FX Forecasts

Desjardins Economic Studies
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Have negative rates and mass asset purchases lost their impact on currencies?

HIGHLIGHTS

- Our scenario calls for two interest rate in the United States increases before the end of the year. We believe that June could be a good time to implement the first of two expected increases. And since the markets are not currently positioned for this type of scenario, it could generate adjustments that would be favourable to the U.S. dollar.
- The loonie could lose a few cents in the short term, with monetary firming in the United States expected to continue. Over the longer term, the loonie should take flight anew more sustainably, in step with the oil price recovery and the improved economic environment in Canada. The currency should close 2016 at around US$0.75 (US$1.33/C$).
- The worst-case scenarios for the euro—extremely negative rates or a new financial crisis—seem less likely to occur. However, the economic and financial trends remain more favourable to the U.S. dollar than to the euro in the coming quarters.

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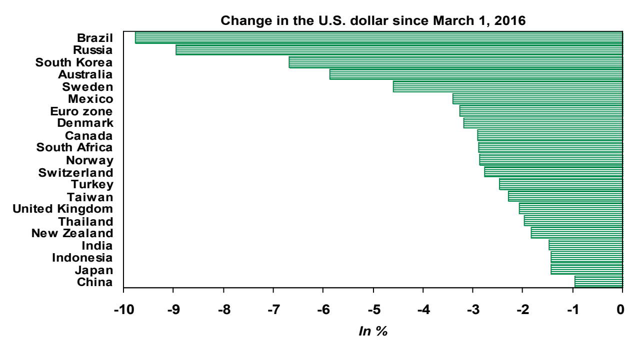
Editorial

The U.S. dollar is under pressure against most other main currencies in developed and emerging countries (graph 1). This weakness is partly explained by a more cautious tone from the Federal Reserve (Fed). Another turning point in the last few weeks was the easing of investor concerns, which sparked the appetite for riskier investments. The emerging currencies, which were down sharply, are now trending much higher. The rebound in oil prices and price increases for some other natural resources also kept several other currencies afloat against the greenback. Explaining the appreciation of currencies like the yen, the euro or the Swedish krona is more difficult, however. In normal circumstances, the new monetary policy easing measures would have penalized these currencies.

Graph 1 – A recent widespread weakness for the U.S. dollar



Sources: Datastream and Desjardins, Economic Studies

THE SENTIMENT THAT EVERYTHING HAS BEEN DONE

The Bank of Japan (BoJ) has shifted into negative rate mode in the past few months, the Bank of Sweden cut its benchmark interest rate by 15 points to -0.50% and the European Central Bank (ECB) announced a series

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of measures, including a new key interest rate cut and an increase in asset purchases. At an earlier time, this type of intervention would have devalued the currencies involved, but things appear to have changed.

One possible explanation is that the markets are reflecting the sentiment that everything has been done in terms of monetary policy. Some comments made by the central banks seem to support this sentiment. In March, ECB President Mario Draghi suggested that interest rates would not be reduced further. For its part, the BoJ hopes to take time to properly analyze the impact of its most recent intervention before it considers further easing. This does not take into account that the decision to opt for negative rates was very tight at the BoJ, with five leaders in favour vs. four who voted against the measure.

Even the effectiveness of these policies is in doubt, suggesting perhaps that inflation in Japan and in several European countries will remain low for an extended period. Yet according to the purchasing power parity theory, countries where inflation advances at a slower pace have currencies that tend to appreciate over the long term. The logic behind this is that the exchange rate has to adjust to balance changes in purchasing power between two monetary zones. This relationship is usually not noted in the short term since the markets believe that central banks have capacity to increase the inflation rate.

WHY DOESN'T IT JUST RAIN BANKNOTES?

