FX Forecasts

Desjardins Economic Studies
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The postponement of U.S. interest rate increases changes the game

Could the greenback tumble?

HIGHLIGHTS

- Downgrading the potential for near-term gains of the U.S. dollar is justified, but the more extreme scenario of a sharp tumble seems unlikely without a major erosion of the U.S. economy.
- Although the Federal Reserve (Fed) has postponed monetary firming, the long status quo forecast for the Bank of Canada and slight potential for increases in oil prices do not support a strong rise by the loonie. The currency could stabilize close to current levels in the very near term, then settle in below US$0.75 (above C$1.33/US$) by next spring.
- In October, the European Central Bank signalled that it would take a deeper look at the factors delaying inflation's comeback, and could further ease its monetary policy as of its December meeting. We therefore expect the euro to tick down in the months to come. It should even return to around US$1.05 once the Fed kicks off monetary firming.

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Editorial

The U.S. dollar has shot up since the summer of 2014. The divergent trajectories forecast for monetary policies have been the main power behind the skyrocketing greenback, but these forecasts included a high probability that the Federal Reserve (Fed) would raise its key rates in 2015. We must now note that this probability was overestimated, with the result that the greenback is no longer going up (graph 1), raising some questions about its future trend. Although downgrading the potential for near-term gains is justified, the more extreme scenario of a sharp tumble seems unlikely without a major erosion of the U.S. economy.

Graph 1 – The greenback has lost its momentum

* U.S. dollar's trade-weighted average against the euro, yen, pound, Canadian dollar, Swedish krone and Swiss franc.
Sources: Bloomberg and Desjardins, Economic Studies

TIME NOT YET RIGHT FOR THE FED

Expectations were fairly split about the outcome of September's monetary policy meeting. In the end, the Fed decided to be cautious, and the latest economic figures seem to back it up.

Without being catastrophic, several indicators have been disappointing in recent weeks. One of them is job creation.

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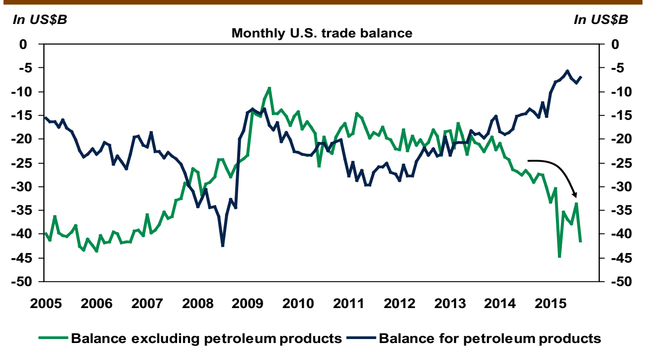
Used to job creation above 200,000, September's results broke away from the pace, dropping below 150,000; the revision to August's figures went in the same direction. The ISM manufacturing index fell to 50.2, also raising doubts about the state of the U.S. economy. Note that this indicator usually signals contracting activity when it goes under 50.

The weakness in the U.S. manufacturing sector is nothing new, however. Slowing investment and production in the oil industry have had negative effects on several other industries. The U.S. dollar's strength is also being blamed for the problems in manufacturing. The trade balance in products other than petroleum has worsened since 2014 (graph 2). This supports the idea that the greenback's appreciation already constitutes a tightening of monetary conditions, meaning that there is less of a rush to raise interest rates.

Graph 2 – U.S. foreign trade is eroding



Sources: Datastream and Desjardins, Economic Studies

Given the recent events, we have pushed back our forecast for the first U.S. interest rate increase to March. By then, the U.S. economic situation should have improved enough. Growth will be buoyed by consumption and the service sector. Inflation should also be well up, when the base effects associated with the drop in oil prices dissipate. The Fed will then no longer be able to justify standing pat on the basis of either of the two variables targeted by monetary policy: employment and inflation.

The postponement of the first rate increase argues for a weaker U.S. dollar in the near term, but spring will still come quickly, especially as any improvement to the data will be likely to lean toward moving this date up, or at least strengthening expectations in that direction. Accordingly, the greenback's near-term trend should rather be for stabilization, with appreciation expected to return near the start of next year.

