RBC Global Asset Management

Global currency outlook

NEW YEAR 2023

U.S. dollar rally fizzles, suggesting greenback has peaked

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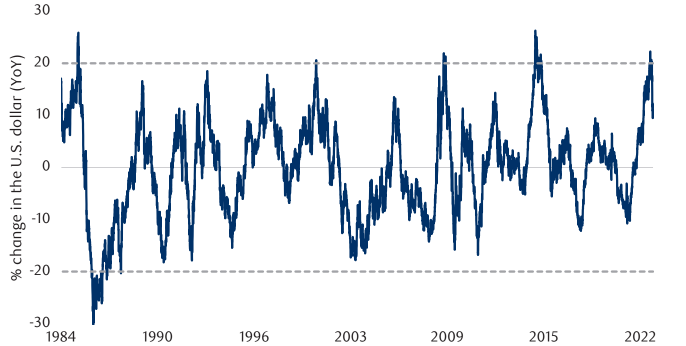
The U.S. dollar extended its 12-year-old bull market through October as the allure of higher U.S. bond yields and economic challenges abroad continued to overshadow longer-term issues facing the greenback. However, the rise in the ever buoyant dollar came to an abrupt halt in early November, leading investors to question whether the greenback's period of dominance is finally coming to an end. With valuations stretched, it's clear to us that the currency's bull market is mature and that a major turning point is near. Such peaks are tough to call, but we have greater conviction that a softening in the greenback is in store and that it will herald the start of a multi-year decline.

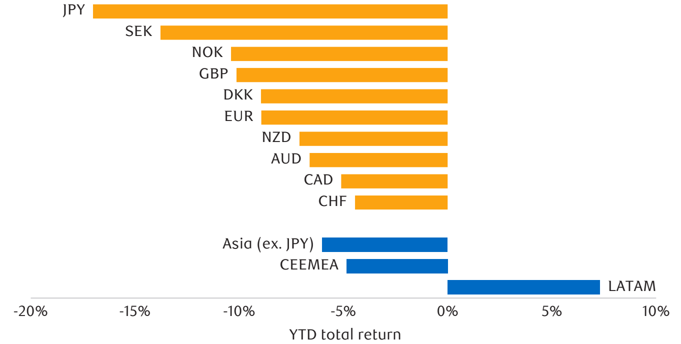
Even with the recent declines, the pace of U.S.-dollar gains this year has been extraordinary, rivalling some of the largest appreciations since the early 1980s (Exhibit 1). The dollar has reached parity with the euro for the first time since the euro was introduced 22 years ago and has registered multi-decade highs against the yen and the British pound. Even the relatively stable renminbi declined 9%, weakening below the levels recorded after Donald Trump initiated a trade war with China. Few other currencies escaped the dollar's exceptional strength, and most now sit 5%-10% lower than where they started the year (Exhibit 2).

Exhibit 1: Breakneck U.S. dollar gains



Note: As at November 29, 2022. Source: Bloomberg, RBC GAM

Exhibit 2: Currency performance



Note: LATAM is the average of (BRL, MXN, PEN, CLP, COP), CEEMEA (ZAR, CZK, RON, PLN, TRY, HUF), Asia ex. JPY (SGD, INR, THB, PHP, MYR, IDR, KRW, CNH, TWD). As at November 29, 2022. Source: Bloomberg, RBC GAM

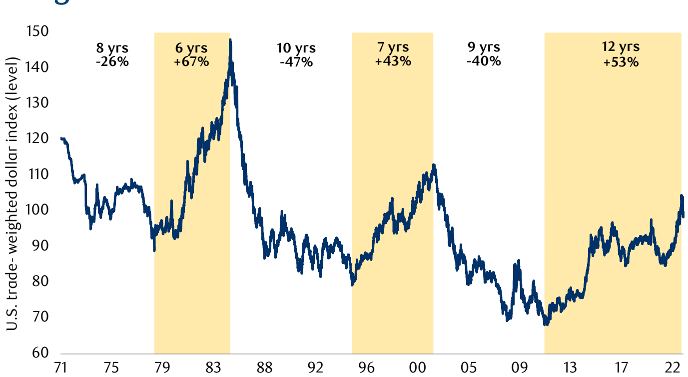
The extension of the U.S.-dollar bull market well into a second decade makes this cycle unusual in length (Exhibit 3). The current uptrend in the currency has been prolonged by a series of temporary factors causing inflation to persist and prompting the U.S. Federal Reserve (Fed) to keep raising interest rates. Other developments, including the Russia-Ukraine war and China's harsh COVID-19 crackdown, have also elevated the dollar by slowing economic growth and weakening the case for investment and tourism in other regions. These themes have captured investors' attention at the expense of more traditional elements that are bearish for the dollar. But as shorter-term influences fade, dollar strength will begin to buckle under the weight of huge budget and current-account deficits, deglobalization, exploding health-care costs, an aging population and a falling share of foreign-exchange reserves. This coming slide in the dollar will be significant given the extent to which the currency is overvalued.

