RBC Global Asset Management

Global Currency Outlook

FALL 2020

U.S. dollar downtrend is established

Dagmara Fijalkowski, MBA, CFA
Head, Global Fixed Income & Currencies
RBC Global Asset Management Inc.

Daniel Mitchell, CFA
Portfolio manager,
Global Fixed Income & Currencies
RBC Global Asset Management Inc.

The U.S. dollar has turned decisively lower, marking an important long-term currency-market milestone that will help shape the investing landscape for several years to come. Such turning points occur once a decade and are rare enough that many foreign-exchange traders have experienced just one or two of these inflections, which convert headwinds into tailwinds for global assets, economies and currencies. Given the length and breadth of currency cycles as shown in Exhibit 1, we expect dollar weakness to continue. The impact of this regime shift should not be underestimated, and investors would be well served to plan for a structurally weaker greenback.

The degree of the U.S.-dollar weakness since the greenback's 10-year high on March 23 has been impressive. Nearly all currencies have risen against the U.S. dollar over the past five months and many commodities have strengthened. At this point, it is tempting to review the dollar's trade-weighted 10% decline and to question whether it might stall. But the dollar remains overvalued and there are a number of other negative factors that can push it still lower (Exhibit 2). A common thread between several of these factors is a relative decline in the attractiveness of U.S. assets, which will likely undermine demand for the currency. We highlight four of these developments below.

First, the much reduced U.S. interest-rate advantage means that investors are no longer as willing to buy U.S. government bonds. Bond yields are so low that investors

Exhibit 1: U.S. trade-weighted dollar

Note: As at Aug. 28, 2020. Source: Bloomberg, RBC GAM are receiving negligible income after adjusting for inflation, a dynamic that is unlikely to change with the U.S. Federal Reserve (Fed) looking to further ease monetary policy. While the U.S. is not unique in having low rates, the yield decline is especially impactful for the U.S. dollar because the interest-rate advantage had been propping up the currency until earlier this year.

Second, the extraordinary fiscal spending that followed pandemic lockdowns raises questions about the sustainability of government finances. This is also an issue for many countries, but the U.S. has been spending more than its peers based on the relative size of recent budget deficits (Exhibit 3) and had already exhausted some of its fiscal wiggle room after tax cuts in 2018. The possibility that the Fed could resort to debt monetization, the permanent funding of government operations through central-bank bond purchases, seems more likely than it did just a few months ago, and the recent ascent of gold, silver and other precious metals is evidence that people are beginning to lose faith in the dollar. While other countries and currency blocs also face questions about their financial future, current trends in twin-deficits appear to be especially bad for the U.S. dollar.

Third, stocks and other "risky" assets outside the U.S. are now looking more attractive, underpinned not only by cheaper valuations abroad but by improving economic and political developments. One trait of past dollar declines has been a re-acceleration of global growth, which acted to pull capital away from the U.S. The relative success of China and Europe in re-opening their economies suggests that capital outflows will put pressure on the greenback.

The fourth issue weighing on the greenback is the November U.S. presidential election. The concerns stem from the possibility of an outcome plagued by delayed ballots and contested results, as well as concern that a Joe Biden victory would be more negative for the dollar. Several elements of Biden's platform threaten America's competitive advantage, including financial re-regulation, tougher restrictions on oil from shale and minimum-wage hikes that would increase business costs. Biden's friendlier stance toward traditional trade allies would also mark a departure from the tensions that have supported the greenback over the past four years and would be particularly negative for the U.S. dollar versus the currencies of Canada, Europe and Mexico. Should Biden win, currency markets will be especially sensitive to the composition of a Biden cabinet. Any mention of Elizabeth Warren as Treasury Secretary, for example, would alarm traders because she has laid out a plan for devaluing the dollar.