EVEN IF THE SITUATION WORSENS, DEMAND FOR THE U.S. DOLLAR COULD REMAIN STRONG

Of course, the situation could still worsen with other disappointing economic indicators. The international situation could also deteriorate with new fears about emerging nations. In this context, expectations of monetary firming would be pushed back again, and the downside pressure on the greenback would intensify.

Such pressures would, however, be offset by a safe-haven effect increasing demand for the U.S. dollar. This would be particularly true if the fears come from outside the United States. A reversal of capital flow from emerging nations to the United States, for example, would give the greenback a lot of support. Fears about the U.S. economy would also power this movement if they increased the risks to the global economy. If the situation eroded to the point that the Fed were to announce a fourth assets purchase plan or other easing measures, downside pressure on the greenback could then outweigh the upside pressure. However, this scenario seems unlikely, for now.

MONITORING THE REACTION OF OTHER CENTRAL BANKS

Lastly, we cannot overlook the influence of the other central banks. In recent years, the feeling that many of them have relaxed their monetary policies to weaken their currencies has increased. If the downside pressure on the greenback became too strong, some central banks could announce further easing measures. This would result in a generalized depreciation by the greenback.

The same effect could be observed if central banks did not react directly to exchange rate movements. Given that exchange rate movements influence inflation, central banks could simply react based on their inflation outlook. This could be the case with the European Central Bank, for example.

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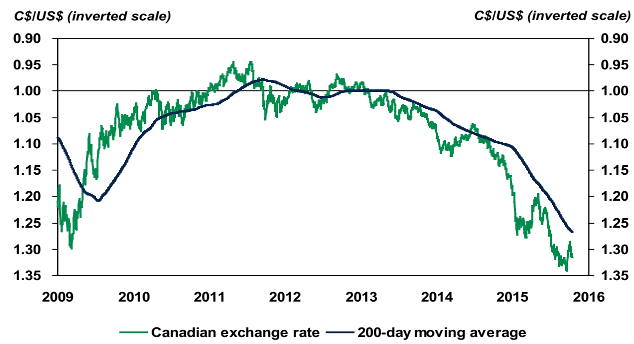
CANADIAN DOLLAR (CAD)

The comeback didn't last

- The Canadian dollar recorded a temporary rebound in the last few weeks, taking it above US$0.77 (below C$1.30/US$). The loonie's push, which started September 30 with the release of Canada's monthly GDP for July, confirmed that the technical recession was over in Canada. After that, oil prices temporarily rebounded and expectations of U.S. monetary firming were pushed back to 2016, helping support the Canadian dollar. This didn't last and the Bank of Canada's (BoC) downgrade to its economic growth outlook helped to erase some of the previous gains.
- Technically, despite the last few weeks' rebound, the tendency to depreciation remains. The 3-month momentum is still negative and the exchange rate has not yet crossed its 200-day moving average. Moreover, speculators are maintaining a bias in favour of sell positions on the loonie.
- Fundamentally, the worse seems to be over. The economy is showing clear signs of rebounding after the shock in the first half of the year. Real GDP by industry went up 0.3% in July after gaining 0.4% in June, delivering a fairly big carryover for the third quarter. August's results promise to be more disappointing, however, with a pullback by exports, among other things.
- Exports are a key factor in the country's future growth. A weak Canadian dollar is justified in this context, but it is not the only element that can support exports. Global demand must also be present, especially demand from the United States.
- The change in oil prices and the interest rate spreads are other factors to watch. Oil is expected to stay low, with supply likely exceeding demand for several more quarters. As for interest rates, even though the BoC has revised its growth outlook, it still expects the output gap to close by mid-2017. Unless there's another shock, the BoC should stay on the sidelines and initiate monetary firming in early 2017.

