FX Forecasts

Desjardins Economic Studies
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The U.S. dollar should not rise as much in 2015

HIGHLIGHTS

- The U.S. dollar is capitalizing on U.S. monetary firming expectations at a time when other central banks are doing the opposite. Another factor currently benefiting the greenback is the safe-haven effect fueled by global economic uncertainty.
- The Canadian dollar could lose further ground in the near term, but this trajectory is expected to reverse slightly in the second quarter with the projected recovery by oil prices.
- The euro's current value already largely reflects the announcement of a sovereign security purchasing program by the European Central Bank and the election of an anti-austerity government in Greece. The onset of monetary firming in the United States toward the end of next summer could however take the euro a little lower in the second half of 2015.
- The Swiss National Bank triggered a shock wave on January 15, when it suddenly announced it was abandoning its floor rate. Everything suggests the Swiss franc will remain very strong in the near future.

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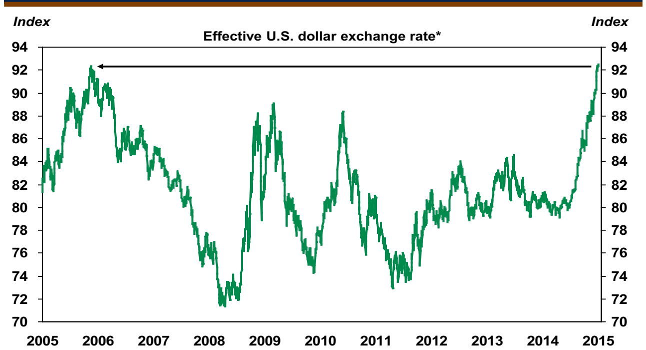
Editorial

The U.S. dollar got 2015 off to a good start following an extraordinary 2014, and recently beat a peak set in 2005 (graph 1). However, it would be very surprising to see it repeat last year's performance, although many of the factors involved in supporting appreciation persist. In particular, global economic uncertainty could act as a brake by reducing the Federal Reserve's (Fed) leeway for firming monetary policy.

Graph 1 – The U.S. dollar crossed a 10-year peak



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

MONETARY POLICY DIVERGENCES SHOULD EXPAND

Among other things, 2014 saw the Fed wrap up its quantitative easing. At the same time, other central banks opted to increase their monetary stimulus, such as the Bank of Japan (BoJ) and European Central Bank (ECB). For the latter, this constitutes a real about-face; prior to announcing new measures, the ECB's balance sheet was slightly smaller, which is more akin to a monetary firming situation.

The divergence between monetary policies will increase in 2015 (graph 2 on page 2). This will be the first full year since 2007 that the Fed will not have a specific security

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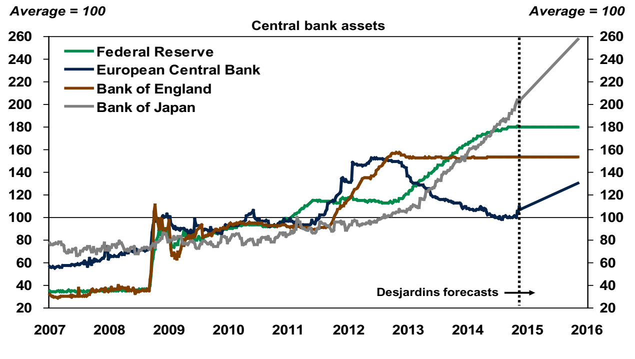
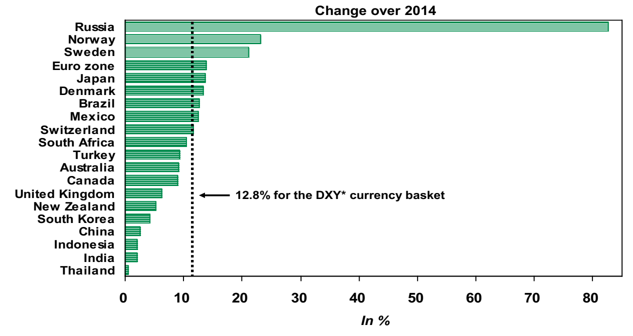
Graph 2 – The Bank of Japan and European Central Bank will expand their balance sheets in 2015



