FX Forecasts

Desjardins Economic Studies
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June 29, 2016

Stronger risk aversion benefits safe haven currencies

Brexit hits the pound hard

HIGHLIGHTS

- Strong demand for safe haven securities will support the greenback even though U.S. interest rate increases have been pushed back. Moreover, monetary policy divergence may ultimately come from another wave of easing in Europe and Japan.
- The Canadian dollar should now be flat or even edge down in the near term. Failing further substantial gains by oil prices, it will be hard for the loonie to advance. Our year-end target for the loonie is US$0.77 (C$1.30/US$).
- The euro will lose further ground as the heightened uncertainty in Europe will play against it. The EUR/USD pair should end the year at around US$1.08.
- The pound could slide below US$1.30 in the near term. Our year-end target is US$1.35, but a lot of uncertainty surrounds this forecast, given the many positive or negative outcomes that could come to pass.

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Editorial

The financial markets bet on the wrong horse in terms of the referendum in the United Kingdom, which generated a lot of movement once the outcome of the vote was released. The currency market was not spared, of course. Having appreciated to nearly US$1.49 on June 23, the pound corrected sharply, dropping more than 10%. The euro and a number of other currencies also depreciated, but not as much as the pound. In contrast, heightened risk aversion intensified demand for safe haven securities, playing in the greenback's favour. The yen also benefited from the stronger risk aversion, even rising against the U.S. dollar.

FEDERAL RESERVE TAKES A BACK SEAT

The surprise created by the Brexit vote has rearranged the priorities in terms of what to keep an eye on in the economic and financial news. Until quite recently, the Federal Reserve (Fed) was a primary focus due to the likelihood of the Fed moving ahead with the monetary firming it kicked off last December. It had seemed fairly clear that the Fed would not move in July, given the more mixed economic numbers in the United States, but the door was open for September and December. Due to the volatility and uncertainty generated by the Brexit, it would now be very surprising for the Fed to raise its interest rates by the fall, and action in December seems less and less likely.

THIS DID NOT KEEP THE GREENBACK FROM APPRECIATING

In the last two years, the prospect of divergence between U.S. monetary policy and those of the other major central banks has had a big influence on the greenback's price. Increasingly accommodative policies elsewhere in the world versus a Fed that was paving the way for interest rate increases made the greenback skyrocket. That being said, the rising trend has waned given the slow pace taken

François Dupuis
Vice-President and Chief Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

Mathieu D'Anjou Senior Economist
Jimmy Jean Senior Economist
Hendrix Vachon Senior Economist

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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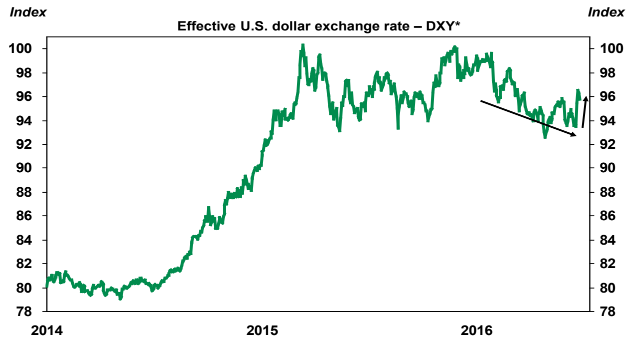
on monetary firming and, now that a longer status quo is shaping up, the U.S. dollar could be more affected. However, the heightened risk aversion and demand for safe haven securities is giving the greenback new support, allowing it to appreciate recently (graph 1).

Graph 1 – Brexit put the brakes on the greenback's depreciation



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

HOW LONG WILL THE UNCERTAINTY PERSIST?

Officially, European treaties allow a maximum of two years to finalize a country's departure. The period of uncertainty, marked by stronger demand for safe haven securities, could therefore potentially last several quarters. In fact, it could be shorter if the negotiations between the parties make rapid progress or if the much-feared economic and financial impacts prove to be limited.

In the next few months, therefore, the economic figures will have special significance. The least sign of a slowdown could fuel concerns. Among other things, we must watch to see whether consumer and business confidence declines, and if any decline translates into slowing consumer and investment spending. These impacts could be seen beyond the United Kingdom and Europe, affecting North America and other parts of the world. Other economic challenges could rear their heads if credit spreads were to widen or if for some reason access to credit became tougher. Political developments in other European nations will also be a focus, as some are concerned about seeing a bandwagon effect that would lead to a wider breakdown of the European Union, even the euro zone.