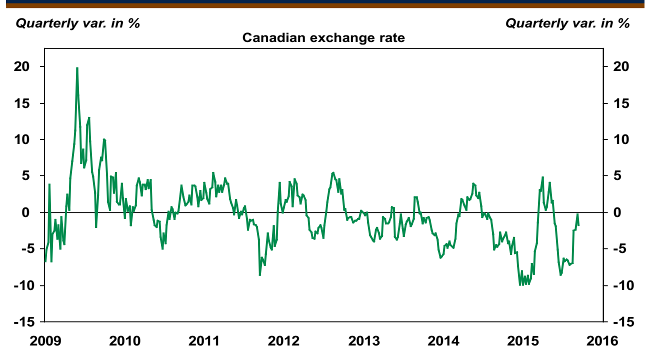
Forecasts: The Canadian dollar's recent rise could not last. Although the Federal Reserve has postponed monetary firming, the long status quo forecast for the BoC and slight potential for increases in oil prices do not support a strong rise by the loonie. The currency could stabilize close to current levels in the very near term, then settle in below US$0.75 (above C$1.33/US$) by next spring.

Canadian dollar and trend



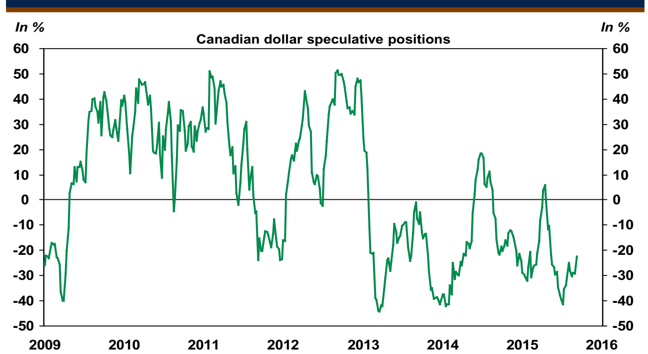
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

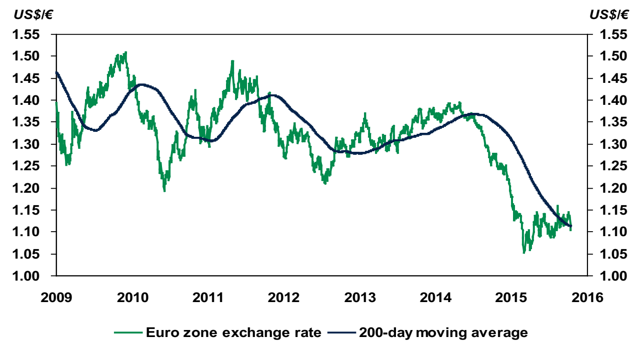
EURO (EUR)

The European Central Bank has not said its last word

- The growing doubts followed by the postponement of monetary firming in the United States have made the common currency appreciate since last summer. The euro was oscillating around US$1.09 in July, and quickly surged to around US$1.13, even closing in on US$1.15 several times when remarks from some Federal Reserve (Fed) leaders or disappointing U.S. data seemed to close the door on a U.S. key rate hike this year. However, the European Central Bank's (ECB) clear signal that it could further relax its monetary policy in December took the euro back below US$1.11.
- In the euro zone, the economic picture has not changed much: the economy is still recovering slowly. Industrial output retreated in August, but, for credit, the news is encouraging. The latest bank lending survey shows another improvement to borrowing terms for business, and widespread improvement in demand for credit. The ECB's last statement remarked that euro zone domestic demand was resilient. In a context in which some U.S. statistics fuelled doubt about the economic recovery there, the ongoing modest growth in the euro zone boosted the euro.
- Although the ECB can be fairly happy with how the economic situation is evolving, in spite of the predominance of downside risks, it is still concerned with weak inflation. The annual inflation rate slid back into negative territory in September, going to -0.1%, which primarily reflects another dip in energy prices. Core inflation is higher, at 0.9%, but the ECB seems to be worried that, if inflation stays this low, it will eventually bring inflation expectations down. In October, therefore, it signalled that it would take a deeper look at the factors delaying inflation's comeback, and could further ease its monetary policy as of its December meeting. Failing a turnaround by the recent trends for emerging markets, commodities or currencies, we can expect further action from the ECB. Given that there are some doubts about the effectiveness of increasing its quantitative purchases, President Mario Draghi signalled that the ECB was no longer ruling out the option of taking its key rates further into negative territory.