Sources: Datastream and Desjardins, Economic Studies

Graph 3 – U.S. dollar's gains against currencies of major advanced and emerging nations



* Currencies of Canada, the euro zone, the United Kingdom, Japan, Switzerland and Sweden.
Sources: Datastream and Desjardins, Economic Studies

purchasing program; moreover, it should start to raise its interest rates. The BoJ will pick up the pace on its purchases, taking them to ¥80,000B (US$680B) per year, making it the most interventionist central bank. The ECB plans to expand its balance sheet to its 2012 level within about two years. So far, the current measures have not substantially bulked up the ECB's balance sheet. However, additional announcements should come shortly to get it to that target, or even beyond it.

MONETARY FIRMING EXPECTATIONS AND THE SAFE-HAVEN EFFECT MAKE STRANGE BEDFELLOWS

The U.S. dollar is capitalizing on U.S. monetary firming expectations at a time when other central banks are doing the opposite. Another factor currently benefiting the greenback is the safe-haven effect fueled by global economic uncertainty. However, the co-existence of these two factors brings on somewhat of a contradiction. In fact, if the current fears grow or persist for several more months, monetary firming expectations will likely be downgraded in the United States. The U.S. economy is not isolated from the rest of the world and could feel the impact of a downturn in trade and global economic activity.

For now, concern about the U.S. economy remains contained and the greenback is not penalized by a change to monetary firming expectations. However, a decline by expectations would not necessarily hurt the greenback, as it would probably come at the same time as an increase in the safe-haven effect. The trouble these two factors have coexisting for a long period is still an argument in favour of less U.S. dollar appreciation in 2015.

AND THE OTHER CURRENCIES...

The greenback's 2014 gains varied substantially from currency to currency (graph 3). The U.S. effective exchange rate index gained about 13%, primarily boosted by the weak yen and euro. Blips in the Japanese and European economies may not affect these currencies as much this year. Moreover, fewer surprises are expected from the Japanese and European central banks.

Several commodity prices tumbled, including oil prices, which had a big impact on commodity currencies. The Norwegian krone leads the pack there. That said, commodity currencies could have a better year in 2015 if prices for oil and other natural resources swing up. Clearly, for such a rise to be both substantial and widespread, fears about the global economy would have to ebb, in particular about major resource consumers like China.

In some emerging nations, the situation should remain precarious, continuing to justify certain currencies' weakness. Especially, keep an eye on currencies that reacted sharply to the spring 2013 rebound in bond yields, as this scenario could recur with the onset of monetary firming in the United States.

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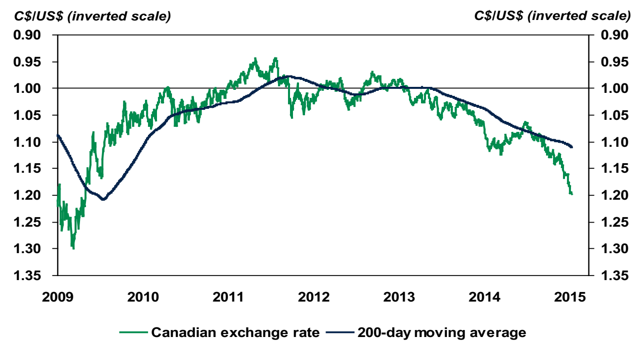
CANADIAN DOLLAR (CAD)

