RBC Global Asset Management

Global Currency Outlook

NEW YEAR 2021

U.S. dollar in decline

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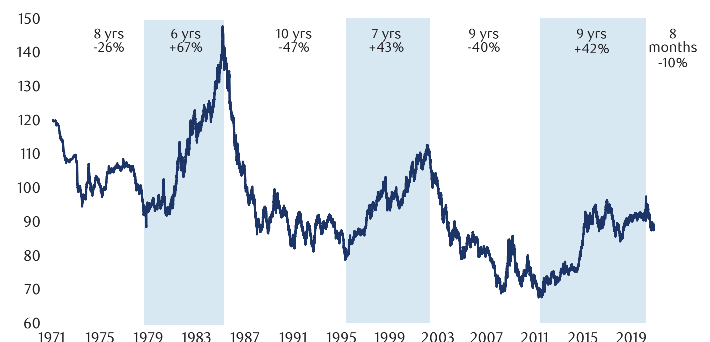
We have just been through an unimaginable year. Had we known last December that 2020 would unfurl a global pandemic, 11th-hour Brexit talks and unprecedented efforts to throw out the U.S. election result, we would have predicted a very challenging year for global financial markets. And yet, major equity indexes are strongly positive this year. Likewise, had we known that the U.S. would end up as a pandemic hotspot, we would have expected significant weakness in the U.S. dollar. And yet the 3% trade-weighted decline so far in 2020 is mild given that this is the first year in a longer-term U.S. dollar bear market – a time in the cycle when exchange rates tend to be especially volatile (Exhibit 1).

Why hasn't the greenback fallen more dramatically? We think the reason lies in the fact that shorter-term themes such as the pandemic, Brexit and U.S. political uncertainty have left investors shying away from shorting the dollar. Arguably, each of these risk factors are nearing resolution: COVID-19 vaccines are on the way, the U.K. and the EU are nearing an agreement on the U.K.'s exit, and President Trump is showing signs of allowing an orderly transition of power to President-elect Joe Biden. As these tensions ease, longer-term factors will prevail in the market narrative, and investors will likely have more conviction in selling the dollar. While we cannot know exactly what 2021 will bring, we are increasingly confident that next year will include a weakening greenback. The continued deterioration in

Exhibit 1: U.S. trade-weighted dollar



Note: As at Nov. 30, 2020. Source: Bloomberg, RBC GAM

fundamental factors such as U.S. fiscal and current-account deficits and relatively strong economic growth in the rest of the world are among the significant headwinds that should push the U.S. dollar meaningfully lower.

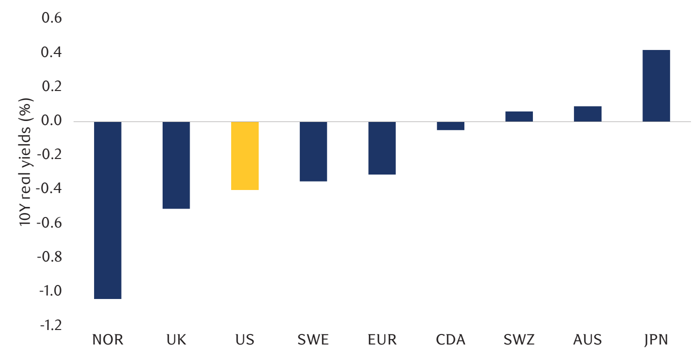
One thing we can say with some confidence is that the U.S. Federal Reserve's (Fed) approach to monetary policy is working against the U.S. dollar – a seemingly unusual assertion given that most developed nations have near-zero nominal interest rates. With limited space to maneuver short-term interest rates, the Fed has been the first major central bank to indicate that it will allow, and even encourage, a period of higher than target inflation to make up for muted price changes in recent years. Known as "average inflation targeting," the effect of this tactic is expected to boost inflation expectations and further depress real interest rates (nominal interest minus inflation expectations). Indeed, in the eight months since the end of March, real yields in the U.S. have fallen to negative levels even as nominal 10-year yields rose. This gap is a direct consequence of investors' expectations that U.S. inflation will rise and has resulted in the U.S. now having one of the lowest real yields among G10 nations (Exhibit 2).

Will other central banks follow suit by focusing on real yields? Maybe. The European Central Bank (ECB) has discussed the idea, though we doubt the governing council, which has historically been firm on its inflation target, would ever embrace above-2% inflation. To date, the ECB has been quiet about the Fed's policies and the resulting euro strength. ECB President Christine Lagarde hardly mentioned the currency at an October 29 press conference, lowering the odds that she would try to talk down the euro as readily as her predecessors did (Exhibit 3). The lack of pushback against the U.S. dollar's decline and the reluctance to follow the Fed down the inflation-stoking path indicates to us that the greenback has much further to fall (Exhibit 4).

Signs point to emerging-market appreciation

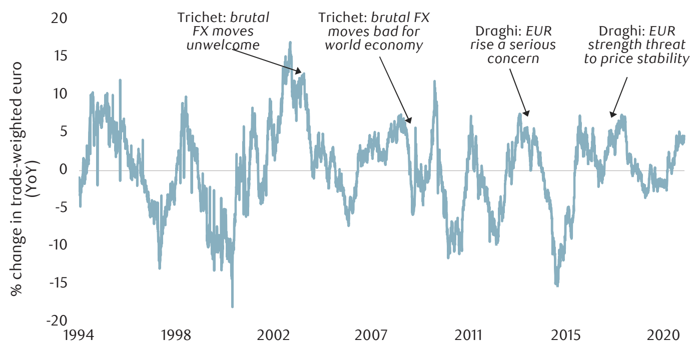
We have become more positive on emerging-market currencies and expect them to appreciate more than their developed-market peers in 2021. The shift in outlook is driven predominantly by improved economic-growth prospects, not only within emerging-market economies but also in many of the export destinations they serve. China, for example, has successfully navigated an exit from pandemic lockdowns and has experienced a quick rebound in economic activity. China accounts for an ever larger share of the global economy and its influence has grown further this year as a newly inked trade deal was struck in November with 14 of its Asian neighbours.

Exhibit 2: G10 real yields



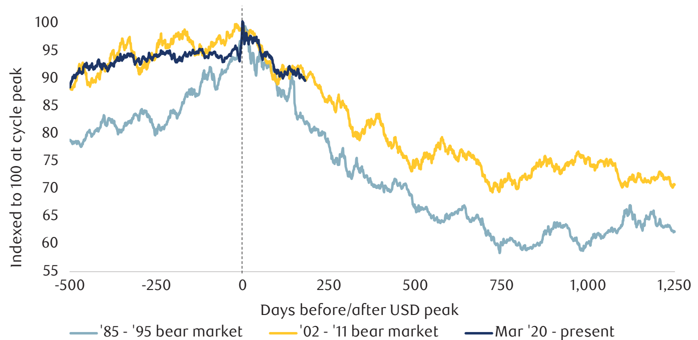
Note: As at Oct. 30, 2020. Source: Bloomberg, RBC GAM

Exhibit 3: Little opposition to USD weakness



Note: As at Nov, 30, 2020. Source: MindOnTheMarkets, Bloomberg, RBC GAM

Exhibit 4: Major USD bear markets



Note: As at Nov. 30, 2020. Source: Bloomberg, RBC GAM

The economic improvement in emerging markets has not been limited to Asia. Measures of economic sentiment such as purchasing managers' indexes and economic-momentum indicators suggest that activity has taken a broad turn for the better across emerging markets. Moreover, the recent announcement of highly effective vaccines should lift consumer and business confidence. Low-cost and easy-to-distribute vaccines won't be rolled out in many emerging-market countries until late 2021, but investors are already starting to factor in an easing of fiscal strains and faster economic growth.

Equally important for emerging-market currencies is the strength of the Chinese renminbi given the country's economic heft. A stronger Chinese currency acts to improve the competitiveness of China's trading partners because China accounts for an increasing percentage of their trade. Moreover, Chinese currency strength (up 8% versus the dollar since June) allows emerging-market currencies to strengthen versus the dollar, diluting U.S. claims that they are actively holding down the value of their currencies. Signs that Chinese policymakers are becoming more tolerant of a strengthening renminbi include the reduced use of foreign-exchange reserves to purchase dollars - historically a tool for controlling the exchange rate. China's willingness to relax its grip on this market is particularly noteworthy given the ever growing capital flows into China resulting from the inclusion of Chinese assets in major global bond and equity indexes.

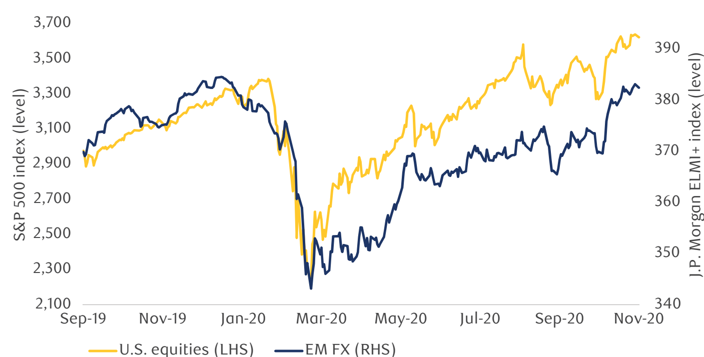
The U.S. political transition should also act to push up emerging-market currencies. For starters, Biden's big-government policies are seen as dollar-negative in that they will boost fiscal deficits. The President-elect's proposals to increase regulations, raise corporate taxes and hike minimum wages also chip away at the sizable competitive advantage that the U.S. firms have enjoyed for several years under President Trump. Second, Biden's friendlier foreign-policy stance offers relief to a market exhausted by combative tweets and will provide a boost to the countries that had attracted the most attention from the Trump administration. While China remains an important U.S. adversary and while Biden may eventually pivot toward dealing with Russia, Iran and others – we think he has more important domestic priorities to tackle during his first 100 days in office. Leading up to the inauguration and through the 100-day period, emerging-market currencies will be the main beneficiaries of a weakening U.S. dollar. This group had been underperforming other risky investments since March, but is beginning to show more convincing signs of strength (Exhibit 5).

Euro

Investor attitudes toward the euro are improving. The currency broke above 1.20 per dollar recently from 1.07 in March, and we think it will continue to rally toward a seven-year high of 1.27 next year. We are bullish for several reasons:

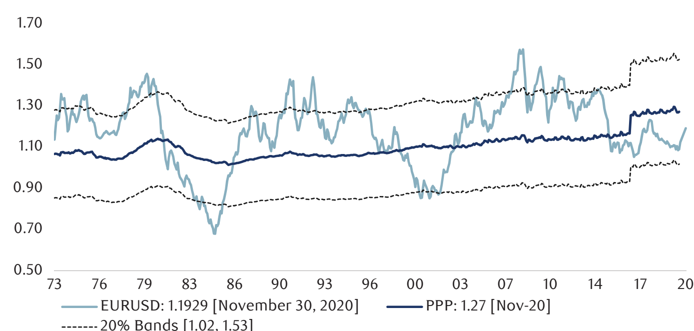
- As the world's second-most-traded currency, the euro acts as the "anti-dollar." Many investors who shun dollars will automatically replace them with euros.
- Even with the recent appreciation, the euro is still meaningfully undervalued (Exhibit 6). Moreover, the rising fair value of the euro in our purchasing- power-parity model is a function of lower inflation in Europe than in the U.S., a trend that will likely accelerate given the Fed's inflation-tolerant approach.

Exhibit 5: Relative asset-class performance



Note: As at Nov. 30, 2020. Source: Bloomberg, RBC GAM

Exhibit 6: EURUSD PPP valuation



Note: As at Nov. 30, 2020. Source: Bloomberg, RBC GAM

- Europe as a whole enjoys a healthier balance of payments, with trade surpluses that will be buoyed by stronger links to Chinese economic growth (Exhibit 7).

Perhaps most importantly, progress in addressing the risks of a Eurozone break-up have been very encouraging. The solidarity shown among European nations in agreeing to a joint 750 billion-euro recovery fund will be rewarded with greater demand for European debt by long term investors, including the massive US$12 trillion collectively invested by global reserve managers. These developments already seem to be having an effect: investor demand for a COVID-19-relief bond issued by the European Commission was a whopping 14 times larger than the amount of bonds being issued.

The course of the pandemic will be key in determining the pace of euro gains. While lockdowns will unquestionably dent economic activity and increase the burden on fiscal accounts, these restrictions are being slowly eased in parts of Europe in response to an improvement in reported infections.

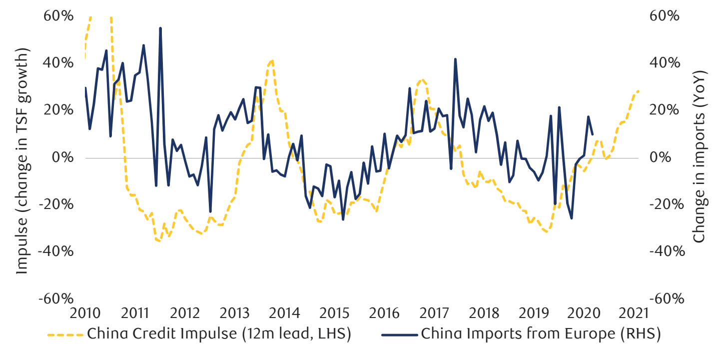
Japanese yen

There are parallels between today's environment and the years following the global financial crisis of 2008-2009 – a time when the yen rallied significantly. One similarity is that deflation in Japan has returned, bolstering real yields and boosting the attractiveness of Japanese government bonds. With lower yields abroad, Japanese investors have been showing a preference for domestic assets (Exhibit 8) and lower hedging costs have led to increased hedges on foreign investments.

The surge in demand for the yen is also reflecting foreign appetite for yen-denominated assets. China stands out as a big buyer of Japanese debt, and this reserve-diversification flow away from the U.S. dollar could also represent a lasting form of support for the yen.

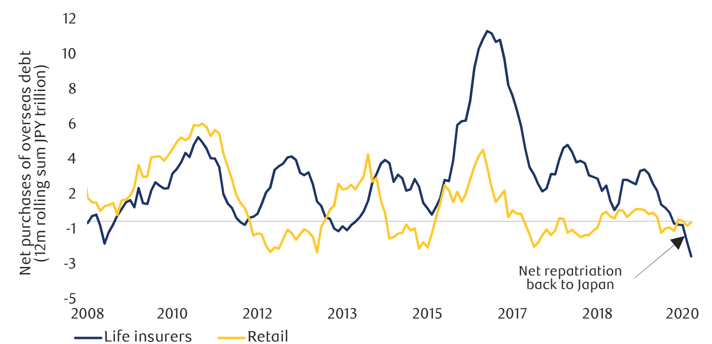
The Japanese monetary and fiscal regime under new Prime Minister Yoshihide Suga will be important for the year ahead, and, since these policies were big drivers of yen weakness during the Abe administration, we will be watching for any changes in policy. We are also waiting to see how Japan-U.S. relations proceed after Biden's inauguration in January. We expect that the yen will remain well-supported by capital inflows and forecast that it will strengthen to 99 per dollar in the coming year.

Exhibit 7: European exports closely linked to China



Note: As at Oct, 31, 2020. Source: Bloomberg, PBOC, China General Administration of Customs, RBC GAM

Exhibit 8: Japanese buying fewer overseas assets



Note: As at Oct. 31, 2020. Source: Bloomberg, BOJ, MOF, RBC GAM

British pound

Finally. Presumably this time after four and a half years, the deadline is real. Either way, there will be a resolution to the Brexit saga in the few weeks that remain before the December 31 deadline. The pound has rallied alongside these headlines, benefitting also from U.S. dollar weakness, and is reflecting more optimism than U.K. equities, suggesting the pound may be overvalued (Exhibit 9). We remain cautious on the pound's prospects for appreciation even if an agreement between the U.K. and EU is struck.

The reality is that the pound has very few things going for it. Although the U.K. may grow quickly in 2021 in an absolute sense, its underperformance in 2020 was so severe that the country is still set to lag most of its peers in the timing of its return to economic normality, a dynamic worsened by Chancellor Sunak's late-November decision to unwind pandemic-related fiscal spending. This puts more pressure

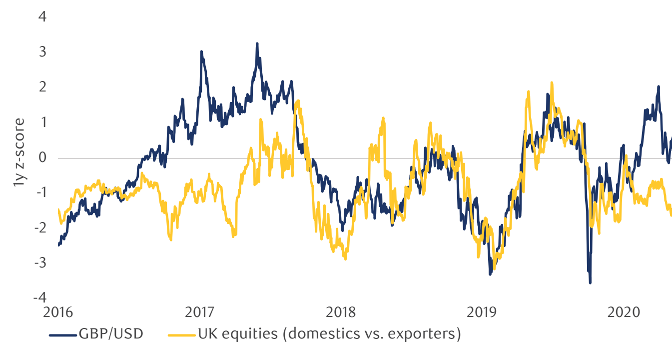
on central bankers to ease monetary conditions, raising the odds that the Bank of England will follow through on a threat to impose negative interest rates next year. The year ahead also brings additional political drama as Scottish elections raise the specter of the country's exit from the U.K., should another referendum be called. Our 12-month forecast is for the pound to remain at 1.33, which would see it weaken relative to other currencies as the U.S. dollar declines.

Canadian dollar

Our view on the Canadian dollar has become more positive this year as we assumed the peak in the U.S. dollar had passed once the safe-haven flows of March subsided. While investors have begun to subscribe to our view and are buying the Canadian dollar, we don't think that the currency's recent strength necessarily reflects this newfound optimism. The improved outlook for the loonie is also an acknowledgement that the U.S. dollar is in decline and that global equities are buoyant – two factors that are more important for the Canadian dollar than are commodities or interest rates (Exhibit 10). Country-specific factors are also playing a part, with investors noting that Canada is better positioned than many countries to provide the fiscal support needed to buttress the domestic economy in a post-pandemic world. Moreover, Canada has pre-ordered more vaccinations per capita than any other developed nation (Exhibit 11), which should translate into a quicker economic recovery once those doses are administered. That task may be also easier to implement in a universal health-care system than it will be in the largely private U.S. system. The approval of COVID-19 vaccines is especially important, given the economy's higher sensitivity to global growth. Finally, a return to normal might also involve faster population growth in the years to come, helping to shore up the economic growth rate as pent-up immigration materializes after borders are reopened.

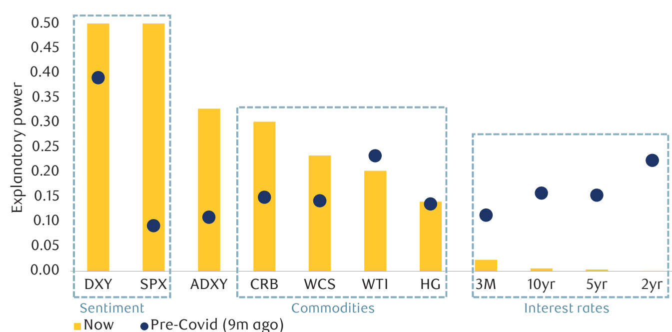
While some point to weaker crude-oil prices as a headwind for the Canadian economy, we wonder whether this might be exaggerated. Yes, the oil patch still forms an important part of the Canadian economy, but much less than it used to. Oil extraction as a percentage of GDP has dropped to 2% from 6% over the past five years, and the energy sector's share of business investment has shown a similar trend (Exhibit 12). Forced to pivot, western provinces are now looking to participate in the global race toward net-zero emissions by 2050 and political support is building for hydrogen and natural gas as the saviours of western provinces. A report released in October by the Province of Alberta outlines a plan for large investments, incentives and partnerships to

Exhibit 9: FX market is optmistic on sterling



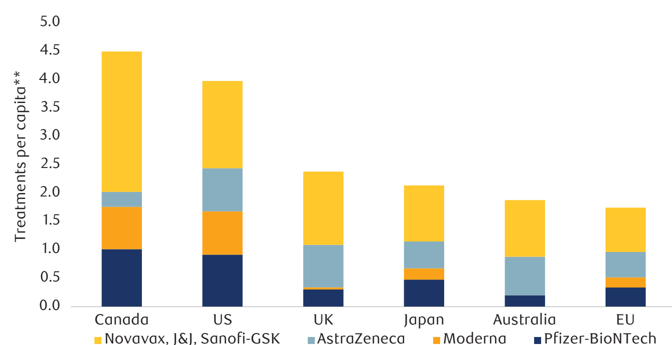
Note: As at Oct. 13, 2020. Source: Bloomberg, Morgan Stanley, RBC GAM

Exhibit 10: Canadian dollar drivers



Note: As at Oct. 30, 2020. Data derived using 90d rolling correlation. Source: Bloomberg, BOC, Macrobond, S&P Dow Jones, RBC GAM

Exhibit 11: Vaccine supply available*



Note: *Consists of advanced purchases and additional purchase options through 2021. **Usually 2 doses per person. As at Nov. 30, 2020. Source:Goldman Sachs, RBC GAM

reposition the economy and capitalize on new opportunities in this area. Also, a variety of non-energy commodities, including metals, lumber and wheat, together make up nearly the same weight as oil in Canada's exports. Prices for these exports have seen a decent rise over the past few months. Lumber prices, for example, saw an impressive spike over the summer and wheat futures this fall traded at levels not seen in six years.

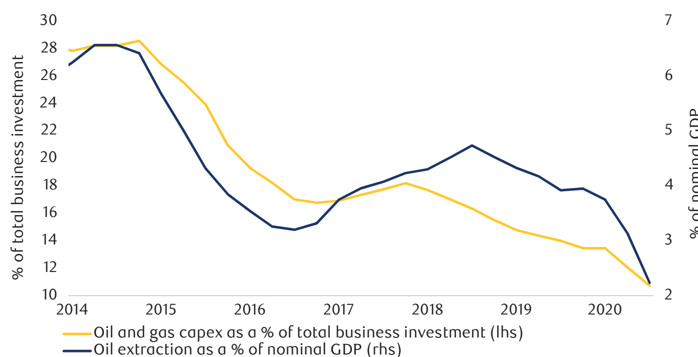
What still concerns us about the outlook for the Canadian dollar is the fact that many Canadian-dollar negatives are being brushed off by investors. These are mostly domestic developments that, at one time, had been a concern but are now being downplayed. Political crises such as negative publicity around Prime Minister Trudeau's ties to a charity and his government's efforts to bury what many are calling a scandal have hardly registered abroad. High levels of consumer leverage are another worry, with household indebtedness rising beyond the country's annual economic output. Yet these economic vulnerabilities have been put on ice by lower borrowing costs and pandemic-related income support. Even as unemployment soared and businesses reeled under springtime lockdowns, personal bankruptcies fell by 15% year over year and 19% for businesses. The country's balance of payments, with a decade of trade deficits and direct investment outflows, is a third cause for concern (Exhibit 13). Foreign purchases of Canadian stocks and bonds have temporarily pushed this structural problem to the back burner.

We remain moderately constructive on the loonie, thinking that it will strengthen to 1.27 per U.S. dollar from its current level of 1.31. However, we note that some Canadian-specific concerns may prevent the currency from appreciating as much as the euro, the yen or emerging-market currencies during a broad U.S. dollar decline.

Conclusion

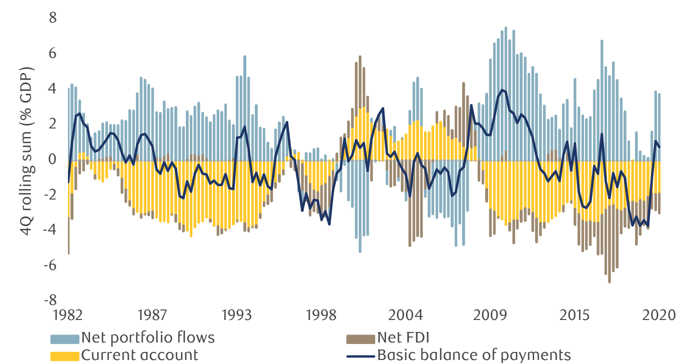
In sum, we expect a sustained U.S.-dollar decline in 2021 as structural headwinds take precedence over short-term factors that have slowed the decline of the greenback over the past year. U.S. twin deficits and the Fed's intention to boost inflation, coupled with economic and political improvements as well as extraordinarily easy financial conditions abroad, should cement that U.S.-dollar downtrend. Emerging-market currencies are likely to finally shine next year, as the euro, yen and loonie outperform the British pound.

Exhibit 12: Oil is now a smaller share of Canadian economy



Note: As at Sep. 30, 2020. Source: Haver Analytics, UBS, RBC GAM

Exhibit 13: Canada basic balance of payments



Note: As at Oct. 31, 2020. Source: Statistics Canada, RBC GAM

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Publication date: December 15, 2020