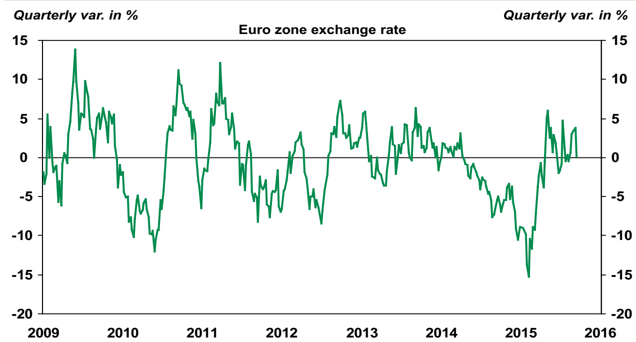
Forecasts: The ECB has taken a clear stance, signalling that it would not tolerate an appreciation of the euro. We therefore expect the euro to tick down in the months to come. It should even return to around US$1.05 once the Fed kicks off monetary firming.

Euro and trend



Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



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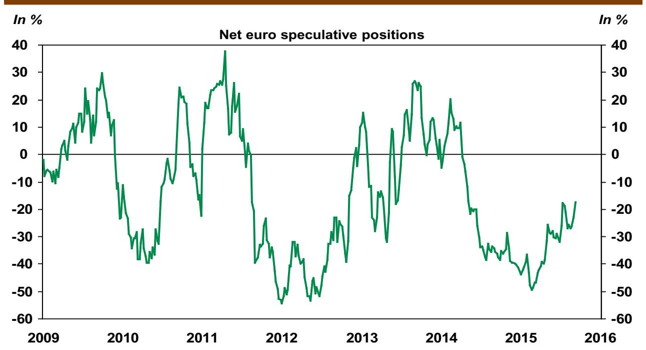
Euro: net speculative positions



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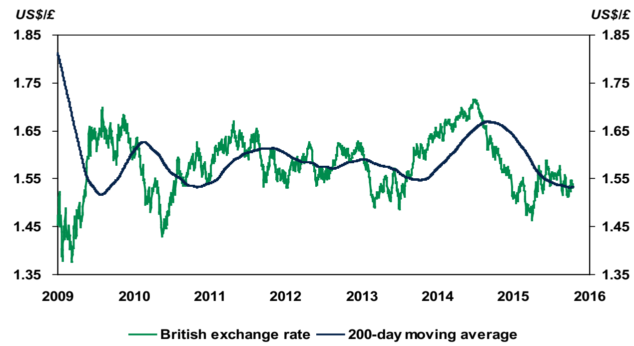
BRITISH POUND (GBP)

Hard for the Bank of England to go it alone

- After sliding close to the US$1.50 mark a few times, the pound sterling recently climbed to around US$1.55. It has not displayed a clear trend against the greenback since May. Until recently, the pound had depreciated somewhat against the euro, however, with the EUR/GBP pair going from under £0.70 in mid-July to around £0.74. The Federal Reserve's status quo had less impact on the pound than on other currencies since it signals that the Bank of England (BoE) will also have to wait longer than anticipated before kicking off monetary firming. We now expect the BoE to wait until the second quarter of 2016 to raise its key rates. While British inflation recently fell back into negative territory, the U.K. economy's solid performance and more than 3% private sector wage growth could theoretically justify gradually raising key rates. In an uncertain international context, in which the European Central Bank could further relax its monetary policy, the BoE's hands are tied however: it does not want to make the pound surge again. **The pound could be fairly stable against the greenback but edge up against the euro in the next few months. The issue of the British referendum on exiting the European Union could affect the pound and British monetary policy in 2016.**

British pound and trend



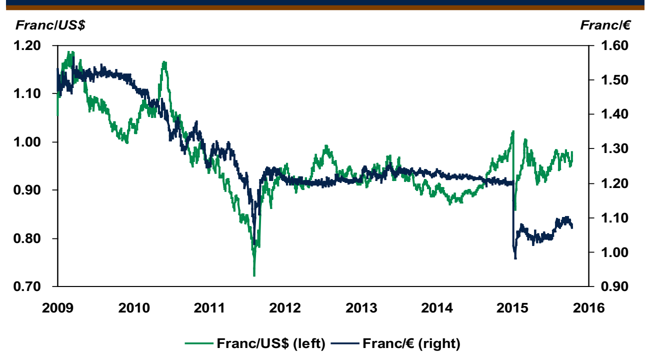
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

Will the European Central Bank trigger further upside pressure on the franc?

