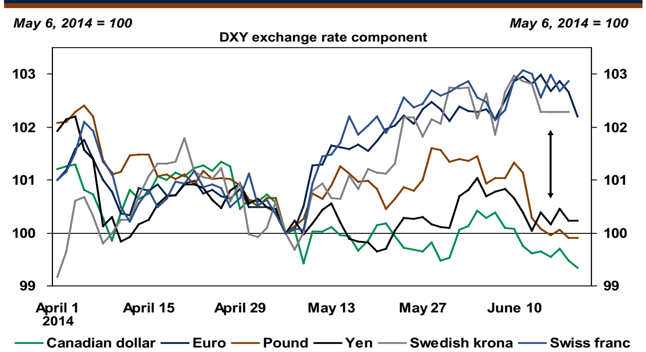
Editorial

Since May, the U.S. dollar has been rebounding again, as shown with the DXY exchange rate index moving up. However, this movement has not spread to include most currencies in the index and remains primarily attributable to the euro's decline (graph 1). The euro began trending down in May after the European Central Bank clearly opened the door to intervention in June, which in the end did take place. The euro's slide is also dragging the Swiss franc in its wake, given the exchange rate ceiling policy applied by the Swiss National Bank. The Swedish krona is also under pressure, though this is mostly due to factors specific to Sweden, including expectations of monetary easing.

Graph 1 – The U.S. dollar's rebound is not widespread



Sources: Datastream and Desjardins, Economic Studies

THE YEN, THE POUND AND THE CANADIAN DOLLAR HOLD FIRM

High hopes were pinned on the yen's depreciation to support an eventual rebound by the U.S. dollar. With the Bank of Japan in no hurry to announce new measures to ensure its inflation target is reached in a lasting fashion, the yen has been resilient since the start of the year and may continue to be so for several more months.

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

The pound's strength is less astonishing, as Britain's economy is doing well and monetary firming is expected earlier than it is for the other major economies. However, most of the pound's gains are probably behind us, and a slight retreat is expected in the coming months. As for the Canadian dollar, accelerating inflation in Canada is helping it, but more recently, it also seems to be getting an edge from the surge by oil prices prompted by geopolitical strains.

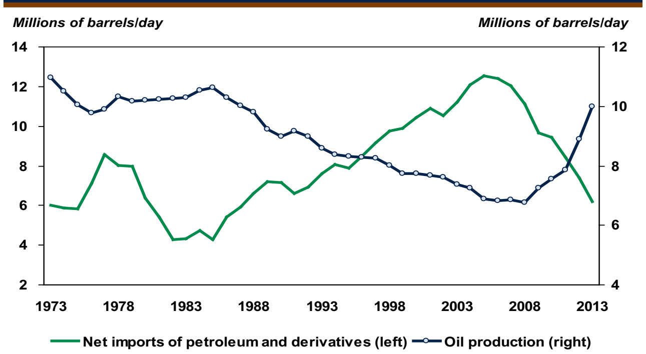
DO GEOPOLITICAL STRAINS CHANGE THE PICTURE?

The Russian-Ukranian conflict and the insurrection in Iraq have dramatically heightened world geopolitical tensions, raising risks to the energy supply and price increases. Usually, these shocks are temporary, limiting their positive influence on petrocurrencies like the Canadian dollar. Among other things, Canada could have a hard time rapidly increasing its oil and natural gas exports to international markets, as it lacks adequate production and transportation capacities. All the same, these conflicts could accelerate investment in production and transportation in geopolitically stable countries; this would justify a more permanent positive effect for some currencies, including the loonie. The positive effect would then be more proportionate to the expected rise in economic activity and capital flows from investment, rather than the hike in energy prices.

To date, oil prices have only gone up a few dollars but, if they skyrocket, the risks of another global economic slowdown would become more important. We can assume that the U.S. dollar would then have a clear advantage over other currencies, given its role as a safe haven. Even petrocurrencies could run into trouble if global oil demand moves less favourably and less global capital is available to grow production capacities.

