FX Forecasts

Desjardins Economic Studies
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Has the U.S. dollar risen too fast?

HIGHLIGHTS

- The U.S. dollar should resume an upwards trend during the summer, when the true monetary tightening will be on the verge of happening. However, the re-appreciation could start sooner if U.S. economic data were to improve quickly, or if disappointments and fears were to arise in other parts of the world.
- The Federal Reserve's signal that its monetary tightening will be gradual and limited should help the euro to stay in the neighborhood of US$1.10 in the months to come. The euro should however fall back in the second half of 2015.
- After a gain of around 20% since summer 2013, the potential for further appreciation of the pound against the euro now appears limited.
- In the short term, headwinds are likely to keep besetting the Canadian dollar. The gradual rise in oil prices that is expected starting in the summer should nevertheless help the Canadian dollar gain back some ground and move past the US$0.80 mark (C$1.25/US$) towards the end of the year.

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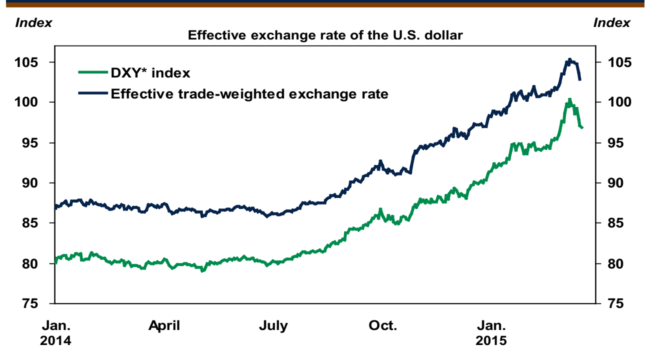
Editorial

The markets have a habit of counting their chickens before they hatch. Actually, it's all a matter of perceptions or probabilities. Why wait if we think we know the end result anyway? The U.S. dollar appreciated sharply at the beginning of March, in anticipation of the Federal Reserve (Fed) soon starting to tighten its monetary policy. Special attention was paid to the meeting of March 18, as there was a strong probability that the Fed would take a significant step by removing the word "patience" from its official press release. In the end it did so, but the U.S. dollar reacted negatively because Fed leaders also opted to lower their economic outlook and their interest rate forecasts, which impacted investors' expectations (graph 1).

Graph 1 – The U.S. dollar has depreciated since the Fed meeting



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

MOVING TOWARDS MONETARY TIGHTENING IN THE FALL

The median forecast for the middle of the federal funds target range (the target for the overnight rate in the United States) by the end of the year 2015 has dropped from 1.125% to 0.625%. In forecasting fewer interest rate hikes, the Fed is sending the message that the probability of early monetary tightening is now very low.

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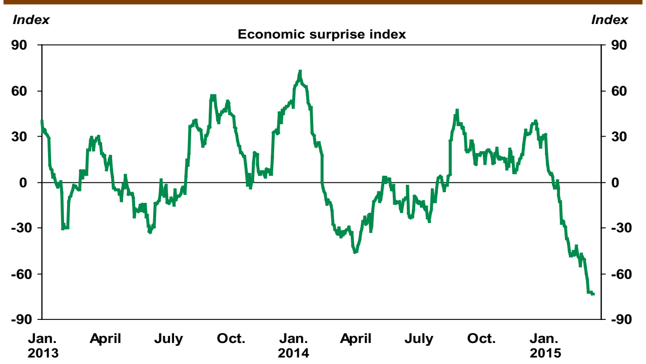
Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

This conclusion is reinforced by the recent trend in economic data from the United States. While employment is still strong, the same cannot be said of most of the other indicators. For example, retail sales pulled back in February, industrial production slowed and homebuilding fell below 900,000 units. The accumulation of disappointments is well captured by the economic surprise index (graph 2). This index falls when economic variables perform below expectations.