Exhibit 2: Mounting dollar negatives

CYCLICAL

- U.S. dollar has lost its interest rate advantage
- Optimism about Europe means more flows into BTPs, EU equities
- U.S. corporates buying euros to adjust over-hedged revenues
- Low oil prices reduce benefit of energy independence
- Improvement in Eurozone outlook
- FX positioning yet to catch up to bearish sentiment
- Abundant USD supply

STRUCTURAL

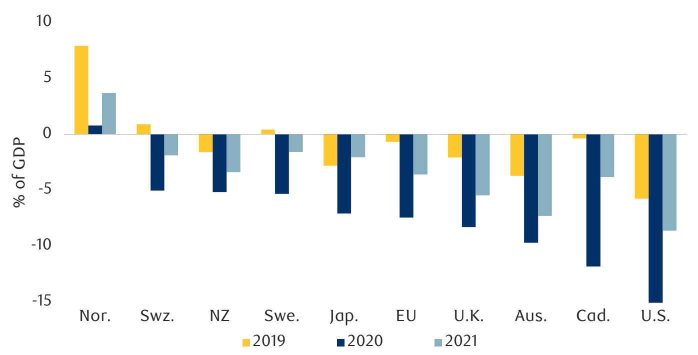
- Loss of fiscal restraint increases likelihood of monetization
- Flight out of fiat hits primary reserve currencies most
- Current account deficits rooted in American consumerism

POLITICAL

- Muddled COVID reopening means economic rebound lags other G10
- De-dollarization of global FX reserves
- U.S. "exceptionalism" at risk of being undermined by possible tech taxes, regulation and rising minimum wages

Source: HSBC, RBC GAM

Exhibit 3: General government budget deficit



Note: As at Apr. 6, 2020. 2020 and 2021 points are IMF forecasts. Source: IMF, RBC GAM

The 2017 comparison

Critics might point to the U.S. dollar's decline in 2017 as an example of how the recent losses can reverse (Exhibit 4). Why, then, should we proclaim that the upswing from 2011 has ended? One reason is that investors have not yet fully reacted to signs of dollar weakness. Sentiment toward the greenback has noticeably soured, and most investment banks are now publishing bearish outlooks on the currency. But they are late to the game in doing so and are struggling to revise forecasts quickly enough to catch up with the decline. Traders have also been caught off-guard by the drop, even though the currency's behaviour is remarkably similar to the beginning of the last U.S. dollar bear market in 2002 (Exhibit 5). With investors waiting to sell every bounce in the greenback, we expect the relentless pace of dollar weakness to continue.

Another important difference from 2017 is that central-bank policy rates have converged toward zero (Exhibit 6), resulting in an absence of interest-rate differentials in the developed world. This removes an important headwind for the euro and yen – historically popular shorts used to buy higher-yielding "carry trade" currencies.

Higher volatility

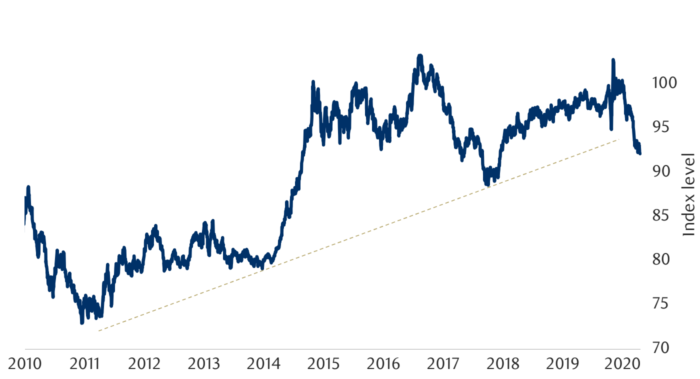
The convergence of interest rates around the globe has another important consequence: it raises the specter of larger currency swings and could lead the greenback to weaken more quickly. With smaller yield differences from which to profit, foreign-exchange specialists will likely be less active in their trading activities. That could leave the currency markets to participants who are less price-sensitive, and their willingness to pay higher prices might increase volatility. This is particularly the case for cross-border mergers and acquisitions, where less attention is paid to the exchange rates at which currency is acquired to fund a deal.

With interest rates near zero in all major markets, there is also one fewer avenue for adjustment in times of macroeconomic stress. Without the ability to cut rates to soften the blow of economic slowdowns, central banks may increasingly accept currency weakness as an economic relief valve.