Another advantage for the greenback is reduced U.S. dependence on foreign oil. Oil production in the United States is up considerably, and the trade deficit in petroleum and derivatives is shrinking fast (graph 2).

Graph 2 – The United States less and less dependent on foreign oil



Sources: Energy Information Administration and Desjardins, Economic Studies

The rise by crude prices would then have less negative impact on the terms of trade and the U.S. economy. Often considered the second ranked safe haven, the yen may have a different fate, given Japan's stronger dependence on fossil fuel imports following its abandonment of nuclear power.

AND WHERE IS THE FEDERAL RESERVE IN ALL THIS?

The retreat by U.S. real GDP in the first quarter justified a downgrade to the economic growth forecast for 2014. However, if the expected rebound by the U.S. economy materializes in the second quarter and growth remains solid after that, the picture should not change for the conduct of U.S. monetary policy.

We still expect the Federal Reserve (Fed) to finish tapering its securities purchases this fall, with a first key rate hike in Q3 2015. The coming monetary firming should support the U.S. dollar. Appreciation should be more pronounced against the euro and yen, due to more divergent monetary policies.

The Fed remained cautious at its June 18 meeting, barely changing its statement. Its leaders see slightly higher potential for monetary firming in 2015 and 2016, followed by lower potential in subsequent years. This double revision did not put any additional upside pressure on bond yields and did not breathe new life into the greenback. We will probably have to wait for further reassurance from the U.S. economy before seeing more movement by yields and the greenback.

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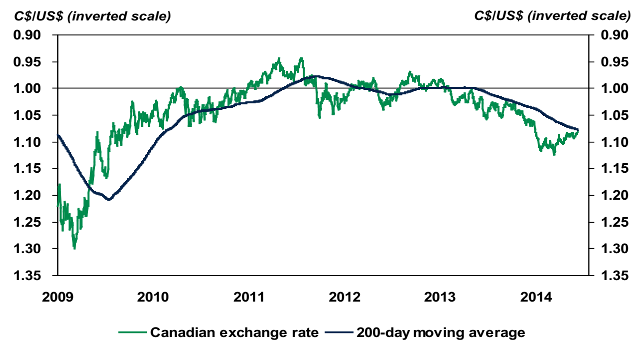
CANADIAN DOLLAR (CAD)

Rising oil prices lend a hand

- The Canadian dollar seems to be settling above US$0.92. The context appears much more favourable for the loonie since inflation has picked up in Canada and the possibility of a key rate cut was ruled out. More recently, the currency has also benefited from surging oil prices and the global energy supply risks behind the Russian-Ukrainian conflict and the jihadist advance in Iraq. Canadian oil is increasingly attractive compared with other, less geopolitically reliable sources.
- From a market standpoint, the Canadian exchange rate is gradually building momentum and could soon beat its 200-day moving average. Crossing this technical threshold could provide good support against further depreciation. That said, speculators are still not ready to bet on a lasting rebound by the Canadian dollar, keeping a surplus of short positions on the currency. Nevertheless, net speculative positions have tended to return to more neutral levels over the last several months.
- Despite rising inflation and oil prices, the fundamentals are not all favourable for the loonie's appreciation. Canada's real GDP advanced 1.2% in the first quarter, failing to meet expectations. For the first time since the 2008–2009 recession, the quarterly change to domestic demand was negative, at -0.3%. This emphasizes the fragility of Canada's economy, though part of this result can be attributed to the harsh weather last winter. A lot of hope is pinned on international trade to support Canada's economic growth in the coming quarters. A weak Canadian dollar would be appropriate in this context, especially since international competition remains fierce and productivity gains are slow to pick up in Canada.
- Though inflation has gone up, the Bank of Canada prefers to remain cautious with its message, now putting more emphasis on economic risks. We can assume that the Canadian dollar would have been even stronger without the adjustment to the monetary authorities's stance.

