FX Forecasts

Desjardins Economic Studies
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Summer under stable skies for the main currencies

HIGHLIGHTS

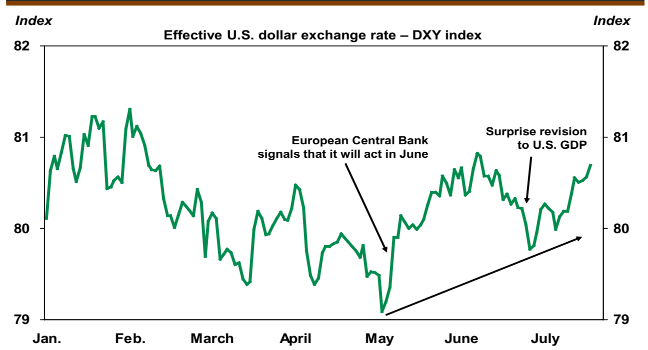
- We will have to wait until we see convincing signs across a broader range of economic variables to support the expected rise in the greenback's value. We may have to wait until the end of summer.
- Despite the loonie's recent gains, we are maintaining our year-end projection of US$0.93 (C$1.075/US$). Inflation advances in the months ahead should not be as steep and short-term improvements in economic data should not be enough for the Bank of Canada to further change its stance.
- We continue to call for a gradual depreciation of the euro, which will see it get back to levels that better reflect the persistent economic and financial difficulties in the euro zone.
- The pound's strength is leading to some tightening of financial conditions, which should allow the Bank of England to wait until the first quarter of 2015 before it acts. This, combined with the expected rally in the U.S. dollar, should keep the pound at close to US$1.70 until the end of 2014.

Contents

Editorial

The decision in the spring by the European Central Bank (ECB) to go ahead with new easing measures could have signalled the start of a period of greater volatility on currency markets. Hopes were also pinned on a rebound in the U.S. economy to support the greenback's recovery. It now seems clear that the movement that began in early May is having difficulty keeping the pace. A lack of clear signals on the U.S. economy is the main reason for this (graph 1). The surprise -2.9% revision to the U.S. GDP annualized growth in the first quarter was very disappointing, while other indicators released thereafter also put into question the strength of the world's largest economy.

Graph 1 – U.S. dollar rebound stifled by mixed economic data in the United States



Sources: Bloomberg and Desjardins, Economic Studies

LACK OF CONSISTENCY IN THE U.S. DATA

A lack of consistency probably best qualifies the recent changes in U.S. economic data. Several indicators showed sharp increases in the last few months, but the movements have rarely been successive. In addition, the signals being sent from the main statistics do not seem to be properly synchronized. Not all data improve over the course of the same month and disappoint the next.

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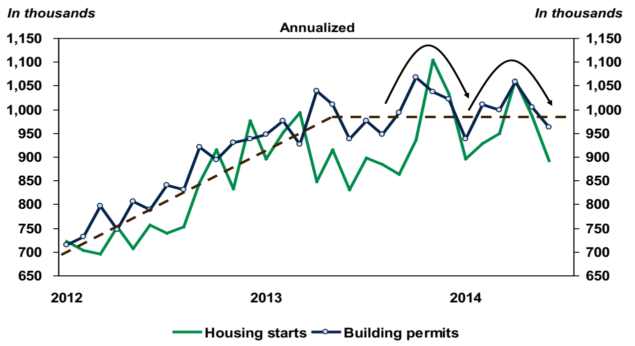
Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

A good example of this lack of consistency in the U.S. data is the changes in residential construction (graph 2). The difficult weather conditions last winter cut short the rebound observed at the end of 2013. However, spring's arrival was not marked by a sustain acceleration. Construction picked up vigorously in April, but June was very disappointing, with starts dipping below 900,000 units. Among other major economic variables, continuous improvement has also been difficult to record with industrial production and retail sales.

Graph 2 – Residential construction struggles to sustain momentum



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

Other indicators—like those for the job market— are sending a much clearer message, however. Job creation has been bustling in recent months and the jobless rate has been sliding. Inflation has also shot up since the end of winter. It seems as though a 6.1% jobless rate and a 2.1% inflation rate are not enough to reassure investors that the U.S. economy is improving and to encourage them prepare for monetary tightening. The delay in the greenback's recovery is a good reflection of this.