- The Swiss franc has recently risen somewhat against the euro. However, the EUR/CHF pair is still around 1.08 francs, a level that is very easy for the Swiss National Bank (SNB) to digest. The latest statistics show that the franc's surge in early 2015 magnified deflation, with Switzerland's inflation rate at -1.4% in September. However, the economic consequences do not seem as serious as could have been feared, as real GDP growth has slowed but remains positive, and the trade balance has improved overall in recent months. In this context, we could expect the SNB to take no action and the franc to remain quite stable in the months to come. **If the European Central Bank opts to expand its easing measures, however, this could foster further franc appreciation and force the SNB to react quickly.**

Swiss franc



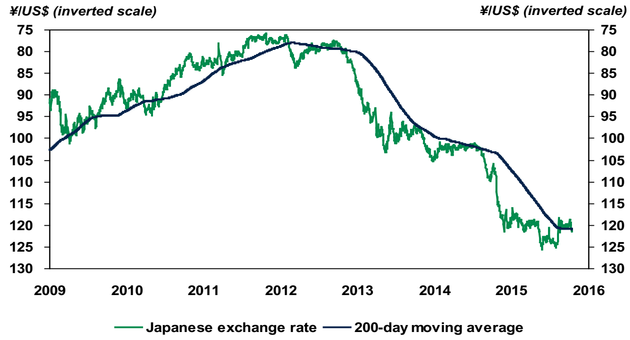
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

The exchange rate is stabilizing around ¥120/US$

- The yen benefited from an upswing in risk aversion over the summer and is managing to hang onto the gains it made, even though the situation has eased somewhat. The greenback's loss of strength is probably helping keep the exchange rate around ¥120/US$, but a look at the Bank of Japan (BoJ) is also in order. The BoJ does not seem very concerned that inflation is back close to 0% and is not signalling that it might expand its securities purchasing policy or opt for negative interest rates shortly.
- While the BoJ is not announcing anything new, it is still one of the most active central banks, with securities purchasing totalling ¥80,000B a year. It should keep purchasing next year in a context of a probable Federal Reserve interest rate increase. **The forecast monetary policy divergence argues for an exchange rate above ¥125/US$.** A drop in risk aversion would also help get it there.

Yen and trend



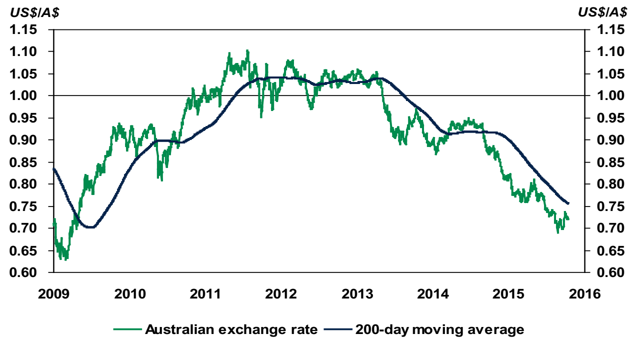
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

Interest rate cut expectations rise

- Australia's economy continues to struggle due to low commodity prices and slowing Chinese demand. Given these issues, the Australian dollar remains under pressure and temporarily dropped below US$0.70 in September. The U.S. dollar's weakness and a downtick in global concerns helped boost the aussie to around US$0.73 in October. The rebound should be temporary though.
- The chances of upcoming intervention by the Reserve Bank of Australia have risen, as the economy increasingly seems to need an extra hand to adjust to its current problems. Chinese economic growth slowed again in the third quarter and this, combined with other figures such as the recent pullback by Australian employment, could finally tip the balance toward an interest rate cut by the end of the year. Moreover, the key interest rate is at 2%, so there is no shortage of leeway. **The AUD/USD pair should revisit US$0.70 in the coming months** and could even hit a new cyclical low if the greenback rebounds or global anxiety notches up.