In terms of our forecasts, we estimate that the period of uncertainty could last for much of the remaining year. This factors in some slowing in economic growth in the coming months, but rules out the worst-case scenarios for now. The expected slowdown will still be enough to maintain strong demand for safe haven securities, which will support the greenback even though U.S. interest rate increases have been pushed back.

STRONGER PROBABILITY OF INTERVENTION BY SOME CENTRAL BANKS

The more precarious economic situation could open the door to further monetary stimulus. The Bank of England could announce at least one interest rate cut by year's end, especially as the United Kingdom is where economic growth should be most hard hit. The European Central Bank (ECB) might not stay on the sidelines. Although it does not have much room to manoeuvre, it could at a minimum announce that it is extending its asset purchases or doing some tweaking. That being said, any ECB action will put additional pressure on the region's other central banks, which will not want to see their currencies go up against the euro. Lastly, we must also watch the Bank of Japan: it might want to take action to reverse the yen's trend.

These actions, if taken, would help make the greenback look very good. In the end, monetary policy divergence might not come from monetary firming in the United States, but rather from another wave of easing in Europe and Japan.

François Dupuis
Vice-President and Chief Economist

Hendrix Vachon
Senior Economist

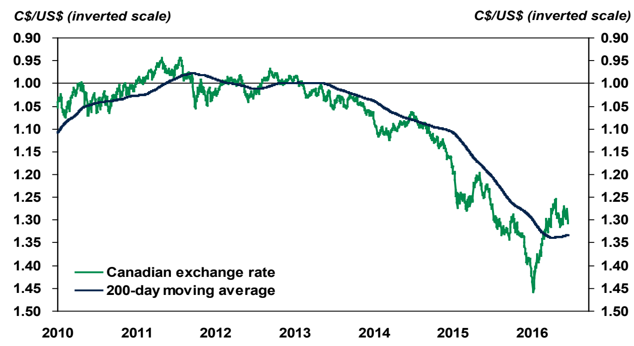
CANADIAN DOLLAR (CAD)

The upswing loses momentum

- The Canadian dollar has been struggling to make further gains since May and is now fluctuating around US$0.77 (C$1.30/US$). The currency is still being influenced by oil prices, but the higher level of risk aversion in the markets had a bigger impact recently, given such things as the British decision to leave the European Union.
- Technically, the Canadian dollar’s extended downtrend still seems to be over, as the 200-day moving average is now going up. The three-month momentum went to particularly high levels in April, then dropped lower, but to more sustainable levels. Net speculative positions have now been in positive territory for several months, attesting to greater investor confidence in the loonie.
- More fundamentally, it is clear that the loonie is getting a boost from the fact that oil prices are now close to US$50 a barrel. However, for the loonie to keep going up and stay above the US$0.80 mark sustainably, crude prices would have to make further strong advances. That could be difficult in the near term, as the least acceleration by oil production due to the higher prices could be all it takes to put the market back into surplus, and any further surplus would quickly put downside pressure on prices.
- The level of risk aversion and the greenback’s movement should continue to steer the loonie in the months to come. Keep an eye on developments in Europe, which could translate into even stronger demand for safe haven securities and the greenback. The economic numbers in the United States and China also merit watching. Nasty surprises would penalize the loonie even more.
- As for Canada’s economy, on average, the results for the second quarter are not as good as those posted last winter. There is now a risk that the third quarter will also disappoint if the uncertainty from Europe impacts consumer and business confidence.

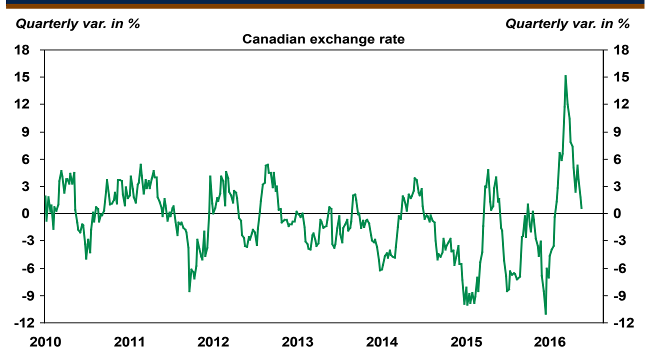
Forecasts: The Canadian dollar should now be flat or even edge down in the near term. Failing further substantial gains by oil prices, it will be hard for the loonie to advance, particularly given that stronger risk aversion should maintain the greenback’s appeal. Our year-end target for the loonie is US$0.77 (C$1.30/US$).

