RBC Global Asset Management

Global currency outlook

FALL 2022

Higher interest rates, concern about the macro backdrop keep the greenback's rally alive

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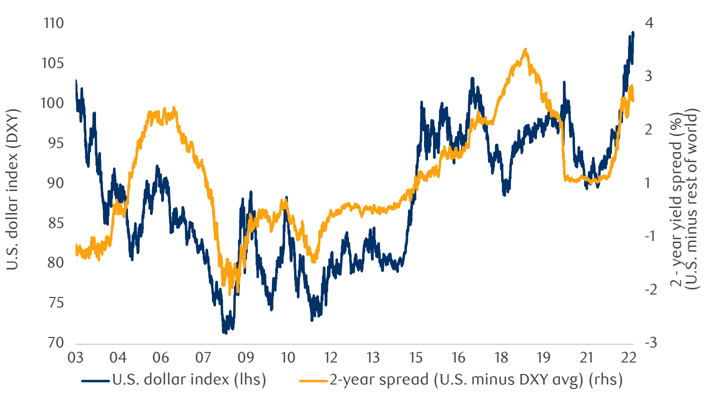
The U.S. dollar has rallied strongly this year, gaining broadly against both developed- and emerging-market currencies. A relatively hawkish U.S. central bank, the uncertain financial-market outlook and softening global economic growth have all played roles in driving both a stronger greenback and foreign-exchange markets in general. The greenback now stands above its March 2020 highs and is extremely overvalued by most measures. In our view, the currency should weaken over the medium term, but extraordinary factors may lend it further support for the rest of this year. On a 12-month horizon, we remain more constructive on the Canadian dollar and Japanese yen than we are on the euro, pound or U.S. dollar.

The rise of the U.S. dollar has been relentless. This year's 7.5% appreciation on a trade-weighted basis came on top of gains last year, resulting in an overall 14% increase since the greenback's rally started in May 2021. These gains are largely attributed to the U.S. Federal Reserve's (Fed) more aggressive approach to raising interest rates than most other developed-market central banks. Divergences in monetary policy between countries are often a chief concern for foreign-exchange markets (Exhibit 1) and have been especially important this year as the Fed was forced to raise rates faster than expected to take into account accelerating consumer inflation caused by rising commodity prices and supply shortages. Developments abroad have also contributed to the dollar's gains: slower economic activity in China buoys the dollar's appeal and the energy crisis in Europe threatens the region's political and economic stability.

Exhibit 1: U.S. dollar and 2-year yield spreads

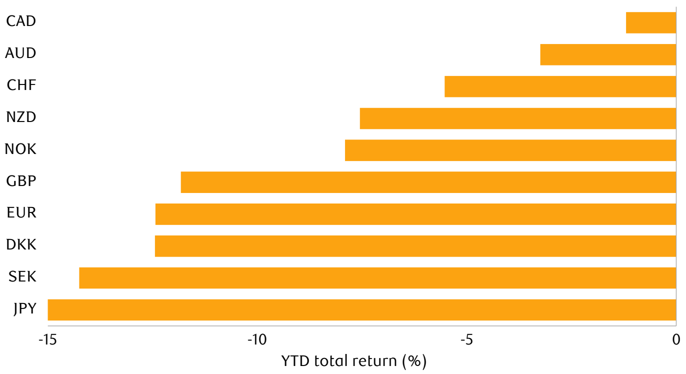


Note: As at August 26, 2022. Source: Bloomberg, RBC GAM

The greenback's trajectory tends to dictate the performance of major currencies, so the recent depreciation of all developed-market currencies (Exhibit 2) against the dollar is not an uncommon occurrence. Monitoring the phases of the dollar cycle is of particular importance because periods of U.S.-dollar strength and weakness tend to persist for many years (Exhibit 3). Turning points in the greenback are notoriously difficult to call, and we have been flagging one such bearish turn for several quarters. The war in Ukraine and the Fed's aggressive approach to tackling inflation have delayed this shift and caused our bear-market roadmap to take a pretty significant detour (Exhibit 4). While these short-term developments have thrown off our forecasts, we have not changed our longer-term expectation of U.S.-dollar weakness, aside from cutting back our euro outlook in response to negative developments on the continent.

