FX Forecasts

Desjardins Economic Studies
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The U.S. dollar is poised to rebound—it only needs good data...

HIGHLIGHTS

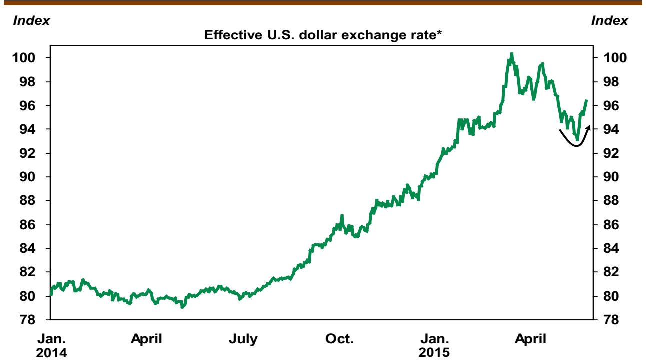
- We remain optimistic for the second quarter in the United States and in our eyes, the most probable scenario remains a first key interest rate increase in September. In this context, we still think the U.S. dollar will rise in the coming months, perhaps hitting new cyclical peaks against several currencies.
- It is too early to look for a lasting rise by the Canadian dollar. The factors that helped weaken it in the last few quarters persist. The Canadian dollar could well drop back below US$0.80 in the coming months.
- Beyond the Greek issue, which is a major downside risk in the near term, our expectation for the U.S. economy and monetary policy suggest that the euro could test its March lows.
- The Bank of Japan is confident it can reach its 2% inflation target in 2016 with the current degree of monetary stimulus. We are cautious about the yen's potential to depreciate for the rest of the year; our target is ¥124/US$.

Contents

Editorial

The foreign exchange markets remain very volatile. The big drops against the greenback recorded by many currencies were followed by a short rise from mid-March to mid-May. This trend could reverse again as the U.S. dollar is showing signs of life (graph 1). One factor is needed however to support a sustained rebound in the U.S. dollar: better economic numbers in the United States.

Graph 1 – The U.S. dollar has strengthened a little since mid-May



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

THE DISAPPOINTMENT IS MOUNTING

U.S. economic growth was very weak in the first quarter, at just 0.2% (annualized), hard hit by the weather, sharp drop in oil sector investment and labour dispute at West Coast ports. This growth could also be downgraded, likely into negative territory. Among other things, the data on international trade was weaker than the assumption used in the first estimate of real GDP.

Expectations are high for the second quarter but, to date, most of the data released for April was disappointing. This includes a dip in industrial output and stagnating retail sales, although they had rebounded in March after a 3-month slide. The carryover for retail sales does not

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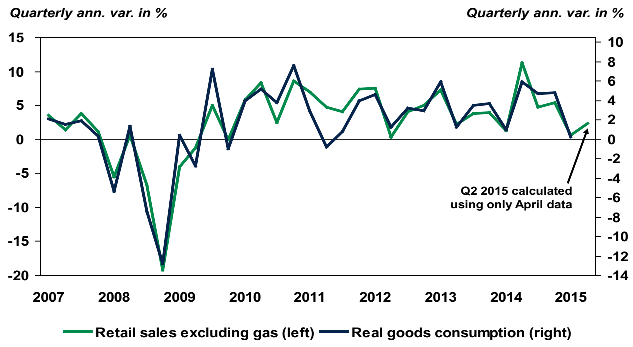
point to any big acceleration by consumption in the second quarter (graph 2). To achieve real GDP growth above 3%, however, consumers will have to make a big contribution. The data for May and June will have to be strong. April's rebound by housing starts and employment helps us to remain optimistic about what's to come.

Graph 2 – U.S. real consumption only looks a little better for the second quarter



Sources: U.S. Census Bureau, Bureau of Economic Analysis and Desjardins, Economic Studies

THE FEDERAL RESERVE COULD WAIT LONGER

Of course, if economic growth advances more slowly than anticipated in the second quarter, that would compromise the scenario of a first Federal Reserve (Fed) key interest rate increase in September. The Fed could decide to wait a few more months, especially if inflation were subdued; this would have a big impact on the greenback's movement. Although it is currently showing signs of renewed life, it could quickly give up ground in the near term.

