FX Forecasts

Desjardins Economic Studies

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Several currencies are agitated by central bank decisions

HIGHLIGHTS

- The current exchange rate movements could aggravate the problem of a current account deficit in the United States, and increase the already considerable surplus in Japan and the euro zone. Such a situation would hardly appear to be sustainable over a long period, suggesting that there are limits to the appreciation of the U.S. dollar.
- The Canadian dollar could lose some more ground in the short term, in anticipation of further interest rate cuts in Canada. In the longer term, the loonie should appreciate as crude prices head up. The currency could end the year at around US$0.82 (C$1.22/US$).
- The euro is likely to be volatile in the short term, reflecting the status of negotiations between Greece and its creditors. Apart from that issue, the euro appears well positioned to climb a little in the months ahead.
- The Bank of England is not concerned by the temporary drop in inflation and is still planning to gradually raise its key interest rates. The pound should keep doing better than the euro in the medium term, although a temporary spike in the EUR/GBP pair could soon occur if the Greek situation is resolved.

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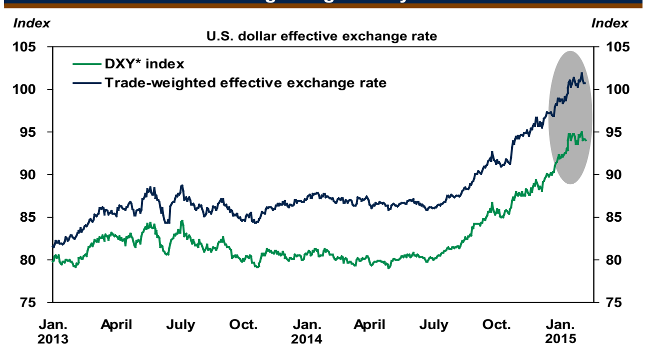
Editorial

Recent weeks have given us a whole series of sudden developments from the central banks, generating a good deal of volatility in the currency markets. After the Swiss National Bank abandoned its exchange rate floor for the EUR/CHF pair, other central banks surprised the markets: the Bank of Canada and the Reserve Bank of Australia lowered their interest rates, and the People's Bank of China lowered its required reserve ratios. The European Central Bank's decision to purchase sovereign bonds was expected, but nevertheless greatly influenced the euro before the decision was announced, not to mention that it forced the National Bank of Denmark to cut its interest rates to defend its currency peg against the euro.

Generally speaking, the U.S. dollar benefited from the announcements by overseas banks that weaken currencies (graph 1), with the exception of the Swiss franc. The release of solid employment numbers in the United States gave an extra boost to the greenback by increasing the chances of near-term monetary firming by the Federal Reserve (Fed).

Graph 1 – The U.S. dollar has kept appreciating since the beginning of the year



* Weighted average of the foreign exchange value of the U.S. dollar against six major currencies: the euro, yen, pound sterling, Canadian dollar, Swedish krona and Swiss franc.
Sources: Bloomberg and Desjardins, Economic Studies

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RETURN TO THE CURRENCY WARS?

These nearly simultaneous decisions by numerous central banks are reviving fears of a currency war. That expression was widely used a few years ago to denounce accommodative monetary policies that weaken currencies and penalize countries that do not adopt such policies. The main risk is that several countries could devalue their currencies to avoid losing their share of international markets, a situation that would be counterproductive in terms of global economic growth.

However, we cannot blame all the central banks for taking action. Japan and the euro zone clearly need a helping hand from monetary policy to get their respective economies back on track. That said, central banks alone cannot bear the entire burden of supporting economic growth over the long term. Structural reforms could be as much, if not more, effective for rescuing troubled economies without further change in interest rates and exchange rates When faced with complex problems, the solution is rarely simple.