The drop in oil prices is still doing damage

- The Canadian dollar depreciated further in December and at the start of this year, with nothing seemingly poised to curb the plunge by oil prices. The loonie recently dropped below a threshold of US$0.84 (C$1.19/US$), a low that dates back to April 2009. Note that earlier in 2009, the Canadian dollar hit a cyclical low at US$0.7655, when fears about the global economy were much stronger than they are now and oil was oscillating under US$40/barrel.
- Technically, the loonie is pursuing the downtrend it started in 2013. Momentum recently dropped close to previous lows, but the net balance of speculative positions is well above the low levels we often saw in 2013 and early 2014. Speculators thus seem to think the loonie's slide could soon bottom out. This limit could be tied to the fact that oil prices cannot keep dropping for long and are likely to correct upwards in the coming months.
- Fundamentally speaking, the U.S. economy's good performance, which should create some positive ripples for Canada, is also a bright spot to consider. The overall state of Canada's economy is also encouraging against the backdrop of the recovery by manufacturing.
- That being said, new fears are emerging about Canada as a result of the soft oil prices. A big part of the economy depends on strong oil prices. In addition to erosion in the terms of trade, Canada could be hurt by a substantial drop in investment in oil and mining. While other sectors are benefiting from a more favourable environment, it could take some time for the positives to outweigh the negatives. This makes it very difficult for the Bank of Canada to firm up its monetary policy, especially as the forecast drop by inflation is giving it some additional room for patience. The markets are thus hesitant to position themselves for upcoming Canadian key interest rate hikes and cuts are even now expected.

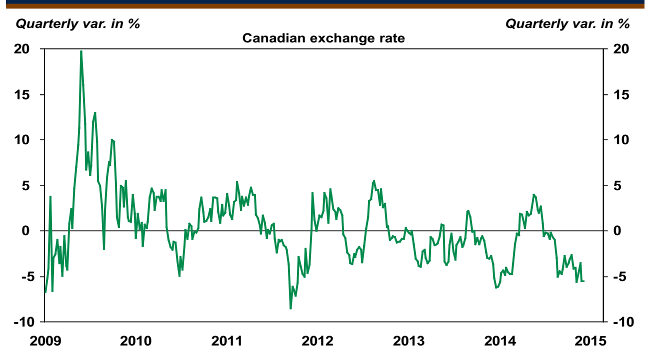
Forecasts: The Canadian dollar could lose further ground in the near term, but this trajectory is expected to reverse slightly in the second quarter with the projected recovery by oil prices. By year's end, the situation should be more favourable to Canadian monetary firming, which will help the loonie wind up the year at around US$0.86.

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)

Deflation is a drag on the euro

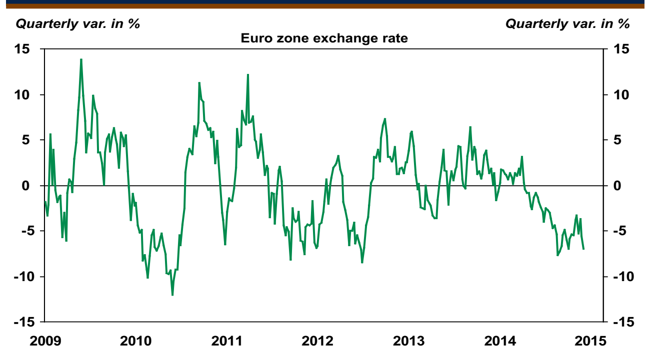
- The lack of announcements at the European Central Bank's (ECB) December 4 meeting helped the euro stabilize at around US$1.24 until mid-December. It then started to trend down again after the December 17 Federal Reserve (Fed) meeting, at which the Fed opened the door a little further to monetary firming. The retreat picked up speed when it became apparent that plunging oil prices would take the inflation rate into negative territory. Then, the euro dropped below US$1.15 after the Swiss National Bank's surprise decision to stop buying euros to weaken the Swiss franc.
- Sliding energy prices in fact pulled the euro zone's annual inflation rate down to -0.2% in December, according to the flash estimate. This technically means the euro zone is experiencing deflation. However, true deflation—which the central banks want to avoid at all costs—is defined as a widespread, sustained price decline. With the euro zone's core inflation index at 0.8%, it is too early to speak of true deflation, as some ECB leaders recently reminded us. Despite this, the spectacular plunge by oil prices will certainly have generated further deterioration in the euro zone's inflation outlook. Having repeatedly pledged to take action if the risks of lasting overly soft inflation increase, the ECB will have to make a substantial gesture in January to protect its credibility. The fact that the ECB will meet three days prior to a major election in Greece constitutes one more reason to keep from disappointing investors.
- Despite Germany's objections, the ECB will now very likely announce a sovereign security purchasing program at its January 22 meeting. Some sources are intimating that the ECB would buy up €500B (US$590B) in investment grade sovereign bonds, which would exclude riskier securities like Greece's. This would allow the ECB to expand its balance sheet substantially, as other major central banks have done in the past. With yields on European sovereign bonds already extremely low, it is hard to see how this quantitative easing program will help jump start the euro zone's economy. Its main benefit could be to consolidate the euro's recent slide.