Our preferred measure of long-term currency valuation is purchasing power parity (PPP) (Exhibit 4), which showed the U.S. dollar at levels more than 30% richer than fair value at the end of October – a reading broadly supported by other types of valuation models. Deviations greater than 20% are generally considered "extreme" – large enough to sway decisions made by households and businesses. As the dollar becomes more expensive (and as other currencies cheapen), U.S. consumers are finding they get more for their money when they spend abroad. At the same time, businesses can reduce input costs by switching to foreign suppliers. Studies by Deutsche Bank have found that currencies tend not to remain in extreme territory for long, with periods beyond 20% thresholds typically being measured in months rather than in years. Having just surpassed 20% overvaluation in May, the dollar's recent drop would align with Deutsche Bank's research that these episodes are very short-lived.

Also supporting this view is the fact that the euro couldn't manage to weaken beyond US$0.95 even though the economic and political news in Europe remains broadly negative. There is a limit to how much other currencies can weaken before their cheapness makes them attractive enough to draw capital away from the U.S. We expect this to be an increasingly powerful headwind for the greenback next year and one that will help crystallize the completion of the cyclical peak in the U.S. dollar's long-term cycle.

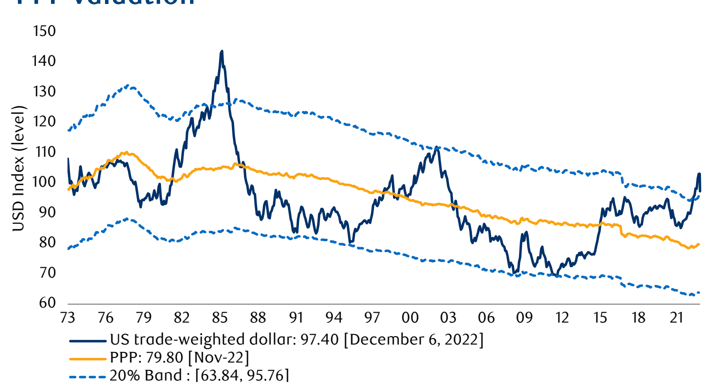
There is a debate over whether the U.S.-dollar peak has already passed. In November, the euro rebounded 10% from its lows and investors trimmed dollar positions after China began easing its stringent COVID lockdowns earlier this month. Meanwhile, the Fed has signaled that it would likely slow the pace of rate hikes at its next few meetings, an important signal from U.S. central bankers that steps in the fight against inflation are finding their mark. Many currency traders are quick to extrapolate this reduced pace as the final stages of the Fed's rate-hiking cycle. And while interest rates remain higher in the U.S. than abroad, the Fed's signal removes an important source of support for the greenback.

Exhibit 3: Long-term cycles of the U.S. trade-weighted dollar



Note: As at November 25, 2022. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 4: U.S. trade-weighted dollar PPP valuation



Note: Uses new Fed USD index from Dec 31, 2019 onward (USTWAFE Index). As at December 6, 2022. Source: U.S. Federal Reserve, Bloomberg, RBC GAM

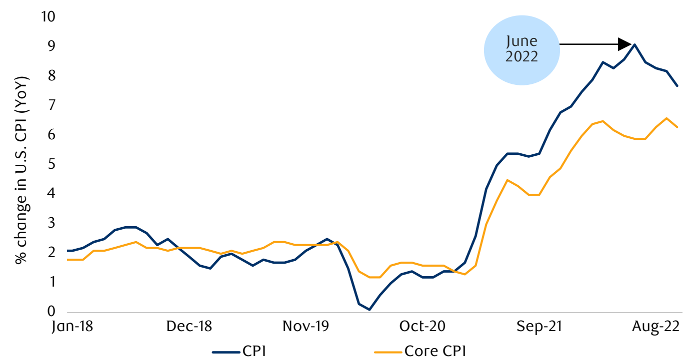
It's clear that we won't see a repeat of this year's 4-percentage-point increase in benchmark interest rates as the Fed nears the end of its tightening cycle and the threat of recession is starting to weigh more heavily on the balance of risks for the dollar. Market sentiment toward the dollar has turned less bullish, a change that could accelerate if consumer prices stabilize over the next few months. There are a few developments that would further tilt the balance toward a bearish outlook for the dollar:

- **Inflation data.** It seems likely that the year-over-year rate of inflation peaked in June (Exhibit 5), but we know that some of the recent stabilization of prices is related to weakness in commodity prices. Core CPI measures, which excludes the highly volatile food and energy components, offer more reliable indicators. A few more months of soft core inflation would support the idea that the Fed could stop hiking in early 2023, a scenario that would likely cause a rush to short the greenback. In addition to CPI, we are closely monitoring the bond market's pricing of the Fed's 'terminal' rate" – the point at which the Fed stops hiking rates. The drop in expectations for the terminal rate from its 5.13% high has so far been insignificant (Exhibit 6), and our view is that further dollar weakness would result if a recession caused terminal interest-rate expectations to fall more meaningfully.

- **Energy scarcity in Europe.** Milder weather in autumn allowed European countries to rebuild natural-gas inventories, and storage facilities are now filled to capacity in nearly every eurozone nation (Exhibit 7). While the economic situation in Europe is certainly still challenged, this development reduces the likelihood of worst-case scenarios and offers relief to investors who previously fretted over a catastrophic winter energy shortage in Europe.

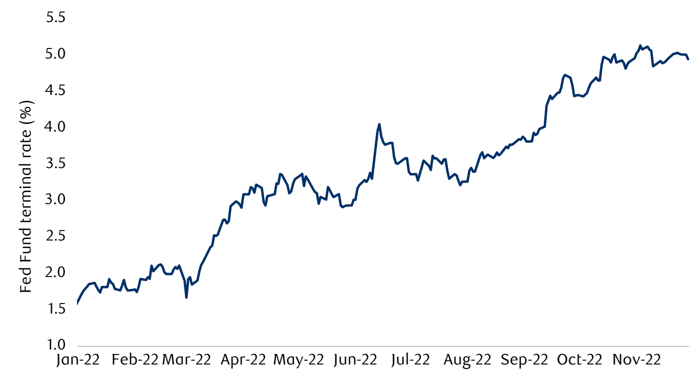
- **China COVID-19 cases.** Risk sentiment surged and the U.S. dollar dropped quickly in response to early-November rumours that Chinese lockdown measures could be lifted. Since then, positive cases in the country have risen to 40,000/day and restrictions remain in place. It's possible now that this reopening theme will take longer to fall into place but once it does, perhaps in the spring when the Chinese roll out new vaccines, the dollar's downward adjustment could be swift.

Exhibit 5: U.S. inflation peaked in Q2



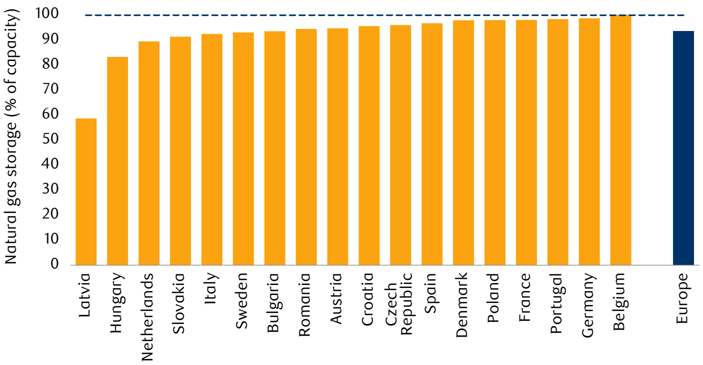
Note: As at October 31, 2022. Source: Bureau of Labour Statistics, Bloomberg, RBC GAM