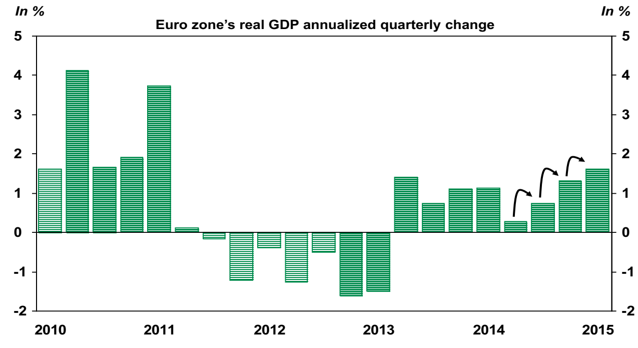
That being said, because we remain optimistic for the second quarter in the United States, in our eyes, the most probable scenario remains a first rate increase in September. In this context, we still think the U.S. dollar will rise in the coming months, perhaps hitting new cyclical peaks against several currencies.

A FEW FLASHES IN THE PAN

The U.S. dollar's weakness between mid-March and mid-May cannot only be chalked up to disappointing data in the United States. For example, the U.S. dollar was hit by the rebounding euro, buoyed by better economic numbers across the pond (graph 3). However, the optimism was probably exaggerated. It seems unlikely that growth will keep accelerating the way it has recently; the first-quarter slowdown in Germany is one sign of that.

As the European figures improved, some started to expect an early end to the European Central Bank's easing measures. Once again, this is likely to be a flash in the pan, as the euro zone's economy is nowhere near full capacity and, accordingly, underlying inflation pressures will be weak for several more quarters. We also remain pessimistic about the euro; other currencies in the region should follow the same downtrend, at least somewhat.

Graph 3 – The euro zone's economy has been gaining speed for the last three quarters



Sources: Eurostat and Desjardins, Economic Studies

Lastly, there is reason to wonder about whether the upswing by oil prices will last—it has boosted some currencies, including the Canadian dollar. West Texas Intermediate (WTI), the benchmark oil price, went from about US$45/barrel in March to over US$60/barrel in early May. For this upswing to persist, however, the imbalance between oil production and demand would have to adjust further. We are therefore pessimistic about crude-sensitive currencies for the near future.

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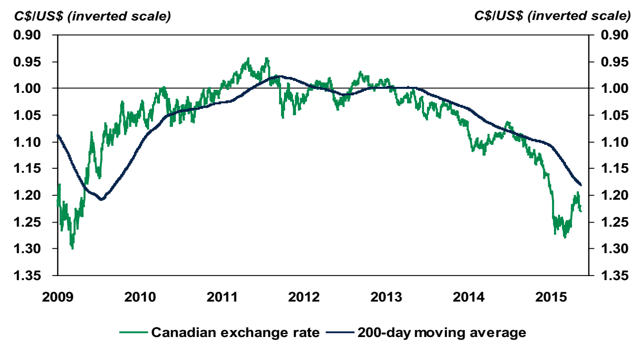
CANADIAN DOLLAR (CAD)

Too soon for a lasting rise

- The main drivers behind the recent rebound by the Canadian exchange rate were the rise by oil prices and weak U.S. dollar. The rebound took the loonie to a 4-month peak at US$0.8389 (C$1.1920/US$) on May 14. The loonie has since then dropped back below US$0.82, as crude prices lost some ground and the greenback seems to be showing new signs of life.
- Technically, the 3-month momentum is back in positive territory, but it is still too early to talk about a Canadian dollar uptrend. The 200-day moving average is still solidly tilted to the downside and has not been tested despite the loonie's upswing. Investors are a lot less pessimistic, however, as net speculative positions are back at neutral.
- Fundamentally, the chances of further depreciation seem stronger than the chances of lasting appreciation. The key factor is still the movement by oil prices, which does not promise to be good in the near term. Firstly, global oil output continues to rise faster than demand. Among other things, oil producing countries responded to the drop in revenue by increasing their export volumes. Also, a possible final agreement on Iran's nuclear program in June and relaxation of sanctions could intensify the oil surplus and delay the much awaited adjustment between supply and demand. In this context, oil prices could relapse close to recent lows before starting a real uptrend.
- The energy sector is vital to Canada's economy and the data acquired to date points to nearly zero real GDP growth in the first quarter. Subsequent quarters are expected to see a rebound, but this scenario will be highly dependent on the ability of other sectors to take up the slack. Investment and exports will have to do well, arguing for an ongoing low dollar. The Bank of Canada (BoC) is less open to another key interest rate cut, but it could rapidly change its stance if the economy is not up to par.