Favourable changes in employment and inflation did little to spur the Federal Reserve (Fed) to adjust its tone. Even if jobs and price stability remain its two main mandates, the Fed has clearly indicated that it tracks the movements of several variables, which are still sending mixed messages. The markets seem to have adopted the Fed's way of thinking. We will therefore have to wait until we see convincing signs across a broader range of economic variables to support the expected rise in the greenback's value. We may have to wait until the end of summer.

GEOPOLITICAL CONFLICTS HAVE LITTLE IMPACT ON CURRENCIES TO DATE

So far, 2014 has been another year rich in conflicts around the world. More recently, the violence in Gaza and Ukraine has captured the most attention. The destruction of a passenger plane in Ukrainian airspace sent a small jolt through the financial markets lately, but the impact on currencies was more subdued.

Contrary to what occurred at the start of the conflict in Ukraine, the euro does not seem to be benefitting from the momentum tied to its new role as a regional safe haven. The fact that most fund transfers have already been carried out could explain the euro's behaviour. However, the context in the euro zone has changed considerably in the last few months. Several recent economic indicators have disappointed and the ECB has moved into interventionist territory. Finding support for the euro has been difficult and it will be tough to balance its role as a regional safe haven with the long downtrend that appears to be in the cards for this currency.

Since the U.S. dollar is often considered the principle international safe haven, worsening global conflicts could be favourable to the greenback. Right now, the current level of conflicts does not seem sufficient to begin mass fund transfers in U.S. dollars. Even if the conflicts were to aggravate significantly, the U.S. dollar could still show softness on exchange markets. Any threat to global economic growth and the stability of financial markets would make the Fed act more prudently and delay monetary tightening in the United States. In this environment, the U.S. dollar would likely be guided by opposing forces—the outcome of which could finally be the continuation of a relative stability. Geopolitical tensions could of course intensify to the point where the safe haven effect would prevail, but this scenario still seems highly unlikely.

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Senior Economist

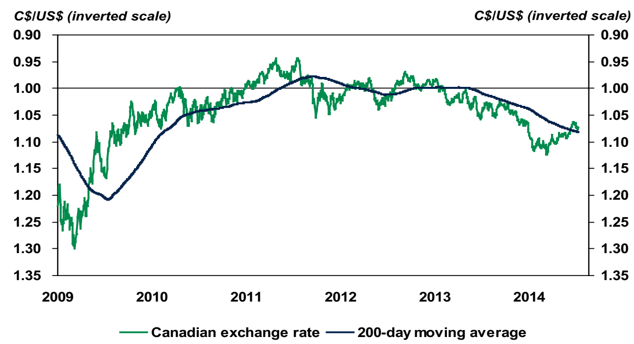
CANADIAN DOLLAR (CAD)

Difficult for the loonie to fly higher

- The Canadian dollar gained new momentum in the second half of June, settling temporarily at close to US$0.94 in early July, largely driven by higher than expected inflation. The disappointing job figures published on July 11 reset the loonie's path, which is currently hovering closer to US$0.93.
- Several interesting developments took place on a technical level for the loonie. The currency run-up in June was followed by a change in speculators' position. Speculative positions are now in positive territory, even reaching a peak not seen since February 2013. The momentum also reached levels we have not seen in several quarters and the exchange rate crossed its 200-day moving average.
- Even if several technical components are strengthening the loonie's position on exchange markets, the fundamentals are not all pointing in the same direction. The main positive development for the Canadian dollar since last winter was the continual and faster than expected increase in the inflation rate. At 2.4%, inflation has moved beyond the median target set by the Bank of Canada (BoC), and by extension, rules out the possibility of an interest rate cut. The BoC in fact changed the tone of its July statement by leaving out its mention of the downside risks to inflation being predominant. The statement nevertheless mentioned that increased inflation rests on several temporary effects, thereby closing the door to early monetary tightening.
- Canada still faces many economic hurdles, however. Stronger exports and business investment are essential in an environment where consumers and governments are more frugal. To facilitate these adjustments, the loonie cannot move up much higher to prevent hindering Canadian businesses already struggling with international competition. A ramp-up in worldwide demand would also help.

