

The pressure on the Canadian dollar is expected to decrease in 2016

HIGHLIGHTS

- The Canadian dollar could continue to lose some altitude in the near term, but has probably seen the bulk of its depreciation. The anticipated stabilization by oil prices, followed by a slow rise in the second half of the year, will help the currency end 2016 at around US\$0.75 (CAN\$1.33/US\$).
- In an alternative scenario, where oil prices would remain near current levels and the Bank of Canada would announce further interest rate cuts, the Canadian dollar could rather depreciate to around US\$0.65 by year's end.
- The greenback has been advancing much more slowly since spring 2015. This is partly because much of the monetary policy divergence had already been anticipated. Currently, the market expects about two U.S. key interest rate increases in 2016; our scenario hypothesizes three. This means we believe there is still room for markets to reposition and for the greenback to rise.
- Certain currencies whose monetary policy will be further relaxed in 2016 could see greater movement. In particular, this could occur with the euro and other European currencies.

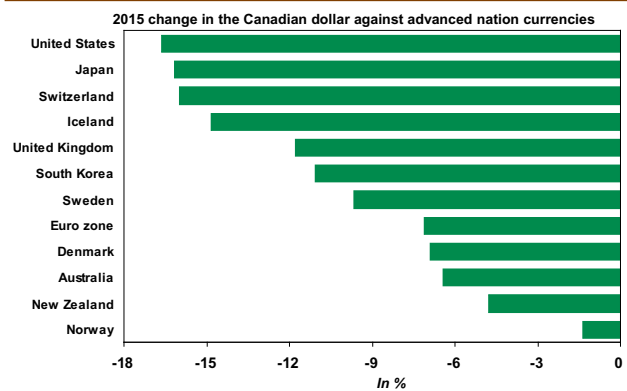
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Editorial

2015 was another highly volatile year for several currencies. The Canadian dollar stood out by depreciating against all other advanced nation currencies (graph 1). It posted its biggest loss against the U.S. dollar, which went up against most currencies due to monetary policy divergence. Other factors that played against the loonie were the tumble by oil prices and the Canadian economy's poor performance.

Graph 1 – In 2015, the Canadian dollar fell against all advanced nation currencies



Sources: Datastream and Desjardins, Economic Studies

2016 should be an easier year for the loonie, as oil prices should eventually see a trend reversal. Ongoing monetary policy divergence should nonetheless give the U.S. dollar an edge over many currencies. The euro could be one of the most penalized, due to the high probability the European Central Bank will further relax its monetary policy. The focus will also be on several emerging market currencies, including the yuan, which is now showing more volatility against the greenback.

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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.

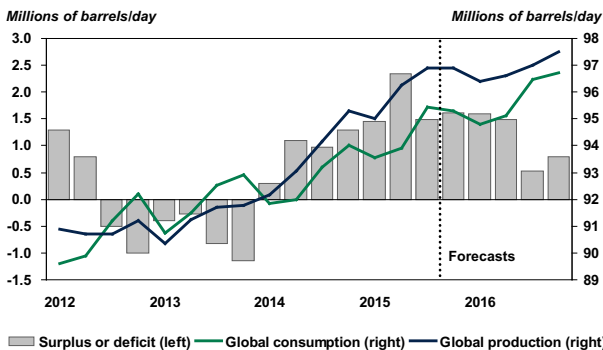
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OIL PRICES ARE PROBABLY CLOSE TO THE BOTTOM OF THE BARREL

Oil prices remained weak throughout 2015 and recently hit new cyclical lows, which could perplex those who have been hoping for a rebound for several months. However, we find that the factors that allowed crude prices to drop so much will be difficult to sustain throughout 2016.

The lively surge in production by OPEC (Organization of the Petroleum Exporting Countries) nations was one of 2015’s surprises. Faced with low prices, several countries opted to produce more to try to maximize their oil revenues. Now, however, they have much less capacity to increase their output. Only Iran should substantially expand its output in 2016, when the international trade sanctions will be lifted. That being said, this influx of oil is broadly anticipated and will not come as a surprise. Simultaneously, production should drop in non-OPEC nations, particularly the United States. Consumption should also remain strong due to low prices. All in all, the current oil surplus should dwindle in 2016 (graph 2) and help support a gradual rise by prices.

