FX Forecasts

Desjardins Economic Studies
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October 25, 2016

The greenback benefits from expectations of a looming key interest rate increase in the United States

HIGHLIGHTS

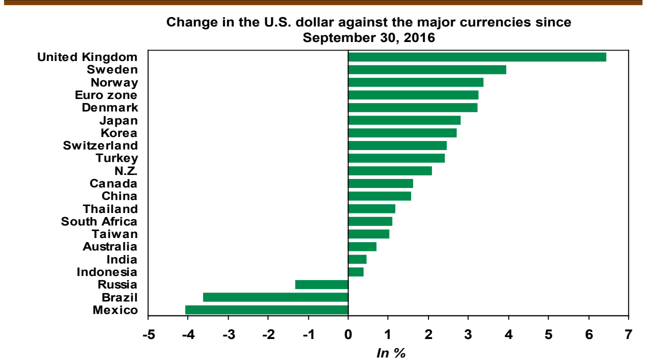
- After several months marked by doubt about the U.S. economy's robustness and the Federal Reserve's ability to move ahead with monetary firming, the situation now seems more favourable for the greenback.
- The Canadian dollar could lose a little more ground by year's end. Next year, a rise by oil to around US$60 a barrel and improved Canadian economic data could allow the loonie to return to the US$0.77 (C$1.30/US$) mark, despite further rate increases in the United States.
- Nothing points to a big rebound by the euro, unless some event triggers a broad drop by the U.S. dollar. The political uncertainties associated with Brexit, the constitutional referendum in Italy, and elections in France and Germany next year, could continue to hurt the currency.
- British and European politicians are very divided, raising fears of a hard Brexit. The pound should remain low in the coming quarters and could well slide below US$1.20 next spring, when the Article 50 will be invoked.

Contents

Editorial

The U.S. dollar appreciated against most currencies recently (graph 1). After several months marked by doubt about the U.S. economy's robustness and the Federal Reserve's (Fed's) ability to move ahead with monetary firming, the situation now seems more favourable again. Several economic statistics are now heading in the right direction and the markets are positioning for a December key interest rate increase from the Fed.

Graph 1 — The greenback strengthens again



Sources: Datastream and Desjardins, Economic Studies

THE PLANETS ALIGNED AT THE START OF OCTOBER

The U.S. dollar's rebound was mainly focused at the start of October, about ten days after the last Fed meeting. Although three dissenters had already come out in favour of an interest rate increase, the markets maintained their position and mainly remembered that Fed leaders had once again lowered their outlook for rates' future trajectory. In the aftermath, the U.S. dollar even edged back on September 21 and 22.

An important ingredient was still missing: data showing that the U.S. economy had achieved a satisfactory cruising speed. Note that growth remained around 1% in the last

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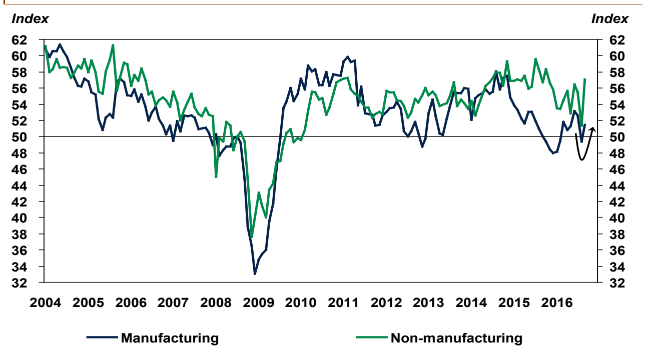
three published quarters. A lot of hopes are pinned on the upcoming results. Yet, in September, further disappointment came from economic statistics, such as major declines by the manufacturing and non-manufacturing ISM indexes.

The situation shifted in October, when many statistics painted a more optimistic picture of the economy. Among other things, the ISM indexes rebounded (graph 2). In addition, retail sales did well and jobless claims are at their lowest point since 1973.

Graph 2 — After the disappointment, the ISM indexes rebounded



Sources: Institute for Supply Management and Desjardins, Economic Studies

The U.S. election campaign also probably had an influence. In the last few weeks, Donald Trump has been looking less and less likely to get into the White House. This substantially reduces uncertainty over the U.S. economy and simultaneously bolsters the outlook for monetary firming and a rising greenback.