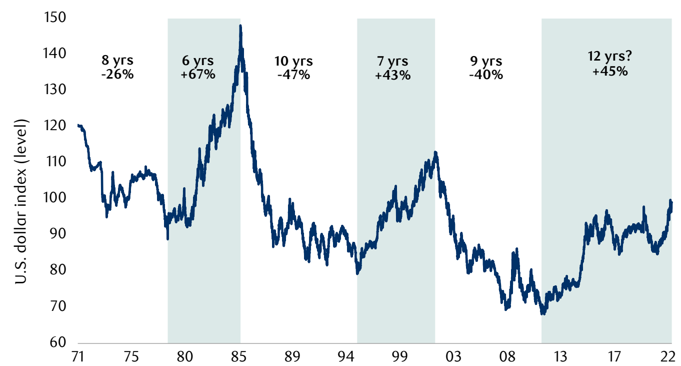
One factor underpinning our conviction that the U.S. dollar will fall is that the greenback is as richly valued as it has been on most measures since the early 2000s. Purchasing power parity (PPP) models indicate that dollar strength over the past few months has pushed the currency beyond thresholds for what can be considered extremely expensive (Exhibit 5), and history has taught us that currencies typically don't remain at such levels for very long. Historical analysis conducted by Deutsche Bank tells us that currencies have

Exhibit 2: Developed-market currency performance



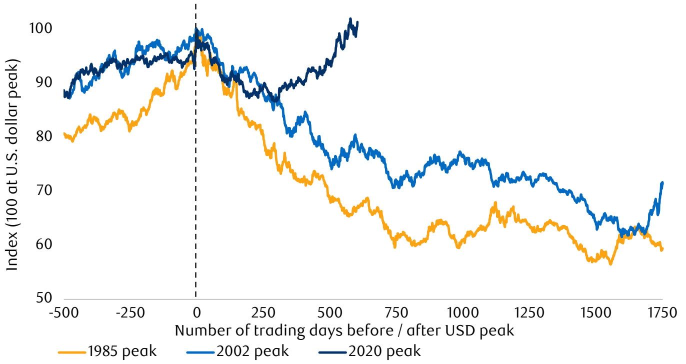
Note: As at August 25, 2022. Source: Bloomberg, RBC GAM

Exhibit 3: Long-term U.S. dollar cycles



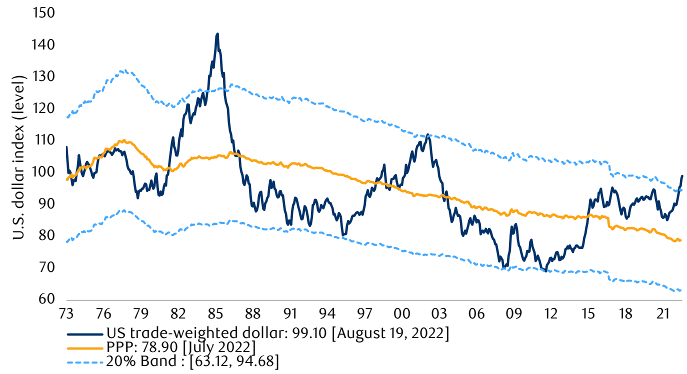
Note: As at August 25, 2022. Source: Bloomberg, RBC GAM

Exhibit 4: U.S. dollar bear-market roadmap



Note: As at August 26, 2022. Source: Bloomberg, RBC GAM

Exhibit 5: U.S. dollar – Purchasing Power Parity valuation



Note: Uses new Fed USD index from December 31, 2019 onward (USTWAFE Index). As at August 19, 2022. Source: U.S. Federal Reserve, Bloomberg, RBC GAM tended to return to fair value within months of crossing outside of their PPP bands. We can therefore expect dollar weakness, when it comes, to unfold relatively quickly.

