FX Forecasts

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The U.S. dollar shoots up: The coming months could be less volatile

HIGHLIGHTS

- Some positive effects for the greenback promise to be temporary which points to less appreciation over the coming months.
- The euro should stabilise slightly below US$1.30. The European Central Bank was proactive in September, and the situation would have to degrade considerably to prompt it to new action.
- The release of more good economic data for Canada, as well as fewer uncertainties could breathe new life into the loonie over the coming months. The Canadian dollar should climb back to around US$0.93 (C$1.075/US$) by the end of the year. However, this improvement should not last very long in 2015, as we expect the Federal Reserve to begin monetary firming a few months before the Bank of Canada.
- Surveys showing a dramatic increase of voters in favour of Scotland's separation have led to a brutal drop in the pound. However, we have good reason to believe that the pound will resume its uptrend once the Scottish question is settled.

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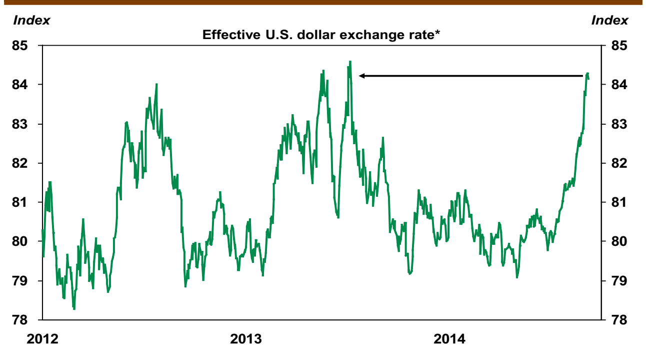
Editorial

Heightened geopolitical risk has increased volatility in the currency market, but other elements are magnifying these movements. For example, economic disappointments that materialized in several European countries and the monetary easing ordered by the European Central Bank (ECB) are hurting the euro. The yen is also struggling due to economic concerns. As for the pound, the political uncertainty created by the referendum on Scottish independence has considerably weakened it over the last few weeks. The U.S. dollar is the clear winner in this situation: it is close to peaks that date back more than a year (graph 1). Some positive effects for the greenback promise to be temporary, though, which points to less appreciation over the coming months.

Graph 1 – The DXY U.S. exchange rate index is at its highest since July 2013



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

HEADING FOR A SMALLER SAFE-HAVEN EFFECT

The U.S. dollar benefited from its role as a safe haven over the summer, when geopolitical tensions were on the rise. These tensions were largely fuelled by the conflicts pitting Ukraine against pro-Russian rebels, Israel against the Gaza strip, and Iraq against the Islamic State.

François Dupuis
Vice-President and 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.

Recent developments now suggest that the safe-haven effect will diminish. Ceasefires have been initiated between Israel and Gaza, as well as in Ukraine. While the risks of a relapse remain high, this is still a step in the right direction, and investor skittishness should gradually lessen. The conflict between the Islamic State and Iraq looks to be much longer, but the fact that many Western nations seem to want to get directly involved allows for a little more optimism.

FEWER WEAKNESSES IN SIGHT FOR OTHER MAJOR CURRENCIES

The reduced safe-haven effect is not the only vulnerability that could rein in the greenback over the short term. Several currencies that have struggled in the last few months could soon do better. This is especially true for the pound, which could rebound after the referendum in Scotland, when investor attention again turns to the likelihood of monetary firming in the United Kingdom.

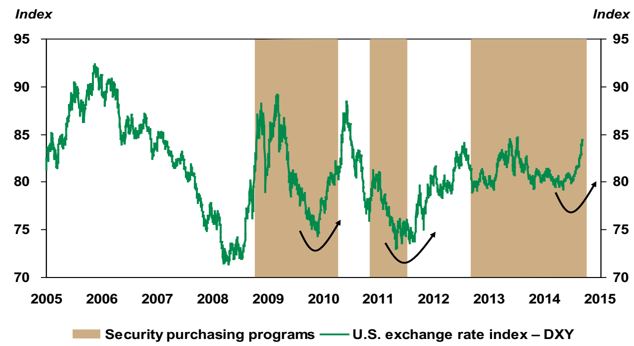
The chances that the euro will rebound are much smaller, but the pace of depreciation for the common currency should slow. The ECB has already made several announcements and may be more discreet at its next meetings. As for the yen, depreciation could also slow since the economic results for the third quarter could hardly be worse than they were for the second. The yen could depreciate further in the face of further intervention from the Bank of Japan, but this scenario is already partially priced into the currency's value.

