FX Forecasts

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Will the divergence in monetary policies turn out to be less than originally anticipated?

HIGHLIGHTS

- The U.S. dollar's short-term trend will mainly depend on developments in the United States. The debate over the continuation of the European Central Bank's and Bank of Japan's easing measures is not likely to have much effect on the exchange rate, because those measures will remain justified for several more quarters.
- The Canadian dollar should stay below US$0.80 for a good part of the year. The recent rally in oil prices could well prove short-lived, due to the lack of a sufficient adjustment to global output.
- Risks of a Greek default and upcoming monetary tightening in the U.S. should keep the euro weak until the end of 2015. This currency should however go up next year to reflect improved economic conditions in the euro zone.
- The pound is likely to be highly volatile until the election in the United Kingdom. After that, it should be relatively stable against the euro for the rest of the year.

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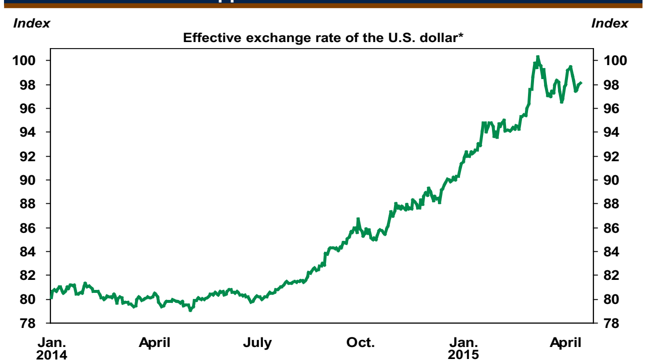
Editorial

One of the main determining factors of exchange rate movements in recent quarters is the fact that investors are anticipating wide divergence between U.S. monetary policy and those of several other economies, including the euro zone and Japan. The outcome of this has been a significant and fairly generalized appreciation of the U.S. dollar, but this effect has been fading since March (graph 1). Various signals are now suggesting that the divergence could turn out to be less than originally thought. In particular, the recent disappointments in U.S. economic data could encourage the Federal Reserve (Fed) to be more cautious, while greater optimism in the euro zone and in Japan could make less easing necessary.

Graph 1 – It has been more difficult for the U.S. dollar to appreciate since mid-March



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

THE U.S. ECONOMY STALLS IN THE FIRST QUARTER

Many U.S. economic indicators proved disappointing in the first few months of the year. Employment was one of the few good news stories, but even there the picture became gloomier, with just 126,000 new jobs in March. In the end, real GDP growth should come in below 1% in the first quarter, which would be a definite slowdown compared to previous quarters.

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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.

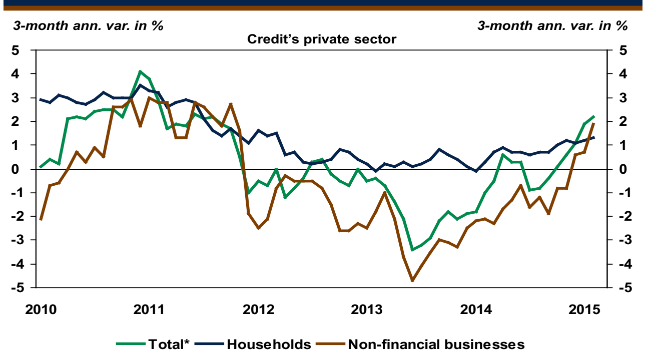
This slowdown would appear to be mainly caused by temporary effects, including the inclement weather in some parts of the United States and labour disputes at West Coast ports. However, this is not enough to dispel all doubts about the months to come. For one thing, it is difficult to tie the disappointments in some variables, like slow wage growth, to the weather. We had also hoped that April would bring some improvement in economic data, but the downturn in the New York Fed's Empire index started the month off on a poor footing.