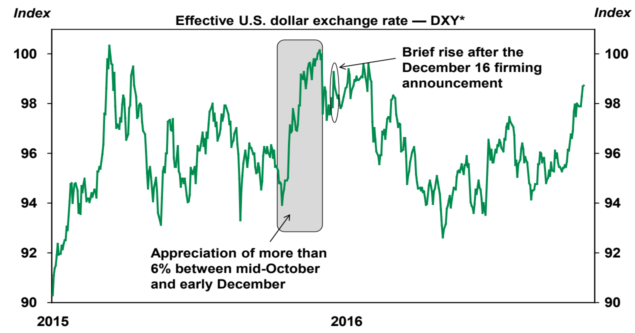
IS THE BULK OF THE ADJUSTMENT DONE?

We may well wonder if the U.S. dollar will go up a lot more before the December Fed meeting, and what it will do after that. Based on what happened last year, it could still have more room to appreciate it.

In the fall of 2015, the greenback mainly rose between mid-October and early December (graph 3). The DXY index of the effective exchange rate had gone above 6% during this period, higher than the 3.5% achieved this year since the end of September. However, the context is very different. Before it rebounded in mid-October last year, the greenback had just tumbled substantially. If it had started higher, the gain would have been between 4% and 5%, suggesting a 1% shortfall this year, or slightly over.

Another feature of last year was the release of some disappointing economic data in early December, which had raised doubts about monetary firming and pulled the greenback down before the meeting on the 16th. It

Graph 3 — Last December's rate increase did not give the greenback new momentum



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

then rebounded a little, but that did not turn into lasting momentum. Although the economy is still subject to blips, the scenario could be very different this year. Our core scenario calls for economic growth to accelerate by the end of 2016, and maintain a pace of 2% or better after that. There should also be more inflation pressure in 2017, which will discourage the markets from banking on another long Fed status quo. In this context, the greenback could continue to appreciate over several quarters.

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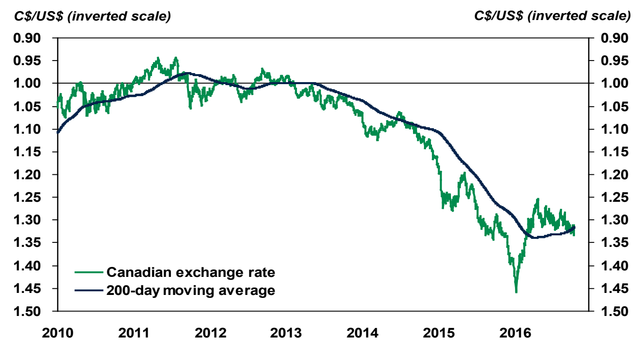
CANADIAN DOLLAR (CAD)

Less volatile but still fragile

- Although the Canadian dollar is showing little volatility, it still ticked down recently to settle near US$0.75 (C$1.33/US$). This movement contrasts with the uptrend shown by its 200-day moving average, which could reverse again shortly, as is being signalled by market indicators such as 90-day momentum and net speculative positions.
- Fundamentally, the Canadian dollar's downtick may seem surprising given that oil prices have been going up since mid-September. In fact, this historical correlation is not being challenged. However, other factors clearly weighed more heavily in the balance in the last few weeks.
- The greenback's generalized strength is one of the factors that hurt the loonie. The prospect of monetary firming in the United States is making interest rate spreads widen, and that is being reflected in exchange rates. The widening by rate spreads with Canada has also been influenced by the increase in concern over Canada's economy and stronger expectations of monetary easing here. Recent economic worries include the trend for exports which, even though it is still heading up, seems increasingly fragile due to the blips in global demand. Then, the new federal real estate market rules should rein in residential construction and activity in the property resale market, although by how much is unknown. Lastly, some doubt is emerging as to what actual impact the federal government's stimulus program will have.
- The Bank of Canada has noted these risks and is taking a more cautious tone. However, the BoC still expects the economy to grow more than potential, and inflation to return to its midpoint target, 2%. We still believe the likelihood of another rate cut is low, although it has certainly increased. Market expectations should keep adjusting to the data and shifts in risk.