FAVOURABLE WINDS FROM THE FEDERAL RESERVE

The U.S. dollar will not be short on support, however. Improved economic data in the United States should again favour the greenback, especially since this will allow the Federal Reserve (Fed) to slowly head toward monetary firming in 2015. The first step will be the end of the Fed's securities purchases, which is expected for October. The end of the last two security purchasing programs coincided with periods of sustained appreciation in the U.S. dollar (graph 2). However, these periods were curbed in by new economic disappointments and the return of expansionary monetary policy. If the U.S. economy holds its course as expected, the U.S. dollar's rise could last much longer this time.

However, in the short term, this will not be enough to keep up the pace of appreciation seen in recent months. Investors may not be surprised by the end of the securities purchases. The shift in the Fed's stance and signals about the first key rate hike could have a greater effect, though, if investors have not properly factored in the next steps for monetary firming.

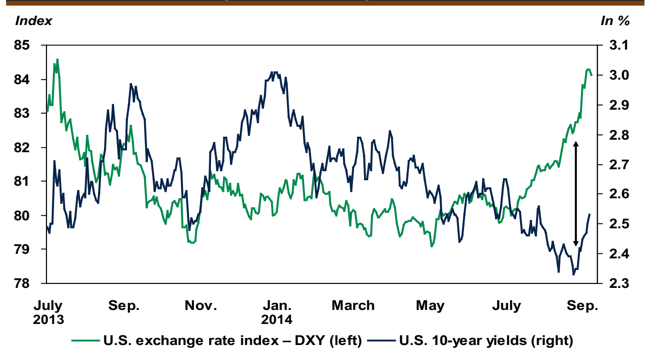
Graph 2 – The U.S. dollar shot up at the end of the previous security purchasing programs



Sources: Bloomberg and Desjardins, Economic Studies

However, we cannot rely on bond yield movements to judge investor expectations. The safe-haven effect from recent months muddied the picture by weighing down bond yields (graph 3). As the safe-haven effect wanes, the U.S. dollar and bond yields should converge again; during this adjustment period, the greenback may tend to remain relatively flat.

Graph 3 – The safe-haven effect caused bond yields and the exchange rate to diverge in the United States



Sources: Bloomberg and Desjardins, Economic Studies

François Dupuis
Vice-President and Chief Economist

Hendrix Vachon
Senior Economist

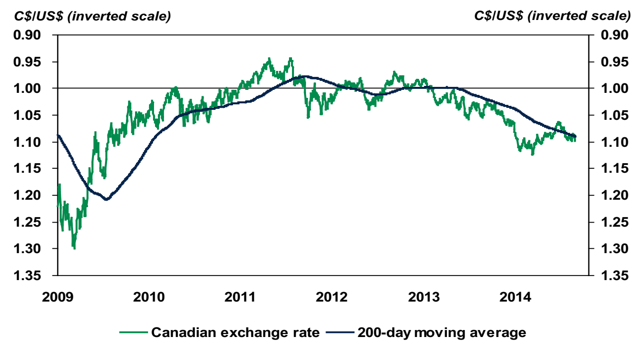
CANADIAN DOLLAR (CAD)

Another contraction after the early summer rebound

- The Canadian dollar has returned to around US$0.91 (C$1.10/US$) after temporarily reaching US$0.94 in early July. Inflation has not generated enough upside pressure for the loonie, as the latest figures show some stabilization on its part. Nor has the Canadian dollar escaped the U.S. dollar's general strength.
- From a technical standpoint, Canada's exchange rate seems to have reached a certain balance. It has close to zero momentum and the exchange rate is much closer to its 200-day moving average. After a long stay in negative territory, net speculative positions are now holding just inside positive territory, which shows that investors are less interested in betting on significant movement by the Canadian dollar.
- On a more fundamental level, recent economic developments have been rather positive in Canada. The second-quarter rebound in exports stimulated economic growth, and the available data for the third quarter bodes quite well. That said, many uncertainties remain. It is still too soon to say that the improvement in exports is sustainable, and business investments have yet to increase. Household debt is also a concern, as is the disappointing economic data recently released in Europe and Asia.
- In the face of these uncertainties, the Bank of Canada (BoC) prefers to remain cautious and maintain its neutral bias. The fact that the Canadian economy still has excess production capacity is helping to give the BoC some flexibility. Weaker inflation growth in recent months has also cooled investor enthusiasm, as an increasing number of them had been banking on a change in tone from the monetary authorities.