Graph 2 – The oil surplus should dwindle in 2016



Sources: International Energy Agency and Desjardins, Economic Studies

We expect the benchmark WTI (West Texas Intermediate) to be priced at around US\$50 a barrel by year’s end. This price is still low, but the trend would at least be heading upwards. Our projection for oil means we can be rather optimistic about the Canadian dollar, even though the U.S. dollar could stay generally strong in 2016.

COULD THE U.S. DOLLAR STILL APPRECIATE SUBSTANTIALLY?

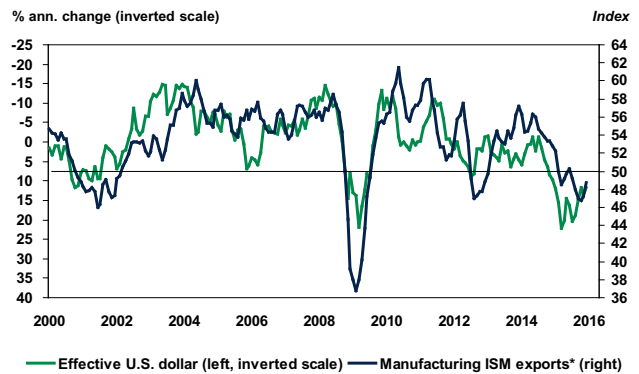
Since mid-2014, the U.S. dollar’s appreciation has primarily been tied to monetary policy divergence. There, a new chapter opened in December when the Federal Reserve (Fed) launched monetary firming while the other major

central banks still seem quite distant from such a move. However, the greenback did not see widespread appreciation following the Fed’s decision. In fact, the greenback has been advancing much more slowly since spring 2015. This is partly because much of the monetary policy divergence had already been anticipated.

Currently, the market expects about two U.S. key interest rate increases in 2016; our scenario hypothesizes three. For their part, Fed leaders are signalling four increases. This means there is still room for markets to reposition and for the greenback to rise. Certain currencies whose monetary policy may be further relaxed in 2016 could see greater movement. In particular, this could occur with the euro and other European currencies.

All in all, even if the Fed and the other central banks took the markets by surprise, the greenback’s potential for appreciation seems limited, in our opinion. Another surge could seriously compromise the U.S. manufacturing sector’s ability to bounce back (graph 3) and, as a result, could eventually prompt the Fed to change tacks. Moreover, an overly strong greenback could be destabilizing for the global economy, particularly for emerging countries that contracted U.S. dollar denominated debt.

Graph 3 – The greenback’s appreciation is a drag on the U.S. manufacturing sector



*Three-month moving average.
Sources: Bureau of Economic Analysis, Datastream and Desjardins, Economic Studies

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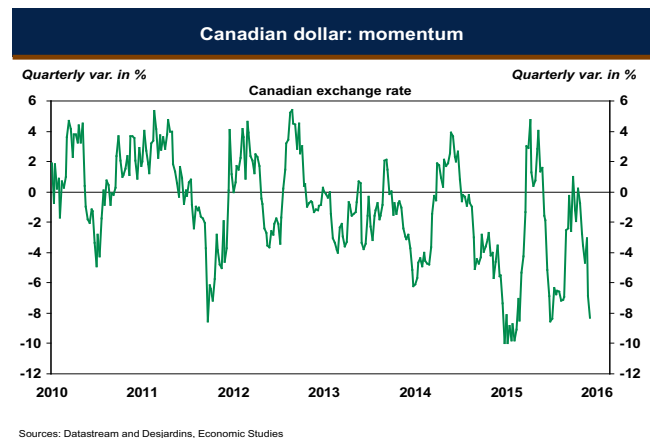
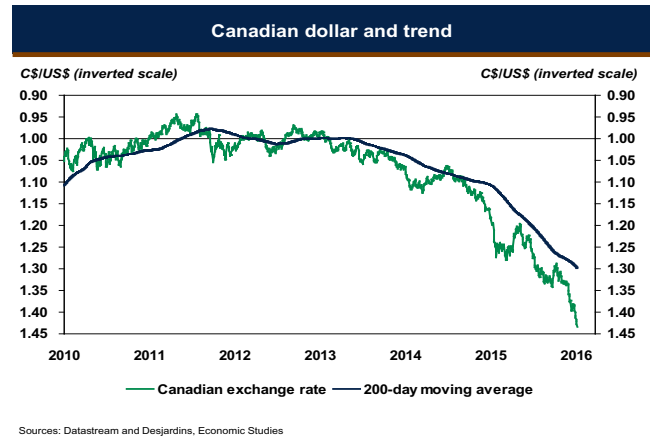
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CANADIAN DOLLAR (CAD)