Emerging-market underperformance

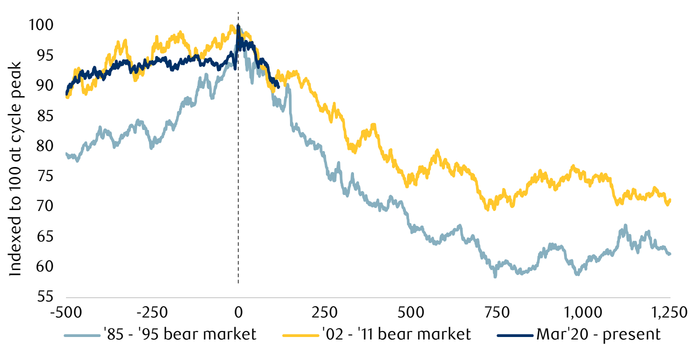
The prospects for emerging-market currencies against the U.S. dollar were improving at the start of 2020, but the outlook has been dimmed by the disproportionately negative impact of the pandemic on emerging markets and their lack of financial resources to cope. Emerging-market

Exhibit 4: DXY breaking support levels



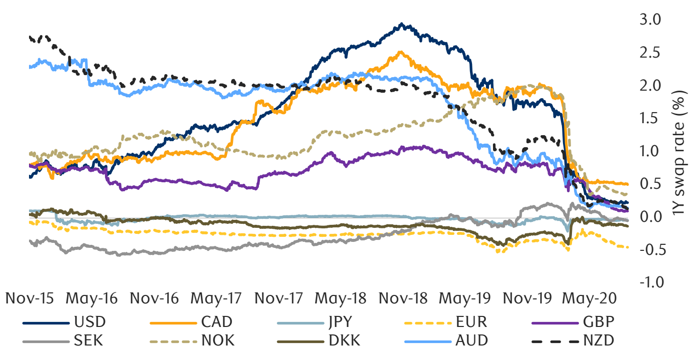
Note: As at Aug. 31, 2020. Source: Bloomberg, RBC GAM

Exhibit 5: First phase of USD bear market is typically relentless



Note: As at Sep. 1, 2020. Source: Bloomberg, RBC GAM

Exhibit 6: Global rates converging to zero



Note: As at Sep. 1, 2020. Source: Bloomberg, RBC GAM currencies have underperformed other risky asset classes since the lows of late March (Exhibit 7). This makes sense in light of still rising COVID-19 cases, an uncertain economic-growth outlook and the negative impact of global trade and supply-chain disruptions. These developments are not new, however, leading us to believe that there are other reasons for the underperformance relative to developed-market peers.

One explanation is that quantitative easing is not as positive for currencies as for other assets that are bought directly by developed-market central banks. To date, all asset-purchase programs have been domestic-only, and so purchases of foreign currencies do not have any role. Another explanation involves the experimental use of unconventional monetary policies by emerging-market central banks with little monetary or fiscal credibility. Indonesia is an example of a country whose currency has weakened after monetary authorities expanded the central-bank balance sheet.

Capital flows into emerging-market assets have been sluggish, with investors having a general preference for making investments on a currency-hedged basis – a less punitive practice now that rates have been slashed in emerging markets. Investor surveys indicate a lack of enthusiasm for emerging-market currencies, and we don't expect this situation to change until economic-growth prospects improve. Investors need more than just a weak dollar to recommit capital to this area.

The euro

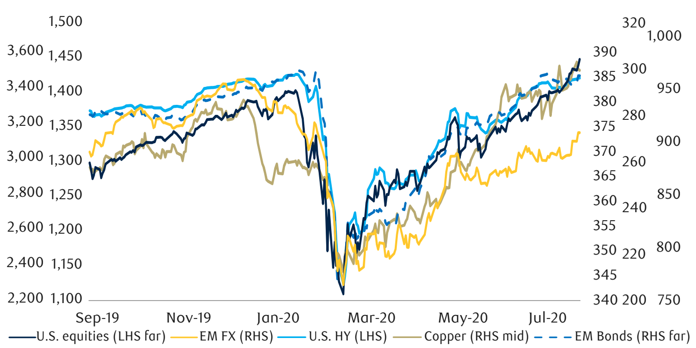
We are optimistic about prospects for continued euro strength. This view is due mainly to the fact that the U.S.-dollar bear market has begun, but also represents a nod to improving long-term economic fundamentals in Europe. The European Central Bank's (ECB) swift easing measures and its pandemic-related bond-purchase program seem to have alleviated any new concerns about a Eurozone break-up. Meanwhile, July's first-ever agreement among Eurozone members to jointly issue bonds is the first hint that member countries are making progress toward greater fiscal integration. The collective €750 billion plan to support Europe's economy is crucial for investor confidence in the Eurozone, and we were particularly impressed that politicians were able to show solidarity without the same degree of financial-market stress that was required to force cooperation in past crises.