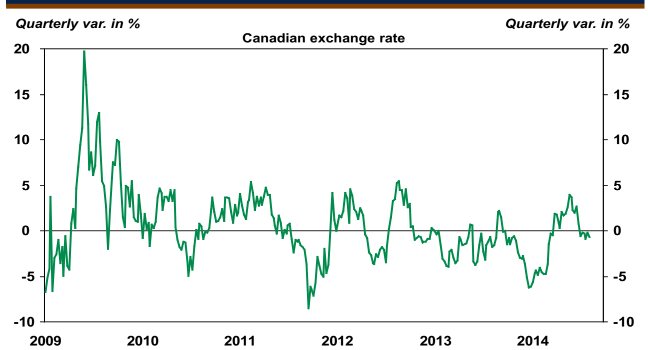
Forecasts: The release of more good economic data for Canada, as well as fewer national and international uncertainties could breathe new life into the loonie over the coming months. Though inflation figures should remain under control, the BoC should gradually adjust its stance if the economy shows clearer signs of improvement. The Canadian dollar should climb back to around US$0.93 (C$1.075/US$) by the end of the year. However, this improvement should not last very long in 2015, as we expect the Federal Reserve to begin monetary firming a few months before the BoC.

Canadian dollar and trend



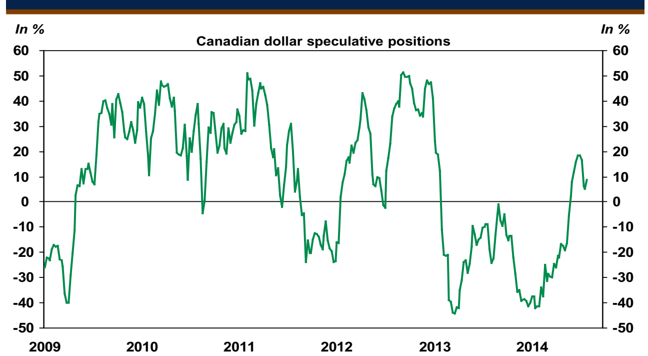
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

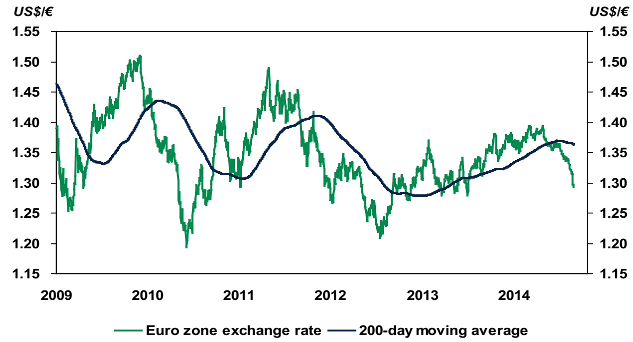
EURO (EUR)

The euro slide should pause soon

- The euro's downtrend, which began last spring, has continued in the last few months. The euro fell from US$1.39 in early May to around US$1.32 at the end of August. This slide then turned into a collapse as the euro fell below US$1.29 after the European Central Bank (ECB) announced new monetary easing measures on September 4.
- The euro's downtrend against the greenback and pound in recent months is fully justified by the relative performance of Euroland's economy. Britain's economy continues to grow at an impressive pace, and the U.S. economy bounced back in the second quarter of 2014 and is sending very encouraging signals for the future. In contrast, Euroland's economy stagnated during the second quarter and the downtrend of several leading indicators points to limited growth over the coming quarters. Inflation also continued to fall in the euro zone, hitting 0.3% in August; it is much closer to the monetary authorities' targets in the other major economies.
- This further erosion of the outlooks for economic growth and inflation convinced the ECB to announce a new set of monetary easing measures at its September meeting. An announcement was likely, as the ECB's president had shared his concerns about decreasing inflation expectations. However, the ECB caused some surprise when it cut its key rates by ten basis points, bringing the refinancing rate to just 0.05%. Furthermore, it announced that it would implement an asset-backed security purchasing program and a third covered bond purchasing program, to begin in October. With these measures, combined with the targeted longer-term refinancing operations (TLTRO), the ECB hopes to stimulate credit in the euro zone. A second goal for the ECB is to substantially increase the size of its balance sheet, bringing it close to where it was at the start of 2012. With this second objective, the ECB is approaching true quantitative policy, but the probability that it will move forward with massive federal bond purchases remains low.