It is also conceivable that the temporary factors underpinning gains in the greenback could persist for longer than investors currently expect. Three items could prolong this period of U.S.-dollar strength:

1. The Fed could maintain tighter monetary policy for longer than the markets expect in order to demonstrate its commitment to stamping out today's inflation problem.
2. A slower-than-expected rollout of effective COVID-19 vaccines in China could result in continued lockdowns and further disappointment on economic activity, which would support the greenback versus the renminbi.
3. A more severe energy crisis in Europe could depress the euro even further. However, the unpredictability of both the weather and Russia's tactics in withholding natural gas from Europe make predictions in this area especially difficult.

How far the dollar rallies against the euro because of these three factors is critical. Deutsche Bank has tried to answer this question using quantitative approaches that include valuation models, technical indicators and the single currency's historical performance during equivalent periods (Exhibit 6). The intent of this framework is not to derive a forecast but rather to estimate how far the euro can fall before its weakness becomes extreme. Most metrics seem to settle on an exchange rate between 0.92 euro per dollar and 0.95 as representing a decline that is severely stretched. That's not far from current levels just below parity. Further declines toward 0.80, as some forecasters are calling for, are much less likely in our view.

Exhibit 6: Euro scenario analysis

Approach	Description	EUR reaches...
Valuation method	Valuation nearing extremes on multiple models	REER : 1.0000 PPP : 0.9850 BEER : 0.9300
Risk premium	Safe haven demand for USD already extreme Global recession could extend US dollar's rally further	EUR to 0.9800
Technical (range)	Median annual EUR range is 16% To extend '22 range to median or 90th percentile, EUR must fall to:	Median : 0.9500 90th percentile : 0.9200
Technical (exhaustion)	USD gains typically slow beyond 20% YoY	EUR to 0.9500
Volcker episode	USD analog to 1984 tightening cycle	EUR to 0.8350
Taper Tantrum	USD analog to 2013 taper tantrum	EUR to 0.9500
	Average	**0.945**

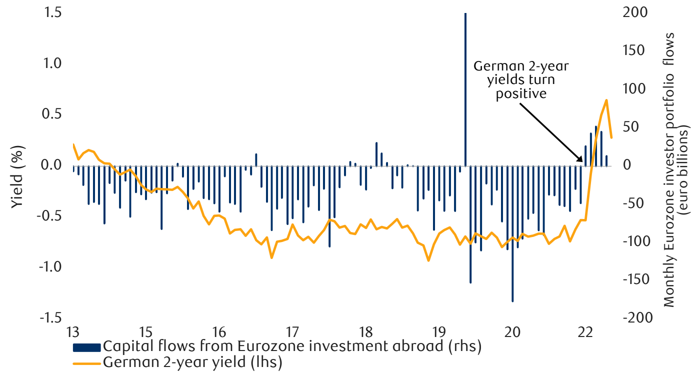
Note: As at August 26, 2022. Source: Deutsche Bank, BIS, Citi, Scotiabank, RBC GAM

Euro

It's not easy these days to find a silver lining in the European outlook. Storm clouds abound with a war raging near Western Europe's borders and high energy prices crushing economic growth. Additional punishment for natural-gas-dependent Germany comes in the form of low water levels in the country's main transport rivers, which has curtailed shipping, and water temperatures in France that are too high for cooling nuclear reactors, thereby limiting fuel exports to Germany. Add to the mix political uncertainty in Italy and the erosion of European solidarity as countries squabble over exemptions from Russian oil-import bans, and it becomes difficult for investors to justify owning the single currency – especially when it offers such low yields.

Perhaps the only marginal positive for the euro is that bond yields are no longer negative as markets have begun pricing in an increasing number of interest-rate hikes by the European Central Bank. European investors have allocated a whopping 4 trillion euros abroad (an average of about 4% of GDP per year) since the central bank imposed negative rates in 2014, and some of this capital has started to return (Exhibit 7). This lone positive seems insufficient to hold back the tide of investor bearishness, and so our US$1.13 per euro forecast is due not so much to a vote of confidence in Europe as it is to a negative view on the greenback.