The U.S. dollar is being penalized by the economic slowdown in the United States, since this may encourage the Fed to bide its time for longer. Nevertheless, the minutes of the Fed's latest monetary policy meeting show that several officials are still in favour of raising key interest rates as early as June. The U.S. dollar was even re-invigorated, temporarily, in reaction to that possibility. However, we should take into consideration the fact that the Fed did not have the latest data, including those on employment, in its possession at the time of its last meeting. Therefore, the scenario of an initial rate hike in September appears to be the most likely at this point. This scenario also suggests that the U.S. dollar will regain strength within a few months, once the doubts about the U.S. economy have dissipated.

THE DATA FROM THE EURO ZONE ARE IMPROVING

While the United States is experiencing a slowdown, the reverse is being observed in the euro zone. Many indicators show that the accelerating growth of the fourth quarter continued into the new year, with an added bonus of improvement in credit, mainly among businesses (graph 2). Thus the sharp depreciation of the euro and the low interest rates in the euro zone appear to be having positive effects. It is interesting to note that these effects materialized even before the European Central Bank (ECB) officially started its sovereign bond purchases in March.

Graph 2 – Credit has started to expand again in the euro zone



* Includes financial institutions other than banks.
Sources: European Central Bank and Desjardins, Economic Studies

The improvement in the euro zone economy is now fuelling speculations about how long the ECB's asset purchase program will last. In its official press release, the ECB indicates that it intends to continue these purchases until September 2016, but that it is keeping an exit door open in case inflation gets back on target sooner than expected. The ECB clarified its position in April, indicating that it would base its decisions on inflation trends, to judge whether its target is achieved in the medium term. This means that it would not necessarily halt its easing measures if inflation rose temporarily to 2%, but it probably would do so if the economy improved enough to generate inflationary pressures that were incompatible with its target.

OTHER CENTRAL BANKS COULD IMITATE THE ECB

The euro zone is not the only place where economic data are improving. Japan is exhibiting many encouraging signs, which are reassuring the officials of the Bank of Japan (BoJ). But as in the case of the ECB, it is still too early to contemplate any reduction of easing measures. The question is likely to become relevant in the longer term, though, if the economy keeps improving. The same holds true for other central banks in Europe and Asia, which could follow the ECB's and the BoJ's lead in limitating easing measures.

In the short term, the debate over the continuation of the ECB's and BoJ's easing measures is not likely to have much effect on the exchange rate, because those measures will remain justified for several more quarters. Consequently, the U.S. dollar's short-term trend will mainly depend on developments in the United States. However, the debate could become a more important issue at the end of the year, and could help arrest the greenback's upwards trend in 2016.

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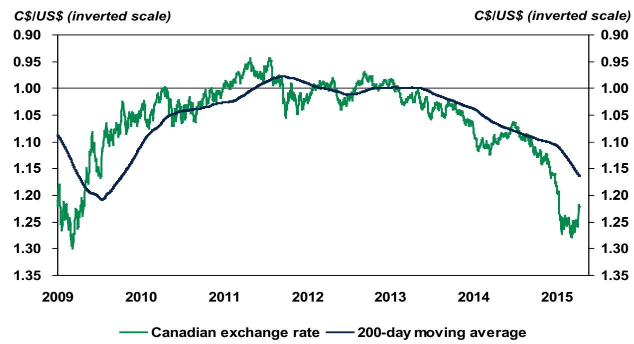
CANADIAN DOLLAR (CAD)