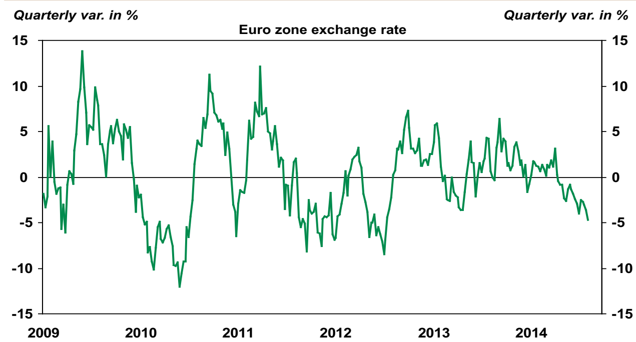
Forecasts: The euro should stabilise slightly below US$1.30. The ECB was proactive in September, and the situation would have to degrade considerably to prompt it to new action. Some easing of geopolitical tensions could also help the euro stabilize in the short term. However, increases to the ECB's balance sheet at a time when other banks will begin monetary firming should keep the euro on a downward trend in 2015.

Euro and trend



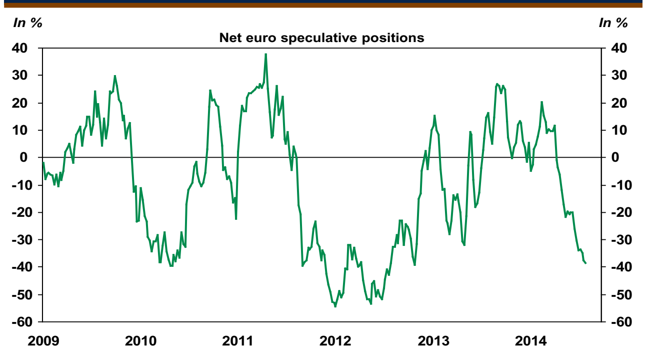
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



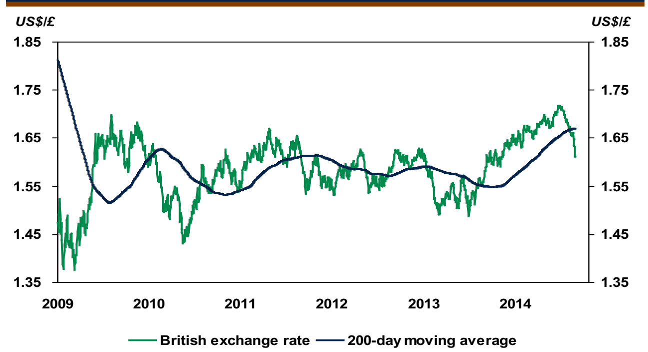
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

Fears of Scottish independence cause the pound to drop

- Until just recently, the pound sterling had continued to post impressive results, holding close to US$1.70 in spite of the greenback's rebound. Surveys showing a dramatic increase of voters in favour of Scotland's separation, however, have led to a brutal drop in the pound, which fell close to US$1.60. As the outcome of the September 18 referendum may be uncertain up until the last minute, we can expect the pound to remain quite volatile over the next few days.
- **However, we have good reason to believe that the pound will resume its uptrend once the Scottish question is settled.** Even if the Yes side win, this would not result in an immediate separation, but rather a long period of negotiation. The Scottish government expect that independence would not take effect until March 24, 2016, which should be enough time to implement measures that would limit financial strains. Besides this matter, the British economy's stellar performance should remain a considerable support for the pound. As the pound's strength cannot be relied on to curb inflation, the Bank of England won't be able to wait too long before beginning monetary firming. Governor Mark Carney recently indicated that key rate hikes could begin next spring.