Exhibit 7: Eurozone investors bringing money home



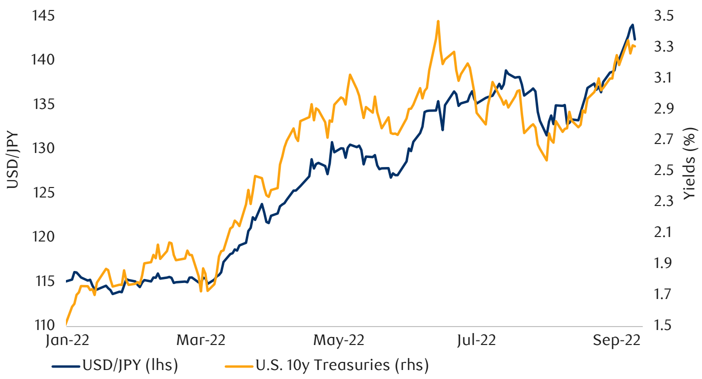
Note: As at July 31, 2022. Source: Bloomberg, RBC GAM

Japanese yen

For most of this year, the Japanese yen has traded in lockstep with U.S. 10-year yields (Exhibit 8), themselves a reflection of Fed rate-hike expectations and recession fears. We suspect that the yen could benefit from concerns about economic growth and we note that trends in web searches and other media intensity indicators (Exhibit 9) are mirroring the top in yields. An environment of falling inflation and deteriorating global growth may indeed be fertile ground for yen strength because the yen tends to benefit both from lower global bond yields and weaker equity markets. A recession-led decline in oil prices might also support the yen as it would reduce Japan's import bill.

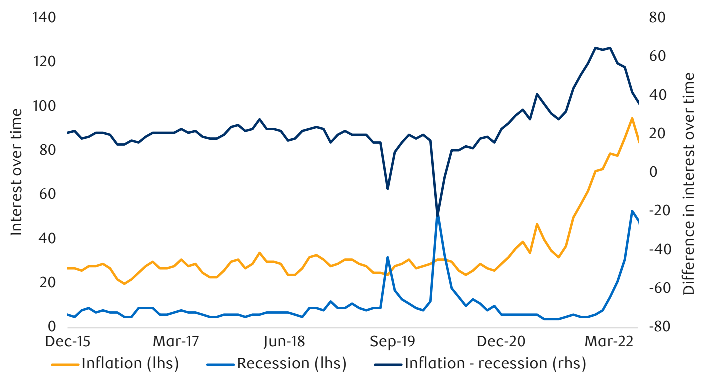
Other factors point to a stronger yen and would be consistent with broad U.S.-dollar weakness. These positives include Japan's large current-account surplus and the currency's significant undervaluation, which make it much less vulnerable during times of economic uncertainty. Once the greenback passes its peak and the Fed has completed its hiking cycle, we believe the yen will be one of the quickest to recover. Our 12-month forecast sits at 118 per dollar.

Exhibit 8: USD/JPY versus 10y nominal yield



Note: As at September 9, 2022. Source: Bloomberg, RBC GAM

Exhibit 9: Google web-search data



Note: Google trend data. Numbers show interest relative to highest point on chart. A value of 100 indicates peak popularity. As at: June 30, 2022. Source: State Street, Google, RBC GAM