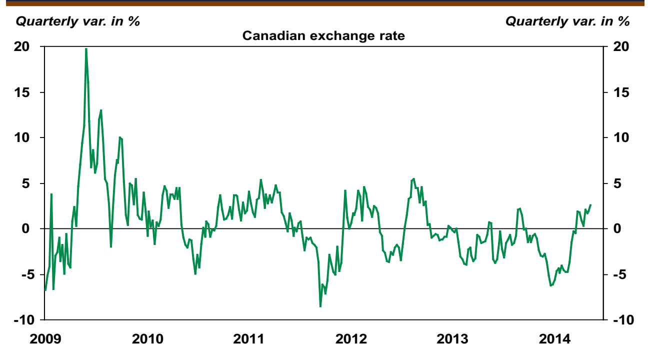
Forecasts: Given the Canadian dollar's recent gains, our forecast for the end of the year has been upgraded slightly, to US$0.93 (C$1.075/US$). Expected improvements to the U.S. economy should help gradually ease fears about the future of Canadian exports in the coming quarters. The currency could also continue to benefit from geopolitical strains in oil-producing regions for a while.

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

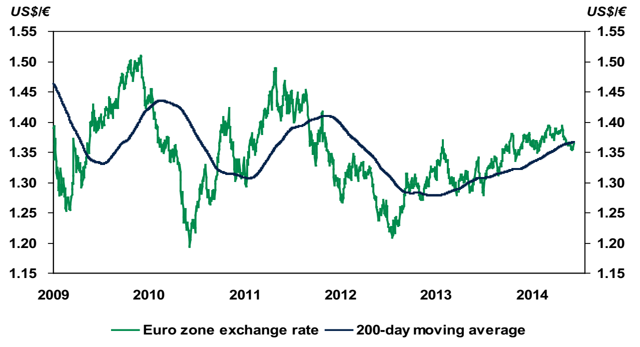
EURO (EUR)

The European Central Bank's increased credibility will play against the euro

- The euro began trending down after the European Central Bank (ECB) meeting on May 8 and continued on this path throughout the month. Note that statements from several ECB leaders and a further drop in inflation, which fell to just 0.5% in May, increasingly confirmed that ECB action in June was inevitable. The euro, which had been oscillating around US$1.390 in early May then fell close to US$1.360 before the June 5 meeting. Even though the ECB delivered the goods, the euro initially edged up—a clear case of "buy the rumour, sell the news"—before falling back to around US$1.355. Market indicators seem to confirm that the euro has changed its trend, as the currency's value has clearly crossed its 200-day average, and both momentum and net speculative positions have dropped into negative territory.
- Faced with an economy that remains sluggish, with real GDP growing an annualized 0.7% in the first quarter of 2014 and inflation moving dangerously close to zero, the ECB had to take decisive action at its June meeting. In addition to lowering its key rates and even taking the deposit rate into negative territory, the ECB has set up a targeted lending program to help financial institutions extend more credit to households and businesses. Note that ongoing soft credit is one of the main obstacles to a genuine European economic recovery. A potential asset-backed security purchasing program could help credit even more. The ECB confirmed that it would ramp up its preparations to implement such a program.
- Even though the ECB did not announce a program to buy sovereign bonds, it decided to stop sterilizing its prior purchases of peripheral nation bonds. With this symbolic decision, it is breaking a major taboo and making the likelihood of euro zone quantitative measures more credible if the situation continues to deteriorate. Though it is difficult to judge the real impact that the actions announced by the ECB have on the economy, the credibility of Europe's monetary authorities was certainly strengthened, making it quite unlikely the euro will take off again.

Forecasts: With its recent actions, the ECB has clearly signalled that it will not tolerate an overly strong euro. This, combined with the widening divergence between Euroland's economy and monetary policy, and those in the United States and United Kingdom, should keep the euro on a downtrend over the coming quarters.