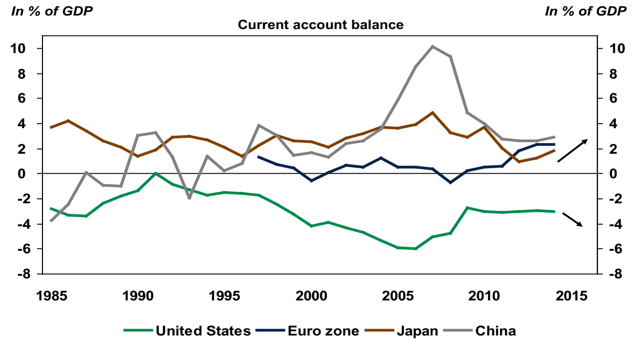
At the same time, in many parts of the world, the transmission mechanisms of monetary policy do not appear to be working terribly well. For various reasons, including over-indebtedness and lack of confidence on the part of households and businesses, low interest rates are not succeeding in encouraging investment and consumption. The value of assets is still being stimulated by these policies, but the wealth effect seems to be having less influence on the real economy. In the end, only the exchange rate adjustment mechanism seems to still be working well. However, this means that many countries are basically relying on their neighbours to stimulate their economies.

PRESSURE ON THE HORIZON FOR THE U.S. TRADE BALANCE

Among such helpful neighbours, the one that stands out is the United States. But if we take a look at the current trade positions of the world's major economies, we find that the United States already has a trade deficit, while the others are in a surplus position (graph 2). Therefore, the current exchange rate movements could aggravate the problem of a current account deficit in the United States, and increase the already considerable surplus in Japan and the euro zone. Such a situation would hardly appear to be sustainable over a long period, suggesting that there are limits to the appreciation of the U.S. dollar.

What will happen to China's current account balance is more uncertain. Chinese authorities are hoping that growth can increasingly rely on domestic demand, and in particular on consumption. Such a transformation would help China cope with a gradual reduction of its trade surplus; it would take some of the pressure off the United States when it comes to supporting the global economy. However, recent interventions by the Chinese authorities are not all going in that direction, as may be seen by their dwindling inclination to revalue the yuan.

Graph 2 – The United States runs the risk of starting to widen its trade deficit again



Sources: International Monetary Fund and Desjardins, Economic Studies

In the short term, it would be astonishing for the appreciation of the greenback to be significantly held in check by any deterioration in the U.S. trade position. Such deterioration would probably have to lead to reduced economic growth, and less potential for monetary firming in the United States, in order for the greenback to depreciate. But the fact is that the solid performance by employment and consumption in the United States does not support that scenario. It is far more likely that the appreciation of the U.S. dollar will slow as a result of an alleviation of global concerns, thereby lowering demand for safe-haven. That would offset a portion of the appreciation that is expected when the Fed puts monetary firming into effect.

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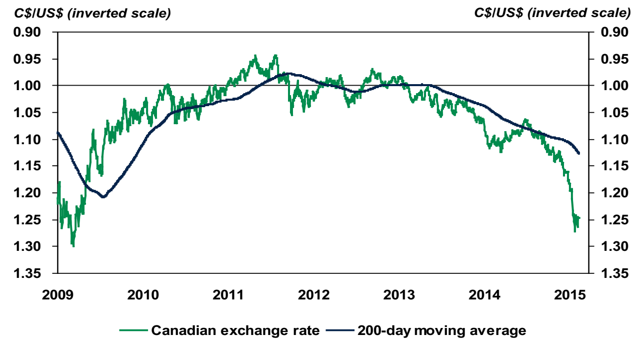
CANADIAN DOLLAR (CAD)

The situation is still highly unfavourable

- The Canadian dollar's depreciation accelerated in January, with oil prices reaching new lows and the Bank of Canada (BoC) surprising the markets by cutting its key interest rates. The loonie bottomed out on January 30, at US$0.7824. That cyclical low is close to the one reached in March 2009, when the global economy was in the throes of a crisis and oil prices were below US$40 per barrel.
- From a technical point of view, the pace of the depreciation appears to be less and less sustainable. The exchange rate is well below its 200-day average, and the momentum has reached a low of nearly -10% in the space of three months. Speculative positions have also diminished, but with a little more restraint. Yet, a technical rebound to more normal levels would seem unlikely, as long as the loonie's depreciation is supported by deterioration in the fundamental variables.
- The BoC threw cold water onto the markets by clearly expressing its concern about the economic consequences of low oil prices. A significant portion of the economy depends on the vitality of oil prices. Apart from deterioration in the terms of trade, Canada could suffer from a serious cutback in investment in the oil and mining sector, even if prices were to head back up soon. On the other hand, other sectors should benefit from a more favourable situation, but it might take some time before the positive effects make up for the negative ones.
- The high debt levels of Canadian households make the economy more sensitive to adverse shocks. While lower interest rates will provide some support, it is now more difficult to count on consumption to support growth. Fortunately, the strong performance by the U.S. economy should generate positive spillover effects for investment and Canadian exports. The weakness of the Canadian dollar will give an extra boost to exporters.