Tumbling oil prices take the loonie to new lows

- The Canadian dollar continues to slide in tandem with oil prices. It reached a 2003 low on January 14, at US\$0.6947 (CAN\$1.4399/US\$). Its drop in the last few weeks is, moreover, occurring when the U.S. dollar is tending to retreat against a number of advanced nation currencies such as the euro and yen. This means that the Canadian dollar has also been depreciating against several other currencies. The loonie is currently valued at about 0.65 euro and 83 yen.
- Technically, the Canadian dollar's recent tendency to depreciate, as measured by its 200-day moving average, has intensified with the recent movements. Still, the lows hit due to momentum and net speculative positions seem hard to sustain. This means we could see a technical correction but, under the circumstances, this scenario is unlikely as long as oil prices keep dropping. Here, crude prices should remain low for several months because the supply is much larger than the demand. However, all it would take for the loonie to stabilize around US\$0.70 would be for oil prices to stop dropping.
- The Canadian dollar's other fundamental determinants are also providing little support. While the Canadian economy returned to growth in the third quarter, the economic situation still seems quite precarious and fourth-quarter growth could be disappointing. September's negative monthly GDP change adds a negative base effect for the fourth quarter, and October's decline worsens the outlook.
- If the Canadian economy underperforms again, that could increase the chances of seeing the Bank of Canada order another interest rate cut. That being said, in a recent speech, Governor Stephen Poloz did not give a signal in that direction. He remains confident in the economy's ability to adjust in the long run. The negative effects of low oil prices should gradually wane, while the positive effects of the boom in other activity sectors will increase. The markets might not be as patient though, and could react sharply to signals suggesting that this scenario is not materializing.

Forecasts: The Canadian dollar could continue to lose some altitude in the near term, but has probably seen the bulk of its depreciation. The anticipated stabilization by oil prices, followed by a slow rise in the second half of the year, will help the currency end 2016 at around US\$0.75 (CAN\$1.33/US\$). This scenario assumes there will be no more Canadian key interest rate cuts.

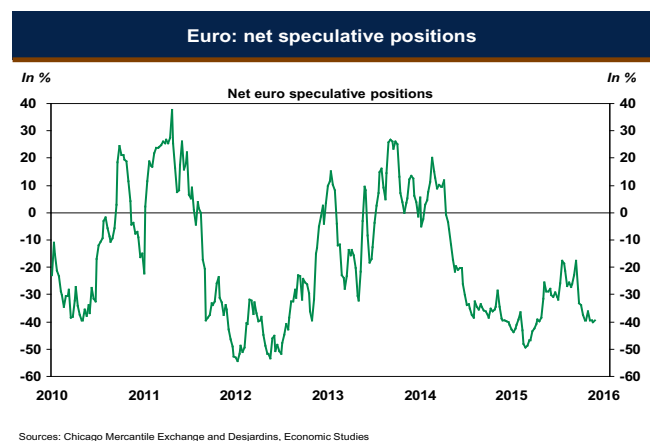
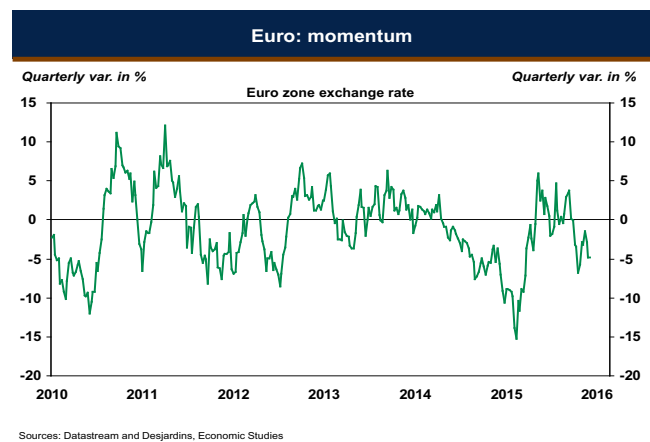
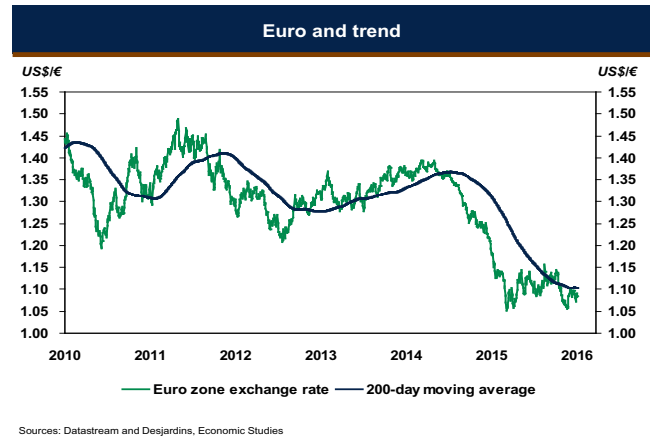