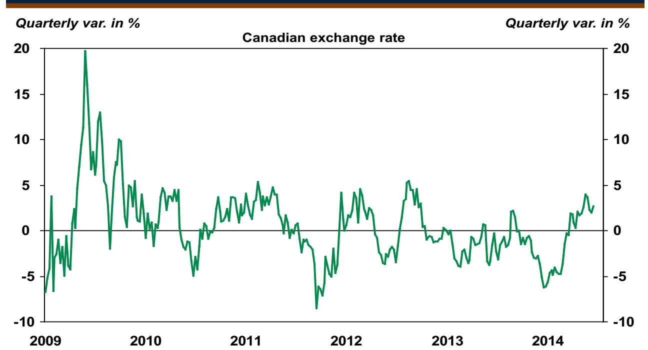
Forecasts: Despite the loonie's recent gains, we are maintaining our year-end projection of US$0.93 (C$1.075/US$). Inflation advances in the months ahead should not be as steep and short-term improvements in economic data should not be enough for the BoC to change its stance. The expected increase in the U.S. dollar will also make it more difficult for the loonie to fly higher.

Canadian dollar and trend



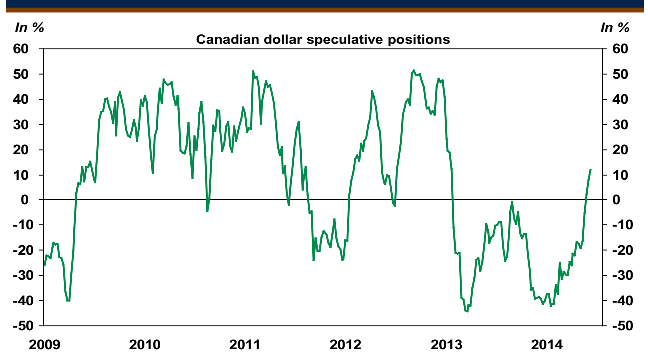
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

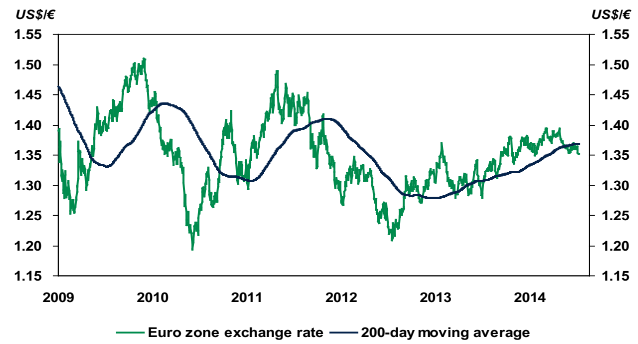
EURO (EUR)

The outlooks for the euro remain unfavourable

- After falling to close to US$1.35 after the June meeting of the European Central Bank (ECB), the euro recovered in the weeks that followed. The announcement that the U.S. economy had contracted by an annualized 2.9% in the first quarter of 2014 helped the euro end June near US$1.37. Disappointing data in Europe and the difficulties of a Portuguese financial group weighed down the euro to close to US$1.35 by mid-July.
- Other than the shock triggered by the revision to U.S. economic growth data, the relative economic performance in the euro zone does not justify any increase in the euro. While Britain's economy is firing on all cylinders and the U.S. economy is showing some encouraging signs, the situation in the euro zone remains very gloomy. Inflation is still very weak, and the recent decline in industrial production points to a lacklustre performance in the Euroland economy in the second quarter of 2014. Furthermore, the recent pullback in some confidence and activity indexes does not point to any sharp acceleration in activity in the second half of 2014. Geopolitical tensions in Eastern Europe and the fragile state of the banking sector—brought to the fore by recent events in Portugal—could also continue to mitigate activity in the euro zone.
- Will weak inflation and growth once again force the ECB to act? At the moment, the ECB's leaders seem willing to give the measures announced in early June time to take effect. At its July meeting, the ECB specified how it would provide banks with liquidity to incite them to grant more loans. The ECB's models suggest that the measures announced in June will have a significant impact on inflation and growth in the euro zone, by stimulating credit, among others. Its effects will not be immediately visible however, since the first operations to provide banks with liquidity will begin in September and December. The ECB is also working toward introducing an asset-backed securities purchase program and is keeping the door open to using other non-conventional measures, if the medium-term inflation outlooks were to deteriorate further. Even if the ECB do not announce new monetary easing, maintaining the key rates at their current level for several quarters while other central banks start to tighten their monetary policy should play against the euro.