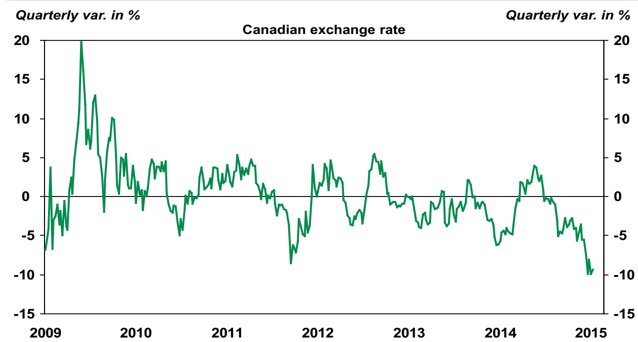
Forecasts: The Canadian dollar could lose some more ground in the short term, in anticipation of further interest rate cuts in Canada, as well as the possibility of further drops in oil prices. But in the longer term, the loonie should appreciate as crude prices head up and the Canadian economy improves. The currency could end the year at around US$0.82 (C$1.22/US$).

Canadian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions

Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

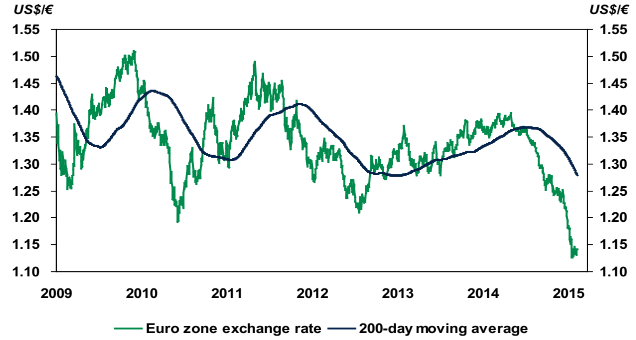
EURO (EUR)

All eyes on Greece

- The announcement of a substantial sovereign bond purchase program by the European Central Bank (ECB) and the election of an anti-austerity government in Greece drove the euro down to US$1.11 on January 25, its lowest point since 2003. Since then it has inched back to around US$1.14 and is fluctuating in tandem with the negotiations between Greece and its European partners.
- After several months of hesitation, the ECB finally decided to move forward with a substantial program for the purchase of bonds from euro zone countries. The fact that inflation was falling into negative territory made this decision almost inevitable, especially since the ECB had made a commitment to take action if inflation's outlook were to deteriorate further. This measure will officially start next March and should extend until September 2016 at least, at the rate of €60B per month. This pace of purchase initially appeared very high, but it includes purchases of secure bonds and agency securities that were already planned. All told, these bond purchases will enable the ECB to expand its balance sheet by €1,100B, bringing it back slightly above the peak reached in 2012. The direct effects of this program on the euro zone economy will probably be quite weak, given that bond yields are already very low, but it should help consolidate the recent declines by the euro and European interest rates. This, combined with an upturn in certain confidence indicators, offers hope of gradual improvement in the euro zone's economic situation. Stronger GDP growth at the end of 2014 is also encouraging.
- Although the euro should be less affected by monetary policy issues, the main downside risk for this currency is linked to the Greek situation. The new government was elected by promising to reverse some of the austerity measures, and this puts it in direct confrontation with its European partners. Given that Greece needs to receive funds by the end of this month, and the ECB has decided to stop accepting Greek government bonds as collateral, fears of a collapse of the Greek financial system, which would force the country to leave the euro zone, have been re-ignited. However, such a scenario would be so damaging, both for Greece and the euro zone, that it would be very surprising if no agreement were reached, sooner or later, to avoid it, as has happened during previous Greek crises.