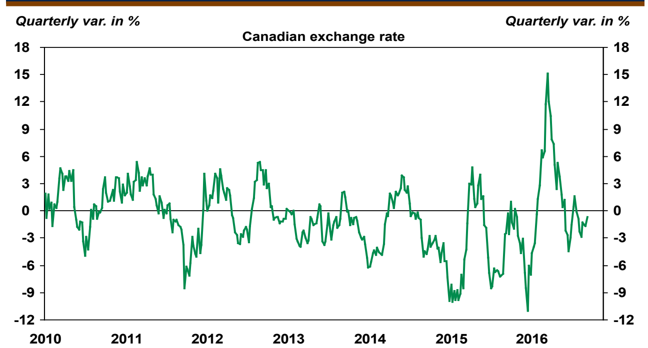
Forecasts: The Canadian dollar could lose a little more ground by year's end, mainly because the greenback is likely to keep going up. Next year, a rise by oil to around US$60 a barrel and improved Canadian economic data could allow the loonie to return to the US$0.77 (C$1.30/US$) mark, despite further rate increases in the United States.

Canadian dollar and trend



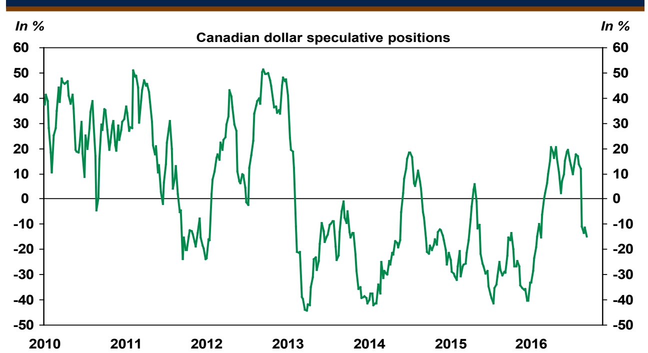
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

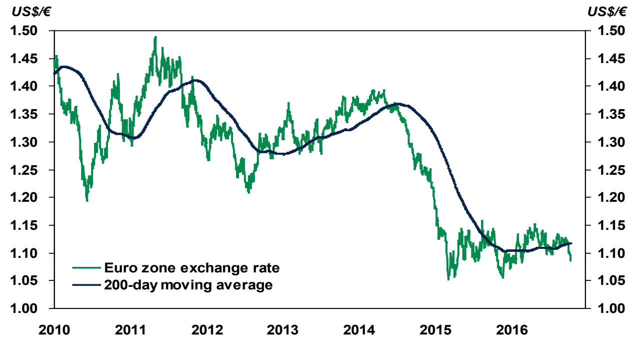
EURO (EUR)

The euro is back below US$1.10, with the ECB maintaining the suspense

- The euro weakened early last summer after the Brexit vote in the United Kingdom and renewed concern over Europe's financial sector. It then strengthened and has generally fluctuated around US$1.12 since the start of August. Like other European currencies, the last few weeks have been much tougher for the euro, which suddenly dropped below the psychological threshold of US$1.10.
- The euro's recent tumble largely reflects movements by other currencies. A big surge in the probability of monetary firming by year's end recently drove the greenback up against most currencies. The spike in concern over the Brexit negotiations also played against all of the European currencies. Note that the return of trade barriers between the United Kingdom and rest of Europe would also have a negative impact on the economic outlooks of the euro zone. Nonetheless, the euro continued to appreciate against the pound, going to its highest point since 2009.
- For the euro zone, investors are primarily focused on monetary policy, as the economic outlooks have not changed much in the last few months. The major question is when the European Central Bank will start to cut back on its huge purchases of financial securities. Officially, purchases should stay at a pace of €80B until March 2017, but could suddenly stop after that. However, this scenario does not seem realistic and analysts are instead expecting the purchases to continue for quite some time. The limited number of German bonds the ECB can still acquire could, however, be an obstacle to extending its securities purchases for too long. The ECB did not really clarify its intentions at October's meeting, but President Draghi acknowledged that the purchases were unlikely to end suddenly. A decision on the future of the purchasing program could be announced in December, which could get a reaction out of the euro.

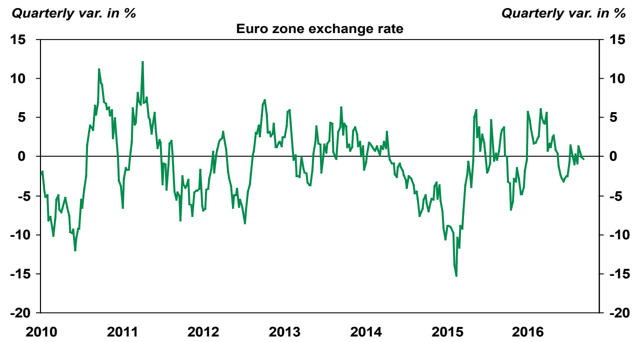
Forecasts: Nothing points to a big rebound by the euro, unless some event triggers a broad drop by the U.S. dollar, such as a surprise outcome to the U.S. election or another postponement of U.S. rate increases. The greenback is, however, more likely to keep moving upward. This could take the euro a little lower in the next few quarters, especially as the political uncertainties associated with Brexit, the constitutional referendum in Italy, and elections in France and Germany next year, could continue to hurt the currency.