Oil is the key ingredient

- The Canadian dollar has been under less pressure since oil prices stopped tumbling. Recently, the rally in crude prices around US$55 per barrel has helped bring the loonie back to over US$0.82. The fact that the Bank of Canada (BoC) is giving no hint of further lowering of interest rates is also favouring the appreciation of the loonie, although that movement appears to be tentative.
- From a technical standpoint, the Canadian dollar was ripe for a correction. The pace of depreciation as calculated over three months had stayed very strong over a long period of time, and the speculative positions were still strongly oriented downwards until just recently. But it took some help from fundamentals, such as the increase in oil prices, to get the correction underway.
- Our prediction for the Canadian dollar is closely tied to the expected trajectory of oil prices. On this point, we do not foresee that the current rebound in crude prices will be permanent. Sustainable upward price movement is unlikely to materialize until later this year, once it becomes clearer that growth in global oil production has slowed sufficiently to rebalance the market. The announcement of a partial agreement on Iran's nuclear program at the beginning of April, and the possibility of a final agreement in June, could delay such an adjustment, as this would lead to the lifting of the sanctions that are currently limiting Iran's oil exports.
- Oil price trends are so important that they also influence Canadian monetary policy. The BoC justified January's interest rate cut by presenting it as an insurance policy against the negative economic impact of the oil price slump. The subsequent stabilization of oil prices gave the BoC some reassurance, but another collapse or an extended period of low prices could prompt the central bank to lower its key interest rates once again.

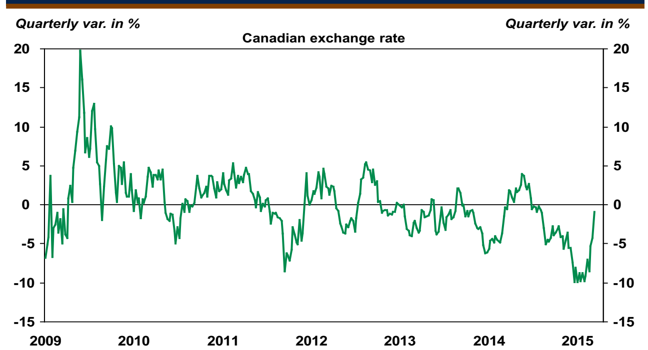
Forecasts: The Canadian dollar should stay below US$0.80 for a good part of the year. The recent rally in oil prices could well prove short-lived, due to the lack of a sufficient adjustment to global output. The possibility of the BoC ordering another rate cut is one more soft spot for the loonie, which will likely also fall victim to an eventual rebound by the U.S. dollar.

Canadian dollar and trend



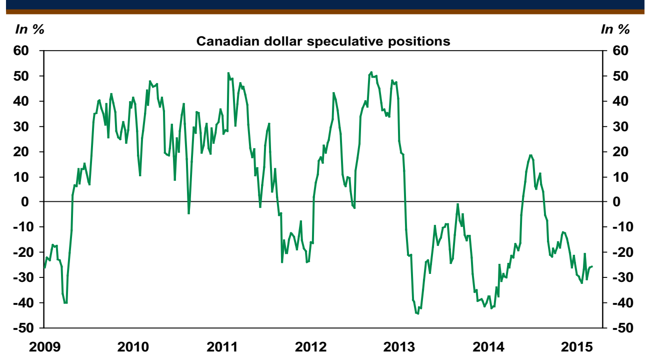
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

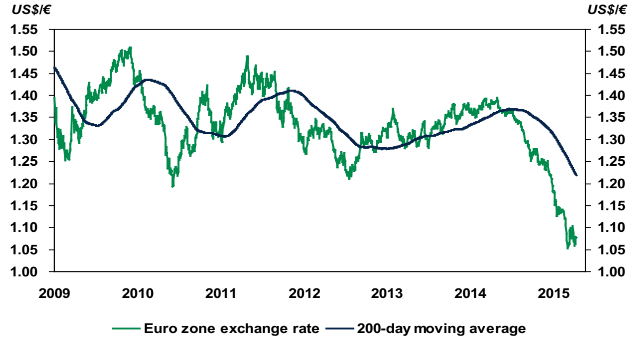
EURO (EUR)