Forecasts: The euro's current value already largely reflects the announcement of a sovereign security purchasing program and the election of an anti-austerity government in Greece. The onset of monetary firming in the United States toward the end of next summer could however take the euro a little lower in the second half of 2015.

Euro and trend

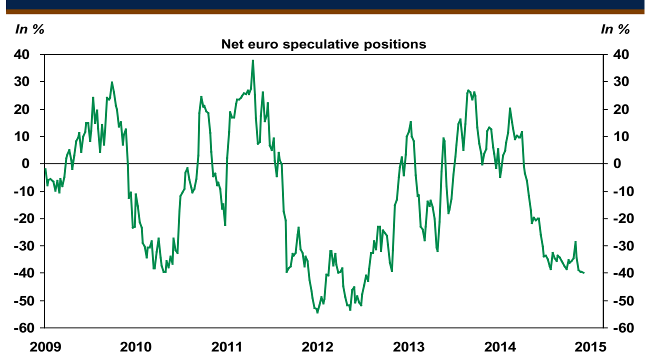
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



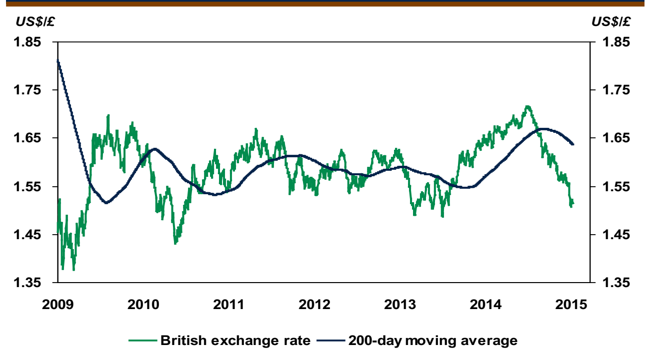
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

The United Kingdom's situation is different from the euro zone's

- After stabilizing around US$1.56, the pound sterling fell close to US$1.50 in early 2015, when the correction of oil prices and drop of certain manufacturing activity indexes prompted investors to once more push back their expectations for British key rate increases. Inflation slipped to 0.5% in December, its lowest point in nearly 15 years, confirming that the Bank of England (BoE) could afford to wait before kicking off monetary firming.
- However, Governor Carney gave the pound some support by stressing that the United Kingdom's situation was very different from the euro zone's, and that key rate increases were still to be expected. This took the pound near US$1.52 while the EUR/GBP pair fell below £0.77, its lowest point since 2008. **The pound could remain relatively weak in the coming months, but should start to trend up against the greenback toward the end of 2015, when the BoE starts to seriously contemplate raising its key rate.**

British pound and trend



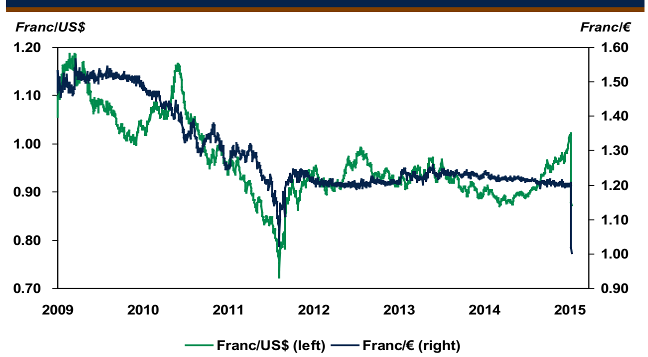
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