Canadian dollar and trend



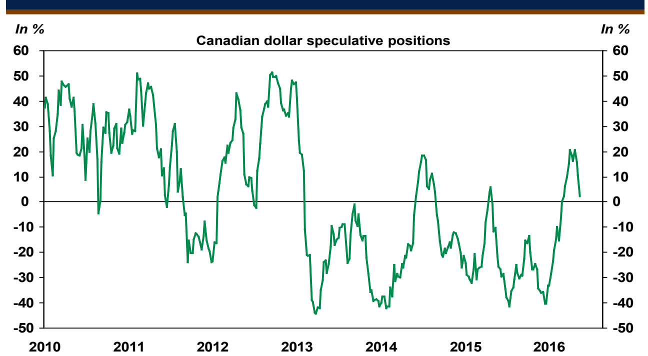
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

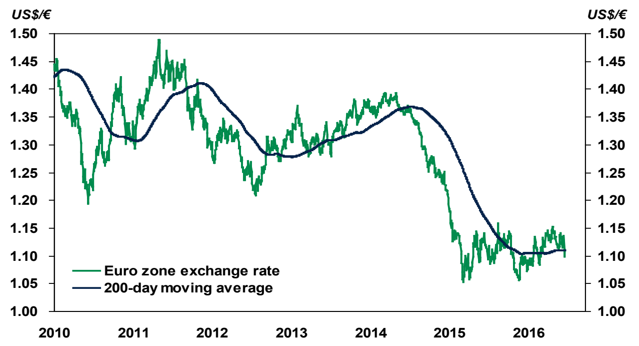
EURO (EUR)

The uncertainty in Europe takes the euro near US$1.10

- The European currency has moved in a fairly stable range against the U.S. dollar since mid-March. Two major forces collided. On one hand, the surge in concern over the referendum in the United Kingdom put downside pressure on the euro against safe haven securities, including the greenback. On the other hand, the postponement of key rate increases in the United States would usually have justified the euro rising against the U.S. dollar. In the end, the outcome of the British referendum tipped the balance, with the euro dropping near US$1.10, but that still does not change the trend of recent months.
- For the euro to slide further, the anxiety over the United Kingdom's exit from the European Union would have to remain high, and even intensify on the expectation of an economic slowdown. Greater monetary policy divergence could also take the euro down. Here, the Federal Reserve (Fed) is showing clear reticence about moving ahead with additional monetary firming, suggesting that monetary policy may not diverge as much as we anticipated previously, unless the European Central Bank (ECB) decides to announce more measures.
- The ECB's monetary policy is already highly accommodating, given the measures introduced so far. The ECB will keep making massive financial security purchases in the next few quarters and, recently, it even started to buy corporate bonds. These purchases have helped take the German 10-year yield into negative territory. There is also the new support program for financial institutions, the TLTRO II. The program's first auction was not a winner, however. All in all, the program's liquidity injection stood at around €30B euros. The lack of success, along with the more uncertain economic context in Europe, increases the chances that the ECB will finally act again, although it does not have much leeway.

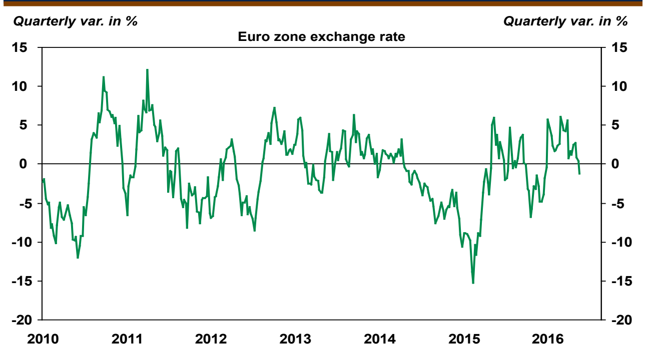
Forecasts: Even though the Fed remains reticent about moving forward with monetary firming, the euro will lose further ground as the heightened uncertainty in Europe will play against it. We can also not rule out an ECB announcement of additional measures, or at least an extension of existing measures. The EUR/USD pair should end the year at around US$1.08.