Things are improving, except for Greece

- After dropping below US$1.05 on March 13, the euro surged back up after the Federal Reserve (Fed) meeting of March 18, at which time the Fed officials revised their forecasts for U.S. key interest rates, downwards. As a result, the euro climbed temporarily above US$1.10 at the end of March. But a rally by the U.S. dollar after the release of the minutes of the Fed meeting, and growing apprehensions of default by the Greek government, recently drove the euro back down to around US$1.07.
- One month ago, we noted that the very negative speculative positions on the euro were opening the door to a technical rebound. That is precisely what happened after the Fed meeting, when some investors reversed their positions. However, this trend did not last, and the speculative positions recently fell even lower into negative territory. It is reasonable to assume that this very negative sentiment towards the euro reflects the worrisome developments of the situation in Greece. The Greek government avoided default at the beginning of April by making a payment of €450M to the International Monetary Fund (IMF). However, it clearly indicated that it would soon be unable to meet its financial obligations. With the negotiations between Greece and its financial partners for a reactivation of the aid plan appearing to be at an impasse, there is a real possibility of imminent default. Such default would not necessarily entail Greece abandoning the euro, but it would generate plenty of volatility for this currency.
- Apart from the Greek issue, the news out of the euro zone is encouraging. The confidence and activity indicators keep heading up, and the latest statistics on industrial output appear to confirm that the euro zone economy has started off the year on the right foot. It is even more encouraging to see that credit creation finally seems to have a bit more energy in its step. Given these developments, the possibility of further monetary easing on the European Central Bank's (ECB) part is now very low; rather, the question is whether the ECB might decide to halt its purchases before the planned date of September 2016. The ECB considers such questioning highly premature, but that possibility could become more serious a few quarters from now, should inflation pick up.

Forecasts: Risks of a Greek default and upcoming monetary tightening in the U.S. should keep the euro weak until the end of 2015. This currency should however go up next year to reflect improved economic conditions in the euro zone.

Euro and trend



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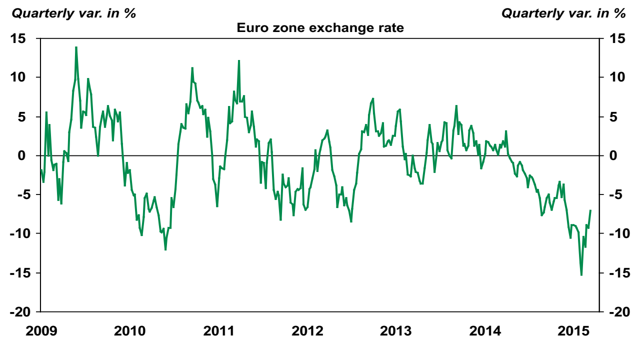
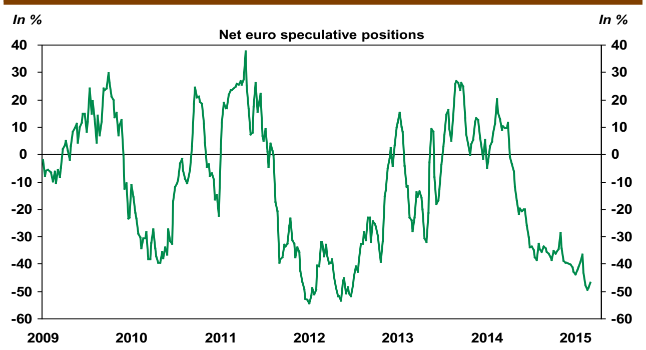
Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



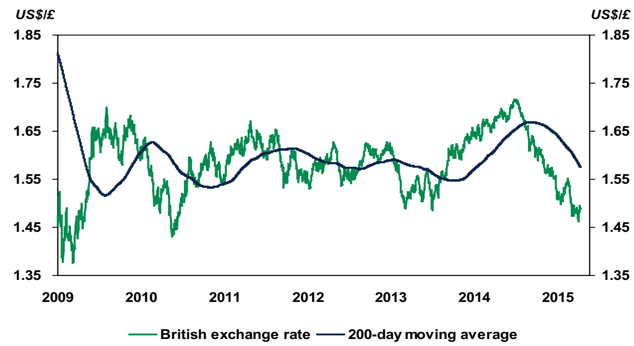
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