These actions will help to temper some of the risks and bolster Europe's standing in the eyes of long-term investors. Indeed, the creation of a jointly issued European safe asset provides an alternative to U.S. Treasuries and German bunds and will aid the single currency in reclaiming a share of the global reserves lost (currently 20%, down from 28%) over the past decade (Exhibit 8). Our expectation is for the euro to reach 1.27 by August 2021, which would make it the best-performing major currency over the next year.

The yen

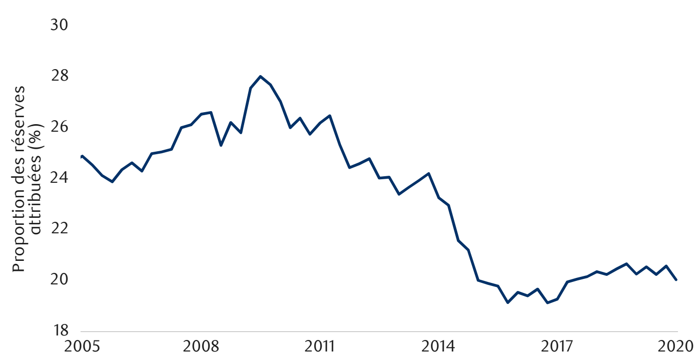
The yen exhibits a tighter link to U.S. Treasuries than other G-10 currencies (Exhibit 9) given Japan's ongoing purchases of U.S. government bonds, and with muted bond-market volatility, we should not be surprised by the yen's stability during the past quarter. More recently, the yen has started to appreciate in response to U.S.-dollar weakness and also due to demand for portfolio insurance as global equities surpass pre-COVID-19 levels. The yen also received a boost from last month's resignation of Prime Minister Shinzo Abe, as many investors believe his successor might end policies that are keeping the yen weak.

Exhibit 7: Relative asset-class performance



Note: As at Sep. 2, 2020. Source: Bloomberg, RBC GAM

Exhibit 8: Euro reserve allocation



Note: As at Mar. 31, 2020. Source: IMF, RBC GAM

Several developments could result in continued yen appreciation: (i) continued low prices for oil, which reduce the cost of imported energy (ii) a more permanent slowing in foreign direct investment by Japanese companies, which appear to have cut back in response to the pandemic and (iii) any decision by the country's massive pension funds to stop selling the yen now that targeted levels for foreign assets have seemingly been reached.

While life insurers are bound to re-emerge as U.S.-dollar buyers at an exchange rate of 100 (compared with about 106 now), we think that broader weakness in the U.S. dollar could lead to yen strength beyond this level. We forecast an exchange rate of 99 yen per dollar in 12 months' time.

British pound

The U.K. has persistently run the largest current-account deficit among developed-market countries, and depends on portfolio inflows to fund it. The share of Britain's public debt owned by foreigners sits at a comparatively high 35%, much of it sitting in the hands of continental European investors. Given Brexit, it seems unlikely that the current level of 10-year gilt yields (at 0.10%, Exhibit 10) is high enough to attract inflows, especially as Bank of England discussions about the possibility of negative interest rates keeps yields capped for now. The onus, therefore, will be on currency weakness to make U.K. assets more attractive.

The pound has room to cheapen, especially versus the euro, against which it is fairly valued. We expect the pound to underperform the euro and yen in the coming year. Our base case forecast of 1.36 implies only modest gains against the U.S. dollar from current levels, with risks skewed to the downside should negotiations falter over the U.K.'s future trading relationship with Europe.