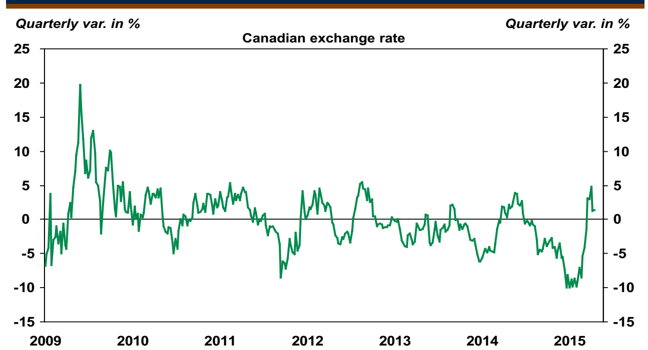
Forecasts: It is too early to look for a lasting rise by the Canadian dollar. The factors that helped weaken it in the last few quarters persist. Oil prices could tumble, the U.S. dollar should go up, and the BoC could still change its mind. In this context, the Canadian dollar could well drop back below US$0.80 in the coming months.

Canadian dollar and trend



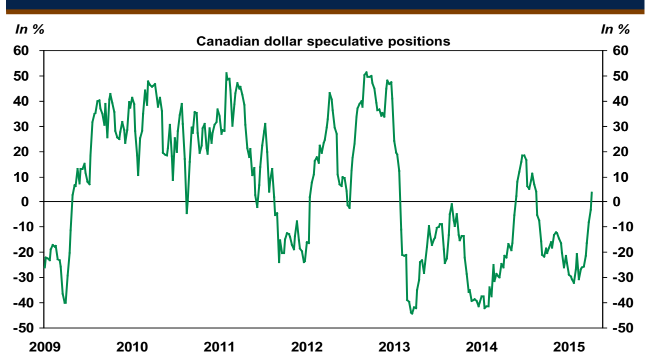
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

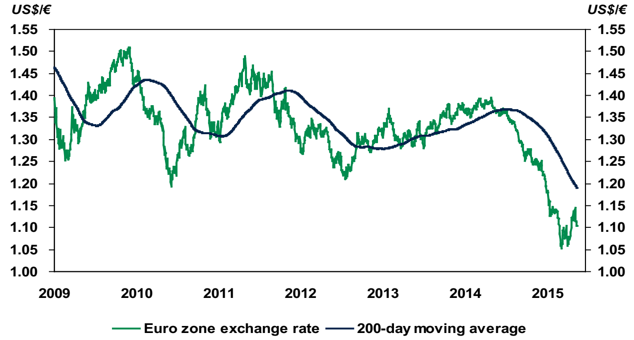
EURO (EUR)

Volatility could remain strong

- After falling to US$1.06 in mid-April, the euro started to trend up sharply, going above US$1.145 in mid-May. The news that the European Central Bank (ECB) will temporarily pick up the pace on its financial securities purchases before the summer lull recently took the euro back to around US$1.10.
- The big rebound of the euro largely seems to reflect the U.S. dollar correction—it had shot up too quickly in early 2015. The euro's rise also came during a particularly volatile period in the markets, in which we also saw sharp upswings by oil prices and bond yields that did not seem to be based on better economic statistics. On the contrary, U.S. economic figures have generally been disappointing in the last few months, prompting investors to push back the forecast timing for the onset of U.S. monetary firming.
- The euro also seems to have benefited from the fact that Europe's economic numbers have recently been better. The euro zone's real GDP is showing annualized 1.6% growth for the first quarter. That, combined with an uptick of inflation, is making some analysts think that the ECB could halt its securities purchases prior to the scheduled September 2016 cut-off date. Changing expectations for monetary policy on both sides of the Atlantic has certainly been one factor in the euro's recent upswing. However, there are good reasons to think this factor will not be a major support for the euro in the months to come. An early halt to the ECB's purchases seems unlikely, as the ECB knows that the improvement to the euro zone's economy is heavily reliant on its stimulus policy. Conversely, the Federal Reserve could surprise investors by kicking off monetary firming toward the end of this summer.
- The euro's recent rebound seems particularly fragile given that nothing has yet been settled with Greece. The negotiations between the Greek government and its European partners seem to have taken a more positive turn lately, but the International Monetary Fund (IMF) is taking a harder line. It seems increasingly likely that Greece will see a partial default or reschedule its debt and the risks of major political and financial crises remain high.