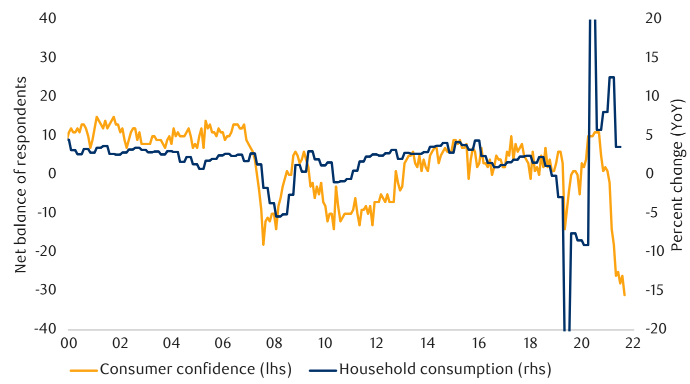
British pound

The pound has declined 14% from its 2021 peak. Sterling is cheap against the U.S. dollar but still expensive compared with the euro, whose Eurozone members are the U.K.'s main trading partners. A further decline in the pound would help restore competitiveness, but also stoke inflation because the U.K. economy is among the most sensitive to a rise in prices of imported goods. This puts the central bank in a major pickle because, while an inflation rate of 10% cries out for an aggressive reaction from policymakers, households and businesses are ill-equipped to deal with higher interest rates.

We don't believe the Bank of England (BOE) can keep up with rate hikes by the Fed, Bank of Canada and others without pushing the U.K. economy into a severe recession. An illustration of how severely household finances have deteriorated can be found in Bloomberg reports that a third of U.K. workers plan to take a second job to pay the bills, that the use of revolving credit is on the rise and that home-energy costs have more than quadrupled over the past two years and are expected to continue rising into next year. An associated plunge in consumer sentiment (Exhibit 10) foretells a major decline in household spending, the largest component of economic growth.

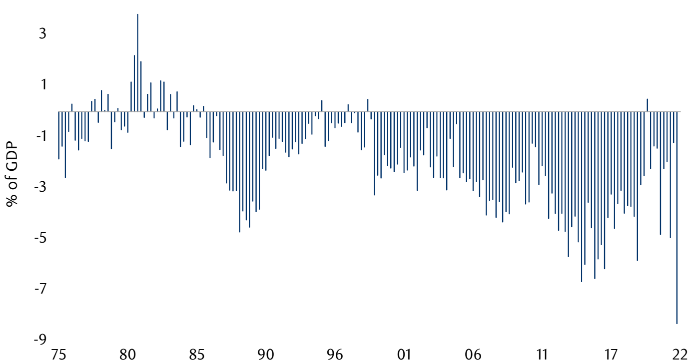
The U.K. current account has been in deficit for years, but the most recent reading in the first quarter of 2022 rang in at a staggering 8% of GDP (Exhibit 11), the largest deficit in 50 years. It looks like the impact of Brexit may finally be hitting home. The BOE's limited room for raising rates means that investors have little incentive to buy U.K. assets because they aren't adequately compensated for the risk of a decline in the pound. We expect the pound to underperform other major currencies in the year ahead. The fact that our forecast of US$1.28 is higher than the prevailing exchange rate is based entirely on our view of a broad U.S.-dollar decline.

Exhibit 10: U.K. consumers getting squeezed



Note: As at June 30, 2022. Source: U.K. ONS, GfK UK, RBC GAM

Exhibit 11: Record current-account deficits



Note: As at June 30, 2022 Source: U.K. ONS, RBC GAM

Canadian dollar

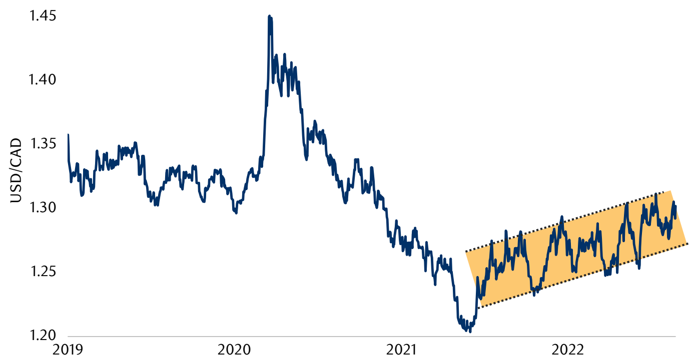
The Canadian dollar's 2022 trading range has been remarkably narrow (Exhibit 12), especially for a year in which asset-market volatility has picked up and the U.S. dollar has rallied strongly. The loonie has meaningfully outperformed against its other G10 peers all year (Exhibit 13), a resilience that can be attributed to a few key factors:

- a central bank that has kept up with U.S. interest-rate hikes and is expected to outstrip the Fed's pace this cycle
- elevated commodity prices that support strong terms of trade
- the outperformance of Canadian equities over stock markets in the U.S. and Europe
- healthy levels of immigration that will make for a more balanced labour market at a time when demand for talent has been strong; strong immigration also supports economic growth

Investors remain optimistic on the loonie, one of the few currencies on which the market is bullish amid U.S.-dollar strength (Exhibit 14). Positions betting on a rise in the Canadian dollar are relatively small, so there is ample space for investors to increase their Canadian-dollar holdings.

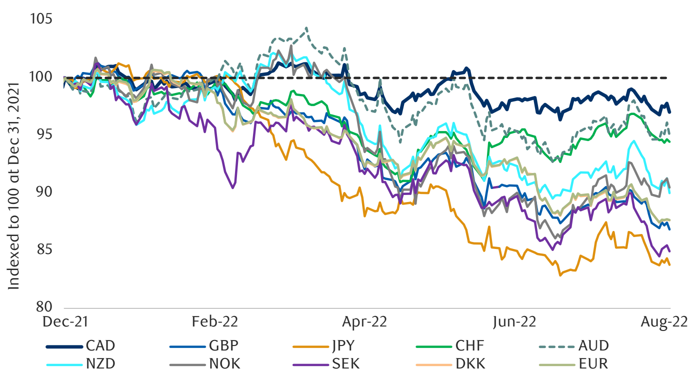
Another reason for the tenacity of the Canadian dollar is Canada's much improved balance of capital flows (Exhibit 15). A decade-long string of current-account deficits has turned into surpluses, helped in large part by high energy prices and from growing income receipts on the country's foreign direct investments. Canada has also experienced a significant improvement in portfolio inflows as Canadian companies issue debt in U.S. dollars. There is no guarantee that proceeds from these bond issues are being converted and repatriated, but we believe conversion is partly responsible for the Canadian currency's resilience and its inability this year to remain weaker than $1.30 per U.S. dollar.

Exhibit 12: Tight range in the Canadian dollar



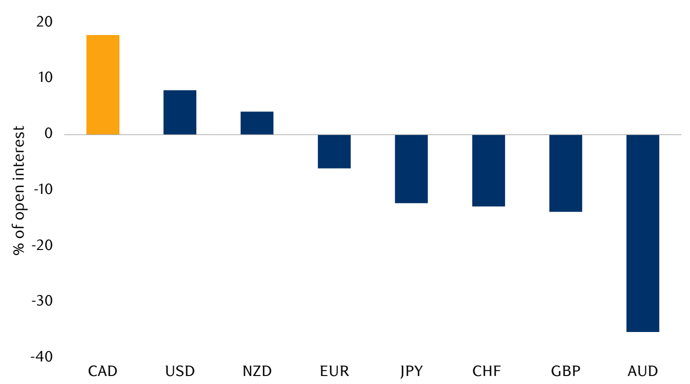
Note: As at August 26, 2022. Source: Bloomberg, RBC GAM

Exhibit 13: G10 performance so far this year



Note: As at August 26, 2022. Source: Bloomberg, RBC GAM

Exhibit 14: FX futures positions



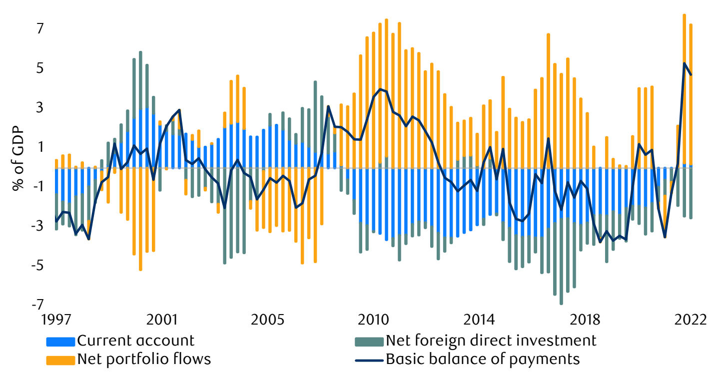
Note: As at August 26, 2022. Source: CFTC, RBC GAM