British pound and trend



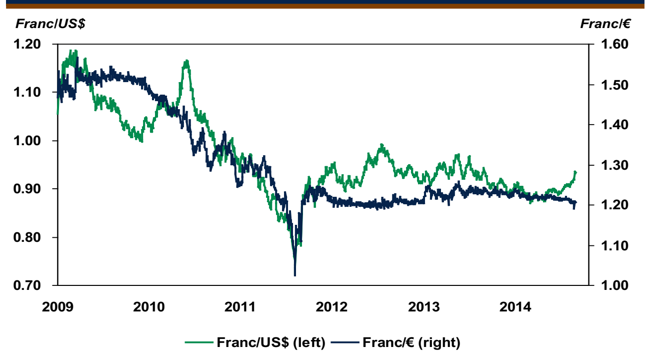
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

Increased pressure on the Swiss National Bank

- Like the other European currencies, the Swiss franc has depreciated considerably against the greenback lately. The USD/CHF pair recently climbed to around 0.94 francs, its highest in over a year. However, the franc has continued to appreciate against the euro, with the EUR/CHF pair even hitting 1.2044 francs/€ following the most recent announcements from the European Central Bank. The franc's strength against the euro is problematic for the Swiss National Bank (SNB), as inflation remains close to zero and the Swiss economy has disappointed, stagnating in the second quarter. In this context, the SNB could soon directly intervene to protect its floor price of 1.20 francs/€. It could even decide to lower some key rates into negative territory on September 18. **We therefore expect the franc to pull back slightly against the euro in the short term.**

Swiss franc

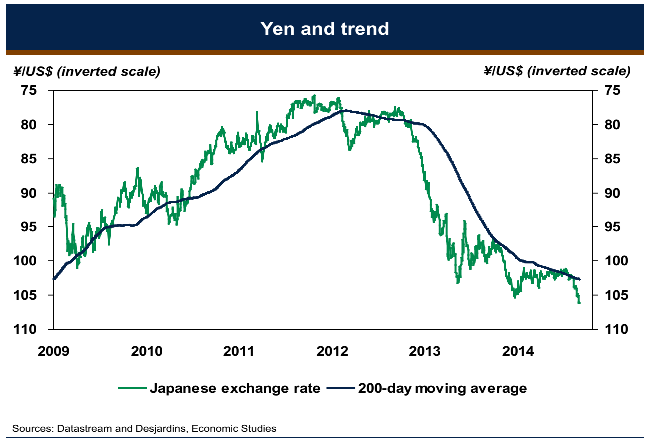


Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

Depreciation returns after several months of stability

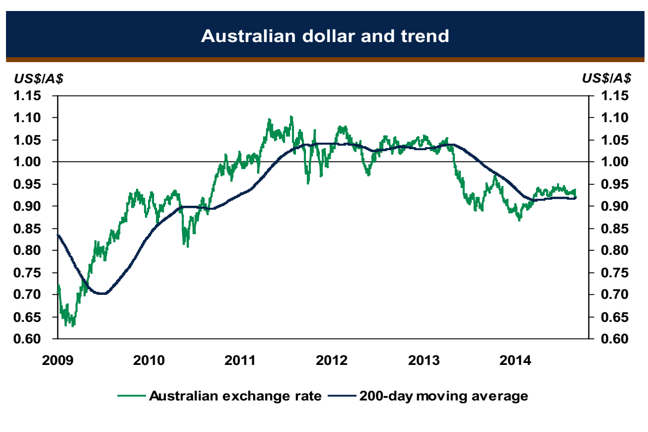
- The Japanese exchange rate was very stable at around ¥102/US$, but this ended in August. The yen even managed to stand up to the greenback's strength for much of the summer, but a series of economic disappointments for Japan changed the game, bringing the exchange rate over ¥106/US$, its peak since 2008. Among other things, it seems that the Japanese economy was more affected by April's sales tax hike than expected. Retail sales have not been able to return to their uptrend.
- Japan's soft economy increases the likelihood that the Bank of Japan will further expand its balance sheet in 2015. The inflation target will be even harder to hit if the economy derails again. For now, inflation remains artificially above 3% as a result of the sales tax increase. Without this effect, inflation is still well below the 2% target. Maintaining an accommodative monetary policy will continue to favour yen depreciation. Due to recent movements, **our end-of-year target has been revised to ¥108/US$**.