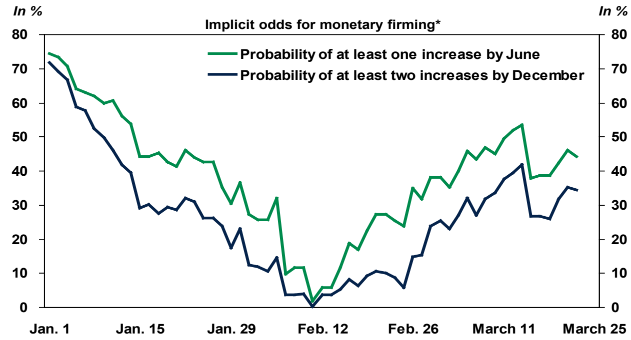
It's hard to believe that we have reached the limit of what monetary policies can do. Believing that central banks cannot generate inflation is even more of a stretch. In theory, inflation can always be increased by creating money. The asset purchase programs adopted by several central banks created money, but this money was never actually released into the real economy. It accumulated instead as deposits at the central banks. An alternative approach would be to send cash to consumers or governments directly so that they could then purchase more goods and services. The image often used to describe this type of policy is that of a helicopter flying through the air with money flowing out the back door.

Ben Bernanke had suggested this in the early 2000s to quell concerns about deflation at the time. This option seems less and less hypothetical these days. Even Mario Draghi alluded to this option in March. It will be interesting to see if this idea makes any headway at the ECB and at other central banks in the next few months. The impact on currencies could be significant.

WHAT'S THE FEDERAL RESERVE'S NEXT MOVE?

The U.S. dollar increased sharply in 2014 and in 2015 as it waited for the Fed to initiate monetary firming, which finally materialized in December 2015. The focus is now on the pace of the next rate hikes. Right now the market expects these increases to be very slow (graph 2).

Graph 2 – The market expects few rate increases in the United States



* Calculated based on federal funds futures.
Sources: Bloomberg and Desjardins, Economic Studies

Our scenario calls for two interest rate increases before the end of the year, which is in line with the Fed's own expectations—also downgraded. We believe that June could be a good time to implement the first of two expected increases. And since the markets are not currently positioned for this type of scenario, it could generate adjustments that would be favourable to the U.S. dollar. Other factors could intensify the impact on the greenback, such as a spike in renewed concerns, a fresh decline in oil prices, or the depreciation of currencies affected by monetary policies that diverge from U.S. policy.

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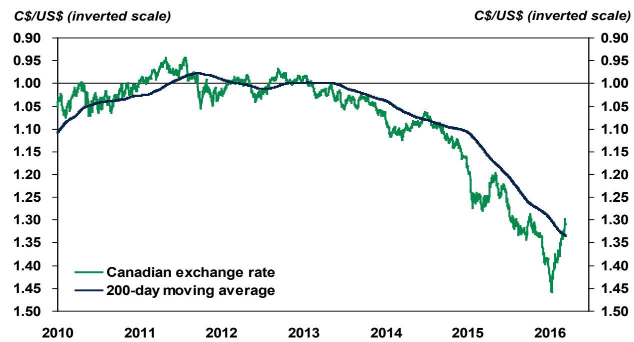
CANADIAN DOLLAR (CAD)

Back above US$0.75

- Canada's currency is edging close to US$0.76 right now, a marked appreciation over the cyclical low of US$0.6808 reached in January 2015. The loonie has also made gains against several other currencies, such as the euro, which is currently trading at about C$0.68/€, an increase of five one-hundredths since the start of February.
- From a technical standpoint, the 200-day moving average for the USD/CAD continues to show a downtrend. Nonetheless, the exchange rate recently topped this average, which could signal the onset of a new long uptrend cycle, or at least some stabilization for the currency after its struggles in recent years. The 3-month momentum is in fact in positive territory, but the net speculative positions continue to call for some caution on the loonie.
- Fundamentally, however, the loonie's rise partly reflects the overall weakness of the U.S. dollar, in addition to other favourable factors, like the rebound in oil prices. The value of the benchmark WTI (West Texas Intermediate) recently soared from a low of US$26 in February to more than US$40. The strength of this increase needs to be checked, however. The global surplus in supply vs. demand for oil is still high and is only expected to decline later in the second half of the year. The risks of a new price drop in the short term are therefore high.
- The rosier results for some economic data in Canada also drove the loonie higher. Advances in exports are still encouraging and point to an acceleration in non-energy investments. If the probability of another rate cut was high at the beginning of the year, it has fallen considerably since then. The more expansionist budget policy in Canada further reduces the relevance of another intervention by the central bank.