Euro and trend



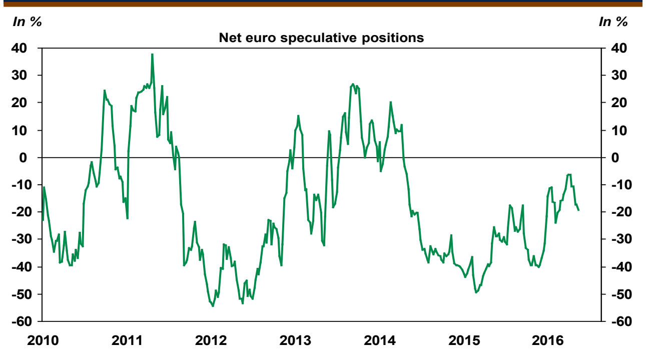
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



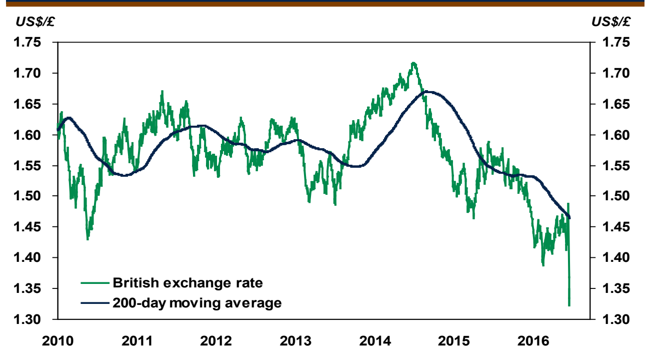
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

Brexit prompts heavy volatility

- The pound climbed back to almost US$1.49 when investors seemed less and less concerned about the June 23 referendum over the United Kingdom's future within the European Union (EU). The outcome came as a brutal wake-up call. The pound is now oscillating around US$1.35, a low that dates back to 1985. The pound fell against all of the major currencies. The EUR/GBP pair went from £0.77 to £0.83 overnight from June 23 to June 24.
- In light of these events, we have slashed our forecast for the British pound. The rest of 2016 and, potentially, much of 2017 will be marked by the negotiations surrounding the U.K.'s exit from the EU. In the best case scenario, the United Kingdom could still manage to negotiate keeping the free trade agreement and other advantages with the EU. In the worst-case scenario, the United Kingdom could end up isolated from the rest of Europe, and see its economic growth slow sharply. The pound could slide below US$1.30 in the near term, especially if the markets remain edgy and if the Bank of England lowers its key interest rate. **Our year-end target is US$1.35, but a lot of uncertainty surrounds this forecast, given the many positive or negative outcomes that could come to pass.**

British pound and trend



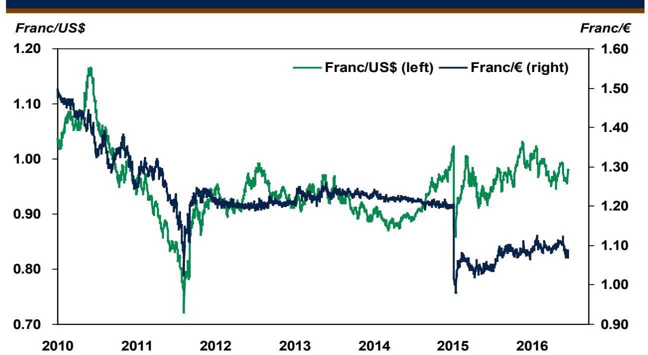
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

The Swiss National Bank has to keep its guard up

- Switzerland's economy got the year off to a disappointing start with first-quarter real GDP growth of just 0.1%. Deflation continues, but the Swiss National Bank (SNB) recently upgraded its inflation outlook slightly to reflect the rise in oil prices. The surge in concern on international markets triggered by Brexit is another challenge for the SNB, which is striving to keep the franc from shooting up at all costs. The USD/CHF pair is now trading at around 0.98 francs, with the EUR/CHF pair close to 1.08 francs. The SNB did not alter its monetary policy at its June 16 meeting, but sent a clear signal that it was ready to intervene in the market. Given the SNB's stated desire, **we do not think the franc will move much against the euro in the coming quarters**.