Exhibit 6: Fed funds terminal rate has not yet fallen



Note: As at November 29, 2022. Source: Morgan Stanley, Bloomberg, RBC GAM

Exhibit 7: European gas inventories near capacity



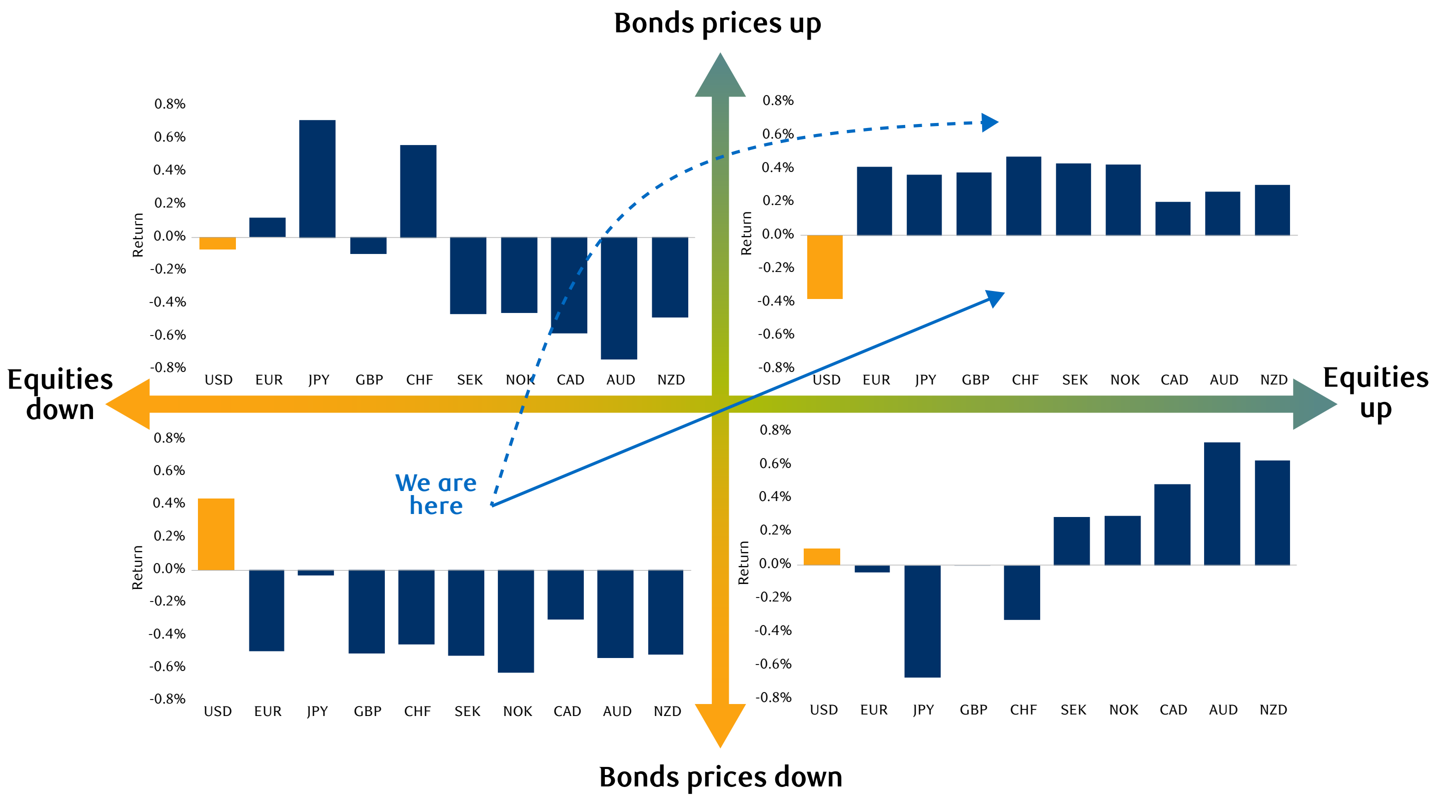
Note: As at November 29, 2022. Source: Gas Infrastructure Europe, Macrobond, RBC GAM

The U.S. dollar's special safe-haven status

The potential for weakness in global equities is one factor that could stand in the way of our forecasts for a lower dollar. The greenback's has long had an inverse relationship with global equities: As stocks sink, investors typically flee to the safety and security of the U.S. dollar. This dynamic has been accelerated by this year's concurrent sell-off in global bonds. The greenback has benefited because higher yields make holding U.S.-dollar assets more appealing than assets denominated in other currencies. Consequently, investors use U.S.-dollar holdings as portfolio protection at a time when other safe-haven assets – bonds, gold and the Japanese yen – haven't offered insurance.

It is rare to see bonds and stocks declining at the same time, and research by RBC Capital Markets confirms that such an environment is one of the best for the U.S. dollar. Indeed, the bottom-left quadrant of Exhibit 8 shows that the greenback rallies across the board during times when stocks and bonds fall, which is precisely what we have witnessed in 2022. Looking forward, we expect markets to migrate to the top-right quadrant, where bonds and stocks both bounce – likely in response to perceptions that the Fed will start to signal rate cuts next year. Regardless of whether that migration happens directly or by first entering other quadrants, the dollar has little to no room for further strength while the risks for dollar decline are significant. In either scenario, the dollar would almost certainly depreciate, leading to a broad recovery in developed- and especially in emerging-market currencies.