EURO (EUR)

A rebound that promises to be short-lived

- The euro's slide this fall, as of October 22 when the European Central Bank (ECB) signalled that it was seriously considering additional monetary easing, gave way to a spectacular rebound when the ECB finally went into action at the start of December. The euro went from US\$1.06 to nearly US\$1.10 when the ECB announced less aggressive easing measures than investors expected. The euro sagged a little after the Federal Reserve's 0.25% key interest rate increase; at around US\$1.09, however, it is still much higher than it was at the end of November, despite the surge in international financial strains.
- Should the euro's recent rebound be read as the end of its downtrend against the greenback? The question is appropriate following the more than 20% drop posted since mid-2014. However, the euro's sharp pullback largely reflects the divergence of monetary policies on either side of the Atlantic, a theme that will be very much with us in 2016.
- Given further deterioration of the inflation outlook, primarily stemming from another drop in commodity prices, the ECB had to act to maintain its credibility and keep the euro from skyrocketing. The euro zone's economic situation remains acceptable, however, and did not justify extreme action such as major key rate cuts or a major increase in the financial securities purchasing program. In our view, the ECB made a reasonable decision in opting to, among other things, cut its deposit rate to -0.30% and push back the projected end of its securities purchasing program to March 2017. Although investors were disappointed, it should be noted that the euro is still much lower than it was in mid-October. Here, we could say "mission accomplished" for the ECB, although its leaders could have curbed currency volatility by being more cautious with their statements. The ECB is keeping the door open to further intervention if it deems it necessary. We can therefore assume it would respond quickly to a surge of the euro.

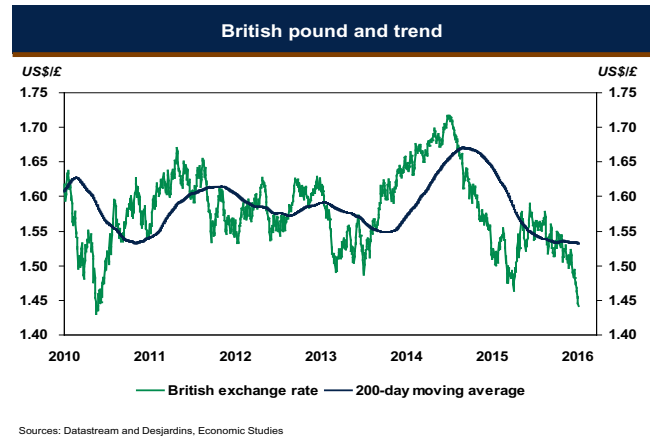
Forecasts: Monetary policy divergence should keep playing against the euro in 2016, as the slow rise of U.S. key rates will contrast with the ECB's asset purchases. This is already largely reflected in the euro's value, but investors currently seem to be underestimating the pace of rate hikes in the United States and the possibility that the ECB will announce new stimulus measures. The euro could therefore end 2016 close to parity against the greenback.