AUSTRALIAN DOLLAR (AUD)

Uncertainties in Asia weigh the currency down

- The U.S. dollar's climb in July and August caused the Australian dollar to retreat to around US$0.93. More recently, the Australian currency fell below US$0.92, due to worries about Asia, including Japan's economic difficulties and the drop in Chinese imports. Nationally, Australia's economy slowed in the second quarter, affected by falling exports and fewer investments in the mining sector.
- The future remains littered with obstacles for the Australian economy, and a weaker currency would offset the slowdown in the mining sector by supporting other sectors of activity. A decline in the terms of trade also calls for a more substantial slide of the currency, as the Reserve Bank of Australia (RBA) has noted. An interest rate cut could add weight to the RBA's words, but inflation of nearly 3% and the risk of a real estate bubble are limiting its capability to act in this direction. **We expect the Australian dollar to hold close to US$0.90 over the coming quarters.**



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EMERGING CURRENCIES

The strong greenback does not leave emerging currencies unscathed

CHINESE YUAN (CNY)

- China's monetary authorities began revaluing the yuan again last spring, but the pace has clearly slowed in recent weeks. Most other emerging currencies depreciated against the U.S. dollar over the summer, but not the yuan. We can understand that the temptation of stopping revaluation goes up when other competing currencies are depreciating. The still-mixed figures coming from China could also prompt monetary authorities to act cautiously. The new pause may be short-lived, however, if the pace of U.S. dollar appreciation slows as expected in the coming months and China's economy continues its soft landing. **China's exchange rate currently stands close to 6.15 yuan/US$ and we expect it to reach 6.10 yuan/US$ by the end of the year.**

MEXICAN PESO (MXN)

- Until recently, the Mexican peso had stood up well to the greenback's appreciation, with the USD/MXN pair holding close to 13.00 pesos/US$. However, the last few days have been more difficult, and the pair climbed above 13.20 pesos/US$. The latest economic figures are fairly positive, however. Mexico's economy bounced back in the second quarter, and signs of robust U.S. demand, in the automotive sector, among others, are encouraging for the second half of 2014. Even though inflation is slightly above its 4% target, and growth outlooks are improving, the Bank of Mexico should wait several months before raising its key rates. **We continue to expect gradual appreciation of the peso in the coming quarters.**

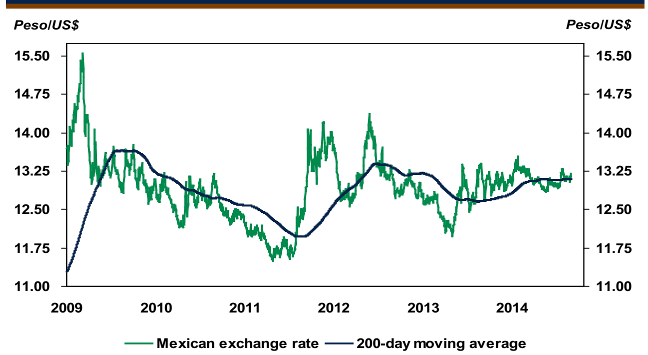
BRAZILIAN REAL (BRL)

- The Brazilian real has neared the 2.30 reals/US$ mark several times since the end of July. Besides the effect of a stronger U.S. dollar, the currency was hurt by disappointing economic figures for Brazil. Real GDP pulled back in the first and second quarters, which technically means Brazil is in a recession. The World Cup is being blamed for second quarter results, as several days of vacation were granted for the event. The effects may also be felt in the third quarter. **The real should remain under pressure over the coming months. The climb in U.S. bond yields could add to the magnitude of this depreciation.**

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

	Spot price	*Percentage return since*				*Last 52 weeks*		
Country – Currency*	**Sep. 10**	**1 month**	**3 months**	**6 months**	**1 year**	**Higher**	**Average**	**Lower**
Americas								
Argentina – peso	8.4100	1.6621	3.4122	6.9566	47.2532	8.4200	7.3493	5.7113
Brazil – real	2.2961	-0.1261	2.9850	-2.0791	1.2033	2.4396	2.2789	2.1592
Canada – dollar	1.0966	-0.1093	0.4535	-1.2606	5.8906	1.1252	1.0784	1.0224
Canada – (CAD/USD)	0.9120	0.1094	-0.4514	1.2767	-5.5629	0.9781	0.9273	0.8888
Mexico – peso	13.2090	-0.2145	1.2785	-0.0976	0.9940	13.5050	13.0753	12.7035
Asia and South Pacific								
Australia – (AUD/USD)	0.9157	-1.3140	-2.3075	1.5154	-1.6528	0.9708	0.9226	0.8684
China – yuan renminbi	6.1294	-0.4353	-1.5278	-0.1491	0.1536	6.2594	6.1459	6.0412
Hong Kong – dollar	7.7507	-0.0116	-0.0116	-0.1366	-0.0516	7.7673	7.7541	7.7500
India – rupee	60.9300	-0.3516	2.8962	0.1397	-4.5657	63.8450	61.1341	58.2850
Japan – yen	106.8450	4.6884	4.3867	3.4668	6.4087	106.8450	101.8480	96.7100
New Zeland – (NZD/USD)	0.8223	-2.8205	-3.5606	-2.9192	1.9242	0.8821	0.8427	0.8068
South Korea – won	1,024	-1.1819	0.6832	-3.9616	-5.5229	1,087	1,049	1,008
Europe								
Denmark – krona	5.7628	3.6540	4.6384	7.1512	2.5145	5.7732	5.4855	5.3568
Euro zone – (EUR/USD)	1.2917	-3.7124	-4.6435	-6.9383	-2.6382	1.3933	1.3601	1.2915
Norway – kroner	6.3435	1.7206	6.1372	6.5257	7.1655	6.3455	6.0707	5.8198
Russia – ruble	37.3360	2.9568	8.9326	2.5538	13.3343	37.4257	34.3626	31.6655
Sweden – krona	7.1041	2.9117	6.1216	11.5077	8.5623	7.1125	6.5922	6.3189
Switzerland – swiss franc	0.9376	3.6423	4.2415	6.7760	0.3049	0.9376	0.8988	0.8712
United Kingdom – (GBP/USD)	1.6147	-3.8783	-3.6661	-2.9161	2.7065	1.7170	1.6548	1.5722