Exhibit 8: Currency returns in various environments for stocks and bonds

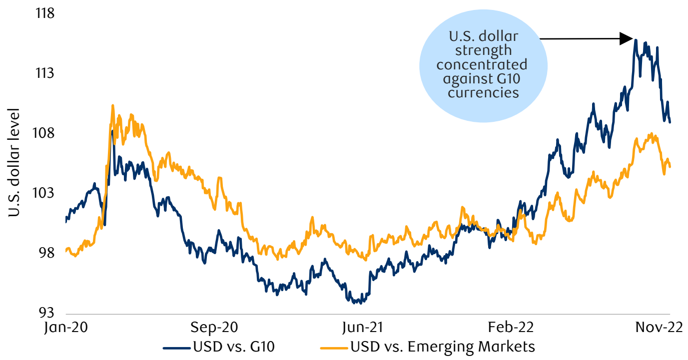


Note: Bars show average of weekly data from 1980-2022, excluding obervations within +/- 0.5 standard deviations. As at November 25, 2022. Source: RBC Capital Markets, Bloomberg, RBC GAM

Emerging markets

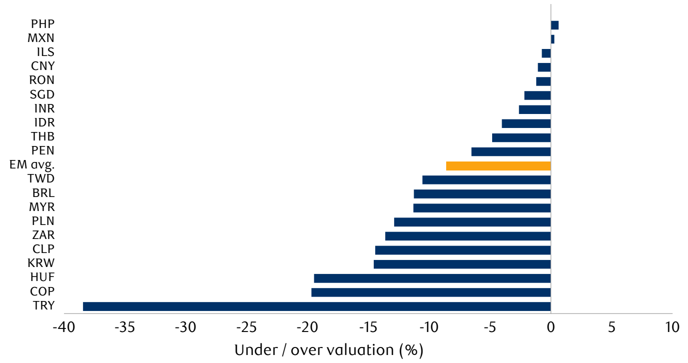
U.S.-dollar strength over the past year has been mostly against G10 currencies, while emerging-market currencies have been more resilient (Exhibit 9). This resilience is not what one would expect in a year of overall dollar strength and surging global bond yields, both of which have traditionally spelled trouble for developing economies. The better performance of emerging markets can be attributed to a few factors. First, these countries are less vulnerable to capital flight than they had been in the past owing to the greater credibility associated with more flexible exchange rates, better current-account balances, larger foreign-reserve buffers and a lower reliance on U.S. dollar-denominated borrowings. Second, emerging-market central banks have been raising interest rates aggressively, and many of them got started well before the Fed's hiking cycle began. High policy rates in emerging markets – in some cases in the double digits – are helping to avoid the large capital outflows that occurred in response to past Fed hiking cycles. Third, many of these currencies are undervalued (Exhibit 10) and under-owned, so there is a noticeable absence of forced selling of emerging-market currencies. These factors lead us to believe that they may outperform developed-market currencies in the year ahead.

Exhibit 9: A tale of two dollars



Note: Indexed to 100 on January 1, 2022. As at November 25, 2022. Source: Bloomberg, RBC GAM

Exhibit 10: Emerging-market currencies are still cheap

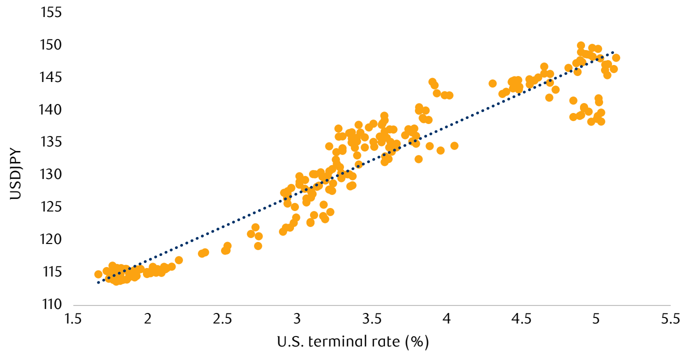


Note: Currency valuation is an average of 16 different valuation models. As at October 14, 2022. Source: Deutsche Bank, Nomura, BIS, Goldman Sachs, Barclays, J.P. Morgan, IMF, RBC GAM