BRITISH POUND (GBP)

The pound seems to have come down too much

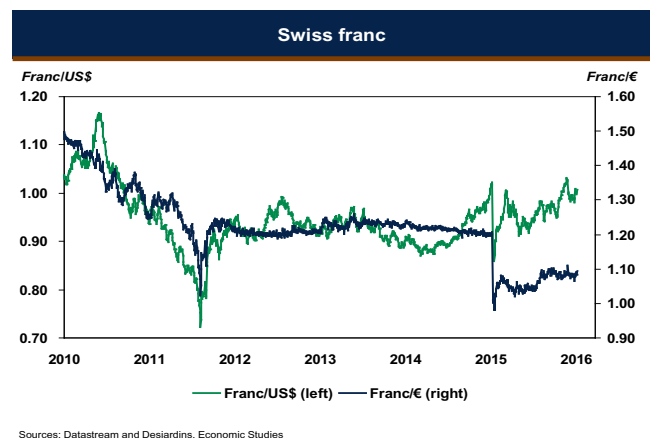
- The last few weeks were especially tough for the pound, which went from around US\$1.52 in mid-December to under US\$1.45. The pound also retreated sharply against the euro, with the EUR/GBP pair jumping to around £0.75, its highest point since last February. The pound seems to be very disadvantaged right now by the surge in concern in the financial markets which is making investors push back the forecast onset of U.K. monetary firming even further. A downgrade to British growth also prompted a retreat by the pound in a context of very low inflation. The news is not all bad in the United Kingdom, however, as the latest statistics on retail sales, home prices and job creation have been robust. The growth outlook therefore remains relatively good in the United Kingdom and, in our view, we are likely to see the onset of monetary firming by the end of 2016. **The financial and economic context therefore does not justify the pound's current correction. We expect the pound to rebound fairly quickly, especially against the euro.**



SWISS FRANC (CHF)

Franc very stable against the euro

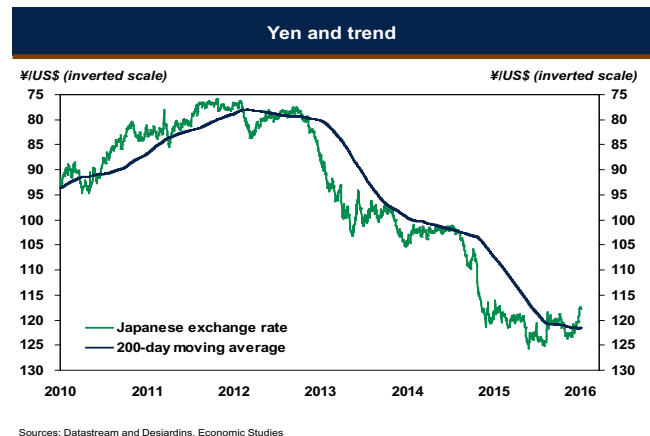
- The USD/CHF pair hit 1.03 francs at the end of November, then plunged in early December; since then, it has generally oscillated around 0.99 francs. The franc's rise essentially reflects the euro's rebound against the greenback. The franc has been quite stable against the euro, with the EUR/CHF pair oscillating in a tight band between 1.078 and 1.091 since mid-October. The euro's rise has certainly been a relief for the Swiss National Bank (SNB), as it did not need to further ease its monetary policy at its December meeting. The franc stability in recent weeks despite the surge in concern in the markets could however signal SNB intervention in the markets. This would not be surprising, as the SNB still thinks the franc is heavily overvalued and says it is ready to step in. The SNB's position is unlikely to change abruptly given the modest growth outlook and inflation at -1.3% in December. **The Swiss franc should continue to be very stable against the euro over the next few months.**



YEN (JPY)