Forecasts: Beyond the Greek issue, which is a major downside risk in the near term, we expect the U.S. economy to rebound and U.S. key rates to rise in the second half of 2015, suggesting that the euro could test its March lows.

Euro and trend



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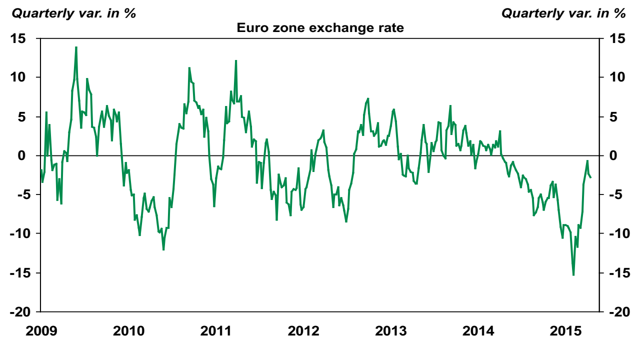
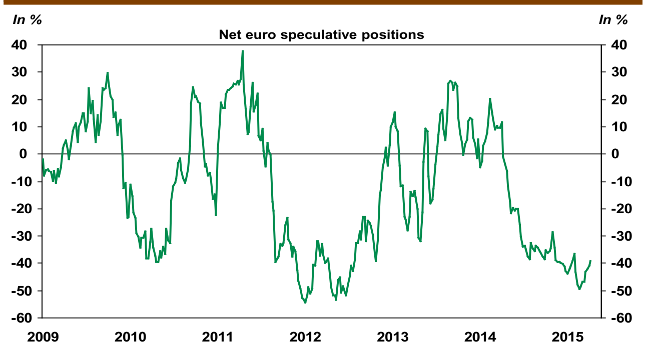
Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions

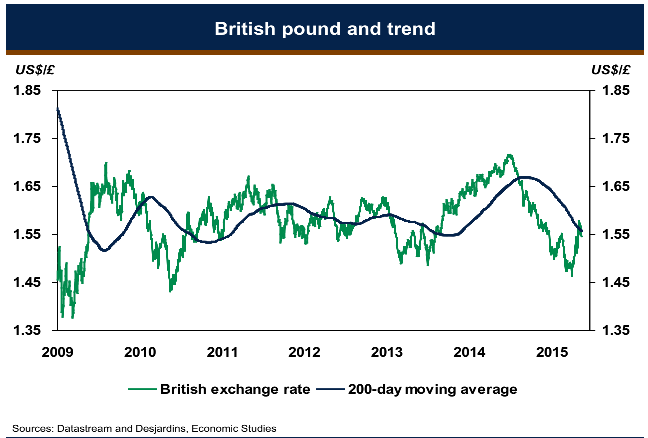


Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

An overdone upswing

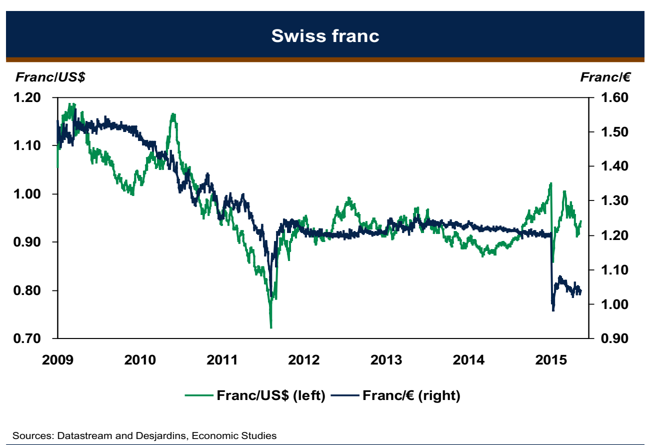
- Like the euro, the pound sterling shot up as of mid-April, rising from about US$1.46 to US$1.54 at the end of the month. The pound did not go up as much as the euro, however, and the EUR/GBP pair hit £0.74 in early May. The Conservative government's surprise victory in the May 7 election gave the pound an extra push, taking it to US$1.58 and wiping out its retreat against the euro. The election of a majority government is especially good for the pound, as numerous surveys had suggested an impasse that would quickly take the United Kingdom back to the polls. Political risks could start to hamper the pound once again in a few quarters, however, with Prime Minister Cameron pledging to hold a referendum by 2017 on whether to keep the United Kingdom in the European Union. Scottish nationalists also made some spectacular gains, raising the spectre of another referendum on Scottish independence. Although the first quarter was a little softer than expected, the economic outlook for the United Kingdom remains relatively good. Weak inflation, which recently slid into negative territory, and the strong pound argue for a long monetary policy status quo, however. **Like most currencies, the pound should slide against the U.S. dollar in the months to come.**



SWISS FRANC (CHF)

The Swiss National Bank managed to curb another rise by the franc

- A month ago, we remarked that the Swiss National Bank (SNB) would have trouble tolerating persisting upside pressure on the franc against the euro. The SNB did not sit on its hands: on April 22, it announced that it was slashing the number of accounts not subject to negative interest rates. Although this decision's real impact seems limited, it was read as a signal that the SNB would not allow the franc to rise further. The EUR/CHF pair immediately went from 1.025 francs to 1.040 francs on the news. After that, the strong euro and rumoured SNB intervention took the pair close to 1.050 francs, a level that seems acceptable to the SNB. A leader recently remarked that SNB was satisfied with the effect of negative rates, but could expand its balance sheet further. **Save for a financial shock due to the Greek problem, the franc should be relatively stable against the euro in the months to come.**

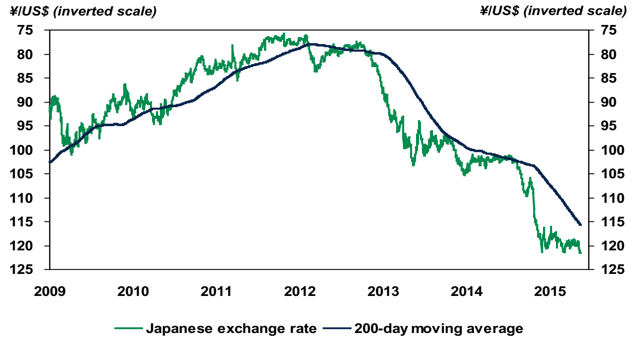


YEN (JPY)

The Bank of Japan thinks it will reach its inflation target in 2016

- Japan's exchange rate has been among the least volatile rates in the last few months. Incursions above ¥120/US$ are always short-lived, with no factors that could support another depreciation movement like a lasting U.S. dollar rebound or signs that the Bank of Japan (BoJ) would relax its monetary policy more.
- While the U.S. dollar should show a persistent rebound in the next few months, further action from the BoJ seems much less likely. The BoJ is confident it can reach its 2% inflation target in 2016 with the current degree of monetary stimulus. Moreover, for the last few meetings, one leader has been voting to cut its securities purchases. We cannot overlook the improvement in some fundamentals, such as the more than ¥2,000B surplus in March's current account, a high that dates back to October 2007. Real GDP growth was also a strong 2.4% in the first quarter. **We are cautious about the yen's potential to depreciate for the rest of the year; our target is ¥124/US$.**

Yen and trend



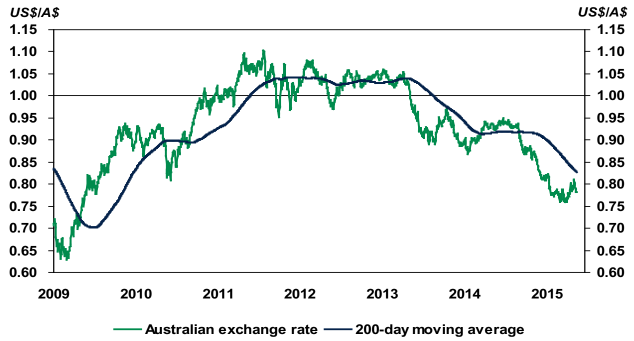
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The Reserve Bank of Australia carries on with its easing cycle