Japanese yen

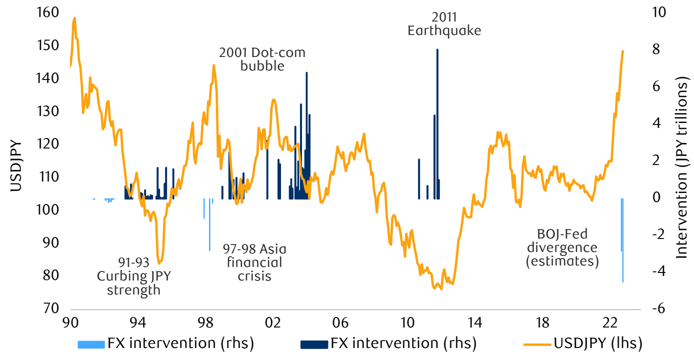
The combination of a hawkish Fed and a Bank of Japan (BOJ) that is steadfastly committed to easy monetary policy has resulted in a near freefall in the Japanese yen. With the BOJ's yield-curve control policy holding longer-term yields in a low, tight range, the yen's depreciation has been purely a function of much higher U.S. monetary-policy rates (Exhibit 11), and only the end of Fed hikes appears capable of turning the yen around. The Japanese currency is now one of the world's most undervalued, but this cheapness is of little solace to exporters because it means even higher rates for energy prices that are set in U.S. dollars. The Japanese Ministry of Finance, intent on slowing the currency's slide, has intervened on several occasions - in late September at 146 yen per dollar and mid-October at 152 (Exhibit 12). The yen didn't actually strengthen until early November, when Treasury yields started to fall. We expect the yen to bounce back once the Fed stops hiking, and to perform quite strongly in the event that the U.S. economy goes into a recession. We forecast the yen at 130 per U.S. dollar in a year's time.

Exhibit 11: USDJPY closely tracks U.S. terminal rates



Note: Data since January 2022. As at November 29, 2022. Source: Bloomberg, RBC GAM

Exhibit 12: USDJPY and Bank of Japan intervention



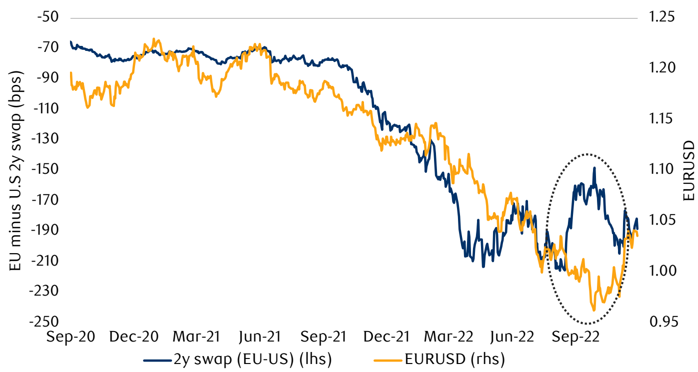
Note: As at November 29, 2022. Source: Japan MOF, Bloomberg, RBC GAM

Euro

The euro was the first major currency to show significant declines in the first half of 2022, as the Fed embarked on its rate-hiking cycle. The euro traded as low as US$0.95 in response to concerns about economic growth and energy security even though interest rates at the time suggested the euro should have traded higher (Exhibit 13). The single currency has since rallied to trade around US$1.05, helped somewhat by the European Central Bank (ECB) rate hikes and higher natural-gas inventories. An unwinding of short-euro positions (Exhibit 14) has helped magnify the euro's bounce, but questions remain about whether an uptrend in the single currency can be maintained.

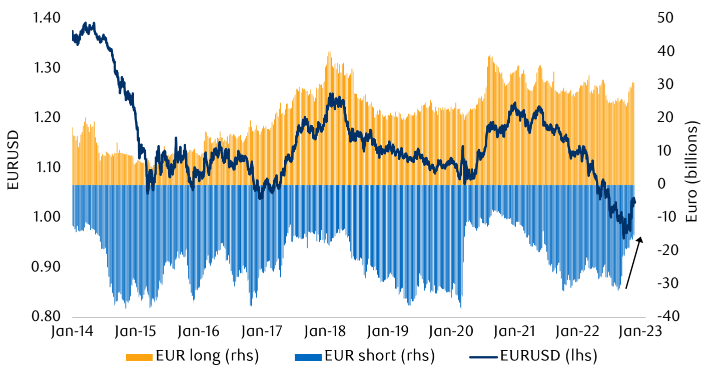
We also note continued improvement in the balance of capital flows back into Europe. Europeans who had invested abroad to avoid negative bond yields are now finding they can get positive yields at home, and are repatriating some of the 4 trillion euros that had made its way overseas (Exhibit 15). While the closing of any related currency hedges would counter the currency impact, we believe at least a portion of this repatriation will be euro-supportive. We think the euro can continue its rally and forecast the currency to hit US$1.10 within the next year.

Exhibit 13: Euro was weaker than rates could explain



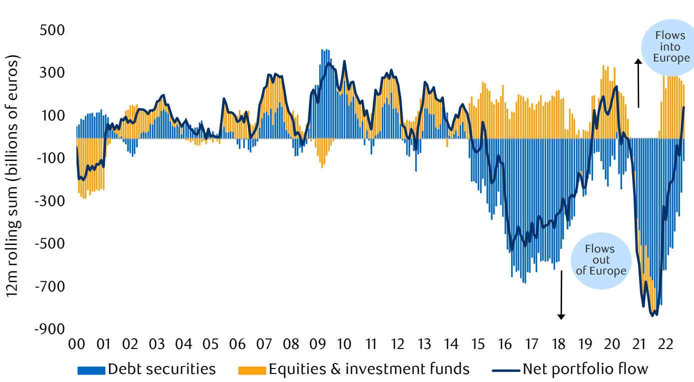
Note: As at November 29, 2022. Source: Macrobond, HSBC, RBC GAM

Exhibit 14: Unwind of short positions helps strengthen the euro



Note: As at November 25, 2022. Source: CFTC, Macrobond, RBC GAM

Exhibit 15: Eurozone investors repatriating money

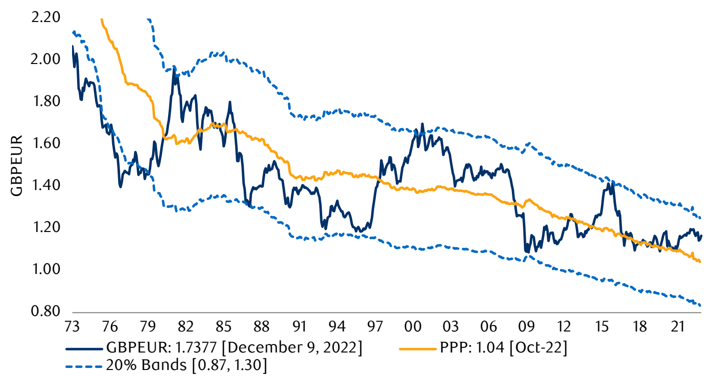


Note: As at September 30, 2022. Source: ECB, Macrobond, RBC GAM

British pound

We remain bearish on the pound relative to its major peers. Persistent current-account deficits have made the U.K. reliant on foreigners for capital, a situation worsened as firms ramp up investments in Continental Europe as Brexit rules are implemented. The government's proposal to spend aggressively did little to help the U.K.'s image as a responsible custodian of capital and caused the pound to briefly plummet to multi-decade lows at US$1.05 per pound. The pound is still about 10% overvalued against the euro (Exhibit 16) and recent pound weakness remains insufficient to revive exports to the eurozone – Britain's largest trading partner. We expect that sterling will be a persistent underperformer within the G10 and see the currency trading at US$1.20 in 12-months' time.

Exhibit 16: GBPEUR – PPP valuation



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

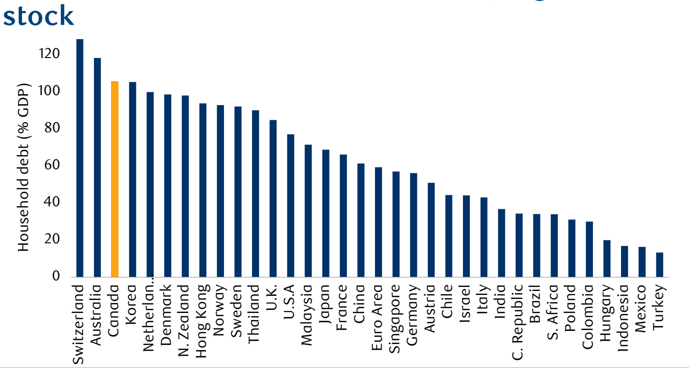
Canadian dollar

The Canadian dollar has held up relatively well this year amid broad U.S.-dollar gains, largely because the Bank of Canada (BOC) has been raising interest rates at roughly the same pace as the Fed. The loonie has slipped more recently, as investors pay more attention to the Canadian economy's reliance on housing and the relatively large stock of household debt that finances it (Exhibit 17). Investors increasingly doubt the BOC's willingness and ability to continue hiking as aggressively as the Fed, and the U.S. dollar recently started to accelerate gains versus the Canadian dollar in lockstep with these doubts (Exhibit 18). Even with the currency's recent pullback, the loonie has managed to outperform other G10 currencies this year (Exhibit 19).