Euro and trend



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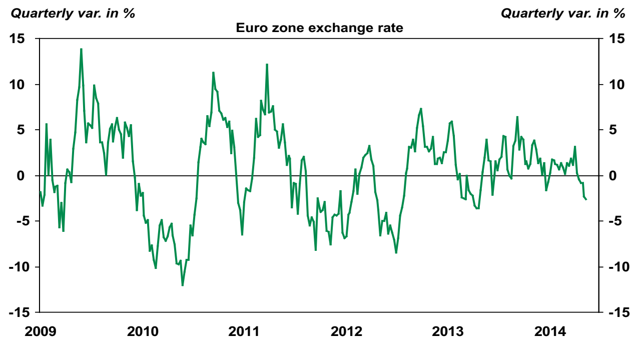
Euro: momentum



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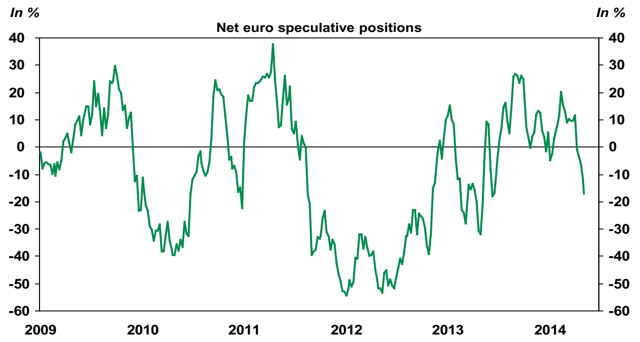
Euro: net speculative positions



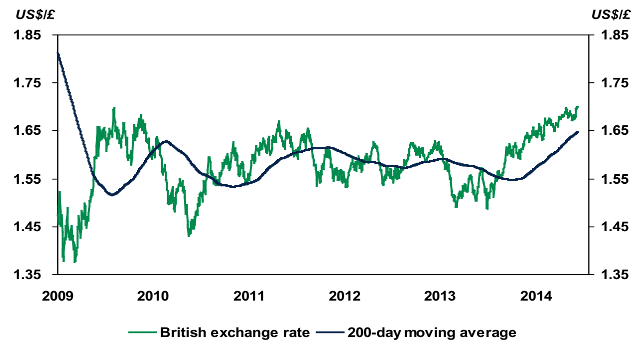
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

The debate heats up at the Bank of England

- After weakening to US$1.67 in late May, the pound quickly resumed its uptrend, boosted by new statistics confirming that Britain's economic recovery is robust, among other things. Governor Mark Carney's hawkish remarks even temporarily drove the pound above US$1.70 in mid-June, its highest point since summer 2009. Unsurprisingly, the pound also appreciated against the euro, with the EUR/GBP pair dropping below £0.80/€.
- Britain's robust economy and the idea that the Bank of England (BoE) will be the first G7 central bank to raise its key rate will be continue to give considerable supports to the pound. We already know that some BoE leaders feel that it will soon be appropriate to contemplate monetary firming. However, it was surprising to hear Governor Carney clearly signal that the first key rate hike could take place sooner than the market expects. The recent slide by inflation and deflationary pressures applied by the pound's appreciation should, however, allow the BoE to wait until Q1 2015 before initiating monetary firming. **In this context, it will probably be early 2015 before we see the pound go over US$1.70 sustainably.**

British pound and trend



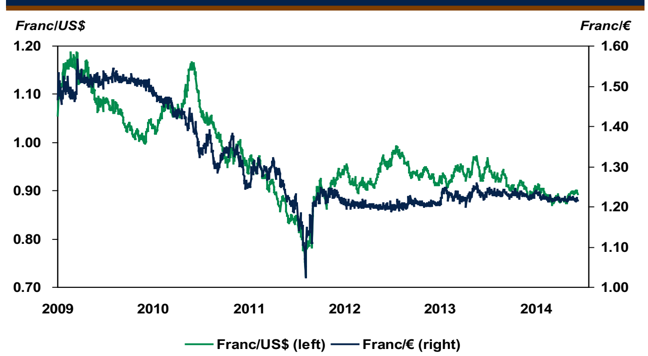
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