Graph 2 – Since the beginning of 2015, economic news in the United States has been more disappointing



Sources: Bloomberg, Citigroup and Desjardins, Economic Studies

The adverse weather in some parts of the United States and the labour dispute at the West Coast ports seem to account for the bulk of the decline in economic indicators. However, this is not enough to dispel all doubts about the months ahead. Among other things, it is difficult to tie the disappointments in certain variables, such as weak wage growth, to the weather. And many analysts believe that more sustained wage growth is a key condition for the Fed to start its monetary tightening.

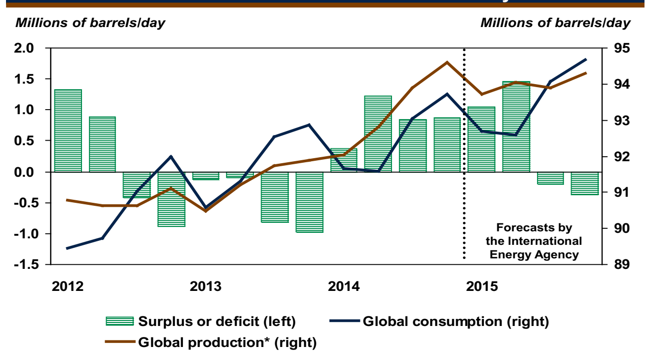
For some time now, our scenario has been calling for an initial interest rate hike in the United States in September. Recent developments reinforce this theory of later tightening, and even suggest that the Fed might wait until October. Monetary tightening in the fall would leave room for a short period of weakness for the U.S. dollar. The currency would resume an upwards trend during the summer, when the true monetary tightening would be on the verge of happening. However, the re-appreciation could start sooner if U.S. economic data were to improve quickly, or if disappointments and fears were to arise in other parts of the world.

OIL SHOULD HEAD UP IN THE SECOND HALF OF THE YEAR

The trend of the U.S. dollar is not the only thing upsetting the currency market; the slump in oil prices also contributes its share of volatility. The currencies of oil-producing countries such as Canada are particularly affected; hence the importance of taking the time to analyze this issue in depth.

In an *Economic Viewpoint*[1] that was published in February, we show that prices should start heading back up in the second half of the year. The plunge observed since the summer is the outcome of a combination of factors that have generated an imbalance between supply and demand, resulting in a large build-up of crude inventories. Within a few months, the imbalance between supply and demand should reverse course under the combined effect of higher consumption and downwards adjustments to production (graph 3). As a result, crude inventories will gradually diminish and prices will move up.

Graph 3 – The balance of supply and demand in the oil market will reverse itself in the second half of the year



* Assuming stable production by the Organization of the Petroleum Exporting Countries (OPEC) at 30 million barrels per day.
Sources: International Energy Agency and Desjardins, Economic Studies

We estimate that the price of a barrel of WTI (West Texas Intermediate) will approach US$70 by the end of 2015 and US$80 by the end of 2016. This increase in oil prices will encourage the development of production capacity in keeping with the expanding demand. On that basis, we are optimistic for currencies that are sensitive to oil prices, in the longer term.

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[1] Desjardins Economic Studies, *Economic Viewpoint*, “Where will oil prices go now? – Three major trends are possible in a complex environment,” February 16, 2015, www.desjardins.com/ressources/pdf/pv150216-e.pdf?resVer=1424111285000.

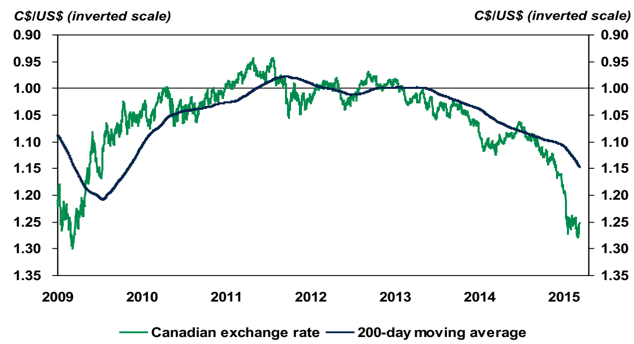
CANADIAN DOLLAR (CAD)