Based on valuation models, the Canadian dollar registers as undervalued but not to an extent that would suggest an immediate strengthening (Exhibit 16). So, in the absence of a strong signal from longer-term models, we zoom in on shorter-term regression models for guidance on where the currency should be trading based on its most important drivers: oil, equity markets and the difference between U.S. and Canadian interest rates. These models also suggest that the loonie should strengthen (Exhibit 17).

We should note some risks for the loonie. It is probable that a recession in the U.S. would drag the currency down as oil prices and equities would both be likely to decline. Our models are quick to adjust to such economic developments and, when shocked for these scenarios, suggest the loonie could weaken to $1.35 per U.S. dollar. Falling Canadian real estate prices and high household debts also present risks to our outlook, especially since the Bank of Canada (BOC) seems bent on raising rates faster than many other central banks.

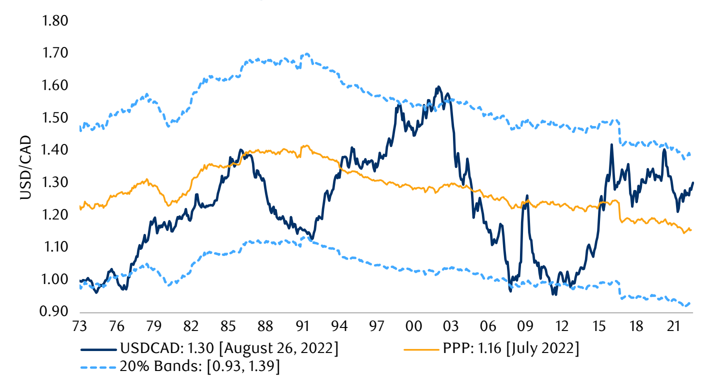
Our base case forecast is that the Canadian economy won't be sunk by a disaster in housing or a severe U.S. recession. We believe oil prices will remain elevated given both strong demand and constrained supply, which will keep the country posting current-account surpluses while the BOC continues to act more aggressively than most of its peers. Finally, an eventual turn weaker in the U.S. dollar would help the loonie strengthen alongside other major currencies. Our forecast is for the Canadian dollar to trade at $1.19 per U.S. dollar sometime over the next 12 months.

Exhibit 15: Canada's basic balance of payments



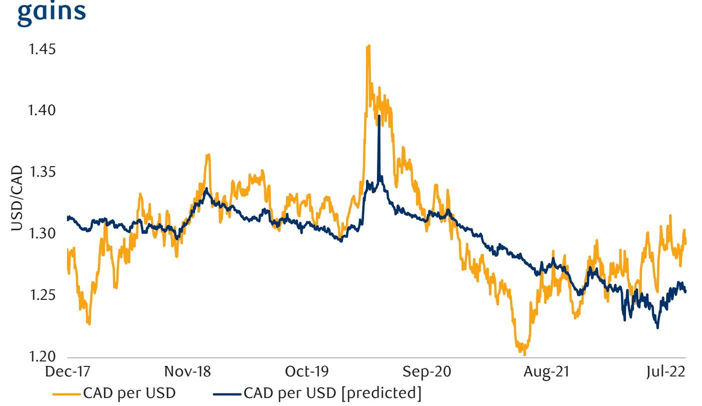
Note: As at June 30, 2022. Source: Statictics Canada, RBC GAM

Exhibit 16: U.S. dollar valuation againt Canadian dollar – Purchasing Power Parity valuation



Note: As at August 26, 2022. Source: Bloomberg, RBC GAM

Exhibit 17: Currency drivers suggest small loonie gains



Note: Model uses S&P 500, crude oil and the spread between 2-year Government of Canada bonds and Treasuries as inputs. As at August 25, 2022. Source: Bloomberg, RBC GAM

Disclosure

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