Slight appreciation by the franc

- The Swiss franc remained relatively stable against the U.S. dollar, and oscillated in a very tight band against the euro. All the same, this currency has appreciated slightly against the euro in the last few weeks, with the EUR/CHF pair going from 1.223 francs in mid-May to around 1.218 francs. The European Central Bank's aggressive measures and the downside pressures they are exerting on European rates are increasing the Swiss franc's appeal—a number of interest rates are already in negative territory there. Besides holding the floor rate at 1.20 francs/€ for a long time, we should not expect much from the Swiss National Bank, which remains preoccupied by the risk of a real estate bubble. **Surging geopolitical tensions should keep the franc close to its current levels over the coming months.**

Swiss franc



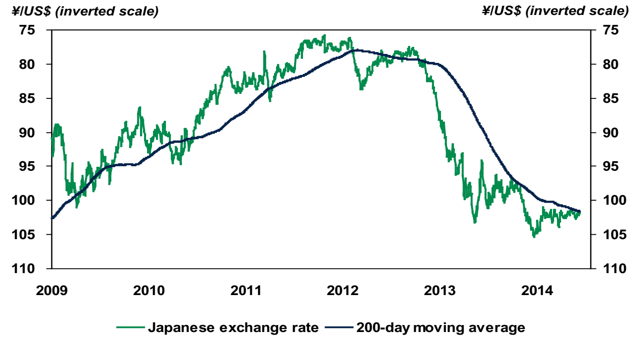
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

The Bank of Japan is in no hurry to do more

- Without any new measures from the Bank of Japan (BoJ), the exchange rate is holding at around ¥102/US$. The strong economic growth in the first quarter, which was even upgraded, also weighs in the balance. Even though spending growth should plunge in the second quarter after the sales tax hike comes into effect, we must all the same note that the acceleration by business investment could be more lasting. The BoJ seems to want to give the economy a chance to stay on the right track, especially since the government has just announced the broad outline of the structural reforms that will complete the three-phase plan promised in 2012. The BoJ also sees signs of resilience in consumption spending after the sales tax hike.
- The recent developments prompt us to reduce the yen's depreciation potential for the coming quarters. **The exchange rate should end the year at close to ¥107/US$.** Japanese and U.S. monetary policies will still move in opposite directions in 2015; this will be enough to let the yen trend down again soon.

Yen and trend



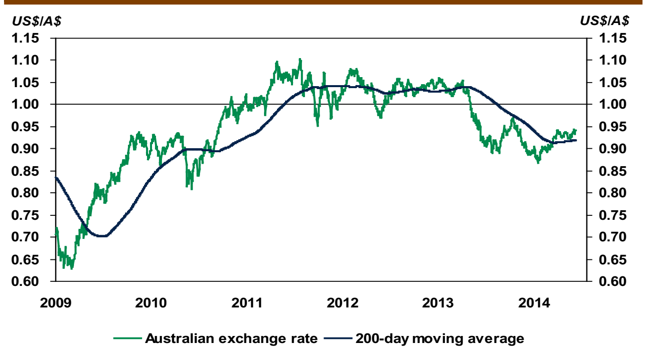
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The currency is still overvalued according to the Reserve Bank of Australia

- The Australian dollar continues to show signs of resiliency, recently hitting US$0.94. The race for returns in the financial markets seems to have benefited the currency, as Australia's interest rates are a bit higher than those of most other advanced nations. The Australian dollar also profited from the release of better-than-expected Q1 results for Australia's economy, as well as encouraging data from the United States and China.
- However, the Australian dollar's appreciation remains fragile. The exchange rate pains to stay above US$0.94. The Reserve Bank of Australia continues to stress that the exchange rate is high, historically speaking, curbing the adjustments expected to balance economic growth. Other activity sectors must make up for the drop in investment in natural resources and the budget consolidation announced by the government. **The exchange rate should hold close to US$0.90 until Australia's economic fundamentals improve further.**