Euro and trend



Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



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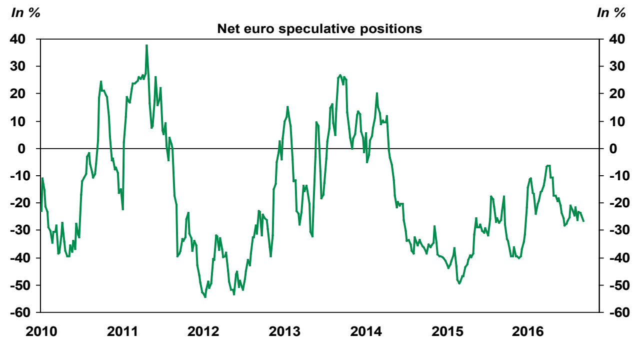
Euro: net speculative positions



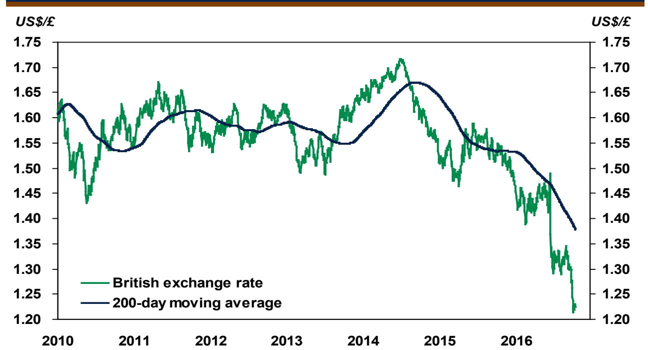
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

Fears of a hard Brexit take the pound down again

- The British pound stabilized at the end of the summer, fluctuating just above US$1.30. Britain posted the strongest second-quarter growth in the G7, and its purchasing manager indexes rebounded quickly after July's tumble; these encouraging signals for the economy even allowed the pound to close in on US$1.35 in early September. However, a speech from Prime Minister May affirming that her government would abide by the electorate's decision and initiate negotiations to leave the European Union before the end of March 2017, by invoking Article 50, once more put substantial downside pressure on the pound in early October. British and European politicians are very divided, even raising fears of the United Kingdom separating unilaterally—a hard Brexit—which would substantially increase the economic fallout. The pound tumbled again, dropping back to around US$1.23. A flash crash even temporarily took it to around US$1.175, not reassuring for investors. The Bank of England is in a tough position. The surge in concern could prompt it to further ease its monetary policy to try to reassure investors. The pound's spectacular tumble and accelerating inflation should, however, convince it to wait before lowering its key rates again. **The pound should remain low in the coming quarters and could well slide below US$1.20 next spring, when the government will invoke Article 50.**

British pound and trend



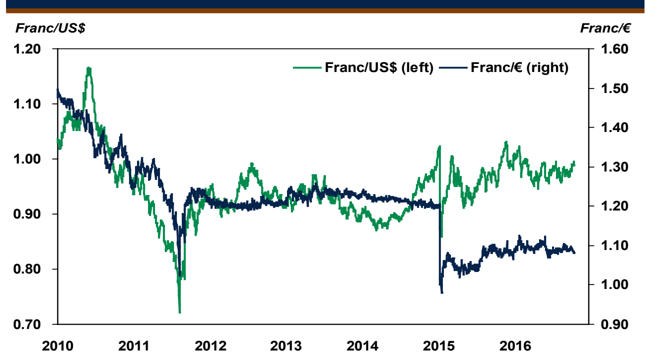
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

The Swiss franc should remain stable against the euro

- Like other European currencies, the Swiss franc sagged recently against the greenback, with the USD/CHF pair dropping from 0.965 francs to around 0.990. The EUR/CHF pair is quite stable, however, and has been fluctuating between 1.08 and 1.10 francs since the end of June. By intervening in the exchange market, the Swiss National Bank (SNB) managed to curb the post-Brexit vote upside pressure on the franc, and when some fears about the European financial sector materialized. The latest economic news is fairly encouraging, as Switzerland's GDP growth beat expectations in the second quarter, and deflation finally seems to be winding down. Numerous risks persist, however, and the **SNB will continue to take action to keep the franc from appreciating.**