Swiss National Bank throws in the towel

- With its floor rate, 1.20 francs/€, getting increasingly tested by investors, the Swiss National Bank (SNB) introduced a -0.25% rate on certain deposits, on December 18, allowing it to aim for a negative three-month Libor rate. The SNB also started to sell francs on the market. Upside pressure on the Swiss franc remains intense, however, and the SNB triggered a shock wave on January 15, when it suddenly announced it was abandoning its floor rate. It tried to justify itself by saying that the euro's slide against other currencies had decreased the franc's overvaluation. Even though the SNB also announced another 50-point cut to the Libor rate, the franc jumped about 30% in the minutes after the news, then wiped out just over half of that gain. **With monetary authorities having lost a lot of their credibility, everything suggests the Swiss franc will remain very strong in the near future; this substantially increases the risks of prolonged deflation and recession in Switzerland.**

Swiss franc



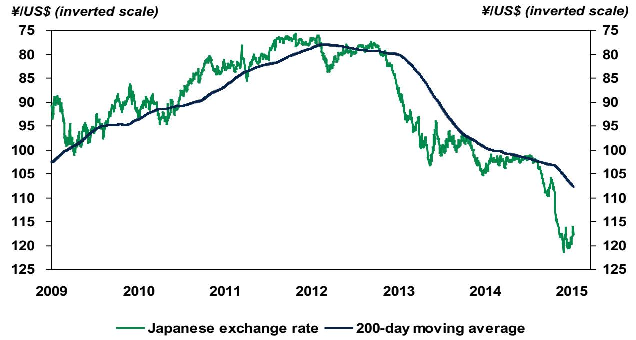
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

The pace of depreciation should slow in 2015

- The yen is on the rise at the start of the year after tumbling more than 15% in four months, taking the exchange rate to a 7-year record at ¥120.83/US$ in December. The widespread upswing in global fears makes the yen benefiting from a safe-haven effect and the USD/JPY pair recently dropped back below ¥117/US$.
- Subsequent to the sharp depreciation seen at the end of 2012 and in early 2013, the yen saw much greater stability, a scenario that could recur in 2015. Some factors continue to argue for further depreciation by the currency, such as the Bank of Japan's (BoJ) ongoing security purchases and the yen's appeal in financing carry trade transactions, but these factors are already largely priced in. The government opted to postpone the next sales tax increase to 2017, so the risk that Japan's economy will stumble as it did in Q2 of 2014 is smaller this year. The BoJ could still surprise the markets by expanding its easing measures again, with the goal of getting inflation to 2%. **Our year-end target for the USD/JPY pair remains at ¥125/US$.**

Yen and trend



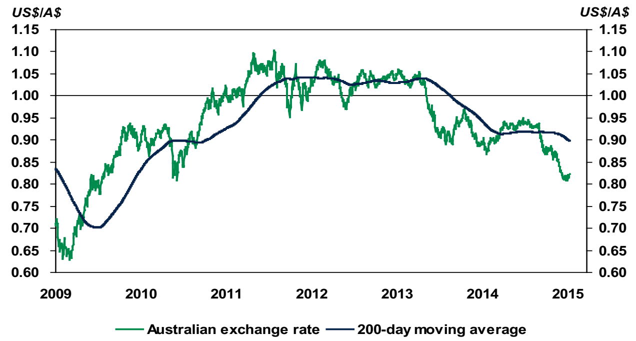
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The Reserve Bank of Australia should keep pushing for a soft currency

- The Australian dollar hit US$0.8033 on January 7, a low not seen since July 2009. Nonetheless, it is a little more stable than it has been in previous months, something that is less true for several other commodity currencies. As Australia is not a major oil producer, the drop in crude prices does not affect its currency, unless it pulls down in its wake prices for more sensitive commodities, such as iron ore and coal.
- **In the near term, the precarious Australian economy and the Reserve Bank of Australia's (RBA) cautious stance could make the dollar lose a little more ground.** Uncertainty about Chinese demand and decline in natural resource sector investment means the economy must rebalance toward other sectors, and a low currency would be best. Although the exchange rate is in the neighbourhood of US$0.80, the RBA should continue to say the currency is overvalued, given that the indicators used to assess its equilibrium value, such as the terms of trade, have kept declining in recent months.