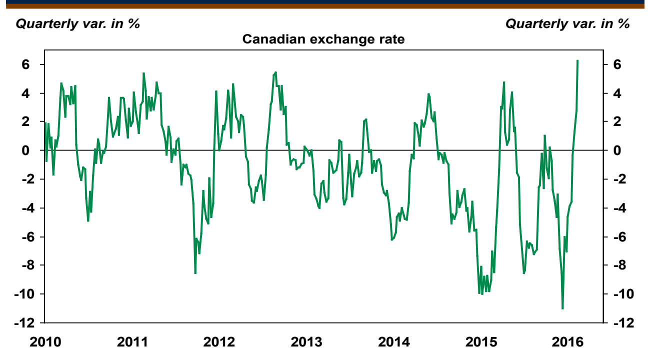
Forecasts: The loonie could lose a few cents in the short term. The recovery in oil prices is still fragile and a pullback would punish Canada's currency. Moreover, the greenback is expected to roar back in the next few months, with monetary firming in the United States expected to continue. Over the longer term, the loonie should take flight anew more sustainably, in step with the oil price recovery and the improved economic environment in Canada. The currency should close 2016 at around US$0.75 (US$1.33/C$) and end 2017 at close to US$0.78 (US$1.28/C$).

Canadian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



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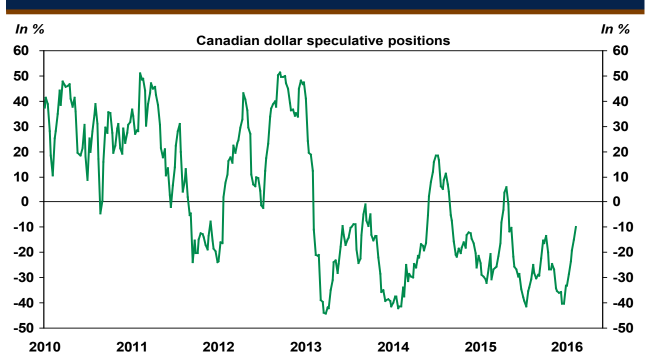
Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

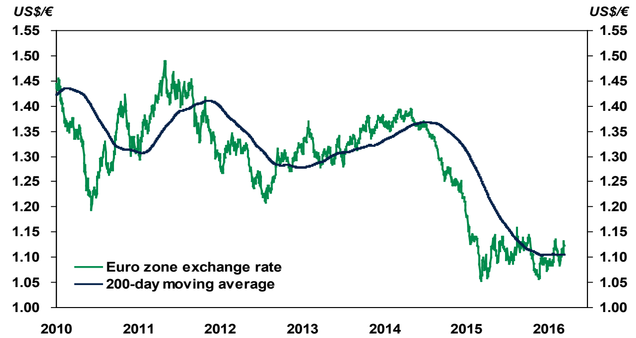
EURO (EUR)