The pound falters as elections draw near

- After falling to around US$1.47 in the middle of March, the pound sterling rose slightly after the Federal Reserve meeting of March 18, briefly approaching US$1.50. A few disappointing data and a rally of the U.S. dollar then drove the pound below US$1.46, on April 13, its lowest level since 2010. The pound has also depreciated against the euro recently. The economic statistics out of the United Kingdom have been rather mixed lately. The upturns in the purchasing managers' indexes and retail sales are encouraging, but the latest data on industrial output and construction were disappointing. With an inflation rate of zero and core inflation at just 1.0% in March, indications are that the Bank of England will hold off on monetary tightening for a good while yet. The pound's recent weakness seems to mainly reflect uncertainty surrounding the upcoming general election of May 7. Polls are indicating a very tight race between the Conservatives and the Labour party, which will probably result in a more or less stable minority government. Even a victory by the incumbent government would not necessarily be positive news for the pound, since Prime Minister Cameron has promised to hold a referendum on whether the United Kingdom should remain in the European Union. **The pound is likely to be highly volatile until the election. After that, it should be relatively stable against the euro for the rest of the year.**

British pound and trend



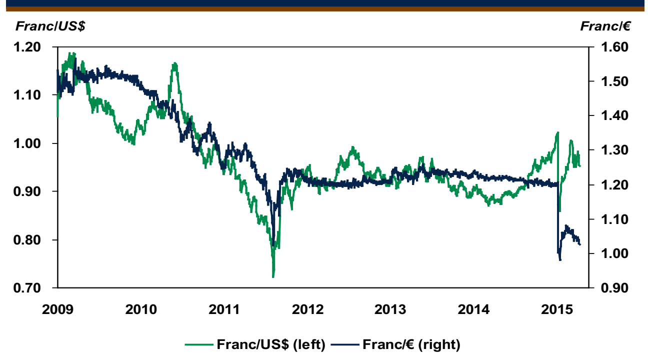
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

The Swiss franc starts appreciating again

- In the middle of March, the Swiss National Bank (SNB) seemed to have succeeded in stabilizing the EUR/CHF pair at a little over 1.05 francs. However, recent weeks have seen a gradual appreciation of the franc, which is now trading below 1.03 francs. While not spectacular, this trend certainly raises concerns for the SNB, which has already revised its forecasts of inflation and economic growth sharply downwards, due to the appreciation of the franc. The International Monetary Fund (IMF) also believes that the franc is overvalued, and is recommending that the SNB ease its monetary policy even further, for example by announcing a program to purchase securities denominated in foreign currencies. **The franc could appreciate further against the euro in the short term, especially if the risk of a Greek default keeps increasing. However, a probable intervention by the SNB could reverse that trend fairly quickly.**

Swiss franc



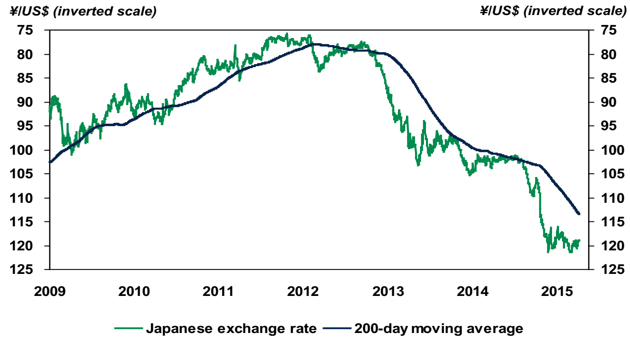
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

Further intervention by the Bank of Japan appears less certain

- The yen's low degree of volatility in recent months is in sharp contrast with the other major currencies. Since the sudden adjustment that occurred last October and November, the Japanese exchange rate has stayed close to the ¥120/US$ mark. The improvement in the Japanese economy is likely helping to stabilize the yen's value, especially since it reduces the probability of another intervention by the Bank of Japan (BoJ).
- Even though inflation should fall back to around 0% in April, when the effect of the sales tax hike comes to an end, the BoJ does not seem prepared to increase its asset purchases. The past depreciation of the yen, combined with lower oil prices, is generating remarkable positive effects on the economy, and this should eventually lead to greater inflationary pressure. We must also consider that the increase in asset purchases that was announced in October was not unanimously supported within the BoJ, and one of the officials is already calling for those purchases to be scaled back significantly. Under these conditions, **the yen's depreciation will likely be more limited, and will mainly result in the appreciation of the U.S. dollar**.