Swiss franc



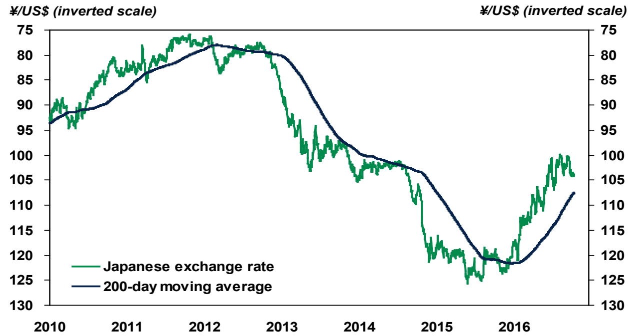
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

The Bank of Japan will have to build its credibility

- The yen uptrend has flagged in the last few months. The exchange rate was unable to settle in below ¥100/US$; more recently, it has tended to depreciate, in response to the U.S. dollar's rise in particular.
- The changes the Bank of Japan (BoJ) made to its monetary policy on September 21 had no noteworthy impact on the currency. Concerned about the negative effects that could be created by overly low long-term interest rates, the BoJ announced that it would set the rate for Japanese ten-year bonds at around 0%. At first glance, this gives the impression that the BoJ has backpedalled on its previous interventions; however, it simultaneously indicated that it still planned to buy about ¥80,000B (US$775B) in assets a year. It also reformulated its inflation target, now aiming for average price growth of 2% a year over the economic cycle. This means that if inflation remains low over the short term, the BoJ will be prepared to tolerate high inflation after that to get to the desired average. The BoJ is thus signalling that it will maintain highly accommodative monetary policy for a longer period. That being said, it will first have to show it still has the means to intervene, among other things by cutting its main policy rate. **The prospect of a more active BoJ should normally weaken the yen, taking it to around ¥120/US$ next year.**

Yen and trend



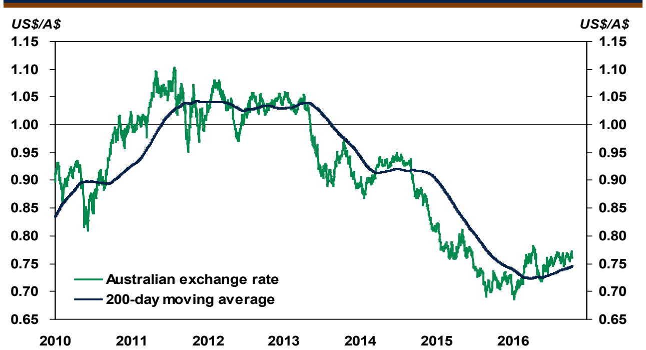
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The potential for appreciation remains low

- The Australian dollar has essentially oscillated between US$0.75 and US$0.77 in recent months. Short rising periods were quickly matched by pullbacks, attesting to the trouble the currency is having making lasting gains. Fundamentally, even though Australia's economy has done a little better than forecast so far in 2016, several concerns remain. Keep an eye on the Reserve Bank of Australia's upcoming decisions. In August, it lowered its primary key rate to a 1.50% low, while inflation fell to 1%. Also keep an eye on commodity price movement, particularly the agricultural and precious metal prices that have been struggling lately. In this context, **we continue to expect the Australian dollar to depreciate in the near term.**

Australian dollar and trend



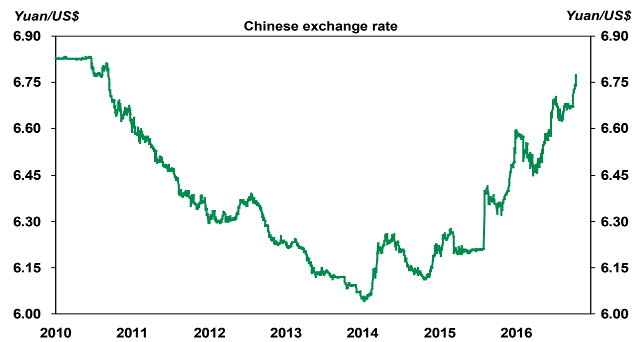
Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