Yen buoyed by stronger risk aversion

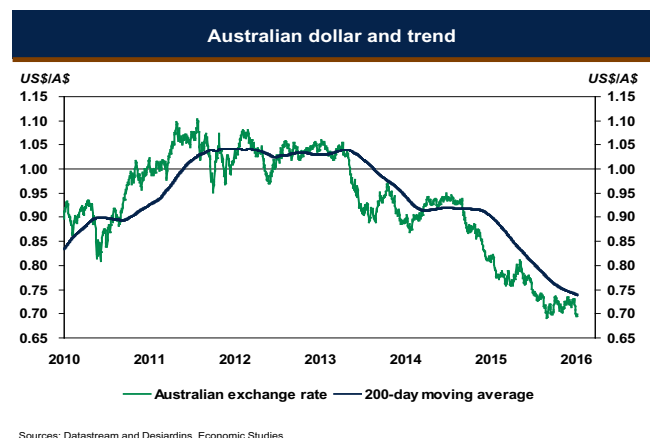
- The yen has tended to appreciate since December. The exchange rate hit a 17-month low at 116.68 ¥/US\$ on January 10, then came back up somewhat. The rise primarily seems to be associated with the surge in concern over China and global economic growth. Demand for the yen tends to rise during such times, supporting its value.
- More fundamentally, the state of Japan's economy and monetary policy do not suggest any lasting appreciation by the yen. Of course, the last estimate of real GDP for the third quarter is not showing further contraction, wiping out the technical recession that had been announced previously. Growth remains too weak, however, to generate inflation of around 2%. Accordingly, the Bank of Japan (BoJ) must continue with massive securities purchases and other programs designed to stimulate credit and the economy. In December, the BoJ announced that it would increase the average maturity of the securities it buys. **In our view, the exchange rate should settle in above 125 ¥/US\$ by year's end**, but global economic uncertainty could still move it away from this target in the near term.



AUSTRALIAN DOLLAR (AUD)

China remains a major issue

- The Australian dollar has lost around three cents since the start of the year, taking the exchange rate to around US\$0.70. The aussie remains very sensitive to movement by China's economy, its main export market. A number of commodities have also seen their prices decline further, contributing to the depreciation.
- Several Australian economic figures had improved in the last few months, which had given the currency some support. The third quarter's real GDP was up sharply from the previous quarter, despite a big drop in investment. Employment also recovered last fall, but that already seems like old news in the current context of greater uncertainty about China. In December, the Reserve Bank of Australia opened the door to another interest rate cut, if needed. Recent developments increase the likelihood of such an announcement in February. **In this context, the Australian dollar could settle in below US\$0.70 for several months.**

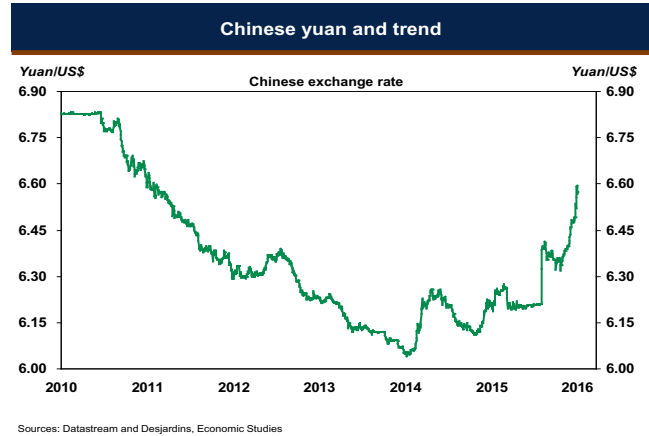


EMERGING CURRENCIES

Renewed depreciation

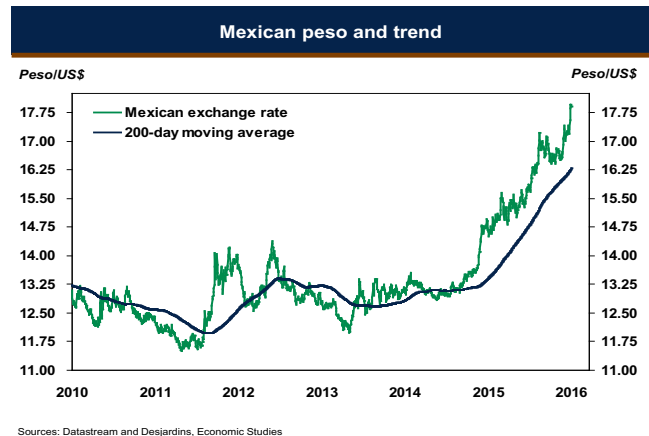
CHINESE YUAN (CNY)