Yen and trend



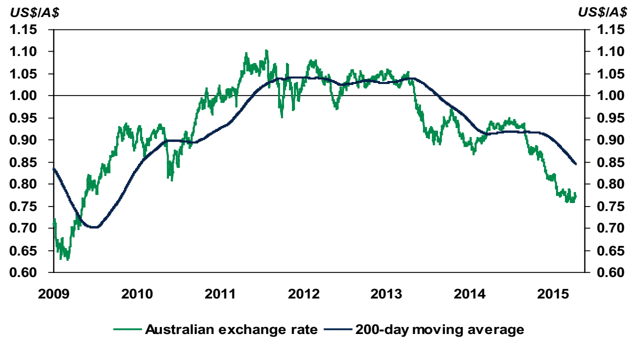
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The slump in iron ore prices is undermining the terms of trade

- In the past few months, the Australian dollar has been fluctuating between US$0.75 and US$0.80. More recently, it has been sticking close to the low end of that range. The weakness of commodity prices, in particular the drop in iron ore prices, is causing deterioration in the Australian terms of trade, on top of other economic problems such as the decline in business investment.
- The Reserve Bank of Australia (RBA) lowered is main key interest rate in February (to 2.25%) and many people were expecting it to do so again at the beginning of April. In the end, the RBA chose the status quo, but it still left the door open to further easing. Sharp growth in home prices in some Australian cities does not make the RBA's job any easier; it apparently wants to avoid encouraging a real estate bubble by dropping interest rates too low. Lastly, the RBA is continuing to assert that the Australian dollar needs to depreciate to support the economy. Considering the recent trends in fundamental variables, **we predict that the Australian currency will settle in below US$0.75 in the months ahead**.

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

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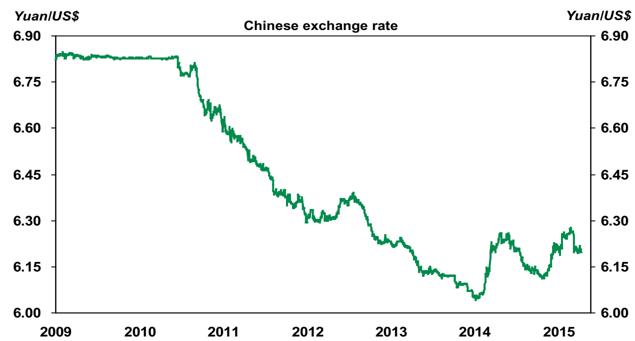
EMERGING CURRENCIES

Chinese economic growth continues to slow

CHINESE YUAN (CNY)

- The Chinese economy is continuing to raise concerns, as its growth rate is slowing. The annual change in real GDP stands at 7.0% in the first quarter of 2015, barely meeting the official target set by Chinese authorities. The slowdown is more obvious if we look at the quarterly change, which dropped from 1.5% in the fourth quarter of 2014 to 1.3% in the first quarter of 2015. To this we must add disappointments in March relating to retail sales, industrial production and international trade. In these circumstances, **the Chinese monetary authorities will probably announce further measures to support the economy, and will likely want to avoid any appreciation of the yuan in the coming quarters**. The exchange rate should hold steady at around 6.25 yuan/US$.