The euro cannot resist forever

- Europe's currency stayed close to US$1.10 in February and in early March. Far from hindering it, the European Central Bank's (ECB) announcement of several new stimulative measures gave the euro a bit of a boost. The cautious tone of the Federal Reserve (Fed) then pushed this currency above US$1.13.
- The euro has been trending in no clear direction for about a year now, since its spectacular drop in 2014. The 200-day average has thus stabilized at about US$1.10. For some analysts, the euro's recent resilience points to a currency that could be on the verge of an uptrend. We do not share this opinion.
- By mid-February a fresh round of concerns about Europe's banking industry prompted the ECB president to state that he would not hesitate to act to prevent this situation from increasing deflationist pressures. The ECB delivered the goods at its March 10 meeting. In addition to trimming its key rates, the ECB decided to ramp up the pace of asset purchases and start buying up corporate bonds. It also announced a new series of operations to provide liquidities to European banks at zero or negative rates. While the euro lagged on this news, it rebounded sharply after President Mario Draghi signaled that he did not expect to push key rates further down, preferring to turn toward other instruments instead.
- The end of rate cuts in the euro zone and strong measures to support the banking industry reassured investors. The ECB's announcements did suggest however that interest rates in Europe would remain extremely low for a very long time. The ECB will buy up massive amounts of bonds until at least March 2017, and the central bank has signaled that its key rates will remain at current levels, or even lower, way beyond this horizon. This level of commitment reflects the fact that the ECB cut its inflation outlooks once again as the annual inflation rate recently slipped below zero. Even if the Fed remains cautious in firming its monetary policy, we have to expect interest rate spreads on both sides of the Atlantic to widen in the next few quarters, which should rein in the euro.

Forecasts: The worst-case scenarios for the euro—extremely negative rates or a new financial crisis—seem less likely to occur. However, the economic and financial trends remain more favourable to the U.S. dollar than to the euro in the coming quarters. Any sign of an upcoming rate hike in the United States should push the euro below US$1.10.

Euro and trend



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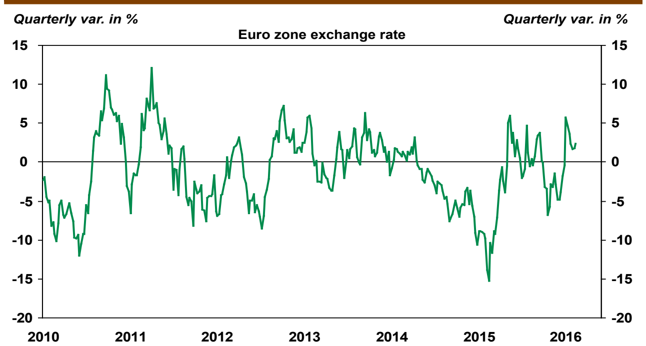
Euro: momentum



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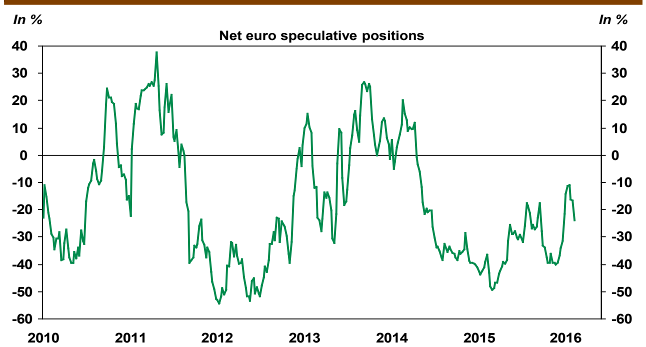
Euro: net speculative positions



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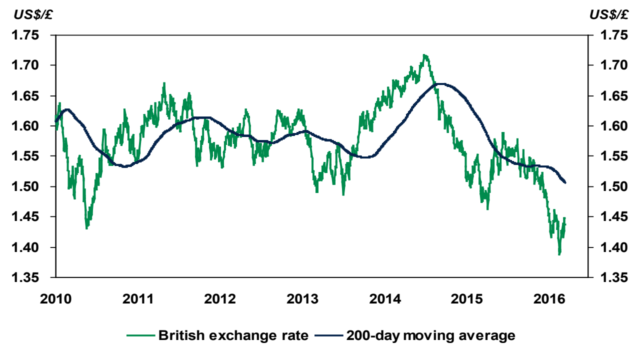
BRITISH POUND (GBP)