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

The yuan's devaluation shows signs of flagging

CHINESE YUAN (CNY)

- China's authorities put an end to the yuan's revaluation in March, hoping to reduce the flow of speculative capital. The currency was devalued, but this movement is already flagging, with the exchange rate remaining rather flat since May. China's authorities could decide to prolong this plateau for some time, but eventually reappreciation should resume. The latest statistics on international trade and retail sales beat expectations, giving us some reassurance that China's economy will make a soft landing. All the same, **the caution displayed by authorities and the delays in revaluing the currency prompt us to upgrade our target for the end of the year to 6.10 yuan/US$**.

Chinese yuan and trend

Sources: Datastream and Desjardins, Economic Studies

MEXICAN PESO (MXN)

- The Bank of Mexico's (BoM) surprise decision to drop its key rate by 50 basis points on June 6 to a historic low of 3.00% hurt the peso. In two days, the USD/MXN pair went from around 12.85 pesos to over 13.00 pesos. Though soft inflation and disappointing economic growth in Q1 2014 give the BoM a lot of leeway, signs of accelerating activity in the spring, both in Mexico and the United States, could have led them to opt for the status quo. The BoM's recent decision shows that it is much more worried about Mexico's economic health than the solidity of the peso. **Key rates below the inflation rate and rising global geopolitical risks could limit the peso's appeal to foreign investors.**

Mexican peso and trend

Sources: Datastream and Desjardins, Economic Studies

BRAZILIAN REAL (BRL)

- The real had a tough time in early June, climbing close to 2.30 reals/US$. The currency was hurt by soft economic growth in Brazil and the Central Bank of Brazil's decision to keep its key interest rate unchanged despite higher inflation, among other things. However, the real's depreciation was short-lived, as the government announced that it was eliminating a 6% tax on bond transactions, making Brazilian securities more attractive. Still, **Brazil's economic fundamentals are not in line with a reappreciation by the currency, and the withdrawal of the tax on financial transactions could simply increase volatility**. If capital flows in more easily, it can flow out just as quickly.