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

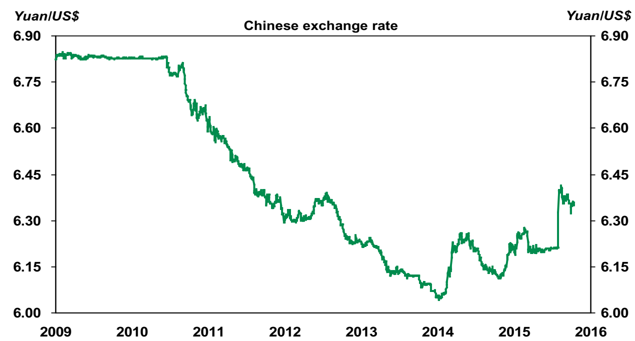
EMERGING CURRENCIES

Concern eases a little, but remains palpable

CHINESE YUAN (CNY)

- China's exchange rate is in the neighbourhood of 6.35 yuan/US$, up slightly after August's devaluation. Like other currencies, the yuan is capitalizing on the greenback's loss of momentum. However, concern over China remains high, as its real GDP growth dropped below the 7% mark in the third quarter, its worst performance since the 2008–2009 financial crisis. The latest data also shows that exports are still sliding; this could support sagging by the yuan. That being said, other figures compensate for the poor ones. China continues to have a big trade surplus, as imports have declined in step with commodity prices, while retail sales have picked up speed. **Failing major greenback movements, China's exchange rate should end the year at around 6.40 yuan/US$.** There promises to be greater volatility early next year.

Chinese yuan and trend



Sources: Datastream and Desjardins, Economic Studies

MEXICAN PESO (MXN)

- The Mexican peso has stabilized since the Federal Reserve (Fed) opted to keep its key rates at their floor last September. After going over 17 pesos a few times, the USD/MXN pair recently returned to around 16.5 pesos. The peso's stabilization and weak Mexican inflation (only 2.5% in September) give the Bank of Mexico (BoM) some leeway and lessen the chances of an upcoming key rate increase. However, the BoM will have to be vigilant, as inflation pressures could materialize given the peso's 20% plunge in the last year. **The peso could be fairly stable until the end of the year, but new downside pressure could emerge when the Fed announces monetary firming. The peso is still expected to rise over the medium range.**

Mexican peso and trend

Sources: Datastream and Desjardins, Economic Studies

BRAZILIAN REAL (BRL)

- The USD/BRL pair hit a peak of 4.2489 reals/US$ on September 24. Brazil is grappling with serious economic difficulties as well as a political crisis given the corruption allegations plaguing numerous leaders. To help calm the situation, the Central Bank of Brazil (CBB) stepped into the currency swap market. The CBB is also trying to boost the economy by moderating key rate increases despite high inflation. **The situation could remain tense over the next few quarters; the exchange rate is expected to go back above 4 reals/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*	Oct. 26	1 month	3 months	6 months	1 year	Higher	Average	Lower
Americas								
Argentina – peso	9.5237	1.2826	3.8707	7.1596	12.1425	9.5237	8.9163	8.4645
Brazil – real	3.8831	-1.7385	16.7501	30.6808	58.2303	4.2061	3.1053	2.4047
Canada – dollar	1.3135	-1.5146	0.5281	7.9252	17.0111	1.3411	1.2406	1.1136
Canada – (CAD/USD)	0.7614	1.5379	-0.5253	-7.3433	-14.5380	0.8980	0.8061	0.7457
Mexico – peso	16.4885	-2.6351	1.4792	7.2021	21.8490	17.1993	15.3546	13.4144
Asia and South Pacific								
Australia – (AUD/USD)	0.7249	3.2113	-0.4603	-7.2780	-17.5788	0.8855	0.7733	0.6908
China – yuan renminbi	6.3532	-0.3271	2.3134	2.5785	3.8605	6.4129	6.2377	6.1112
Hong Kong – dollar	7.7503	-0.0039	-0.0142	0.0006	-0.0902	7.7708	7.7533	7.7499
India – rupee	64.9205	-1.8880	1.2702	1.9765	6.1313	66.8855	63.3760	61.1700
Japan – yen	121.0950	0.4271	-2.2008	1.7733	11.9591	125.6250	120.1067	107.8150
New Zeland – (NZD/USD)	0.6788	6.2996	3.1973	-10.7664	-13.5768	0.7924	0.7174	0.6260
South Korea – won	1,134	-5.0975	-2.9198	5.0398	7.2278	1,204	1,119	1,047
Europe								
Denmark – krona	6.7463	1.2228	-0.7196	-1.6918	14.8101	7.1086	6.5568	5.8463
Euro zone – (EUR/USD)	1.1049	-1.1187	0.7569	1.6842	-12.7876	1.2761	1.1396	1.0522
Norway – kroner	8.3323	-2.1726	1.5695	7.3259	26.2845	8.5333	7.7675	6.5977
Russia – ruble	62.8404	-4.2155	7.0909	22.6232	49.8251	72.4500	58.1759	41.5525
Sweden – krona	8.5065	1.1595	-0.9455	-1.4767	17.3019	8.8229	8.2351	7.2518
Switzerland – swiss franc	0.9818	0.4810	2.3402	3.0330	3.1088	1.0194	0.9570	0.8533
United Kingdom – (GBP/USD)	1.5358	1.1959	-0.9353	1.2727	-4.5019	1.6158	1.5402	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