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

Several emerging currencies ended the year under pressure

CHINESE YUAN (CNY)

- China's monetary authorities let the yuan depreciate in December, with the result that the exchange rate went back where it was two years ago. Several currencies are depreciating, including those of emerging nations that compete with China, likely making the authorities cautious in managing the exchange rate. China's situation is already delicate, as economic growth there has dropped substantially in the last few years, and erosion by the trade balance would not be welcome. **Given the U.S. dollar's forecast strength, it would be very surprising to see a substantial yuan revaluation in the next few quarters. It should end the year at around 6.15 yuan/US$.**

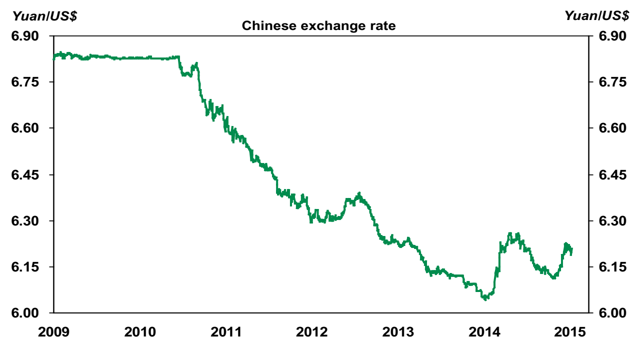
MEXICAN PESO (MXN)

- The peso's slide turned into a violent correction at the end of November. The USD/MXN pair jumped nearly 10% in just a few weeks, settling in at around 14.75 pesos. The intense volatility forced the Bank of Mexico (BoM) and government to reactivate a program that has them selling US$200M if the peso drops more than 1.5% in a single day. This seems to have helped curb the peso's tumble; the intervention mechanism was only used once. The peso is still very low, however, increasing the risk that inflation will stay above the 3% target. The BoM's governor recently stated that there was a high probability that Mexican key rates would go up this year. **The peso should strengthen a little over the coming quarters.**

BRAZILIAN REAL (BRL)

- Following a tough year end, the real stabilized above 2.60 reales/US$. The markets remain concerned about the state of Brazil's economy and the impact of Dilma Rousseff's re-election. Although the choice of the new finance minister was well received, the decision to cut some tax relief to reduce the public deficit is making some unhappy. Among other things, the government decided to bring back the sales tax on new motor vehicles. Dropping oil prices are adding to the problems, undermining investment prospects and reducing ethanol's appeal. High inflation is also a major challenge, forcing the central bank to raise interest rates further, to the detriment of economic growth. **We do not expect a lasting appreciation by the real in the near 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 Jan. 16	Percentage return since 1 month	3 months	6 months	1 year	Last 52 weeks Higher	Average	Lower
Americas								
Argentina – peso	8.5988	0.5555	1.4004	5.4867	26.9422	8.5988	8.2018	6.7738
Brazil – real	2.6261	-4.6268	6.3629	18.3941	10.8012	2.7535	2.3682	2.1959
Canada – dollar	1.1972	2.9185	6.1395	11.2795	9.5785	1.1972	1.1092	1.0632
Canada – (CAD/USD)	0.8353	-2.8358	-5.7843	-10.1362	-8.7412	0.9406	0.9015	0.8353
Mexico – peso	14.6138	-1.3135	7.7512	13.0098	9.7870	14.9463	13.3845	12.8363
Asia and South Pacific								
Australia – (AUD/USD)	0.8227	0.1152	-6.0471	-12.1766	-6.7341	0.9498	0.8968	0.8080
China – yuan renminbi	6.2070	0.2827	1.3677	0.0484	2.4976	6.2594	6.1683	6.0481
Hong Kong – dollar	7.7512	-0.0393	-0.0947	0.0039	-0.0464	7.7693	7.7547	7.7500
India – rupee	61.8700	-2.8118	0.0485	2.9023	0.5362	63.6700	61.0576	58.2850
Japan – yen	117.6400	1.0566	10.6315	15.6963	12.7252	121.4250	106.5621	100.9900
New Zeland – (NZD/USD)	0.7795	-0.0390	-2.0345	-10.5464	-6.7114	0.8821	0.8267	0.7653
South Korea – won	1,077	-0.8724	1.4781	4.3618	1.2997	1,118	1,054	1,008
Europe								
Denmark – krona	6.4233	7.9846	10.4960	16.5119	17.2360	6.4233	5.6573	5.3568
Euro zone – (EUR/USD)	1.1498	-8.0899	-10.0387	-15.0567	-15.4688	1.3933	1.3204	1.1498
Norway – kroner	7.5525	1.7062	15.4022	21.8696	22.2107	7.7586	6.3762	5.8995
Russia – ruble	65.0820	-10.1698	59.0139	89.0792	94.8140	72.4500	39.9557	33.4072
Sweden – krona	8.1193	6.6603	13.6202	18.9275	25.7315	8.1193	6.9334	6.3285
Switzerland – swiss franc	0.8533	-11.1192	-9.6320	-4.9777	-5.8583	1.0194	0.9193	0.8533
United Kingdom – (GBP/USD)	1.5114	-3.9130	-5.6554	-11.8306	-7.5257	1.7170	1.6419	1.5061