Chinese yuan and trend



Sources: Datastream and Desjardins, Economic Studies

MEXICAN PESO (MXN)

- Despite some recovery in oil prices, the Mexican peso has remained weak and very volatile. Disappointing economic data from the United States may have helped to foster rather negative sentiment towards the peso, since the Mexican economy is very dependent on U.S. demand. But the latest Mexican statistics are a little more encouraging; for example, vehicle exports reached a new peak in March. The Bank of Mexico's decision to preserve the status quo at the end of March was also detrimental to the peso, as some investors believe that a key interest rate hike is necessary to prevent the Mexican currency from declining further. The release of the minutes of that meeting, which showed that the decision was unanimous, also weighed the peso down. **The peso should stay weak in the months to come, while the uncertainty surrounding U.S. monetary policy will limit the appeal of emerging currencies. However, it should appreciate in the longer term.**

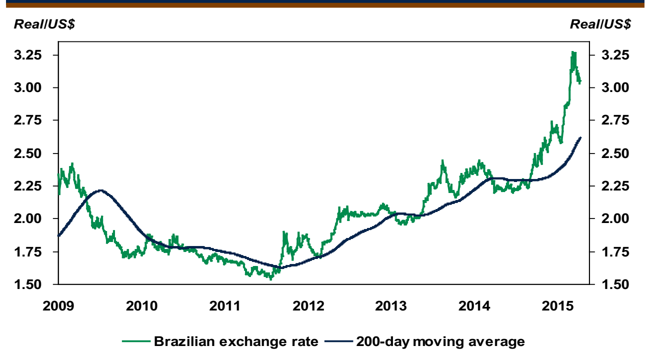
Mexican peso and trend

Sources: Datastream and Desjardins, Economic Studies

BRAZILIAN REAL (BRL)

- The Brazilian real has appreciated in recent weeks and is currently trading at close to 3.05 real/US$. A few factors have led to this rally, including stabilizing oil prices and stronger-than-expected economic growth in Brazil in the fourth quarter of 2014. On the other hand, **the outlook for Brazil is still very uncertain, and this should put the real back on a downward trend**. In particular, prices for oil and other commodities could fall again in the short term. The high inflation rate, currently 8.1%, is also a sizable challenge, since it forces the central bank to keep up monetary firming, despite the negative effects that this entails for economic growth.

Brazilian real and trend



Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

Country – Currency*	Spot price April 20	Percentage return since 1 month	3 months	6 months	1 year	Last 52 weeks Higher	Average	Lower
Americas								
Argentina – peso	8.8675	0.8484	2.9758	4.5696	10.8327	8.8675	8.4295	8.0005
Brazil – real	3.0464	-5.3767	16.0448	23.7448	35.5620	3.2926	2.5232	2.1959
Canada – dollar	1.2196	-3.1602	0.8851	8.1973	10.9787	1.2803	1.1459	1.0632
Canada – (CAD/USD)	0.8199	3.2634	-0.8773	-7.5763	-9.8926	0.9406	0.8726	0.7811
Mexico – peso	15.4013	2.3305	5.2052	13.7408	17.9030	15.5843	13.8410	12.8363
Asia and South Pacific								
Australia – (AUD/USD)	0.7726	-0.6258	-5.4465	-12.0365	-17.2126	0.9498	0.8616	0.7590
China – yuan renminbi	6.2010	-0.0677	-0.2092	1.2648	-0.3735	6.2744	6.1943	6.1112
Hong Kong – dollar	7.7502	-0.1012	-0.0303	-0.0947	-0.0542	7.7708	7.7537	7.7500
India – rupee	63.1374	1.1655	2.4043	3.1067	4.7142	63.6700	61.2511	58.2850
Japan – yen	119.2000	-0.6956	0.3283	11.4487	16.3892	121.4500	110.8136	101.1750
New Zeland – (NZD/USD)	0.7663	1.2644	0.3142	-3.8238	-10.7969	0.8821	0.8017	0.7262
South Korea – won	1,079	-3.8956	-0.8270	1.8496	3.9037	1,132	1,063	1,008
Europe								
Denmark – krona	6.9500	0.8840	7.9746	19.4712	28.5716	7.1086	5.9887	5.3593
Euro zone – (EUR/USD)	1.0755	-0.3706	-7.0684	-15.8522	-22.2688	1.3933	1.2530	1.0522
Norway – kroner	7.8805	-1.8838	2.7150	20.2285	31.5500	8.3125	6.8208	5.8995
Russia – ruble	53.0313	-10.5387	-18.9967	29.1870	48.4762	72.4500	46.3900	33.6595
Sweden – krona	8.6964	0.8571	6.5148	21.1493	31.8156	8.8229	7.4372	6.4969
Switzerland – swiss franc	0.9545	-2.2581	8.7692	1.1177	8.3556	1.0194	0.9346	0.8533
United Kingdom – (GBP/USD)	1.4916	-0.0402	-1.8200	-7.5352	-11.2648	1.7170	1.6033	1.4642