Brazilian real and trend

Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

Country – Currency*	*Spot price* June 19	*Percentage return since* 1 month	3 months	6 months	1 year	*Last 52 weeks* Higher	Average	Lower
Americas								
Argentina – peso	8.1375	0.8364	2.3424	27.1782	52.2095	8.1438	6.7331	5.3463
Brazil – real	2.2279	0.7735	-4.4784	-5.4172	2.4652	2.4513	2.2895	2.1592
Canada – dollar	1.0832	-0.2211	-3.1042	1.3569	6.3006	1.1252	1.0693	1.0190
Canada – (CAD/USD)	0.9232	0.2216	3.2036	-1.3387	-5.9272	0.9814	0.9352	0.8888
Mexico – peso	12.9870	0.6393	-1.3933	0.1948	0.8719	13.5050	13.0456	12.4578
Asia and South Pacific								
Australia – (AUD/USD)	0.9398	0.7613	3.9380	5.9915	1.1184	0.9708	0.9175	0.8684
China – yuan renminbi	6.2292	-0.1331	0.5448	2.6008	1.6689	6.2594	6.1349	6.0412
Hong Kong – dollar	7.7507	-0.0187	-0.1919	-0.0368	-0.0883	7.7673	7.7554	7.7507
India – rupee	60.0950	2.9465	-1.4432	-3.3065	2.3416	68.8050	61.3968	58.2850
Japan – yen	101.9350	0.4187	-0.4006	-2.2159	5.6595	105.3150	100.9490	96.2200
New Zeland – (NZD/USD)	0.8717	1.0199	1.8131	6.4243	10.3644	0.8742	0.8272	0.7708
South Korea – won	1,019	-0.3180	-4.8344	-3.9053	-9.9094	1,161	1,071	1,016
Europe								
Denmark – krona	5.4791	0.6253	1.5391	0.3416	-2.3290	5.8361	5.5057	5.3568
Euro zone – (EUR/USD)	1.3632	-0.6378	-1.9950	-0.2671	1.7009	1.3933	1.3553	1.2786
Norway – kroner	6.1195	3.1678	1.3901	-0.5170	6.0021	6.2863	6.0278	5.7730
Russia – ruble	34.3487	-0.4918	-4.3663	4.1589	6.3659	36.6510	33.7883	31.6655
Sweden – krona	6.6970	1.6360	4.6039	1.5882	3.7394	6.7935	6.5293	6.3189
Switzerland – swiss franc	0.8917	0.0168	1.9260	-0.5631	-3.0128	0.9735	0.9057	0.8712
United Kingdom – (GBP/USD)	1.7055	1.3460	2.5680	4.2164	8.9049	1.7055	1.6219	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	1.0870	1.0811	1.0753	1.0695	1.0638	1.0695	1.0695
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	1.7000	1.6800	1.7000	1.7100	1.7000	1.6900	1.6800
Swiss franc	(USD/CHF)	0.9052	0.8908	0.8869	0.9000	0.9200	0.9300	0.9400	0.9500	0.9700	0.9800
Yen	(USD/JPY)	98.23	105.32	103.22	102.00	104.00	107.00	109.00	110.00	111.00	112.00
Australian dollar	(AUD/USD)	0.9317	0.8918	0.9264	0.9300	0.9100	0.9000	0.9100	0.9100	0.9200	0.9300
Chinese yuan	(USD/CNY)	6.1215	6.0540	6.2172	6.2200	6.1700	6.1000	6.0500	6.0000	6.0000	5.9500
Mexican peso	(USD/MXN)	13.09	13.04	13.06	13.05	12.95	12.75	12.65	12.50	12.40	12.30
Brazilian real	(USD/BRL)	2.2297	2.3423	2.2627	2.2500	2.3000	2.2800	2.2500	2.2000	2.2000	2.1500
Effective dollar*	(1973 = 100)	75.19	76.44	76.86	76.90	77.70	78.20	78.50	78.80	79.30	79.80
Canadian dollar											
American dollar	(CAD/USD)	0.9700	0.9414	0.9050	0.9200	0.9250	0.9300	0.9350	0.9400	0.9350	0.9350
Euro	(EUR/CAD)	1.3955	1.4638	1.5229	1.4674	1.4378	1.4194	1.4011	1.3830	1.3797	1.3690
British pound	(GBP/CAD)	1.6695	1.7594	1.8421	1.8478	1.8162	1.8280	1.8289	1.8085	1.8075	1.7968
Swiss franc	(CAD/CHF)	0.8780	0.8386	0.8027	0.8280	0.8510	0.8649	0.8789	0.8930	0.9070	0.9163
Yen	(CAD/JPY)	95.28	99.14	93.41	93.84	96.20	99.51	101.92	103.40	103.79	104.72
Australian dollar	(AUD/CAD)	0.9605	0.9473	1.0237	1.0109	0.9838	0.9677	0.9733	0.9681	0.9840	0.9947
Chinese yuan	(CAD/CNY)	5.9377	5.6989	5.6267	5.7224	5.7073	5.6730	5.6568	5.6400	5.6100	5.5633
Mexican peso	(CAD/MXN)	12.70	12.27	11.82	12.01	11.98	11.86	11.83	11.75	11.59	11.50
Brazilian real	(CAD/BRL)	2.1628	2.2049	2.0478	2.0700	2.1275	2.1204	2.1038	2.0680	2.0570	2.0103

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