Pulled down once again by the oil price slump

- The depreciation of the Canadian dollar resumed in March after a lull in February, and a new cyclical low was reached at US$0.7793. The loonie's return to a downwards trajectory was linked to oil prices heading down again. The price of a barrel of WTI (West Texas Intermediate) reached US$42 in mid-March, whereas it stood at around US$50 at the beginning of the month.
- Technically speaking, the pace of the Canadian dollar's depreciation calculated over three months has not had enough time to get back to normal. In fact, at -10%, the momentum is still at historically very low levels. Meanwhile, the speculative positions are not at historic lows, but they are close. Despite these signs of overselling of the Canadian currency, a technical rebound appears to be unlikely as long as the depreciation remains supported by obvious deterioration in fundamental variables such as the weakness of oil prices and the risks that it carries with it for the Canadian economy.
- A large share of the Canadian economy does indeed depend on the vitality of oil prices. The slump in the prices of oil and other commodities results in deterioration in the terms of trade and lost revenues. Repercussions are also expected on business investment, especially in the oil and mining sector. On the other hand, other sectors could benefit from low oil prices and a lower Canadian dollar. However, these positive effects might not entirely compensate for the negative ones, and it could take some time before they fully materialize.
- The Bank of Canada (BoC) decided to sit on the sidelines in March, after surprising the markets with a 25 basis point cut to its key interest rates. This does not prevent another rate cut from being announced if oil prices were to fall too far, or if the balance of risks and the economic situation in Canada were to deteriorate more than anticipated.

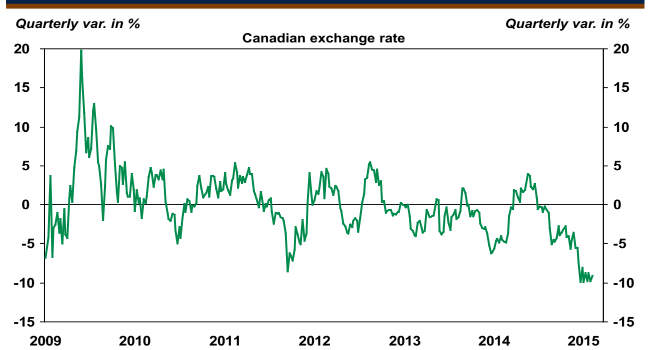
Forecasts: In the short term, headwinds are likely to keep besetting the Canadian dollar, which could test the cyclical low of US$0.7655 that was reached in March 2009. The gradual rise in oil prices that is expected starting in the summer should nevertheless help the Canadian dollar gain back some ground and move past the US$0.80 mark (C$1.25/US$) towards the end of the year. Meanwhile, the main impediments to a more significant appreciation of the loonie will be the strength of the U.S. dollar and a continued cautious stance by 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

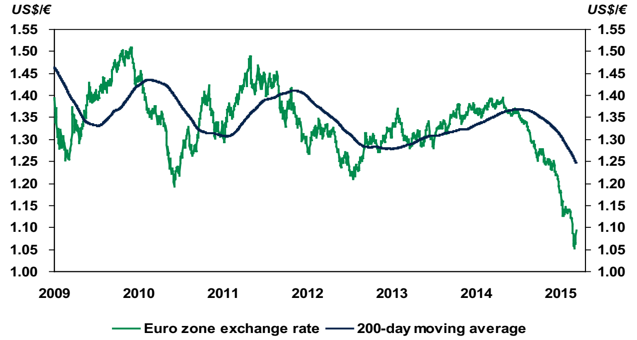
EURO (EUR)