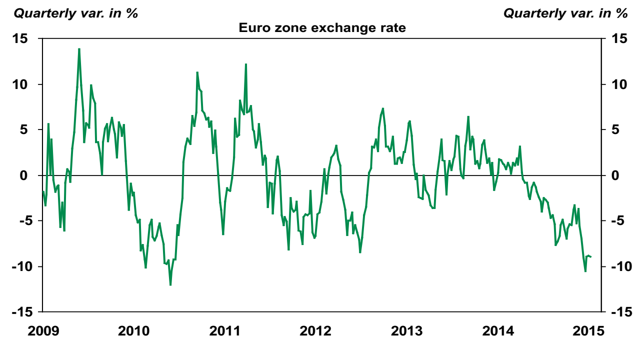
Forecasts: The euro is likely to be volatile in the short term, reflecting the status of negotiations between Greece and its creditors. Apart from that issue, the euro appears well positioned to climb a little in the months ahead. However, the beginning of monetary tightening in the United States should push the euro back close to US$1.10 at the end of this year.

Euro and trend



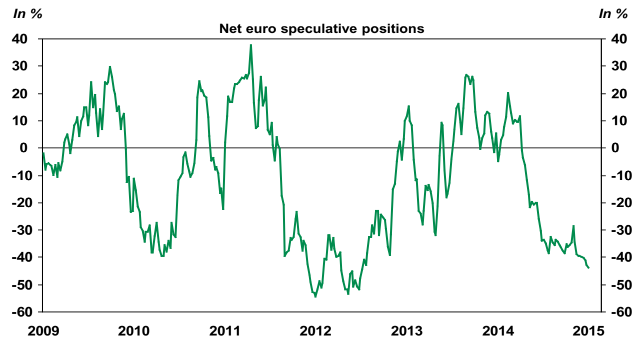
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



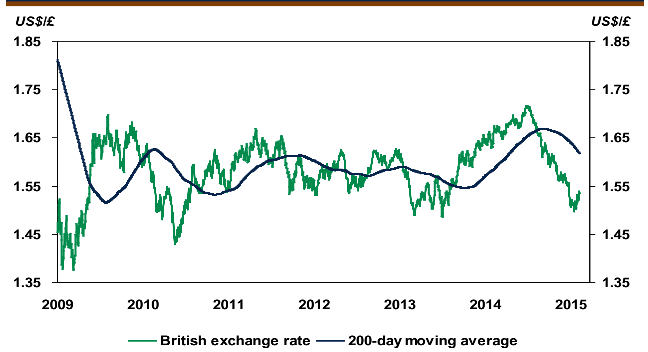
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

The Bank of England's positive attitude puts the pound in good stead

- The pound sterling slipped just below US$1.50 after the European Central Bank meeting, but since then it has quickly resumed an upward trend. The optimism shown by the Bank of England (BoE) when it presented its report on inflation actually lifted the pound back to around US$1.54 recently. It has also kept appreciating against the euro: the EUR/GBP pair has fallen below £0.74/€. Unlike many other central banks that currently appear to be in panic mode, the BoE believes that the plunge of oil prices, recent monetary easing and the decline in bond yields are good news that will support the global economy. It also considers that the outlook for British economic growth has improved further, and that wages are beginning to accelerate. In these circumstances, it is not concerned by the temporary drop in inflation and is still planning to gradually raise its key interest rates. **The pound should keep doing better than the euro in the medium term, although a temporary spike in the EUR/GBP pair could soon occur if the Greek situation is resolved.**

British pound and trend



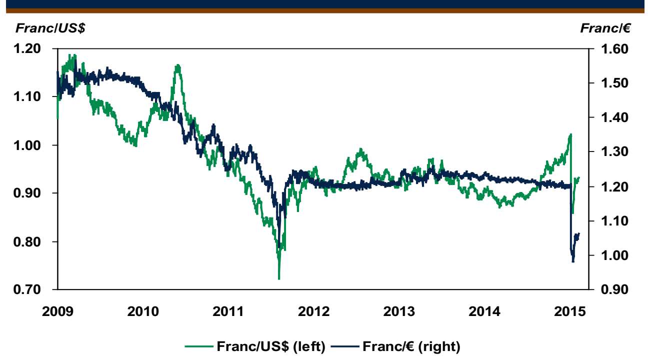
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