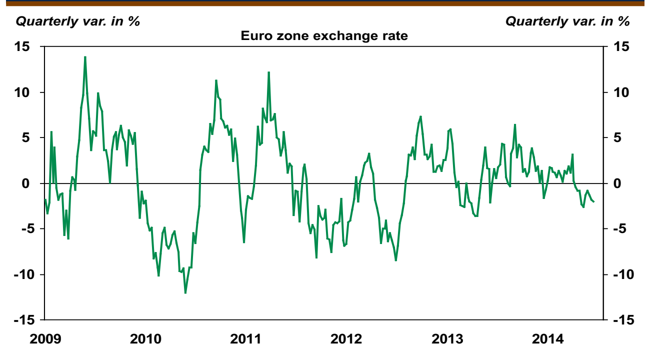
Forecasts: We continue to call for a gradual depreciation of the euro, which will see it get back to levels that better reflect the persistent economic and financial difficulties in the euro zone.

Euro and trend



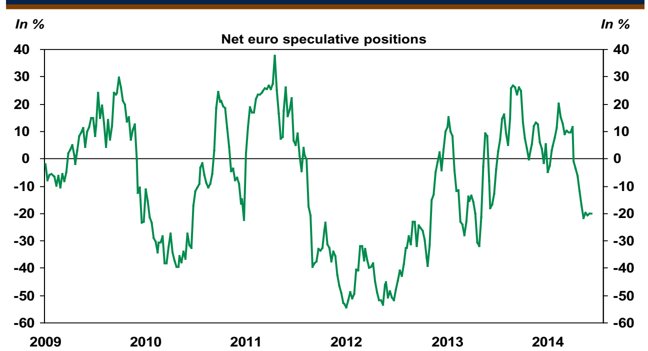
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



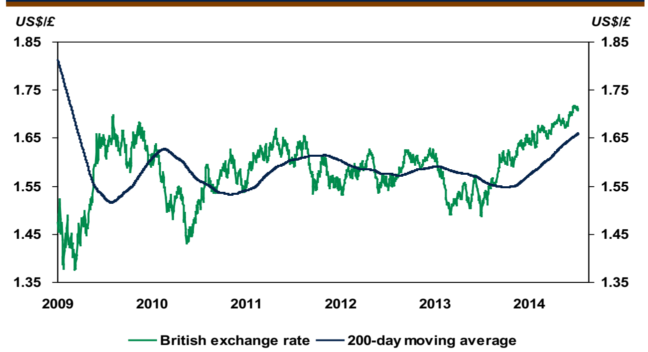
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

Climbing inflation supporting the pound sterling

- Much like the euro, the pound sterling rose in value in June against the greenback, closing the month at above US$1.71. Unlike the euro, the pound maintained its July gains, pushing the EUR/GBP pair to less than £0.79 recently. In the past year, the pound has gained more than 12% against the U.S. dollar and more than 9% against the euro, an impressive result.
- Some recent data published on Britain's economy—including industrial production—disappointed. That said, the PMI indexes are still very high, and an index that estimates quarterly growth is pointing to GDP growth in excess of 3% in the second quarter. In this environment, the surprising rise in inflation near the 2% target triggered speculation about a possible hike to the key rate this year. Spiralling rising home prices and the drop in the unemployment rate to 6.5%—its lowest level since December 2008, also argue in favour of monetary tightening in the near term. The pound's strength is already leading to some tightening of financial conditions, however, which should allow the Bank of England to wait until the first quarter of 2015 before it acts. **This, combined with the expected rally in the U.S. dollar, should keep the pound at close to US$1.70 until the end of 2014.**

British pound and trend



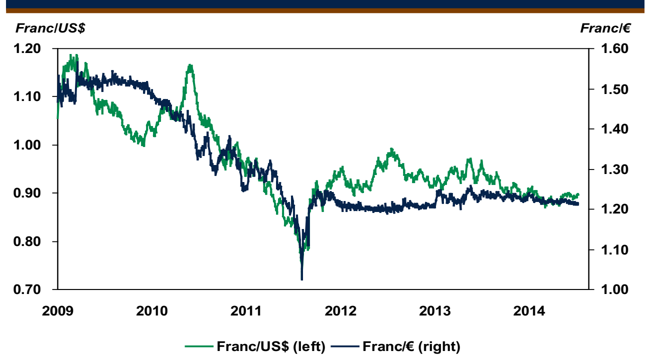
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