Caution is in order until mid-year

- The pound's significant drop in February, which intensified after the announcement that the referendum on the United Kingdom's future within the European Union (EU) would be held on June 23, 2016, turned to an upswing at the beginning of March. The pound rose from US$1.39 at the end of February to about US$1.42. This increase largely reflects the weakness of the U.S. dollar while the EUR/GBP pair has stabilized to about £0.78. Renewed investor confidence is a favourable turn for the pound, but signs of a slowdown in Britain's economy combined with persistent weak inflation confirm that a key rate increase is not in the cards in the short term. Real GDP advances slowed to 1.9% (annualized) in the last quarter of 2015 and the NIESR monthly estimate of GDP growth in February hit a 3-year low. **The pound could fall as the June referendum approaches, while investors seem to be underestimating the risk of a Brexit (name given to the possibility of Britain's withdrawal from the EU) victory.** Surveys show that both camps are running neck-and-neck.

British pound and trend



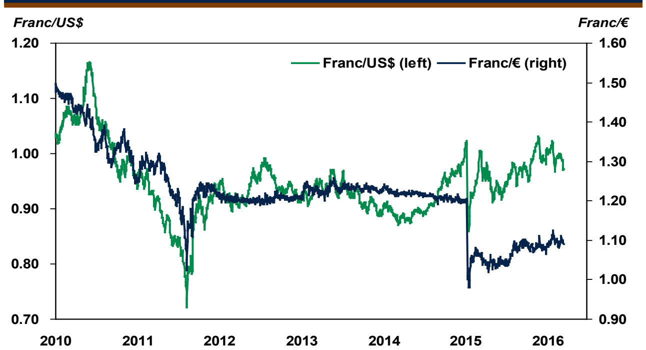
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

The Swiss National Bank will remain vigilant

- Like most currencies, the Swiss franc recently increased against the U.S. dollar while the USD/CHF pair slipped from about 1.00 franc in early March to less than 0.97 franc. The franc is still relatively weak vs. the euro and the EUR/CHF pair even hit 1.12 francs temporarily at the beginning of March, its highest level since the floor level of 1.20 francs was abandoned in January 2015. The easing of financial strains and the euro's new shine have lifted the upside pressures on the Swiss franc, making things easier for the Swiss National Bank (SNB), which did not have to resort to slashing its key rates. The SNB will stay extremely vigilant, however, as it continues to maintain that the franc is substantially overvalued. The SNB now expects inflation in Switzerland to be at only -0.8% on average in 2016. **Another drop in the euro and mounting concerns of a Brexit could increase upward pressures on the franc in the months ahead**, but the Swiss franc's fluctuations against the euro should be limited.

Swiss franc



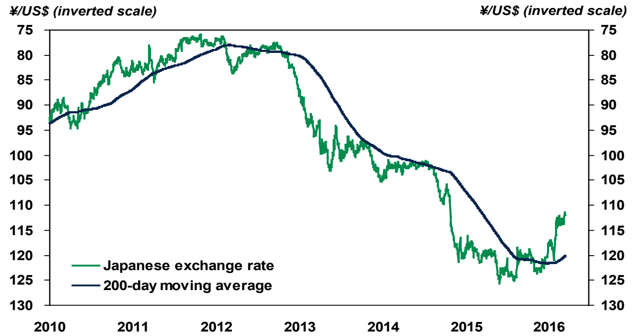
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

The Bank of Japan seems to have lost control of its currency

- The yen continues to grow and the USD/JPY pair recently fell below ¥112/US$. Stronger risk aversion at the beginning of the year was favourable to safe-haven currencies like the yen, but the resurgence of optimism on the markets did not trigger a new decline and the yen was not punished by the Bank of Japan's (BoJ) decision to charge a negative interest rate for some deposits.
- Like other currencies, the yen is benefiting from the weakness of the U.S. dollar, which could have offset the impact of the BoJ's decision and the drop in the demand for safe havens. The fact that the BoJ's decision was not unanimous (5 vs. 4) could also have been interpreted as a signal the BoJ is nearing its capacity to intervene. That said, Japan's economy continues to seesaw. A new decline in the real GDP was recorded at year-end after a slight rebound in the third quarter, and inflation is still far from its 2% target. In this environment, we can at least expect the BoJ to keep its current measures in place over the long haul, which should penalize the yen given the monetary firming already underway in the United States. **We expect the exchange rate in Japan to climb back to over ¥120/US$ by the end of the year.**