Donald Trump's slide in the polls is helping the Mexican peso

CHINESE YUAN (CNY)

- The yuan has given up over 1% of its value against the U.S. dollar since the start of October. **At close to 6.77 yuan/US$, the exchange rate is back where it was six years ago. The depreciation trend can be expected to persist** in the near term, due to the U.S. dollar's generalized strength. Chinese authorities will not take risk having the yuan gain too much value against competitors' currencies. Chinese exports remain on a slight downtrend; if it steepens, that could compromise the fragile stabilization the economy has been showing in the last few quarters. Movement by foreign exchange reserves should also be watched. Too much pressure on the reserves could do more to encourage authorities to let the yuan slide.

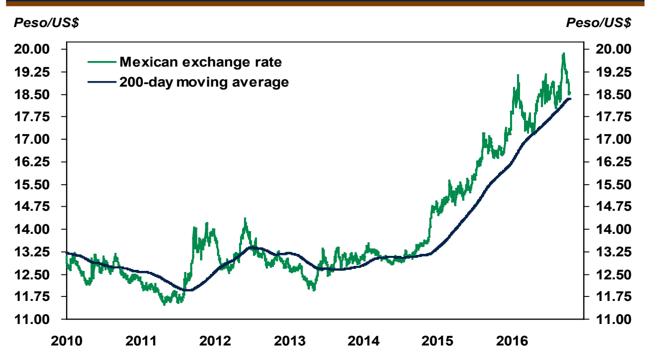


Sources: Datastream and Desjardins, Economic Studies

MEXICAN PESO (MXN)

- The Mexican peso continued to struggle in early fall, with the USD/MXN pair jumping to a historic high of 19.9 pesos at the end of September. Donald Trump's momentum in the presidential campaign seemed to be the main factor behind the peso's new slide; a Trump win would be a major risk to Mexican business's access to the U.S. market. However, Hillary Clinton has rebounded in the polls since the first presidential debate, allowing the peso to come back to around 18.5 pesos per dollar. Moreover, the Bank of Mexico raised its key rate to 4.75% at the end of September—the third 0.50% hike this year—as the peso's spectacular tumble raised fears of a surge by inflation. Further rate increases can be expected, especially if monetary firming in the United States puts additional downside pressure on emerging currencies. **Assuming the Democratic candidate wins, the peso should keep gaining a little strength in the near term.**

Mexican peso and trend



Sources: Datastream and Desjardins, Economic Studies

BRAZILIAN REAL (BRL)

- Brazil's currency stands out for its resilience: most other currencies have fallen against the greenback recently. Note that the real got a nice boost from the stabilization of the country's political situation after President Rousseff resigned. The rise by oil prices is also helping. Still, it would take a convincing improvement to Brazil's economy for the real to make further substantial gains, which is not yet a sure thing. Caution is in order. A Fed rate increase in December and expectations of other increases in 2017 could still put pressure on the real. **We think the USD/BRL could go back around 3.50 reals next year.**

Brazilian real and trend

Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

Country – Currency*	Spot price Oct. 24	Percentage return since 1 month	3 months	6 months	1 year	Last 52 weeks Higher	Average	Lower
Americas								
Argentina – peso	15.1025	-0.3053	0.8009	4.3531	58.6580	15.9350	13.7888	9.4909
Brazil – real	3.1316	-2.9548	-4.5942	-12.9131	-19.3448	4.1608	3.5846	3.1316
Canada – dollar	1.3352	1.6985	1.3896	5.5578	1.5052	1.4637	1.3267	1.2526
Canada – (CAD/USD)	0.7490	-1.6702	-1.3706	-5.2651	-1.4829	0.7983	0.7537	0.6832
Mexico – peso	18.5678	-5.8156	-0.1325	6.4894	12.4466	19.8525	18.0600	16.4004
Asia and South Pacific								
Australia – (AUD/USD)	0.7611	-0.1294	1.9445	-1.2558	5.4835	0.7814	0.7386	0.6866
China – yuan renminbi	6.7752	1.5848	1.4320	4.2178	6.7112	6.7752	6.5557	6.3181
Hong Kong – dollar	7.7575	0.0129	-0.0032	0.0103	0.0961	7.8194	7.7611	7.7500
India – rupee	66.8445	0.2066	-0.4609	0.2763	3.0081	68.7678	66.8963	64.8925
Japan – yen	104.1850	3.1586	-1.7818	-6.8029	-14.2263	123.6350	110.7670	99.8850
New Zeland – (NZD/USD)	0.7138	-1.4277	2.0059	4.1616	5.6963	0.7451	0.6884	0.6410
South Korea – won	1,131	2.5850	-0.3085	-1.0629	0.5601	1,239	1,158	1,090
Europe								
Denmark – krona	6.8356	2.9334	0.8639	3.1151	0.9645	7.0620	6.7162	6.4525
Euro zone – (EUR/USD)	1.0884	-2.9859	-0.8473	-3.1671	-1.3416	1.1518	1.1092	1.0561
Norway – kroner	8.2551	1.7503	-3.4768	0.1407	-1.5727	8.9520	8.4306	7.9816
Russia – ruble	62.1962	-2.4421	-4.0033	-5.9325	0.2401	84.2412	67.7545	61.9969
Sweden – krona	8.9107	4.3188	3.0043	9.2721	4.8207	8.9196	8.4522	7.9588
Switzerland – swiss franc	0.9931	2.2761	0.4603	1.6168	1.7052	1.0299	0.9841	0.9513
United Kingdom – (GBP/USD)	1.2207	-5.8140	-6.7067	-15.3032	-20.4788	1.5444	1.4057	1.2153