* 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		2014 Q3	Q4	2015 Q1f	Q2f	Q3f	Q4f	2016 Q1f	Q2f	Q3f	Q4f
American dollar											
Canadian dollar	(USD/CAD)	1.1199	1.1621	1.1976	1.1905	1.1834	1.1628	1.1364	1.1236	1.1236	1.1111
Euro	(EUR/USD)	1.2632	1.2101	1.1500	1.1600	1.1300	1.1000	1.1200	1.1500	1.1300	1.1200
British pound	(GBP/USD)	1.6212	1.5593	1.5300	1.5400	1.5400	1.5600	1.5800	1.6000	1.5800	1.5700
Swiss franc	(USD/CHF)	0.9534	0.9894	0.8500	0.8800	0.9100	0.9500	0.9600	0.9500	0.9700	0.9700
Yen	(USD/JPY)	109.66	119.70	119.00	120.00	123.00	125.00	125.00	126.00	128.00	130.00
Australian dollar	(AUD/USD)	0.8746	0.8170	0.8000	0.8000	0.8100	0.8200	0.8200	0.8300	0.8300	0.8400
Chinese yuan	(USD/CNY)	6.1385	6.2061	6.1900	6.1500	6.1800	6.1500	6.1500	6.1300	6.1000	6.1000
Mexican peso	(USD/MXN)	13.43	14.75	14.50	14.00	14.20	13.90	13.80	13.60	13.50	13.40
Brazilian real	(USD/BRL)	2.4507	2.6559	2.6500	2.6000	2.7000	2.6000	2.5500	2.4500	2.4000	2.4000
Effective dollar*	(1973 = 100)	81.30	85.13	87.30	87.10	88.30	89.10	88.00	86.80	87.60	88.00
Canadian dollar											
American dollar	(CAD/USD)	0.8929	0.8605	0.8350	0.8400	0.8450	0.8600	0.8800	0.8900	0.8900	0.9000
Euro	(EUR/CAD)	1.4147	1.4061	1.3772	1.3810	1.3373	1.2791	1.2727	1.2921	1.2697	1.2444
British pound	(GBP/CAD)	1.8155	1.8119	1.8323	1.8333	1.8225	1.8140	1.7955	1.7978	1.7753	1.7444
Swiss franc	(CAD/CHF)	0.8513	0.8514	0.7098	0.7392	0.7690	0.8170	0.8448	0.8455	0.8633	0.8730
Yen	(CAD/JPY)	97.91	103.00	99.37	100.80	103.94	107.50	110.00	112.14	113.92	117.00
Australian dollar	(AUD/CAD)	0.9795	0.9494	0.9581	0.9524	0.9586	0.9535	0.9318	0.9326	0.9326	0.9333
Chinese yuan	(CAD/CNY)	5.4813	5.3406	5.1687	5.1660	5.2221	5.2890	5.4120	5.4557	5.4290	5.4900
Mexican peso	(CAD/MXN)	11.99	12.69	12.11	11.76	12.00	11.95	12.14	12.10	12.02	12.06
Brazilian real	(CAD/BRL)	2.1883	2.2855	2.2128	2.1840	2.2815	2.2360	2.2440	2.1805	2.1360	2.1600

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