Yen and trend



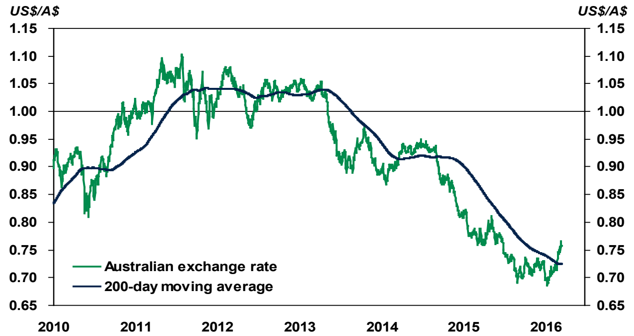
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

Economic data posts upside surprises

- The Australian dollar is doing well this March, currently trading at close to US$0.76. The monetary policy meeting held early in the month is not behind this increase. The Reserve Bank of Australia stayed on hold, leaving the door open to another rate cut. Better than expected economic data gave the currency a boost, however. Real GDP growth in particular was stronger than expected at year-end and the third quarter results were upgraded. The Australian dollar is also benefiting from rising commodity prices, including iron ore prices. Part of this appreciation simply reflects the widespread weakness of the U.S. dollar.
- Considering that Australia's economy still needs to adjust to an environment that is still difficult for natural resources, the growth potential for the Australian dollar seems limited. **The currency could fall to close to US$0.70 given the high probability the U.S. dollar will rebound and the ongoing risks weighing over Australia's economy.**

Australian dollar and trend



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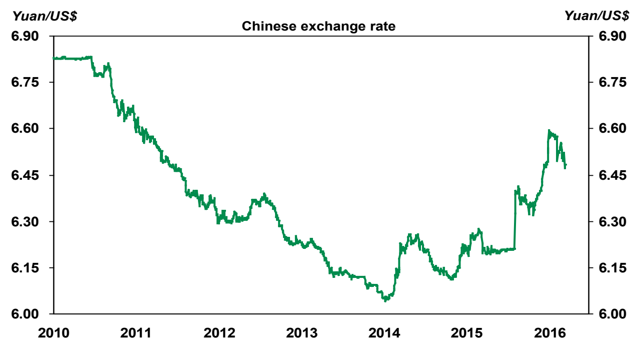
EMERGING CURRENCIES

Back to calmer waters

CHINESE YUAN (CNY)

- The increased aversion to risk early in the year was particularly difficult for most currencies in the emerging countries. Calm has since been restored and these currencies are making up lost ground, something the greenback's current weakness is helping to support. The general trend seen in recent months has not spared the yuan—the exchange rate edged close to 6.60 yuans/US$ in January before it gradually slid back below 6.50 yuans/US$. That said, the state of China's economy should continue to stay in the headlines for the next few quarters, or at least periodically. The pace of economic growth in China should continue its slow descent now that its development model based on massive investment is showing its age. **The yuan should be under increasing pressure; we expect it to end the year at about 6.70 yuans/US$.** The monetary authorities will probably continue to sell foreign exchange reserves to limit the volatility.