- China's monetary authorities seem more and more disinclined to tolerate the yuan rising at the same pace as the greenback. In December, the People's Bank of China released the make-up of a basket of currencies it could use as a basis for stabilizing the yuan's value. This means the currency will be more volatile against the U.S. dollar and could depreciate further. Since the start of the year, it has already depreciated about 1.5% against the greenback. The problems in China's stock market and fears about its economy put additional pressure on the exchange rate, prompting monetary authorities to use foreign exchange reserves to limit the yuan's movement. **Our year-end target for the Chinese exchange rate is 6.70 yuan/US\$, but it could beat this level during the year on a major surge by the U.S. dollar.**



MEXICAN PESO (MXN)

- The Mexican peso started again to slide steeply in early December after solid U.S. employment figures were published, making a U.S. key rate increase nearly inevitable. Another tumble by oil prices and renewed concern in the markets also helped push the USD/MXN pair to around 17.40 pesos in mid-December. In this context, the Bank of Mexico (BoM) did not hesitate to fall into step with the Federal Reserve, raising its key rate by 0.25% on December 17, even though Mexico's economic situation and low inflation did not require any monetary firming. The BoM's action temporarily took the USD/MXN pair to around 17.00 pesos, but another surge in financial tensions at the start of January took the peso down to a new historic low. **The peso should rise once financial strains ease.**



BRAZILIAN REAL (BRL)

- Like several emerging currencies, the Brazilian real has retreated against the U.S. dollar in the last few weeks. The tumble by commodity prices, the weak Brazilian economy and the political uncertainty that holds sway there continue to weigh on the real. More recently, however, the source of the depreciation primarily seems to be tied to renewed global risk aversion. The problems in China's economy are a major issue for Brazil given its important trade ties with China. **The USD/BRL pair could spend much of the year above 4.00 reales/US\$.**

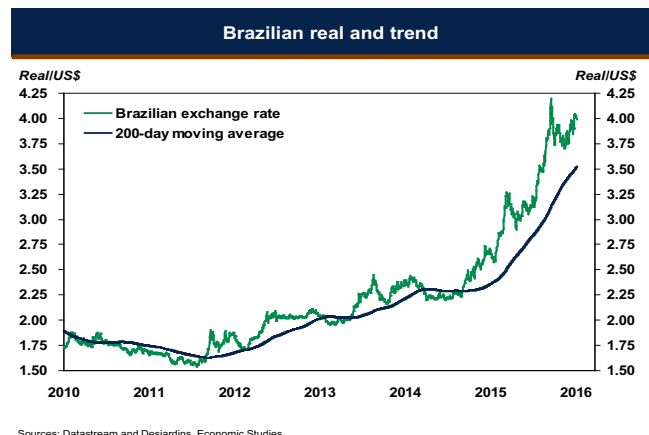


Table 1
Currency market

Country – Currency*	Spot price	Percentage return since					Last 52 weeks		
	Jan. 13	1 month	3 months	6 months	1 year	Higher	Average	Lower	
Americas									
Argentina – peso	13.5462	38.6510	43.1121	48.4515	57.6881	13.9867	9.4388	8.5905	
Brazil – real	3.9884	2.8031	4.0951	25.9426	51.0824	4.2061	3.3818	2.5571	
Canada – dollar	1.4259	4.0347	9.9044	11.6733	19.5072	1.4272	1.2866	1.1917	
Canada – (CAD/USD)	0.7013	-3.8783	-9.0119	-10.4530	-16.3230	0.8392	0.7773	0.7007	
Mexico – peso	17.8561	2.7314	8.1192	13.4443	22.6025	17.9183	15.9699	14.5518	
Asia and South Pacific									
Australia – (AUD/USD)	0.6957	-3.2278	-3.9617	-6.0835	-14.8139	0.8227	0.7475	0.6908	
China – yuan renminbi	6.5754	1.8605	3.6753	5.9113	6.0976	6.5965	6.2964	6.1875	
Hong Kong – dollar	7.7618	0.1393	0.1497	0.1251	0.1135	7.7708	7.7527	7.7499	
India – rupee	66.9175	-0.3440	2.7945	5.4649	7.9663	67.1485	64.2532	61.3580	
Japan – yen	117.6850	-2.6310	-1.7203	-4.6622	-0.2078	125.6250	121.0112	116.1650	
New Zeland – (NZD/USD)	0.6514	-3.1073	-1.9217	-2.6774	-15.8100	0.7824	0.6938	0.6260	
South Korea – won	1,204	2.0772	4.7184	6.5157	11.1368	1,210	1,135	1,069	
Europe									
Denmark – krona	6.8610	1.0367	4.6347	1.1484	8.5893	7.1086	6.7433	6.3093	
Euro zone – (EUR/USD)	1.0849	-1.3414	-4.6072	-1.4622	-7.9107	1.1787	1.1065	1.0522	
Norway – kroner	8.8196	1.5650	8.1224	9.0482	13.6751	8.9520	8.1111	7.3096	
Russia – ruble	76.2681	9.3039	21.9200	34.2986	15.9531	76.5325	61.7390	49.0402	
Sweden – krona	8.5303	0.3825	4.7923	0.5072	5.7052	8.8229	8.4502	8.0699	
Switzerland – swiss franc	1.0094	2.6127	5.1406	6.2865	-0.9859	1.0299	0.9630	0.8533	
United Kingdom – (GBP/USD)	1.4443	-5.0708	-5.1363	-6.9874	-4.8237	1.5884	1.5259	1.4369	