The Swiss National Bank set to keep its floor rate for some time

- The Swiss franc continues to generally trend in lockstep with the euro. The franc continued to slightly gain versus the euro, however, and the EUR/CHF pair fell to below 1.215 francs. While the European Central Bank's adoption of a negative deposit rate and the intensifying geopolitical tensions in Eastern Europe could make the Swiss franc more attractive, the Swiss National Bank (SNB) will have to remain vigilant to limit its currency's appreciation. The euro's expected downtrend against most other currencies could force the SNB to hold its floor rate at 1.20 francs/€ for several more quarters. Weak inflation and the downside risks weighing on Switzerland's economic outlooks are giving the SNB a lot of leeway. **We will have to wait several more quarters before the conditions are ripe for a sustainable and significant depreciation of the Swiss franc against the euro.**

Swiss franc



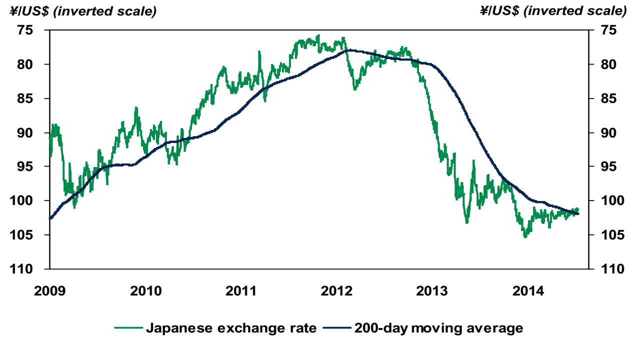
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

The period of stability continues

- The Japanese exchange rate continues to show long-term stability, at close to 102¥/$US. This trend has lasted since the end of January due to no new developments in Japan's monetary policy. Certain economic data triggered some peaks and valleys in currency values, but nothing compared to what occurred last year when the Bank of Japan (BoJ) implemented its massive asset purchase program.
- The BoJ is confident it will reach its 2% inflation target by 2016. New projections published in July almost mirrored April's predictions. The margin of error remains significant, however, and new measures for monetary easing may still be necessary. At a minimum, the BoJ should stick to its current policy for several more quarters. Together with the opposite direction about to be taken by U.S. monetary policy, the actions of the BoJ could potentially drive down the value of yen. **The depreciation should start up again this fall, resulting in an exchange rate of close to 106¥/$US by the end of 2014.**

Yen and trend



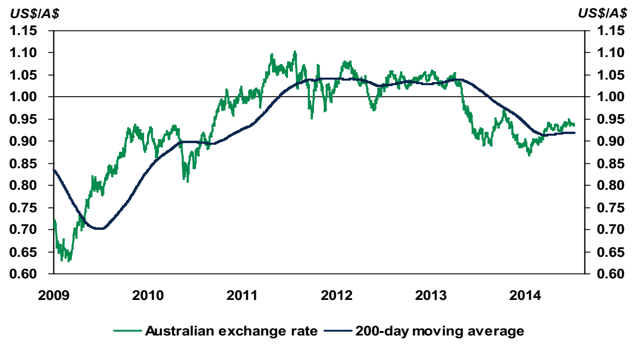
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The Reserve Bank of Australia struggles to rein in its currency

- By continuing to hover at close to US$0.94, the Australian dollar is showing resilience. Even if the Reserve Bank of Australia (RBA) continues to signal its discomfort with the current exchange rate, it no longer seems to exercise any influence. The RBA argues in favour of a weaker currency by resting on the deterioration in the terms of trade, among others, characterized in large part by weak iron ore prices. The RBA also believes that the overvaluation of its currency will contribute to its anticipated economic underperformance in the next few quarters. The drop in investments in the natural resources sector means that Australia's economy will have to adjust by developing other sectors of activity. That said, a weaker currency would help facilitate the transition and accelerate growth.
- There are factors that explain the currency's strength, such as Australia's higher interest rates, the country's good credit rating, investor appetite for returns and the recent improvement in Chinese data. The impact of some of these key determinants could be quite short lived, however. As a result, **the Aussie is more likely to fall to about US$0.90 over the next few quarters**.