The franc should stay close to where it stands now

- The Swiss franc shot up in spectacular fashion after the Swiss National Bank (SNB) abandoned its exchange rate floor of 1.20 francs/€. After dropping below 1.00 franc in mid-January, the EUR/CHF pair managed to climb back to around 1.05 francs. The franc followed a similar trend against the greenback, with the USD/CHF pair suddenly tumbling from 1.02 francs to less than 0.85 franc, before edging back up to 0.93 franc. The franc's decline after the initial shock, and its great stability thereafter (despite renewed concerns about the future of the euro zone) is telling many analysts that the SNB started intervening in the currency markets again in order to weaken the franc. In fact, Switzerland's foreign currency reserves are still rising. It must be pointed out that the SNB has said that it stands ready to intervene in the market or to lower its key interest rates further into negative territory, in order to avoid further appreciation of the franc. **That, combined with deterioration in growth and inflation expectations in Switzerland, should keep the franc close to its current levels in the months to come.**

Swiss franc



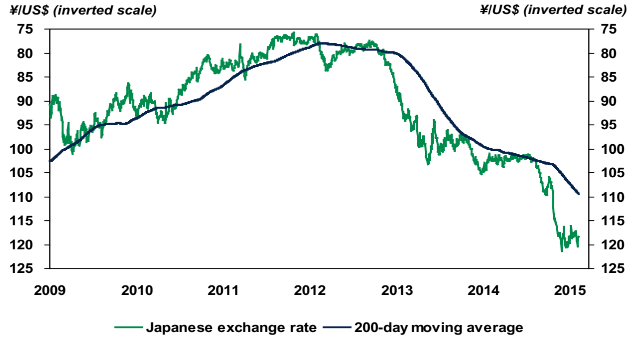
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

The ¥120/US$ threshold is still difficult to cross

- The Japanese exchange rate surged to over ¥120/US$ last fall, after the decision by the Bank of Japan (BoJ) to increase its asset purchases. Since then, the exchange rate has retreated slightly and has never sustainably crossed back above ¥120/US$. Earlier in 2013 and 2014, the yen had shown great stability at around ¥100/US$ following easing by the BoJ. That scenario seems to be repeating itself.
- Fundamentally, the yen is likely to remain under pressure, given the diverging trends of U.S. and Japanese monetary policies. However, in the short term, the expected trends are already amply reflected in the exchange rate. Furthermore, Japan's economic growth rebounded in the fourth quarter, and falling oil prices should have positive repercussions, which could support the currency. **But the yen will probably depreciate later this year, when the Federal Reserve confirms its monetary firming, and when the BoJ might announce further easing** to reach its inflation target.

Yen and trend



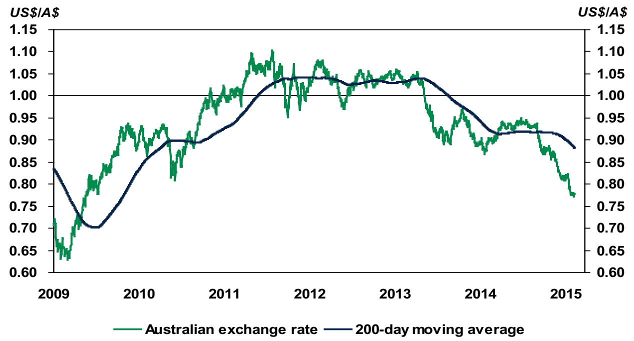
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The Reserve Bank of Australia joins in on monetary easing

- On February 3, the Australian dollar reached a nearly 6-year low, at US$0.7626. That low coincided with the decision by the Reserve Bank of Australia (RBA) to lower its key interest rate by 25 basis points, to 2.25%. But the aussie had already depreciated sharply in the days preceding that announcement. The surprising decision by the Bank of Canada, disappointing statistics in China and depressed commodity prices were all factors that played against the Australian currency. The RBA's decision was partly expected, given recent developments overseas.
- On the home front, the weakness of the Australian economy was also beginning to warrant an interest rate cut, especially since inflation had recently fallen below the official target of 2% to 3%. It is interesting to note that the RBA reiterated, in its monetary policy statement, that the Australian dollar was still overvalued and that a weak currency was necessary to rebalance the country's economic growth. We cannot rule out another interest rate cut in the months to come; this should maintain pressure on the Australian dollar. **The currency is likely to remain below US$0.80 for several quarters, and the US$0.75 mark will probably be tested in the short term.**

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

Concerns persist for many emerging countries

CHINESE YUAN (CNY)

- China's exchange rate has climbed back to 6.25 yuan/US$ in light of disappointing economic data in China. Real GDP growth slowed to an annualized pace of 6.1% in the fourth quarter of 2014, the PMI manufacturing index fell below 50 in January, and imports dropped by 19.7% during that same month. However, trade data are always volatile at this time of year, and a rally is expected in the months ahead. While the scenario of a soft landing for the Chinese economy is not compromised at this point, **the monetary authorities should show caution by announcing further easing measures and by limiting the revaluation of the yuan**.

MEXICAN PESO (MXN)

- After stabilizing at around 14.75 pesos in December and January, the USD/MXN pair ticked up above 15 pesos in February, its highest point since March 2009. The current financial environment, which is not very favourable for emerging countries, is contributing to the peso's weakness, as are the continuing very low oil prices, which have led the Mexican government to announce spending cuts. While the economic data are fairly mixed, the significant downturn in inflation in January is reducing the immediate risk associated with the weakness of the currency. The Bank of Mexico held its key interest rate steady at 3.00% at the end of January, and remarked that the Mexican economy was facing significant risks. **The peso should remain weak for a few more months, and then head up in the second half of this year.**

BRAZILIAN REAL (BRL)

- The real continues to depreciate. Consumer confidence is at its lowest since 2004, and the analysts surveyed by the Central Bank of Brazil (CBB) are constantly revising their short-term growth forecasts, downwards. Brazil also has a galloping inflation problem to cope with. The annual change in prices climbed back above 7% in January; this is above the CBB's target range. The CBB will therefore be forced to maintain monetary firming, and the SELIC rate was raised by 50 basis points in January, to 12.25%. This is a vicious circle, because higher interest rates reduce prospects for growth and penalize the currency, which in turn creates inflationary pressure through import prices. As things stand, **the Brazilian exchange rate could reach 3 reals/US$ in the months to come**.

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	Percentage return since				Last 52 weeks		
	Feb. 16	1 month	3 months	6 months	1 year	Higher	Average	Lower
Americas								
Argentina – peso	8.6805	0.9507	1.9885	4.8370	11.4313	8.6805	8.2818	7.7613
Brazil – real	2.8338	7.9072	8.6248	24.6508	18.6911	2.8669	2.3921	2.1959
Canada – dollar	1.2480	4.2391	10.2673	14.3806	13.6877	1.2680	1.1203	1.0632
Canada – (CAD/USD)	0.8013	-4.0667	-9.3113	-12.5726	-12.0397	0.9406	0.8926	0.7887
Mexico – peso	14.8864	1.8657	9.9662	13.6605	12.3184	15.1082	13.4998	12.8363
Asia and South Pacific								
Australia – (AUD/USD)	0.7773	-5.5227	-11.1349	-16.6071	-13.9487	0.9498	0.8878	0.7719
China – yuan renminbi	6.2486	0.6694	1.9422	1.6479	2.9950	6.2597	6.1830	6.0641
Hong Kong – dollar	7.7592	0.1026	0.0593	0.1142	0.0471	7.7693	7.7541	7.7500
India – rupee	62.1050	0.3798	0.6319	2.1800	0.4042	63.6700	61.0193	58.2850
Japan – yen	118.4800	0.7140	1.8920	15.7483	16.3851	121.4250	107.8068	101.1750
New Zeland – (NZD/USD)	0.7502	-3.7584	-5.1463	-11.5679	-10.3826	0.8821	0.8193	0.7262
South Korea – won	1,102	2.3376	0.1590	7.9624	3.6628	1,118	1,056	1,008
Europe								
Denmark – krona	6.5571	2.0830	10.3387	17.8582	20.3237	6.6430	5.7418	5.3568
Euro zone – (EUR/USD)	1.1405	-0.8089	-8.6141	-14.7837	-16.6703	1.3933	1.3027	1.1249
Norway – kroner	7.5695	0.2251	12.0660	23.4044	24.5393	7.8328	6.4947	5.8995
Russia – ruble	63.1800	-2.9225	33.9553	74.6546	79.8437	72.4500	42.4938	33.6595
Sweden – krona	8.4172	3.6690	13.9646	23.0981	30.7161	8.4458	7.0792	6.3285
Switzerland – swiss franc	0.9295	8.9300	-3.4486	2.8094	4.0815	1.0194	0.9200	0.8533
United Kingdom – (GBP/USD)	1.5379	1.7533	-1.7096	-7.8274	-8.0808	1.7170	1.6316	1.5019