* 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	2015		2016				2017			
	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
American dollar										
Canadian dollar (USD/CAD)	1.3315	1.3841	1.4286	1.3699	1.3514	1.3333	1.3158	1.2987	1.2658	1.2346
Euro (EUR/USD)	1.1162	1.0863	1.0600	1.0500	1.0300	1.0100	1.0300	1.0400	1.0600	1.0800
British pound (GBP/USD)	1.5148	1.4739	1.4600	1.4800	1.4900	1.5000	1.5100	1.5200	1.5300	1.5500
Swiss franc (USD/CHF)	0.9734	0.9903	1.0200	1.0300	1.0500	1.0600	1.0500	1.0500	1.0400	1.0200
Yen (USD/JPY)	119.87	120.32	121.00	124.00	125.00	126.00	127.00	128.00	127.00	126.00
Australian dollar (AUD/USD)	0.7020	0.7280	0.6900	0.6900	0.7000	0.7200	0.7400	0.7500	0.7500	0.7700
Chinese yuan (USD/CNY)	6.3571	6.4937	6.6500	6.6500	6.7000	6.7000	6.6500	6.6000	6.5800	6.5500
Mexican peso (USD/MXN)	16.92	17.18	17.75	17.00	17.30	16.80	16.50	16.30	16.15	16.00
Brazilian real (USD/BRL)	3.9725	3.9045	4.0000	3.9000	4.0000	3.8000	3.7000	3.6000	3.5000	3.5000
Effective dollar* (1973 = 100)	92.26	94.46	96.30	96.10	96.60	97.10	96.00	95.30	93.60	92.00
Canadian dollar										
American dollar (CAD/USD)	0.7510	0.7225	0.7000	0.7300	0.7400	0.7500	0.7600	0.7700	0.7900	0.8100
Euro (EUR/CAD)	1.4863	1.5035	1.5143	1.4384	1.3919	1.3467	1.3553	1.3506	1.3418	1.3333
British pound (GBP/CAD)	2.0169	2.0400	2.0857	2.0274	2.0135	2.0000	1.9868	1.9740	1.9367	1.9136
Swiss franc (CAD/CHF)	0.7311	0.7155	0.7140	0.7519	0.7770	0.7950	0.7980	0.8085	0.8216	0.8262
Yen (CAD/JPY)	90.02	86.93	84.70	90.52	92.50	94.50	96.52	98.56	100.33	102.06
Australian dollar (AUD/CAD)	0.9346	1.0076	0.9857	0.9452	0.9459	0.9600	0.9737	0.9740	0.9494	0.9506
Chinese yuan (CAD/CNY)	4.7744	4.6918	4.6550	4.8545	4.9580	5.0250	5.0540	5.0820	5.1982	5.3055
Mexican peso (CAD/MXN)	12.71	12.41	12.43	12.41	12.80	12.60	12.54	12.55	12.76	12.96
Brazilian real (CAD/BRL)	2.9835	2.8211	2.8000	2.8470	2.9600	2.8500	2.8120	2.7720	2.7650	2.8350

f: forecasts; * Trade-weighted against major U.S. partners.

Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies