The dollar’s decade of strength coming to an end

We have witnessed a significant about-turn in U.S. monetary policy over the past year, and yet currency markets in 2019 have been about as exciting as a fireplace channel. The euro range for the year has been the narrowest in 40 years (Exhibit 1) and the Canadian dollar has been similarly moribund. Even the British pound, which has had ample reason to fluctuate, has “kept calm and carried on”.

We do not expect this lack of volatility to persist and forecast that the U.S.-dollar topping process will resolve into a bear market during our 12-month horizon. This changing backdrop will have varying implications for different groups of currencies: we think emerging-market ones have the most to gain while the outlook for developed-market currencies depends largely on individual country factors.

The debate over the next phase of the U.S.-dollar cycle has been simmering for several years. Bearish sentiment toward the U.S. dollar emerged in 2017 as the greenback declined 10% on a trade-weighted basis in response to improvement in European economic data. We were not persuaded at the time that the dollar’s long-term descent was about to begin and had correctly forecast a continued choppy environment. Indeed, the 2017 episode proved to be a false start to the widely anticipated bear market, and the greenback
has since been slowly grinding higher (Exhibit 2), even though a number of longer-term negative developments have materialized. These negatives include moderate overvaluation, the U.S. administration’s jawboning efforts, and worsening U.S. fiscal and current-account deficits (Exhibit 3). Another negative is the renewed interest among global reserve managers in diversifying their holdings away from the U.S. dollar. Russian authorities have led the charge in this effort by substantially reducing their dependence on the greenback as a store of value. Other reserve managers, who all told hold US$12 trillion, have followed suit, converting approximately US$400 billion into Japanese yen and Chinese renminbi since the beginning of 2017.

While these factors are not new, the market looked beyond them in the past year, focusing instead on what the U.S. dollar had to offer: stronger growth and higher interest rates. More recently, however, industrial production and business sentiment indicators started pointing toward softer U.S. economic activity, and the U.S. Federal Reserve (Fed) has reduced the dollar’s yield advantage by cutting interest rates three times. These developments, when combined with what lies ahead, are enough to tip our outlook onto a more bearish path.

The next section addresses these negative near-term expectations.

1. Election uncertainty
Uncertainty over the outcome of the 2020 U.S. elections could dent the appeal of holding U.S. dollars next year. Predicting the outcome of the election has its challenges, with the possibility that results are swayed by ongoing impeachment proceedings and the questionable health of several candidates. Former New York Mayor Michael Bloomberg’s decision to run as a Democrat could dilute Joe Biden’s support and perversely boost the odds of an Elizabeth Warren presidency. This would most certainly be a negative outcome for the greenback since Warren’s policies are widely viewed as investor-unfriendly. Her protectionist plans are similar to those of President Trump. Her government would actively manage the value of the greenback and would also implement a financial transaction tax - both of which are negative for the U.S. dollar.

2. Quantitative easing
In mid-September, the Fed began injecting liquidity into financial markets by buying US$60 billion of T-bills every month. Such quantitative easing is often associated with currency weakness because it expands the money supply and threatens to debase the purchasing power of the currency. The historical relationship between excess reserves in the banking system and the U.S. dollar is shown in Exhibit 4, and points to a decline in the greenback assuming the current pace of Fed purchases remains unchanged. Perhaps more intuitive is the fact that the Fed’s provision of liquidity to financial markets will reduce borrowing stress in short-term markets, thereby lowering the currency’s yield advantage and eroding demand for the greenback.

3. U.S./China currency accord
It is not uncommon for currency issues to feature in trade negotiations. The White House has pushed for currency-specific clauses to be included in several trade deals this year, including the U.S.-Mexico-Canada deal (USMCA), and is seeking a similar concession from China in current talks. We think it is likely that China would accede on this point if...
Trump agreed to roll back existing tariffs. A currency accord between the two countries would lessen the chances that China seeks a competitive advantage by devaluing.

4. Improved global growth
Faster economic growth outside the U.S. would reduce the extent to which the U.S. stands apart. We believe that the U.S. growth advantage will begin to wane in 2020 owing to a renewed emphasis on policy support for economies in the rest of the world. By our count, more than 50 central banks have eased policy this year, including those in the U.S., China and the Eurozone – three of the largest economies in the world. Since monetary-policy decisions affect economic activity with a lag, and since the lags vary by country, it can be difficult to assess how much of a boost will be felt from this easing.

We note, however, that recent efforts to loosen financial conditions should not be underestimated because of the magnitude and breadth of the policy response. It may take time, but it does feel to us as though there is too much pessimism, particularly with regard to the economic prospects in Europe.

Fiscal easing could also support global growth given the widely held notion that there is little room for further monetary easing in most countries. Germany is one of the few countries with ample capacity to ramp up fiscal deficits, and there are hints that Japan, Canada and Australia could loosen their belts. Climate change driven investments in infrastructure could be one way to overcome objections to increased government spending.

Taking these new U.S.-dollar factors into consideration, we’ve shifted our outlook from expectations of a range-bound dollar to one in which the greenback can decline on a more sustainable basis (Exhibit 5). It is unlikely, however, that all currencies will benefit evenly. Developed-market currencies, for instance, can be divided into those with stronger qualities, such as stable current-account surpluses and more attractive valuations, and those with poorer fundamentals. Emerging-market currencies have been hit hardest and have the most to gain in the event that the U.S. and China strike a trade deal, fiscal spending is stoked and/or the U.S dollar weakens. Finally, emerging-market currencies enjoy much higher yields than their developed-market counterparts, which has been an important contributor to total returns in recent years (Exhibit 6).
Euro
Our outlook for the euro has become more positive, leading to our 12-month forecast of US$1.20. Underpinning that relatively optimistic view (the median forecast is US$1.14, according to Bloomberg) is an improvement in the Eurozone’s balance of payments (Exhibit 7). While the single currency has enjoyed the support of a current-account surplus for several years, the most striking change is that net capital outflows – which were previously offsetting the positive impact of trade surpluses – have reversed. Not only have European investors stopped allocating investments abroad, but foreign investors seem to be showing more interest in European assets. Net foreign direct investment (FDI) has also turned positive, hinting that businesses could be making up for a long period of underinvestment in the region. Together, net inflows from the current account, portfolio investments and FDI have amounted to an impressive 500 billion euros over the past year.

While these positive factors have us more constructive on the euro outlook, we are cautious not to get carried away. Uncertainty about global trade and Brexit have weighed on economic sentiment, and neither issue has been fully resolved. Another headwind is negative yields in the region, which act as a deterrent for investing in the euro. Investors who choose to hold euros instead of the U.S. dollar are sacrificing 2% in the hope that the currency appreciates. In the current low-volatility environment, many investors are opting instead to short the euro in order to fund higher-yielding currencies (Exhibit 8).

Japanese yen
We continue to like the Japanese yen, and forecast that it will appreciate to 98 per U.S. dollar within the next 12 months from 109 currently. As one of the major U.S.-dollar alternatives, the yen would especially benefit in the event that the greenback weakens, while still enjoying support from its undervaluation and Japan’s current-account surplus.

While the Swiss franc and U.S. dollar are sometimes grouped in the safe-haven category, the Japanese yen is the only currency in the developed world that reliably rises when stocks fall and therefore offers portfolio insurance in times of market stress (Exhibit 9).
Speculation that any additional monetary easing by the Bank of Japan (BOJ) would weaken the currency are not consistent with the past movements in the yen (Exhibit 10). An increasing emphasis on Modern Monetary Theory – central-bank-financed fiscal spending – would cause us to re-evaluate our stance, given that the BOJ has been a leader in testing new monetary-policy approaches.