		2014		2015				2016			
End of period		Q3	Q4	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f
American dollar											
Canadian dollar	(USD/CAD)	1.1199	1.1621	1.2688	1.2493	1.3315	1.3158	1.3514	1.3333	1.3158	1.2987
Euro	(EUR/USD)	1.2632	1.2101	1.0740	1.1142	1.1162	1.0900	1.0600	1.0600	1.0800	1.1000
British pound	(GBP/USD)	1.6212	1.5593	1.4845	1.5727	1.5148	1.5300	1.5200	1.5400	1.5600	1.5700
Swiss franc	(USD/CHF)	0.9534	0.9894	0.9744	0.9314	0.9734	0.9800	1.0100	1.0200	1.0100	1.0000
Yen	(USD/JPY)	109.66	119.70	120.14	122.50	119.87	122.00	125.00	126.00	126.00	127.00
Australian dollar	(AUD/USD)	0.8746	0.8170	0.7607	0.7709	0.7020	0.7100	0.7000	0.7100	0.7300	0.7500
Chinese yuan	(USD/CNY)	6.1385	6.2061	6.1995	6.2010	6.3571	6.4000	6.5000	6.5000	6.4500	6.4000
Mexican peso	(USD/MXN)	13.43	14.75	15.26	15.74	16.92	16.50	16.80	16.50	16.25	16.00
Brazilian real	(USD/BRL)	2.4507	2.6559	3.2077	3.1022	3.9725	4.0000	4.1500	3.9000	3.8000	3.6000
Effective dollar*	(1973 = 100)	81.30	85.13	92.06	89.94	92.26	92.80	95.20	94.80	93.60	92.60
Canadian dollar											
American dollar	(CAD/USD)	0.8929	0.8605	0.7882	0.8004	0.7510	0.7600	0.7400	0.7500	0.7600	0.7700
Euro	(EUR/CAD)	1.4147	1.4061	1.3626	1.3920	1.4863	1.4342	1.4324	1.4133	1.4211	1.4286
British pound	(GBP/CAD)	1.8155	1.8119	1.8835	1.9648	2.0169	2.0132	2.0541	2.0533	2.0526	2.0390
Swiss franc	(CAD/CHF)	0.8513	0.8514	0.7680	0.7455	0.7311	0.7448	0.7474	0.7650	0.7676	0.7700
Yen	(CAD/JPY)	97.91	103.00	94.69	98.05	90.02	92.72	92.50	94.50	95.76	97.79
Australian dollar	(AUD/CAD)	0.9795	0.9494	0.9651	0.9630	0.9346	0.9342	0.9459	0.9467	0.9605	0.9740
Chinese yuan	(CAD/CNY)	5.4813	5.3406	4.8863	4.9636	4.7744	4.8640	4.8100	4.8750	4.9020	4.9280
Mexican peso	(CAD/MXN)	11.99	12.69	12.03	12.60	12.71	12.54	12.43	12.38	12.35	12.32
Brazilian real	(CAD/BRL)	2.1883	2.2855	2.5282	2.4832	2.9835	3.0400	3.0710	2.9250	2.8880	2.7720

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