- The Australian dollar rose in the second half of April and early May, taking it back above US$0.80. The release of a few better than anticipated statistics last month, including employment, certainly had something to do with the currency's rebound. Stronger prices for commodities also played in favour of the Australia's dollar, along with the U.S. dollar's weakness. However, the aussie's rise is already running out of steam. One of the factors against it is the Reserve Bank of Australia's recent key rate cut, ordered in May, and the suggestion that the easing cycle is not over yet.
- Australia's economic situation remains uncertain due to the sharp drop by mining investment and mixed data from China. At 1.3%, inflation is also well below its target range (2% to 3%). **We expect Australia's dollar to slide back to around US$0.75 in the coming months**, consistent with the evolution of the Australian economy's fundamentals and anticipated U.S. dollar rebound.

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

Emerging currencies did not respond as strongly to the new jump by bond yields

CHINESE YUAN (CNY)

- Chinese monetary authorities capitalized on the greenback's weakness as of mid-March to revalue the yuan to 6.20 yuan/US$. The rebound by advanced nations' bond yields did not trigger another wave of emerging currency depreciation, which may also have bolstered Chinese authorities in revaluing their currency. However, **it would be surprising to see the yuan surge against the greenback this year**. Firstly, the greenback should rise, as China's economic numbers remained mixed. This could result in further monetary easing measures to try to speed up credit. The People's Bank of China also ordered another interest rate cut on May 10.

MEXICAN PESO (MXN)

- The Mexican peso has been fairly stable against the U.S. dollar since mid-April, with the USD/MXN pair generally fluctuating between 15.0 pesos and 15.5 pesos. The peso's resilience despite the upswing by bond yields could be due to the fact that the rise in yields does not reflect a change in expectations for U.S. monetary policy. The Bank of Mexico recently downgraded its growth outlooks for 2015 and 2016, as Mexican oil production has declined. It is keeping the door open to a key rate increase this year, however, especially if the Federal Reserve initiates monetary firming. In this context, **a key rate increase in the United States in response to a rebound of the U.S. economy would probably hurt the peso less than other emerging currencies**.

BRAZILIAN REAL (BRL)

- The Brazilian real has been less volatile since April and is currently trading at close to 3.05 reales/US$. The 2013 rebound by bond yields had hit the real hard and we could have expected it to depreciate recently. Brazil's exchange rate is much higher than it was in 2013, however. Now, it is mainly affected by commodity prices and economic indicators. Here, the outlook remains gloomy, with runaway inflation (8.2% in April) and a central bank that must pursue monetary firming in order to subdue inflation. **It will be hard for Brazil's economic growth to pick up speed and the exchange rate could climb over 3.25 reales/US$.**