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

The yuan set for yet another revaluation

CHINESE YUAN (CNY)

- China's monetary authorities devalued the yuan to discourage speculative capital inflows, but a new revaluation trend has been shaping up since mid-June. The devaluation policy was difficult to justify over the long term, given China's significant trade surplus—more than US$30B in May and June. China's economic growth also surged this spring—to 7.5%—which reduces the risk of a hard landing. Despite the data, the **caution shown by the monetary authorities suggests a slower pace for the revaluation than in previous years**. The increase in the U.S. dollar could prompt the authorities to tone down the pace. **Our year-end target is 6.10 yuans/US$.**

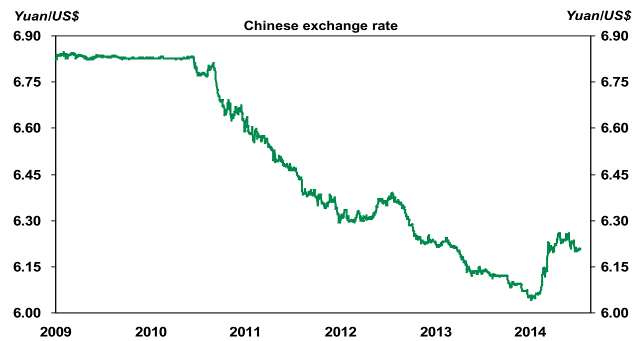
MEXICAN PESO (MXN)

- The Mexican peso has stayed relatively stable, at about 13 pesos to a U.S. dollar since Mexico's key rate suffered a surprise cut in early June. In July, Bank of Mexico (BoM) kept its key rate at 3%. The leaders at the BoM saw signs of economic acceleration after a tough start to the year, but they expect inflation to remain under control. In this environment, the key rate should stay the same in the next few months, with the next move expected to be an increase. Despite Mexico's weak interest rates, hopes for reforms that would facilitate foreign investment, especially in the oil industry, are fuelling foreign demand for Mexican bonds. **These reforms could trigger a medium-term increase in the peso.**

BRAZILIAN REAL (BRL)

- Brazil's exchange rate has remained below 2.25 reals/US$ since April. With no recovery in bond yields in the United States and the return of capital inflows in emerging countries, the real has been shielded from new downside pressures. The many spin-offs from the World Cup may also have helped the currency, as has the extension of support measures by the Central Bank of Brazil. However, one can imagine that as soon as the Federal Reserve further clarifies its intentions, volatility could set in for some currencies in emerging countries. The real was particularly volatile last year. The more likely scenario for the real is a depreciation at around 2.30 reals/US$ in the next few quarters.

Chinese yuan and trend



Sources: Datastream and Desjardins, Economic Studies

Mexican peso and trend

Sources: Datastream and Desjardins, Economic Studies

Brazilian real and trend

Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

Country – Currency*	Spot price July 21	Percentage return since 1 month	3 months	6 months	1 year	Last 52 weeks Higher	Average	Lower
Americas								
Argentina – peso	8.1650	0.4243	1.9988	18.5481	49.6449	8.1650	6.9638	5.4563
Brazil – real	2.2234	-0.4945	-0.5746	-5.8401	-0.5613	2.4513	2.2876	2.1592
Canada – dollar	1.0749	-0.2228	-2.4460	-2.0950	3.6250	1.1252	1.0713	1.0224
Canada – (CAD/USD)	0.9304	0.2233	2.5073	2.1398	-3.4982	0.9781	0.9334	0.8888
Mexico – peso	12.9798	-0.2747	-0.4334	-2.5061	3.6121	13.5050	13.0476	12.5043
Asia and South Pacific								
Australia – (AUD/USD)	0.9373	-0.1687	0.4780	6.4439	2.1839	0.9708	0.9193	0.8684
China – yuan renminbi	6.2093	-0.2442	-0.2907	2.6237	1.1633	6.2594	6.1412	6.0412
Hong Kong – dollar	7.7517	-0.0006	-0.0284	-0.0703	-0.0825	7.7673	7.7549	7.7500
India – rupee	60.2450	0.1163	-0.5776	-2.6501	1.5251	68.8050	61.4174	58.2850
Japan – yen	101.4000	-0.6613	-1.1889	-2.7991	0.7452	105.3150	101.1540	96.2200
New Zeland – (NZD/USD)	0.8689	-0.0869	1.3555	4.4574	9.5317	0.8821	0.8352	0.7727
South Korea – won	1,027	0.6025	-1.1694	-3.6093	-8.4600	1,124	1,061	1,008
Europe								
Denmark – krona	5.5137	0.5764	1.8566	0.2026	-2.8312	5.6851	5.4856	5.3568
Euro zone – (EUR/USD)	1.3521	-0.4051	-2.0538	-0.1771	2.8997	1.3933	1.3600	1.3119
Norway – kroner	6.1965	1.2831	3.3008	0.4376	3.7888	6.2863	6.0358	5.8198
Russia – ruble	35.1990	2.1230	-1.3640	3.7286	8.7353	36.6510	33.9091	31.6655
Sweden – krona	6.8465	2.0297	3.5223	5.6966	4.7538	6.8465	6.5375	6.3189
Switzerland – swiss franc	0.8983	0.1840	1.6521	-1.4211	-4.4971	0.9448	0.9012	0.8712
United Kingdom – (GBP/USD)	1.7065	0.2732	1.5532	3.6505	11.8287	1.7170	1.6378	1.5161