* 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 Q1	Q2f	Q3f	Q4f	2016 Q1f	Q2f	Q3f	Q4f
American dollar											
Canadian dollar	(USD/CAD)	1.1199	1.1621	1.2688	1.2821	1.2987	1.2658	1.2500	1.2195	1.2048	1.1905
Euro	(EUR/USD)	1.2632	1.2101	1.0740	1.0800	1.0400	1.0500	1.0600	1.0900	1.1000	1.1200
British pound	(GBP/USD)	1.6212	1.5593	1.4845	1.5000	1.4700	1.4800	1.5100	1.5500	1.5600	1.5500
Swiss franc	(USD/CHF)	0.9534	0.9894	0.9744	0.9600	1.0100	1.0000	1.0000	0.9800	0.9800	0.9700
Yen	(USD/JPY)	109.66	119.70	120.14	120.00	122.00	125.00	124.00	125.00	126.00	127.00
Australian dollar	(AUD/USD)	0.8746	0.8170	0.7607	0.7400	0.7200	0.7500	0.7600	0.7800	0.7900	0.8000
Chinese yuan	(USD/CNY)	6.1385	6.2061	6.1995	6.2500	6.2500	6.2200	6.2000	6.2000	6.1800	6.1500
Mexican peso	(USD/MXN)	13.43	14.75	15.26	15.20	15.40	14.70	14.60	14.50	14.25	14.00
Brazilian real	(USD/BRL)	2.4507	2.6559	3.2077	3.2000	3.4000	3.3500	3.2500	3.0500	3.0000	2.9000
Effective dollar*	(1973 = 100)	81.30	85.13	92.06	92.15	94.50	93.80	92.70	90.80	90.20	89.50
Canadian dollar											
American dollar	(CAD/USD)	0.8929	0.8605	0.7882	0.7800	0.7700	0.7900	0.8000	0.8200	0.8300	0.8400
Euro	(EUR/CAD)	1.4147	1.4061	1.3626	1.3846	1.3506	1.3291	1.3250	1.3293	1.3253	1.3333
British pound	(GBP/CAD)	1.8155	1.8119	1.8835	1.9231	1.9091	1.8734	1.8875	1.8902	1.8795	1.8452
Swiss franc	(CAD/CHF)	0.8513	0.8514	0.7680	0.7488	0.7777	0.7900	0.8000	0.8036	0.8134	0.8148
Yen	(CAD/JPY)	97.91	103.00	94.69	93.60	93.94	98.75	99.20	102.50	104.58	106.68
Australian dollar	(AUD/CAD)	0.9795	0.9494	0.9651	0.9487	0.9351	0.9494	0.9500	0.9512	0.9518	0.9524
Chinese yuan	(CAD/CNY)	5.4813	5.3406	4.8863	4.8750	4.8125	4.9138	4.9600	5.0840	5.1294	5.1660
Mexican peso	(CAD/MXN)	11.99	12.69	12.03	11.86	11.86	11.61	11.68	11.89	11.83	11.76
Brazilian real	(CAD/BRL)	2.1883	2.2855	2.5282	2.4960	2.6180	2.6465	2.6000	2.5010	2.4900	2.4360

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