Swiss franc



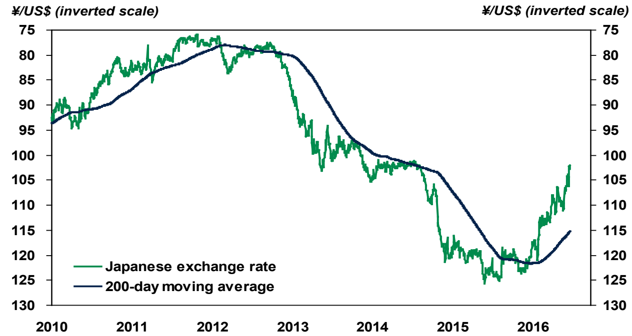
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

Foreign exchange intervention?

- The yen has risen about 20% since the start of the year. The strengthened demand for safe haven securities since the British referendum came at the same time as a drop in Japan's exchange rate, which temporarily went below ¥100/US$, a level not seen since the end of 2013. Fundamentally, aside from the yen's safe haven value, the main reason for the yen's rise seems to be that less monetary policy divergence is now expected between Japan and the United States.
- The yen's strength could do some serious damage to Japan's economy, which is already struggling to pick up speed. It could be even harder for the Bank of Japan (BoJ) to hit its 2% inflation target. As a result, it seems more and more likely that the monetary authorities will have to step in. Note however that in January, the decision to take the main key interest rate into negative territory did not result in further depreciation by the yen. This time, the solution could be found in one or more foreign exchange interventions. The last time such an intervention occurred was November 2011, when ¥1,000B was sold for foreign currency. By year's end, **we think Japan's exchange rate will climb above ¥115/US$**, assuming that the BoJ takes action, among other things.

Yen and trend



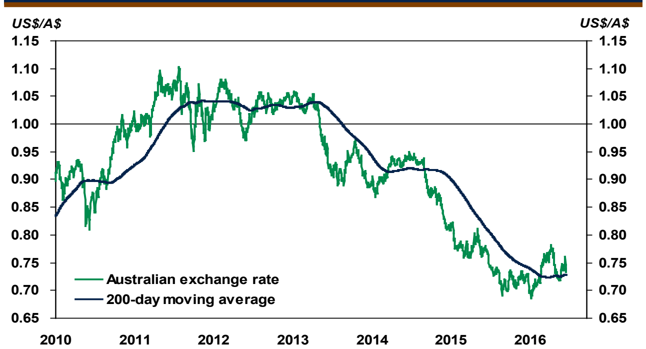
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

Renewed appreciation seems even more remote

- In March and April, the Australian dollar had a good run after several weak months due to a drop in concerns over China and a better context for commodities. Things got worse again after that, with, among other things, the Reserve Bank of Australia ordering an interest rate cut at the start of May. The aussie still managed to rebound in June, but the new surge of concern in the financial markets since Brexit is considerably undermining the chances that it will keep going up. Although Australia's economy is not heavily intertwined with Europe's, it could still be affected by contagion, in particular by a potential return of the fears over China, or any signal indicating weaker demand for commodities. **The most likely scenario for now is for the aussie to return close to US$0.72.**

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

The Mexican peso takes a beating

CHINESE YUAN (CNY)

- The Chinese authorities adjusted the yuan's value in the wake of Brexit. The reference exchange rate was devalued by 0.9% on June 27, the biggest adjustment since August 2015. The official exchange rate is now oscillating close to 6.65 yuan/US$. The yuan is thus back at 2011 levels. Cornered by weaker economic growth, China cannot take a chance on penalizing its exports and must therefore keep its exchange rate competitive in terms of its competition. **In the months to come, unless the concern from Europe drops sharply, the yuan should consolidate close to current levels.**

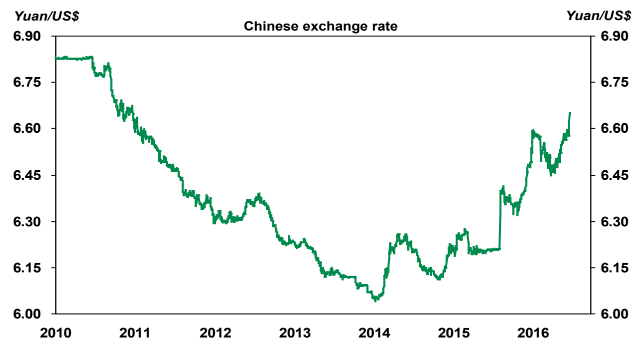
MEXICAN PESO (MXN)