* 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	Q4	2016 Q1	Q2	Q3	Q4f	2017 Q1f	Q2f	Q3f	Q4f
American dollar											
Canadian dollar	(USD/CAD)	1.3315	1.3841	1.3006	1.2925	1.3129	1.3514	1.3514	1.3333	1.3158	1.2987
Euro	(EUR/USD)	1.1162	1.0863	1.1395	1.1110	1.1238	1.0800	1.0700	1.0700	1.0800	1.0900
British pound	(GBP/USD)	1.5148	1.4739	1.4373	1.3368	1.2990	1.2100	1.2000	1.1700	1.1900	1.2000
Swiss franc	(USD/CHF)	0.9734	0.9903	0.9631	0.9793	0.9684	1.0000	1.0100	1.0100	1.0100	1.0000
Yen	(USD/JPY)	119.87	120.32	112.58	103.29	101.35	106.00	110.00	115.00	117.00	120.00
Australian dollar	(AUD/USD)	0.7020	0.7280	0.7658	0.7450	0.7664	0.7400	0.7400	0.7300	0.7400	0.7500
Chinese yuan	(USD/CNY)	6.3571	6.4937	6.4490	6.6481	6.6716	6.8000	6.7700	6.8000	6.7800	6.8200
Mexican peso	(USD/MXN)	16.92	17.18	17.28	18.28	19.38	18.40	18.25	18.50	18.25	18.35
Brazilian real	(USD/BRL)	3.9725	3.9045	3.5586	3.2095	3.2459	3.2500	3.3000	3.5000	3.3000	3.4000
Effective dollar*	(1973 = 100)	92.26	94.46	89.84	90.64	90.01	93.70	94.50	95.30	94.80	94.30
Canadian dollar											
American dollar	(CAD/USD)	0.7510	0.7225	0.7689	0.7737	0.7617	0.7400	0.7400	0.7500	0.7600	0.7700
Euro	(EUR/CAD)	1.4863	1.5035	1.4820	1.4359	1.4754	1.4595	1.4459	1.4267	1.4211	1.4156
British pound	(GBP/CAD)	2.0169	2.0400	1.8693	1.7278	1.7055	1.6351	1.6216	1.5600	1.5658	1.5584
Swiss franc	(CAD/CHF)	0.7311	0.7155	0.7405	0.7577	0.7376	0.7400	0.7474	0.7575	0.7676	0.7700
Yen	(CAD/JPY)	90.02	86.93	86.56	79.91	77.19	78.44	81.40	86.25	88.92	92.40
Australian dollar	(AUD/CAD)	0.9346	1.0076	0.9960	0.9629	1.0062	1.0000	1.0000	0.9733	0.9737	0.9740
Chinese yuan	(CAD/CNY)	4.7744	4.6918	4.9587	5.1436	5.0816	5.0320	5.0098	5.1000	5.1528	5.2514
Mexican peso	(CAD/MXN)	12.71	12.41	13.29	14.14	14.77	13.62	13.51	13.88	13.87	14.13
Brazilian real	(CAD/BRL)	2.9835	2.8211	2.7362	2.4832	2.4723	2.4050	2.4420	2.6250	2.5080	2.6180

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