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 May 25	Percentage return since 1 month	3 months	6 months	1 year	Last 52 weeks Higher	Average	Lower
Americas								
Argentina – peso	8.9699	0.9283	2.8806	5.3300	11.2201	8.9699	8.5158	8.0638
Brazil – real	3.0645	3.1315	6.6100	20.8832	38.0974	3.2926	2.5983	2.1959
Canada – dollar	1.2286	0.9532	-1.2340	9.1846	12.9280	1.2803	1.1572	1.0632
Canada – (CAD/USD)	0.8139	-0.9442	1.2494	-8.4120	-11.4480	0.9406	0.8642	0.7811
Mexico – peso	15.2824	-0.6394	2.4101	12.0842	18.7859	15.5843	14.0583	12.8363
Asia and South Pacific								
Australia – (AUD/USD)	0.7825	0.0861	-0.7786	-8.2786	-15.2347	0.9498	0.8483	0.7590
China – yuan renminbi	6.2020	0.1372	-0.9162	1.0674	-0.5540	6.2744	6.1908	6.1112
Hong Kong – dollar	7.7519	0.0219	-0.0677	-0.0335	-0.0161	7.7708	7.7536	7.7500
India – rupee	63.4960	-0.2611	2.6417	2.6364	8.4938	64.1470	61.5996	58.5250
Japan – yen	121.5600	2.1641	2.2716	3.0388	19.2115	121.5600	112.5166	101.1750
New Zeland – (NZD/USD)	0.7310	-3.9108	-3.2529	-6.4181	-14.4225	0.8821	0.7912	0.7262
South Korea – won	1,090	0.9913	-0.8143	-1.7264	6.3979	1,132	1,068	1,008
Europe								
Denmark – krona	6.7926	-1.0171	3.3315	13.8915	24.0295	7.1086	6.1129	5.4452
Euro zone – (EUR/USD)	1.1023	1.4541	-2.9409	-11.7096	-19.1322	1.3691	1.2276	1.0522
Norway – kroner	7.6437	-1.5438	1.3162	12.3323	28.2363	8.3125	6.9755	5.9455
Russia – ruble	49.8950	-2.6377	-19.8731	8.9042	46.1133	72.4500	47.8725	33.6595
Sweden – krona	8.4163	-2.5214	1.3988	13.3486	26.6495	8.8229	7.6116	6.6218
Switzerland – swiss franc	0.9428	-1.0600	-0.6691	-2.1638	5.2470	1.0194	0.9394	0.8533
United Kingdom – (GBP/USD)	1.5503	2.2255	0.0742	-1.4149	-7.9506	1.7170	1.5894	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	1.2500	1.2821	1.2500	1.2346	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	1.1100	1.1300
British pound	(GBP/USD)	1.6212	1.5593	1.4845	1.5200	1.4800	1.4900	1.5100	1.5500	1.5600	1.5500
Swiss franc	(USD/CHF)	0.9534	0.9894	0.9744	0.9700	1.0000	1.0000	1.0000	0.9800	0.9700	0.9600
Yen	(USD/JPY)	109.66	119.70	120.14	121.00	122.00	124.00	124.00	125.00	126.00	127.00
Australian dollar	(AUD/USD)	0.8746	0.8170	0.7607	0.7700	0.7300	0.7500	0.7600	0.7800	0.7900	0.8000
Chinese yuan	(USD/CNY)	6.1385	6.2061	6.1995	6.2000	6.2500	6.2000	6.2000	6.1900	6.1700	6.1500
Mexican peso	(USD/MXN)	13.43	14.75	15.26	15.40	15.60	14.80	14.60	14.50	14.25	14.00
Brazilian real	(USD/BRL)	2.4507	2.6559	3.2077	3.1000	3.3500	3.3000	3.2500	3.1000	3.0000	2.9500
Effective dollar*	(1973 = 100)	81.30	85.13	92.06	91.00	94.40	93.40	92.30	90.70	90.10	89.00
Canadian dollar											
American dollar	(CAD/USD)	0.8929	0.8605	0.7882	0.8000	0.7800	0.8000	0.8100	0.8200	0.8300	0.8400
Euro	(EUR/CAD)	1.4147	1.4061	1.3626	1.3500	1.3333	1.3125	1.3086	1.3293	1.3373	1.3452
British pound	(GBP/CAD)	1.8155	1.8119	1.8835	1.9000	1.8974	1.8625	1.8642	1.8902	1.8795	1.8452
Swiss franc	(CAD/CHF)	0.8513	0.8514	0.7680	0.7760	0.7800	0.8000	0.8100	0.8036	0.8051	0.8064
Yen	(CAD/JPY)	97.91	103.00	94.69	96.80	95.16	99.20	100.44	102.50	104.58	106.68
Australian dollar	(AUD/CAD)	0.9795	0.9494	0.9651	0.9625	0.9359	0.9375	0.9383	0.9512	0.9518	0.9524
Chinese yuan	(CAD/CNY)	5.4813	5.3406	4.8863	4.9600	4.8750	4.9600	5.0220	5.0758	5.1211	5.1660
Mexican peso	(CAD/MXN)	11.99	12.69	12.03	12.32	12.17	11.84	11.83	11.89	11.83	11.76
Brazilian real	(CAD/BRL)	2.1883	2.2855	2.5282	2.4800	2.6130	2.6400	2.6325	2.5420	2.4900	2.4780

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