- Although Mexico's economy posted solid growth in the first quarter, and oil prices have come up, the peso remains under pressure. After getting the year off to a tough start, the currency did well temporarily in March and April, allowing the USD/MXN pair to drop close to 17 pesos. May's greenback rebound and the recent surge in market concern, however, took the pair to a new record, above 19 pesos. The currency's weakness continues to worry the Bank of Mexico; another key interest rate increase could be ordered to try to reverse the trend. However, this strategy may well not succeed, especially if it hurts the economy and provides another argument for betting against the currency. **In this context, it is hard to imagine the peso coming up sharply, and it could end the year at around 18.50 pesos/US$.**

BRAZILIAN REAL (BRL)

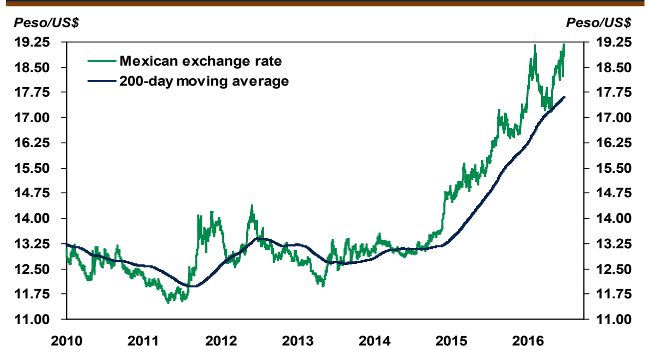
- After being pummelled for several quarters, the Brazilian real is getting a break. Of course, the surge in market concern did result in some depreciation for Brazil's currency, but it did not go anywhere near the levels seen at the start of the year. Political scandals are no longer grabbing all the headlines in Brazil since the removal of President Dilma Rousseff. The looming Rio Olympic Games and a drop in fears over the Zika virus are also positive factors. That being said, Brazil's economy is not out of the woods by any means and the situation could worsen fast if commodity demand slows again. **We prefer to bet the real to depreciate in coming quarters.**

Chinese yuan and trend



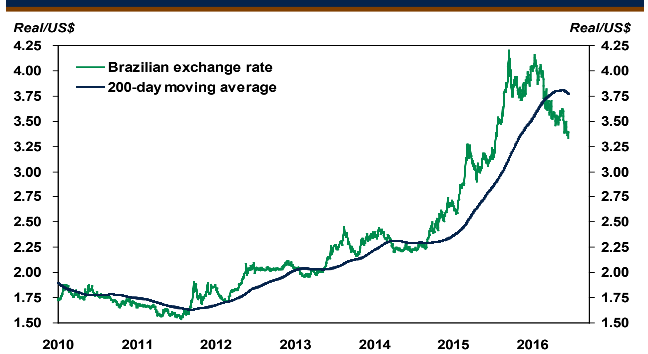
Sources: Datastream and Desjardins, Economic Studies

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 June 28	Percentage return since 1 month	3 months	6 months	1 year	Last 52 weeks Higher	Average	Lower
Americas								
Argentina – peso	15.0400	7.3136	2.9080	15.2151	65.9064	15.9350	11.9479	9.0654
Brazil – real	3.3226	-8.1026	-8.8714	-14.6576	6.1738	4.2061	3.6980	3.1064
Canada – dollar	1.3082	0.3760	-0.8339	-5.8038	5.6621	1.4637	1.3259	1.2381
Canada – (CAD/USD)	0.7644	-0.3746	0.8409	6.1614	-5.3587	0.8077	0.7542	0.6832
Mexico – peso	18.9417	2.5742	8.2169	9.6982	21.6105	19.1583	17.2994	15.5758
Asia and South Pacific								
Australia – (AUD/USD)	0.7388	2.8628	-2.0871	1.9172	-3.4945	0.7814	0.7284	0.6866
China – yuan renminbi	6.6481	1.2928	2.1606	2.4574	7.0720	6.6516	6.4378	6.2010
Hong Kong – dollar	7.7588	-0.1017	0.0161	0.1071	0.0813	7.8194	7.7594	7.7499
India – rupee	67.7150	1.0204	1.6620	2.3860	6.7180	68.7678	66.2526	63.2640
Japan – yen	102.7600	-6.7810	-9.4266	-14.6547	-17.0320	125.1300	116.9223	102.0050
New Zeland – (NZD/USD)	0.7048	5.2298	4.8492	2.9250	2.9532	0.7254	0.6676	0.6260
South Korea – won	1,171	-0.6700	0.4244	0.4977	4.9037	1,239	1,172	1,115
Europe								
Denmark – krona	6.7276	0.5380	1.0180	-1.1200	0.6839	7.0620	6.7185	6.4226
Euro zone – (EUR/USD)	1.1050	-0.7278	-1.4668	0.7200	-0.8080	1.1576	1.1097	1.0561
Norway – kroner	8.4756	1.6667	0.5075	-2.5939	8.1223	8.9520	8.4025	7.8389
Russia – ruble	64.6681	-2.5578	-5.5000	-10.2610	17.3651	84.2412	67.3124	55.1000
Sweden – krona	8.5066	1.8632	2.6586	1.6017	2.4768	8.7666	8.4097	7.9588
Switzerland – swiss franc	0.9806	-1.2339	0.7760	-0.8042	4.8717	1.0299	0.9795	0.9293
United Kingdom – (GBP/USD)	1.3322	-8.8630	-6.5650	-10.5970	-15.3250	1.5744	1.4853	1.3148