* 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		2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3f	2014 Q4f	2015 Q1f	2015 Q2f	2015 Q3f	2015 Q4f
American dollar											
Canadian dollar	(USD/CAD)	1.0310	1.0623	1.1050	1.0671	1.0811	1.0753	1.0695	1.0638	1.0695	1.0753
Euro	(EUR/USD)	1.3536	1.3780	1.3782	1.3691	1.3400	1.3200	1.3100	1.3000	1.2900	1.2800
British pound	(GBP/USD)	1.6194	1.6563	1.6672	1.7099	1.7000	1.7100	1.7200	1.7100	1.7000	1.6800
Swiss franc	(USD/CHF)	0.9052	0.8908	0.8869	0.8900	0.9100	0.9200	0.9400	0.9500	0.9600	0.9800
Yen	(USD/JPY)	98.23	105.32	103.22	101.33	102.00	106.00	108.00	109.00	110.00	110.00
Australian dollar	(AUD/USD)	0.9317	0.8918	0.9264	0.9432	0.9200	0.9000	0.9100	0.9100	0.9200	0.9300
Chinese yuan	(USD/CNY)	6.1215	6.0540	6.2172	6.2038	6.1700	6.1000	6.1000	6.0500	6.0000	6.0000
Mexican peso	(USD/MXN)	13.09	13.04	13.06	12.97	12.95	12.80	12.65	12.50	12.40	12.30
Brazilian real	(USD/BRL)	2.2297	2.3423	2.2627	2.2022	2.2800	2.3000	2.2700	2.2500	2.2000	2.1500
Effective dollar*	(1973 = 100)	75.19	76.44	76.86	75.91	76.70	77.30	77.70	78.00	78.50	79.00
Canadian dollar											
American dollar	(CAD/USD)	0.9700	0.9414	0.9050	0.9372	0.9250	0.9300	0.9350	0.9400	0.9350	0.9300
Euro	(EUR/CAD)	1.3955	1.4638	1.5229	1.4610	1.4486	1.4194	1.4011	1.3830	1.3797	1.3763
British pound	(GBP/CAD)	1.6695	1.7594	1.8421	1.8245	1.8378	1.8387	1.8396	1.8191	1.8182	1.8065
Swiss franc	(CAD/CHF)	0.8780	0.8386	0.8027	0.8341	0.8418	0.8556	0.8789	0.8930	0.8976	0.9114
Yen	(CAD/JPY)	95.28	99.14	93.41	94.96	94.35	98.58	100.98	102.46	102.85	102.30
Australian dollar	(AUD/CAD)	0.9605	0.9473	1.0237	1.0065	0.9946	0.9677	0.9733	0.9681	0.9840	1.0000
Chinese yuan	(CAD/CNY)	5.9377	5.6989	5.6267	5.8140	5.7073	5.6730	5.7035	5.6870	5.6100	5.5800
Mexican peso	(CAD/MXN)	12.70	12.27	11.82	12.15	11.98	11.90	11.83	11.75	11.59	11.44
Brazilian real	(CAD/BRL)	2.1628	2.2049	2.0478	2.0638	2.1090	2.1390	2.1225	2.1150	2.0570	1.9995

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