Chinese yuan and trend



Sources: Datastream and Desjardins, Economic Studies

MEXICAN PESO (MXN)

- Mexico's currency continued its slump until mid-February amid falling oil prices and rising investor concerns, which drove the USD/MXN pair to more than 19 pesos. The peso's meltdown convinced the Bank of Mexico to announce a surprise key rate increase of 0.50% on February 17 and review how it intervenes on commodity markets. These actions and, especially, the more favourable international environment, including the recovery in oil prices and stock markets, helped the peso rally. The greater caution signaled by the Federal Reserve even drove the USD/MXN below 17.50 pesos by mid-March. **The peso should continue to rise in the medium term. However, a temporary setback could occur when the next increase in U.S. key rates gets closer.**

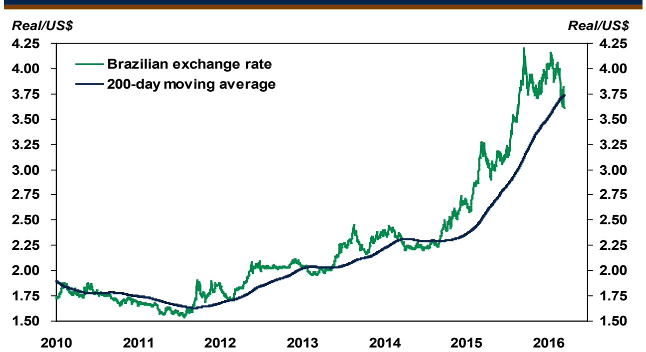
Mexican peso and trend

Sources: Datastream and Desjardins, Economic Studies

BRAZILIAN REAL (BRL)

- The Brazilian real seems to have a more measured response to the political scandals that rock Brazil's government—it usually stays in line with the overall uptrend seen in the emerging currencies. The exchange rate, which broke through 4 reals/US$ in recent months, now stands at about 3.60 reals/US$. The recent recovery in commodity prices is also weighing in the balance. We will maintain our downbeat stance on this currency for the next few quarters. Brazil's economy is still in a very precarious situation, with inflation at more than 10%. **The real is also more likely to react sharply to any signs of monetary firming in the United States and a rebound in the greenback.**

Brazilian real and trend



Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

Country – Currency*	Spot price March 22	Percentage return since 1 month	3 months	6 months	1 year	Last 52 weeks Higher	Average	Lower
Americas								
Argentina – peso	14.3050	-5.4215	10.1643	52.3502	62.6881	15.9350	10.5367	8.7733
Brazil – real	3.5876	-9.2862	-10.5751	-11.4677	11.4336	4.2061	3.5792	2.9095
Canada – dollar	1.3053	-4.6217	-6.3428	-1.7611	3.6446	1.4637	1.3103	1.1961
Canada – (CAD/USD)	0.7661	4.8456	6.7724	1.7927	-3.5164	0.8361	0.7632	0.6832
Mexico – peso	17.3305	-4.1107	0.7810	2.6728	15.1493	19.1583	16.5679	14.7870
Asia and South Pacific								
Australia – (AUD/USD)	0.7622	5.4649	5.3201	7.4924	-1.9588	0.8113	0.7361	0.6866
China – yuan renminbi	6.4901	-0.4868	0.1736	1.7887	4.5905	6.5965	6.3518	6.1935
Hong Kong – dollar	7.7532	-0.2413	0.0148	0.0426	-0.0625	7.8194	7.7572	7.7499
India – rupee	66.7553	-2.5939	0.7723	1.2833	6.9625	68.7678	65.3009	61.9600
Japan – yen	112.3750	-0.4870	-7.1856	-6.4711	-6.3815	125.6250	120.2484	111.3850
New Zeland – (NZD/USD)	0.6753	0.7901	-0.7766	7.2798	-10.7577	0.7718	0.6790	0.6260
South Korea – won	1,154	-6.5052	-1.6322	-2.1286	2.7648	1,239	1,155	1,069
Europe								
Denmark – krona	6.6445	-1.7914	-2.4209	-0.8964	-3.5505	7.0711	6.7644	6.4226
Euro zone – (EUR/USD)	1.1226	1.8045	2.3709	0.8352	4.0019	1.1576	1.1029	1.0561
Norway – kroner	8.4044	-2.2937	-3.6132	1.4044	4.6391	8.9520	8.2706	7.3096
Russia – ruble	67.3763	-10.6741	-5.3704	1.2530	13.6608	84.2412	63.8865	49.0402
Sweden – krona	8.2288	-3.1872	-2.3334	-2.0486	-4.5660	8.8229	8.4695	8.1096
Switzerland – swiss franc	0.9706	-2.7845	-1.7760	-0.3133	-0.6042	1.0299	0.9727	0.9137
United Kingdom – (GBP/USD)	1.4217	0.5837	-4.0948	-7.3663	-4.7247	1.5884	1.5090	1.3863