* 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 Q1	2016 Q2f	2016 Q3f	2016 Q4f	2017 Q1f	2017 Q2f	2017 Q3f	2017 Q4f
American dollar											
Canadian dollar	(USD/CAD)	1.3315	1.3841	1.3006	1.2987	1.3158	1.2987	1.3158	1.2903	1.2658	1.2500
Euro	(EUR/USD)	1.1162	1.0863	1.1395	1.1100	1.0800	1.0800	1.0700	1.0900	1.1200	1.1200
British pound	(GBP/USD)	1.5148	1.4739	1.4373	1.3500	1.3000	1.3500	1.3500	1.4000	1.4500	1.4500
Swiss franc	(USD/CHF)	0.9734	0.9903	0.9631	0.9800	1.0000	1.0000	1.0100	1.0000	0.9800	0.9800
Yen	(USD/JPY)	119.87	120.32	112.58	103.00	110.00	115.00	120.00	120.00	122.00	125.00
Australian dollar	(AUD/USD)	0.7020	0.7280	0.7658	0.7400	0.7300	0.7200	0.7200	0.7300	0.7400	0.7500
Chinese yuan	(USD/CNY)	6.3571	6.4937	6.4490	6.6400	6.6600	6.6500	6.6800	6.6500	6.6000	6.6200
Mexican peso	(USD/MXN)	16.92	17.18	17.28	18.60	19.00	18.50	18.75	18.25	17.75	18.00
Brazilian real	(USD/BRL)	3.9725	3.9045	3.5586	3.2500	3.5000	3.5000	3.7000	3.6000	3.5000	3.6000
Effective dollar*	(1973 = 100)	92.26	94.46	89.84	90.10	93.00	93.00	94.30	92.90	91.20	91.20
Canadian dollar											
American dollar	(CAD/USD)	0.7510	0.7225	0.7689	0.7700	0.7600	0.7700	0.7600	0.7750	0.7900	0.8000
Euro	(EUR/CAD)	1.4863	1.5035	1.4820	1.4416	1.4211	1.4026	1.4079	1.4065	1.4177	1.4000
British pound	(GBP/CAD)	2.0169	2.0400	1.8693	1.7532	1.7105	1.7532	1.7763	1.8065	1.8354	1.8125
Swiss franc	(CAD/CHF)	0.7311	0.7155	0.7405	0.7546	0.7600	0.7700	0.7676	0.7750	0.7742	0.7840
Yen	(CAD/JPY)	90.02	86.93	86.56	79.31	83.60	88.55	91.20	93.00	96.38	100.00
Australian dollar	(AUD/CAD)	0.9346	1.0076	0.9960	0.9610	0.9605	0.9351	0.9474	0.9419	0.9367	0.9375
Chinese yuan	(CAD/CNY)	4.7744	4.6918	4.9587	5.1128	5.0616	5.1205	5.0768	5.1538	5.2140	5.2960
Mexican peso	(CAD/MXN)	12.71	12.41	13.29	14.32	14.44	14.25	14.25	14.14	14.02	14.40
Brazilian real	(CAD/BRL)	2.9835	2.8211	2.7362	2.5025	2.6600	2.6950	2.8120	2.7900	2.7650	2.8800

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