**British pound**

In the more than three years since the Brexit referendum, economic growth in the U.K. has gone from being among the best in the G7 to among the worst (Exhibit 11). We remain skeptical that the U.K. economy can manage a rebound even after a Brexit deal is struck because the country has yet to establish a future trade relationship with Europe. This is a process that is scheduled to be hashed out by politicians and trade lawyers before the end of 2020, an almost impossibly tall order given that it took negotiators for Canada and the Eurozone almost eight years to hammer out their 1,634-page agreement and a further two years for it to be enacted by European parliaments. Those who think a Conservative majority government will end the Brexit drama are mistaken. Trade uncertainty will continue to hold back investment in the years ahead. Consumers, having already reduced their savings rates since the 2016 referendum (Exhibit 12), are not well-placed to pick up the slack. Our 12-month forecast of 1.28 suggests that the pound will remain weak, even as the U.S. dollar declines versus other major currencies.

**Canadian dollar**

Canada’s central bank stands apart from its peers, and not simply because it was named central bank of the year in 2018. These days, inflation is low globally and most other central banks have been forced to capitulate toward offering more monetary stimulus. The Bank of Canada (BOC), however, has been in the enviable position of watching the economy reach its 2% inflation target, allowing the central bank to stand firm on its policy setting. The Canadian dollar has benefited from this relatively less dovish stance. Canada’s currency still enjoys the support of yields that are higher than many other developed-market nations, including the U.S. However, Canada’s cyclical economic strength, which led to such stable yields, may be short-lived given the country’s dependence on the slowing U.S. economy.
In a recent monetary policy meeting, the BOC lowered its growth forecasts, warned of downside economic risks and, in an unusual move, noted the stronger currency. BOC Governor Stephen Poloz understands well how a fluctuating currency provides a critical offset during economic hard times, and the central bank has analyzed scenarios that include a 15% drop in the loonie in the event of a pronounced global slowdown. Exhibit 14 reveals one reason why the bank may be increasingly uncomfortable with the currency’s recent strength: the fall in global trade volumes bodes poorly for small open economies like Canada.

Another concern is Canada’s sluggish economic growth amid healthy immigration and impressive job gains. Even after the massive drop in job creation in November, the gap between the pace of hiring and GDP growth suggests a worrying productivity problem (Exhibit 15).

In the near term, economic growth may be supported by increased fiscal spending as the new minority government seeks to secure support for its agenda. There is also hope that final ratification of the USMCA trade deal will bolster corporate investment by reducing uncertainty.

We are not expecting large support for the economy from business investment, however. Canada has become a less attractive place to do business, with its higher taxes, stricter regulations and greater uncertainty over environmental policies. According to a survey conducted by the Fraser Institute, not one Canadian province was among the 10 most attractive jurisdictions (including all provinces and U.S. states) for oil and gas investment. This sentiment was reflected in Encana’s recent decision to relocate its headquarters to the U.S., and also by FDI data that shows Canadian businesses prefer to invest abroad (Exhibit 16). Given these competitiveness challenges, it’s no surprise that Canadian exports continue to languish and capital outflows worsen. A minority government does little to provide clarity on Canadian taxation and regulatory policies, and October’s election debates featured surprisingly little discussion about helping small businesses succeed. This is hard to believe, given that small business is responsible for 70% of private-sector employment and generates 41.5% of Canadian GDP.
This year, the currency has kept to an exceptionally narrow 1.30-1.36 range, one that we think will be broken by Canadian dollar weakness in early 2020. Our forecast of 1.37 per U.S. dollar aims to account for some of the economically supportive immigration and labour-market trends while also recognizing the country’s longer-term challenges. Ultimately, we think the longer-term negatives will cause the loonie to marginally underperform next year, even in an environment where the U.S. dollar declines overall.

Conclusion
After touching multi-decade lows in 2011, the U.S. dollar has appreciated for nearly nine years, buoyed by relatively strong U.S. growth and higher interest rates. These tailwinds are beginning to dissipate, however, as the Fed has undertaken a series of rate cuts and resumed quantitative easing. The upcoming U.S. election introduces additional downside risk for the greenback, adding to the mounting headwinds of overvaluation as well as fiscal and trade deficits. An acceleration in global growth would further erode the relative attractiveness of the U.S. dollar and tip it into a period of sustained weakness. In this environment, we believe emerging-market currencies with strong economic fundamentals stand to benefit the most. In developed markets, our expectation is for the euro and yen to outperform the loonie and the pound.
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