The country now boasts a current-account surplus, strong terms of trade, high population growth and one of the highest yields in developed markets. The economy is expected to perform better than in the U.K. or Europe and the country is in decent fiscal shape, having posted a few monthly surpluses this year.

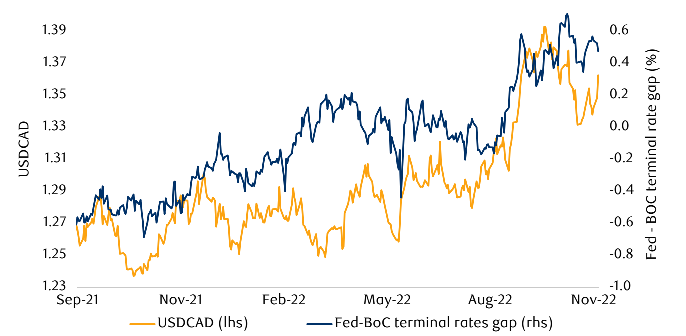
The greenback has strengthened against the Canadian dollar beyond the well-worn range that had held for more than a year (Exhibit 20), in part because of the recent focus

Exhibit 17: Canadians have a relatively high debt stock



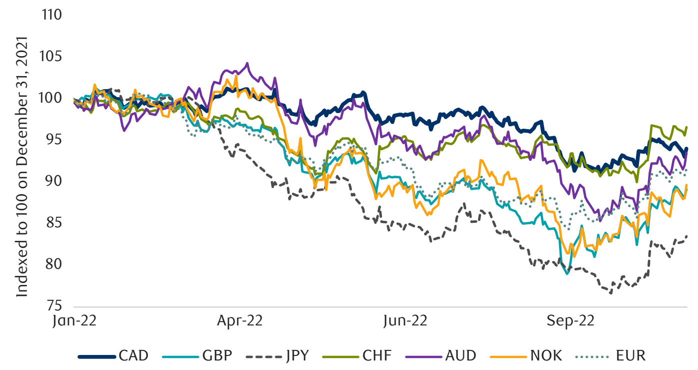
Note: As at March 31, 2022. Source: BIS, Macrobond, RBC GAM

Exhibit 18: USDCAD and U.S. – Canada terminal rate spread



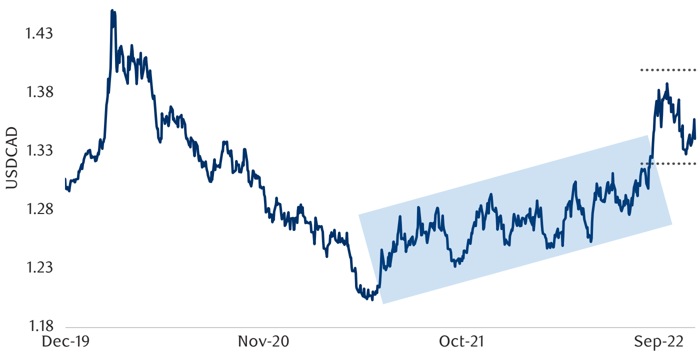
Note: As at November 29, 2022. Source: Morgan Stanley, Macrobond, RBC GAM on Canadian housing. The exchange rate has found a new trading range of C$1.32 to C$1.40 per U.S. dollar, where the top represents the level at which corporations and institutional investors begin to take an interest in the loonie. Typical drivers of the currency, including short-term interest rates and oil, have lessened in importance as the currency has become hitched to both equities and the U.S. dollar. A further selloff in stocks, then, could push the exchange rate above C$1.40, at which level we would recommend that investors with a long-term horizon acquire Canadian dollars and hedge U.S.-dollar exposure. Our forecast is for the loonie to strengthen alongside broader weakness in the U.S. dollar. We think the currency can rise to C$1.23 per U.S. dollar over the next year.

Exhibit 19: G10 year-to-date performance



Note: As at November 30, 2022. Source: Bloomberg, RBC GAM

Exhibit 20: USDCAD has broken through channel



Note: As at November 30, 2022. Source: Bloomberg, RBC GAM

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