* 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 Q3	2015 Q4	2016 Q1f	2016 Q2f	2016 Q3f	2016 Q4f	2017 Q1f	2017 Q2f	2017 Q3f	2017 Q4f
American dollar											
Canadian dollar	(USD/CAD)	1.3315	1.3841	1.3158	1.3514	1.3514	1.3333	1.3333	1.3158	1.2987	1.2821
Euro	(EUR/USD)	1.1162	1.0863	1.1200	1.0900	1.0700	1.0500	1.0600	1.0900	1.1000	1.1100
British pound	(GBP/USD)	1.5148	1.4739	1.4200	1.4200	1.4400	1.4600	1.4900	1.5300	1.5300	1.5500
Swiss franc	(USD/CHF)	0.9734	0.9903	0.9700	1.0000	1.0100	1.0300	1.0300	1.0100	1.0000	0.9900
Yen	(USD/JPY)	119.87	120.32	113.00	118.00	120.00	123.00	125.00	125.00	126.00	127.00
Australian dollar	(AUD/USD)	0.7020	0.7280	0.7500	0.7200	0.7000	0.7200	0.7400	0.7500	0.7500	0.7600
Chinese yuan	(USD/CNY)	6.3571	6.4937	6.5000	6.6200	6.6500	6.7000	6.6500	6.6000	6.5800	6.5500
Mexican peso	(USD/MXN)	16.92	17.18	17.50	18.00	17.30	17.50	16.90	16.60	16.30	16.00
Brazilian real	(USD/BRL)	3.9725	3.9045	3.7000	4.0000	3.8000	3.9000	3.7000	3.6000	3.5000	3.5000
Effective dollar*	(1973 = 100)	92.26	94.46	91.30	93.80	94.70	95.30	94.90	93.40	92.70	91.80
Canadian dollar											
American dollar	(CAD/USD)	0.7510	0.7225	0.7600	0.7400	0.7400	0.7500	0.7500	0.7600	0.7700	0.7800
Euro	(EUR/CAD)	1.4863	1.5035	1.4737	1.4730	1.4459	1.4000	1.4133	1.4342	1.4286	1.4231
British pound	(GBP/CAD)	2.0169	2.0400	1.8684	1.9189	1.9459	1.9467	1.9867	2.0132	1.9870	1.9872
Swiss franc	(CAD/CHF)	0.7311	0.7155	0.7372	0.7400	0.7474	0.7725	0.7725	0.7676	0.7700	0.7722
Yen	(CAD/JPY)	90.02	86.93	85.88	87.32	88.80	92.25	93.75	95.00	97.02	99.06
Australian dollar	(AUD/CAD)	0.9346	1.0076	0.9868	0.9730	0.9459	0.9600	0.9867	0.9868	0.9740	0.9744
Chinese yuan	(CAD/CNY)	4.7744	4.6918	4.9400	4.8988	4.9210	5.0250	4.9875	5.0160	5.0666	5.1090
Mexican peso	(CAD/MXN)	12.71	12.41	13.30	13.32	12.80	13.13	12.68	12.62	12.55	12.48
Brazilian real	(CAD/BRL)	2.9835	2.8211	2.8120	2.9600	2.8120	2.9250	2.7750	2.7360	2.6950	2.7300

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