The euro falls again despite encouraging developments in the euro zone

- After stabilizing at around US$1.13 in February, the euro started falling again at the beginning of March, as investors prepared themselves for the beginning of sovereign bond purchases by the European Central Bank (ECB). The confirmation of the start of the ECB's purchases, and positive job data from the United States, amplified the euro's tumble, temporarily driving it below US$1.05 on March 13—its lowest level since 2003. Market indicators show that the euro's recent plunge was supported by very negative investor sentiment towards the currency. This opens the door to a rebound.
- The euro's nearly 25% depreciation against the greenback over the past year is mainly due to the significant divergence between the economies and monetary policies on either side of the Atlantic. While the U.S. economy has assumed a very encouraging trend since the spring of 2014, the euro zone economy has experienced new setbacks that even sparked fears of a new recession. That, together with the sharp drop in inflation, has led the ECB to lower its key interest rates into negative territory and to announce a series of quantitative measures in recent quarters. Conversely, the Federal Reserve (Fed) put an end to its quantitative measures last year and is now signalling that it could soon raise its key interest rates.
- These divergences appear to be diminishing, however. GDP growth in the euro zone accelerated in the fourth quarter of 2014, and gains in several confidence indexes are encouraging for 2015. It must be pointed out that a low euro and low oil prices will stimulate the euro zone economy. Conversely, the U.S. economy now seems to be going through a rough patch that could lead the Fed to hesitate about starting its monetary tightening, especially if the U.S. dollar remains so strong. However, this weakness in the U.S. economy is largely due to weather conditions.
- While the fundamentals now seem to be more favourable to the euro, the ECB's asset purchases could keep putting downwards pressure on the currency by encouraging the European institutions that sell their sovereign assets to the ECB to buy foreign assets. Continued significant uncertainty about the future of Greece is also limiting the potential for a rebound of the euro.

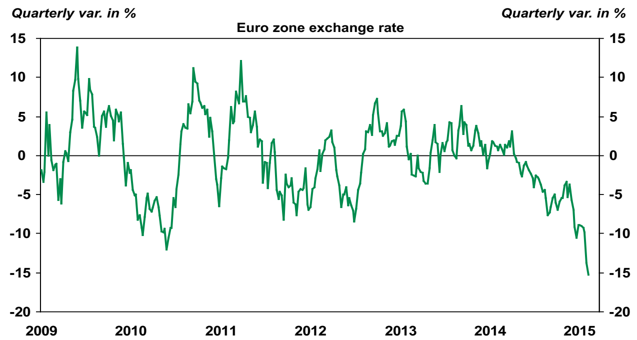
Forecasts: The Fed's signal that its monetary tightening will be gradual and limited should help the euro to stay in the neighborhood of US$1.10 in the months to come. The euro should however fall back in the second half of 2015.

Euro and trend



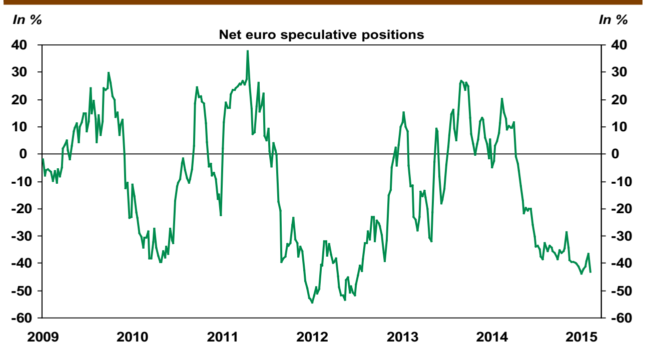
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



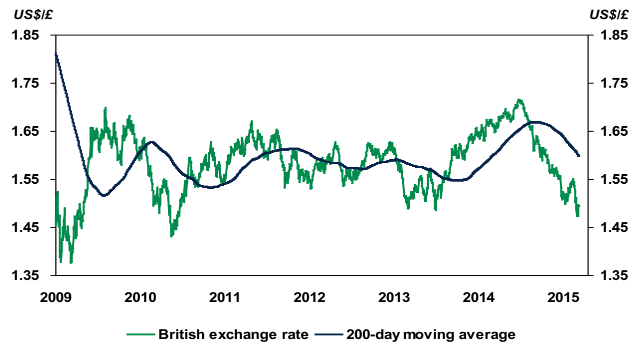
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

The pound will not be able to stray too far from the euro

- The optimism shown by the Bank of England (BoE) allowed the pound sterling to surpass US$1.55 at the end of February, but the new surge in the U.S. dollar quickly sent the pound tumbling below US$1.50 at the beginning of March. Initially, the pound continued to appreciate against the euro, and the EUR/GBP pair fell very close to £0.70/€ on March 11, its lowest level since 2007. But in recent days, some disappointing data in the United Kingdom have led to a slight pullback by the pound against the euro. The minutes of the last BoE meeting show that its officials are still relatively confident about growth outlooks in the United Kingdom. They do note, however, that the divergence in monetary policies could keep promoting appreciation of the pound against the euro. This could prolong the period of weak inflation and increase the risk of inflation expectations becoming unanchored. Under such conditions, the BoE will bide its time before initiating monetary tightening. **After a gain of around 20% since summer 2013, the potential for further appreciation of the pound against the euro now appears limited.**

British pound and trend



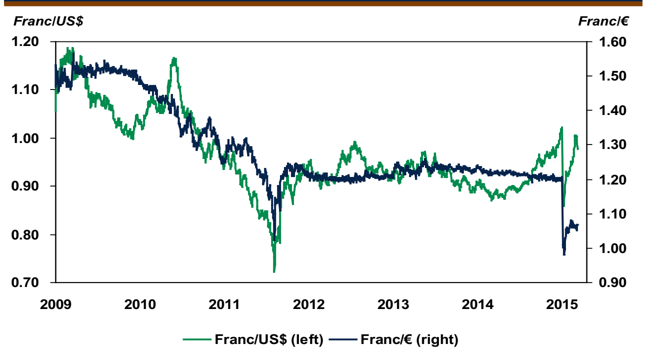
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

The Swiss franc should remain relatively stable against the euro

- After its spectacular collapse below 1.00 franc/€ in mid-January, the EUR/CHF pair edged back up a bit, then stabilized at just above 1.05 franc. The absence of any new surge in the franc despite substantial downwards pressure on the euro is due to the commitment by the Swiss National Bank (SNB) to take action to avoid further appreciation of the franc, and by the negative interest rate of 0.75% on deposits, which discourages investors from holding that currency. Consequently, the franc has depreciated sharply against the U.S. dollar, and the USD/CHF pair has returned close to the levels that were seen before the SNB abandoned its currency floor. The Swiss economy rounded off the year on a positive note, with quarterly economic growth of 2.4%. However, declines in several confidence indicators at the beginning of 2015 show the deleterious effects of the Swiss franc's sudden appreciation. Therefore, the SNB has revised its economic growth and inflation outlooks downwards, to a significant degree. **The franc should keep holding fairly steady against the euro in the next few quarters.**

Swiss franc

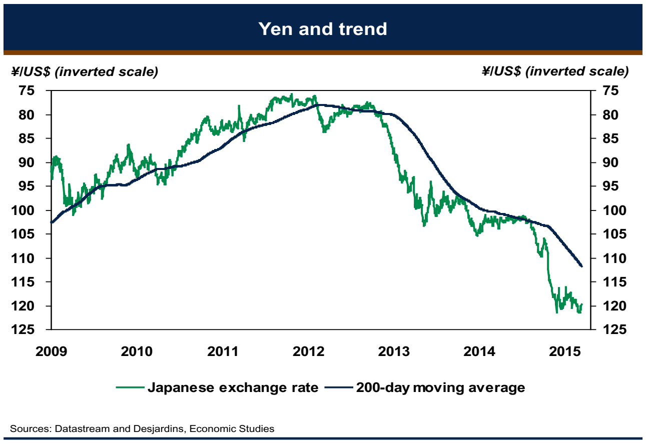


Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

Is the Bank of Japan heading towards another intervention?

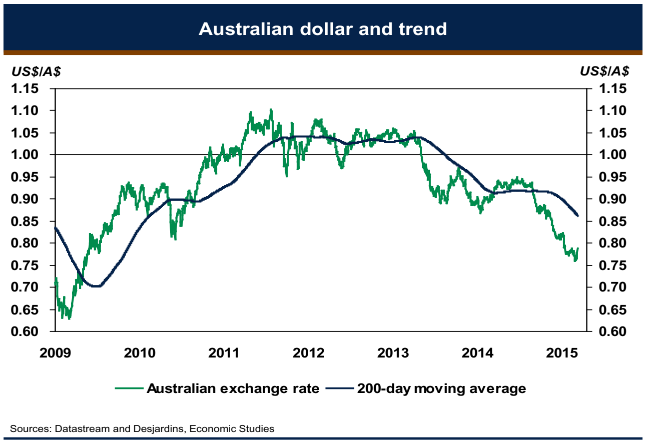
- The Japanese exchange rate ticked up above ¥120/US$ during the first week of March. Compared to what has been observed for most of the other major currencies, the yen's depreciation has been limited since the beginning of the year. The latest surge in the greenback did not make itself felt to the same extent, especially since the yen appears to be benefiting from a rally in the Japanese economy and from a safe haven effect linked to persistent concerns about some emerging economies.
- But pressure on the yen could increase in the spring, once it becomes clearer that the Bank of Japan (BoJ) has missed its 2% inflation target. The BoJ estimates that the annual change in prices excluding fresh food currently stands somewhere between 0.0% and 0.5% without the effect of last April's sales tax hike. Therefore, inflation could easily fall into negative territory in the months ahead, which could incite the BoJ to announce new measures. On the other hand, more sustained economic growth could encourage it to bide its time. **We are still calling for an exchange rate of around ¥125/US$ by the end of the year.**



AUSTRALIAN DOLLAR (AUD)

Running short of support

- The Australian dollar is still under pressure and reached a new, nearly six-year low of US$0.7560 on March 11. The Australian economy is adversely affected by the decline in its terms of trade and the drop in investments in the natural resources sector. This reflects the downturn in many commodity prices, as well as the slowdown in demand from China, the main outlet for Australian exports. Monetary policy is also playing against the Australian dollar, since the Reserve Bank of Australia is leaving the door open to further easing after lowering its key interest rate by 25 basis points in February. Moreover, it maintains that the currency is over-valued, and that it needs to depreciate further to support the economy.
- Due to lack of support, **the Australian dollar will likely remain below US$0.80 for several quarters, and the US$0.75 mark could be tested**. Re-appreciation should take hold in the second half of the year if commodity prices head back up and concerns about the Chinese economy dissipate.



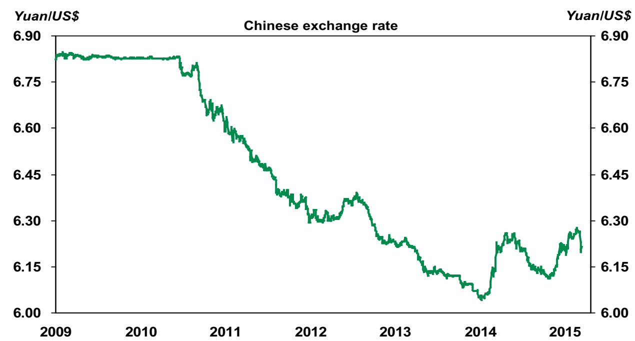
EMERGING CURRENCIES

Many emerging currencies are still under pressure

CHINESE YUAN (CNY)

- The Chinese monetary authorities now appear to be far more reluctant to revalue the yuan. Economic conditions in China are quite precarious, with the pace of growth that is still slowing. Inflation is also following a downwards slope, which has encouraged the People's Bank of China to lower interest rates again at the beginning of March. That said, the strength of the U.S. dollar is probably weighing more in the balance, with respect to the decision as to whether or not to revalue the yuan. Under the current conditions, even a slight revaluation against the greenback would involve significant revaluations against most other currencies. **As long as the U.S. dollar remains strong, the Chinese exchange rate is likely to stay put at around 6.25 yuan/US$.**

Chinese yuan and trend



Sources: Datastream and Desjardins, Economic Studies

MEXICAN PESO (MXN)

- The strength of the U.S. dollar, especially against the emerging currencies, and another slide in oil prices sent the USD/MXN pair soaring to over 15.65 pesos in mid-March, a new historic peak. Even though inflation is low in Mexico at the moment, the Bank of Mexico (BoM) appears to be increasingly concerned about the peso's depreciation. It recently established a new program that allows it to sell up to US$52M worth of pesos every day, in addition to the existing program which allows it to sell US$200M worth of pesos if the currency posts a daily decline of more than 1.5%. The BoM is now contemplating raising its key interest rates before the Federal Reserve, but the relatively lacklustre economic data in both the United States and Mexico will probably convince it to wait a bit before taking action. **The peso is still expected to appreciate by the end of the year.**

Mexican peso and trend

Sources: Datastream and Desjardins, Economic Studies

BRAZILIAN REAL (BRL)

- The Brazilian exchange rate recently reached a 12-year record, at 3.31 real/US$. Nothing seems to be able to stand in the way of the depreciating trend of the Brazilian real, which has lasted since September 2014. The Brazilian economy is in a very precarious situation, amplified by the slump in commodity prices. The country must also cope with frenzied inflation. The annual change in prices rose to 7.7% in February, pushing the Central Bank of Brazil to order another interest rate hike in March. This is feeding a vicious circle, since high interest rates weaken economic growth and penalize the currency, which in turn exerts inflationary pressure through import prices. In this context, **the USD/BRL pair could reach 3.50 real/US$**.

Brazilian real and trend

Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

	Spot price	Percentage return since				Last 52 weeks		
Country – Currency*	March 23	1 month	3 months	6 months	1 year	Higher	Average	Lower
Americas								
Argentina – peso	8.7851	0.9057	2.7437	4.0889	10.2617	8.7929	8.3658	7.9657
Brazil – real	3.1610	10.3876	17.0766	31.4680	36.1451	3.2926	2.4567	2.1959
Canada – dollar	1.2516	-0.5048	7.7943	13.3131	11.8249	1.2803	1.1347	1.0632
Canada – (CAD/USD)	0.7990	0.5074	-7.2307	-11.7490	-10.5745	0.9406	0.8813	0.7811
Mexico – peso	14.9583	-0.7234	1.7516	12.6735	13.1379	15.5843	13.6844	12.8363
Asia and South Pacific								
Australia – (AUD/USD)	0.7881	1.0167	-2.7505	-10.8484	-13.2206	0.9498	0.8744	0.7595
China – yuan renminbi	6.2140	-0.6571	-0.1903	1.2415	-0.1775	6.2744	6.1948	6.1112
Hong Kong – dollar	7.7564	-0.0071	-0.0052	0.0593	-0.0219	7.7708	7.7540	7.7500
India – rupee	62.2300	0.1086	-1.9073	1.9245	2.1839	63.6700	61.0870	58.2850
Japan – yen	119.7350	0.7743	-0.7872	9.9545	17.0831	121.4500	109.5060	101.1750
New Zeland – (NZD/USD)	0.7653	1.7067	-0.7271	-4.9441	-10.3398	0.8821	0.8097	0.7262
South Korea – won	1,115	0.5367	1.0837	7.1830	3.1844	1,132	1,060	1,008
Europe								
Denmark – krona	6.8125	3.5051	11.4583	17.5755	25.8823	7.1086	5.8734	5.3593
Euro zone – (EUR/USD)	1.0926	-3.7694	-10.2657	-15.0581	-20.7219	1.3933	1.2759	1.0522
Norway – kroner	7.8890	3.5642	5.8997	24.1248	30.3816	8.3125	6.6699	5.8995
Russia – ruble	58.7450	-7.1592	6.6037	52.2293	62.1205	72.4500	44.9265	33.6595
Sweden – krona	8.5008	1.0250	8.9588	18.9207	32.3033	8.7158	7.2735	6.3977
Switzerland – swiss franc	0.9670	2.0420	-2.0711	3.0534	9.4144	1.0194	0.9284	0.8533
United Kingdom – (GBP/USD)	1.4934	-3.3492	-3.7851	-8.7192	-9.4607	1.7170	1.6172	1.4686

* 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

		2014		2015				2016			
End of period		Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
American dollar											
Canadian dollar	(USD/CAD)	1.1199	1.1621	1.2658	1.2821	1.2658	1.2346	1.2195	1.1905	1.1905	1.1765
Euro	(EUR/USD)	1.2632	1.2101	1.0800	1.0900	1.0500	1.0300	1.0600	1.1000	1.0800	1.1000
British pound	(GBP/USD)	1.6212	1.5593	1.5000	1.5200	1.5000	1.4900	1.5200	1.5600	1.5400	1.5500
Swiss franc	(USD/CHF)	0.9534	0.9894	0.9700	0.9700	1.0000	1.0200	1.0000	0.9800	0.9900	0.9900
Yen	(USD/JPY)	109.66	119.70	121.00	122.00	123.00	125.00	125.00	126.00	128.00	130.00
Australian dollar	(AUD/USD)	0.8746	0.8170	0.7700	0.7700	0.7800	0.7900	0.8000	0.8100	0.8200	0.8200
Chinese yuan	(USD/CNY)	6.1385	6.2061	6.2500	6.2500	6.2500	6.2500	6.2200	6.2000	6.1800	6.1500
Mexican peso	(USD/MXN)	13.43	14.75	15.00	14.90	15.25	14.50	14.70	14.50	14.25	14.00
Brazilian real	(USD/BRL)	2.4507	2.6559	3.2000	3.3000	3.5000	3.4000	3.2000	3.0000	2.9000	2.9000
Effective dollar*	(1973 = 100)	81.30	85.13	92.00	91.80	93.40	93.80	92.10	90.00	91.00	90.20
Canadian dollar											
American dollar	(CAD/USD)	0.8929	0.8605	0.7900	0.7800	0.7900	0.8100	0.8200	0.8400	0.8400	0.8500
Euro	(EUR/CAD)	1.4147	1.4061	1.3671	1.3974	1.3291	1.2716	1.2927	1.3095	1.2857	1.2941
British pound	(GBP/CAD)	1.8155	1.8119	1.8987	1.9487	1.8987	1.8395	1.8537	1.8571	1.8333	1.8235
Swiss franc	(CAD/CHF)	0.8513	0.8514	0.7663	0.7566	0.7900	0.8262	0.8200	0.8232	0.8316	0.8415
Yen	(CAD/JPY)	97.91	103.00	95.59	95.16	97.17	101.25	102.50	105.84	107.52	110.50
Australian dollar	(AUD/CAD)	0.9795	0.9494	0.9747	0.9872	0.9873	0.9753	0.9756	0.9643	0.9762	0.9647
Chinese yuan	(CAD/CNY)	5.4813	5.3406	4.9375	4.8750	4.9375	5.0625	5.1004	5.2080	5.1912	5.2275
Mexican peso	(CAD/MXN)	11.99	12.69	11.85	11.62	12.05	11.75	12.05	12.18	11.97	11.90
Brazilian real	(CAD/BRL)	2.1883	2.2855	2.5280	2.5740	2.7650	2.7540	2.6240	2.5200	2.4360	2.4650

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