* 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		2015				2016			
		Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
American dollar											
Canadian dollar	(USD/CAD)	1.1199	1.1621	1.2658	1.2500	1.2500	1.2195	1.2048	1.1765	1.1765	1.1628
Euro	(EUR/USD)	1.2632	1.2101	1.1300	1.1500	1.1200	1.1000	1.1200	1.1600	1.1300	1.1200
British pound	(GBP/USD)	1.6212	1.5593	1.5400	1.5500	1.5300	1.5400	1.5700	1.6000	1.5800	1.5700
Swiss franc	(USD/CHF)	0.9534	0.9894	0.9300	0.9300	0.9500	0.9500	0.9600	0.9500	0.9600	0.9700
Yen	(USD/JPY)	109.66	119.70	118.00	119.00	121.00	124.00	125.00	126.00	128.00	130.00
Australian dollar	(AUD/USD)	0.8746	0.8170	0.7700	0.7800	0.7900	0.7900	0.8000	0.8100	0.8200	0.8200
Chinese yuan	(USD/CNY)	6.1385	6.2061	6.2500	6.2000	6.2000	6.1500	6.1500	6.1300	6.1000	6.1000
Mexican peso	(USD/MXN)	13.43	14.75	14.85	14.75	14.45	14.00	13.80	13.60	13.50	13.40
Brazilian real	(USD/BRL)	2.4507	2.6559	3.0000	2.8500	2.9500	2.8000	2.7000	2.6000	2.5000	2.5000
Effective dollar*	(1973 = 100)	81.30	85.13	89.50	88.70	89.90	90.30	89.30	87.50	88.70	89.10
Canadian dollar											
American dollar	(CAD/USD)	0.8929	0.8605	0.7900	0.8000	0.8000	0.8200	0.8300	0.8500	0.8500	0.8600
Euro	(EUR/CAD)	1.4147	1.4061	1.4304	1.4375	1.4000	1.3415	1.3494	1.3647	1.3294	1.3023
British pound	(GBP/CAD)	1.8155	1.8119	1.9494	1.9375	1.9125	1.8780	1.8916	1.8824	1.8588	1.8256
Swiss franc	(CAD/CHF)	0.8513	0.8514	0.7347	0.7440	0.7600	0.7790	0.7968	0.8075	0.8160	0.8342
Yen	(CAD/JPY)	97.91	103.00	93.22	95.20	96.80	101.68	103.75	107.10	108.80	111.80
Australian dollar	(AUD/CAD)	0.9795	0.9494	0.9747	0.9750	0.9875	0.9634	0.9639	0.9529	0.9647	0.9535
Chinese yuan	(CAD/CNY)	5.4813	5.3406	4.9375	4.9600	4.9600	5.0430	5.1045	5.2105	5.1850	5.2460
Mexican peso	(CAD/MXN)	11.99	12.69	11.73	11.80	11.56	11.48	11.45	11.56	11.48	11.52
Brazilian real	(CAD/BRL)	2.1883	2.2855	2.3700	2.2800	2.3600	2.2960	2.2410	2.2100	2.1250	2.1500

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