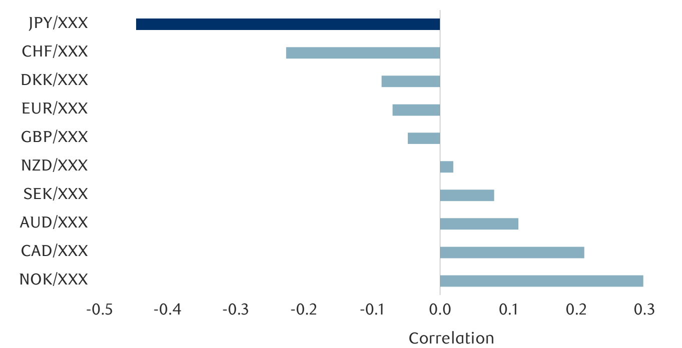
The Canadian dollar

Our view on the Canadian dollar is more nuanced, shifting from bearish to bullish versus the U.S. dollar, while remaining bearish against other major currencies. The country's economic-growth prospects are weaker than they are in developed markets in Europe and Asia given Canada's close trade ties with the U.S., whose post-pandemic re-opening has been troubled. Moreover, the combination of low crude prices, Canada's at best indifferent approach to the oil industry and a global movement toward cleaner energy alternatives has limited foreign investment in Canada. France's Total SA, one of the world's largest oil companies, recently wrote off its Canadian investments, and some European lenders have refused to lend to oil-sands producers, which account for most of Canada's energy reserves. Trade and direct-investment dollars have steadily flowed out of the country and continue to put pressure on the loonie.

There are some bright spots for the Canadian dollar. Canada has a highly educated workforce that continues to expand through immigration, and Canadians have been better than Americans in adhering to a pandemic-reopening plan that limits the spread of COVID-19. Moreover, even with the sizable emergency programs recently rolled out by the government, Canada retains capacity for further fiscal spending if needed – an option that many other countries don't have. This advantage is thanks to a build-up in foreign assets by private interests, supporting Canada's balance sheet and improving its creditworthiness in the eyes of debt-rating agencies (Exhibit 11).

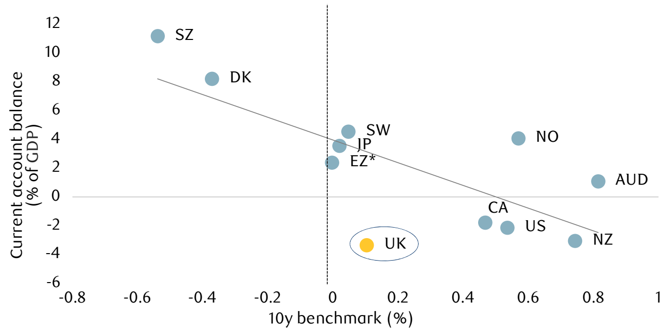
Other Canadian-dollar positives include a recovery-led rally in metals prices (likely a more important variable for 2021), and the possibility that competitiveness can be regained

Exhibit 9: Currency correlation to U.S. yields



Note: Values indicate average correlation to U.S. 10-year yields when each currency is crossed against the the remaining G10 currencies. As at Sep. 1, 2020. Source: Bloomberg, RBC GAM

Exhibit 10: U.K. yields too low based on current-account balance



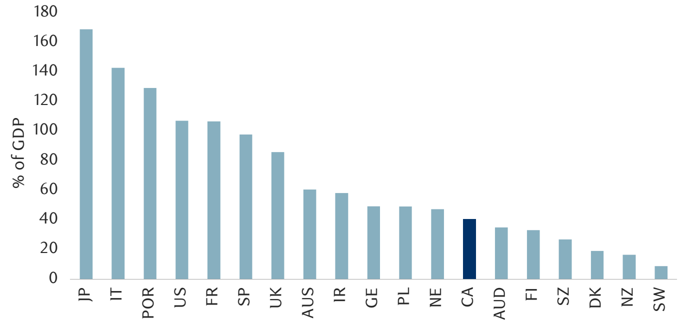
Note: EZ* is a weighted avg. of the top 10 EZ economies. As at Jul. 31, 2020. Source: Macrobond, RBC GAM relative to U.S., Canada's main trade partner, if Biden wins the U.S. election.

We think the Canadian dollar can manage a small amount of appreciation in the year ahead. It is likely that the broader U.S.-dollar trends will set the tone for the Canadian currency. In expectation of further U.S.-dollar weakness, we are changing our forecast to $1.29 per U.S. dollar, which implies that loonie gains will lag other major currencies.

Conclusion

The downtrend in the U.S. dollar is now clearly established. The 10% trade-weighted decline since March is just the beginning of a longer-term period of U.S.-dollar weakness, supported by a number of structural, cyclical and political factors. We expect G10 currencies, most notably the euro and the yen, to continue outperforming their emerging-market peers during this phase in the U.S.-dollar cycle. Our view on the Canadian dollar is more nuanced. We have shifted from bearish to bullish on the Canadian currency in acknowledgement of some new positive factors and in recognition that the U.S.-dollar downtrend will likely prevail as a more important influence on currency markets.

Exhibit 11: Canada's net debt to GDP is comparatively low



Note: As at Apr. 30, 2020. Source: IMF, RBC GAM

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