* 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**	**Q2**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
American dollar											
Canadian dollar	(USD/CAD)	1.0310	1.0623	1.1050	1.0671	1.0870	1.0753	1.0695	1.0870	1.0989	1.0870
Euro	(EUR/USD)	1.3536	1.3780	1.3782	1.3691	1.2900	1.2800	1.2800	1.2600	1.2600	1.2500
British pound	(GBP/USD)	1.6194	1.6563	1.6672	1.7099	1.6400	1.6800	1.7000	1.6900	1.6800	1.6800
Swiss franc	(USD/CHF)	0.9052	0.8908	0.8869	0.8900	0.9400	0.9500	0.9500	0.9600	0.9700	0.9800
Yen	(USD/JPY)	98.23	105.32	103.22	101.33	106.00	108.00	108.00	109.00	110.00	110.00
Australian dollar	(AUD/USD)	0.9317	0.8918	0.9264	0.9432	0.9200	0.9000	0.9000	0.9100	0.9100	0.9200
Chinese yuan	(USD/CNY)	6.1215	6.0540	6.2172	6.2038	6.1500	6.1000	6.1000	6.0500	6.0000	6.0000
Mexican peso	(USD/MXN)	13.09	13.04	13.06	12.97	13.10	12.90	12.75	12.60	12.60	12.40
Brazilian real	(USD/BRL)	2.2297	2.3423	2.2627	2.2022	2.3000	2.3500	2.3200	2.3000	2.2500	2.2000
Effective dollar*	(1973 = 100)	75.19	76.44	76.86	75.91	79.70	79.90	79.70	80.70	81.10	81.20
Canadian dollar											
American dollar	(CAD/USD)	0.9700	0.9414	0.9050	0.9372	0.9200	0.9300	0.9350	0.9200	0.9100	0.9200
Euro	(EUR/CAD)	1.3955	1.4638	1.5229	1.4610	1.4022	1.3763	1.3690	1.3696	1.3846	1.3587
British pound	(GBP/CAD)	1.6695	1.7594	1.8421	1.8245	1.7826	1.8065	1.8182	1.8370	1.8462	1.8261
Swiss franc	(CAD/CHF)	0.8780	0.8386	0.8027	0.8341	0.8648	0.8835	0.8883	0.8832	0.8827	0.9016
Yen	(CAD/JPY)	95.28	99.14	93.41	94.96	97.52	100.44	100.98	100.28	100.10	101.20
Australian dollar	(AUD/CAD)	0.9605	0.9473	1.0237	1.0065	1.0000	0.9677	0.9626	0.9891	1.0000	1.0000
Chinese yuan	(CAD/CNY)	5.9377	5.6989	5.6267	5.8140	5.6580	5.6730	5.7035	5.5660	5.4600	5.5200
Mexican peso	(CAD/MXN)	12.70	12.27	11.82	12.15	12.05	12.00	11.92	11.59	11.47	11.41
Brazilian real	(CAD/BRL)	2.1628	2.2049	2.0478	2.0638	2.1160	2.1855	2.1692	2.1160	2.0475	2.0240

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