RBC Global Asset Management

Global Currency Outlook

SPRING 2021

The U.S. dollar has further to fall

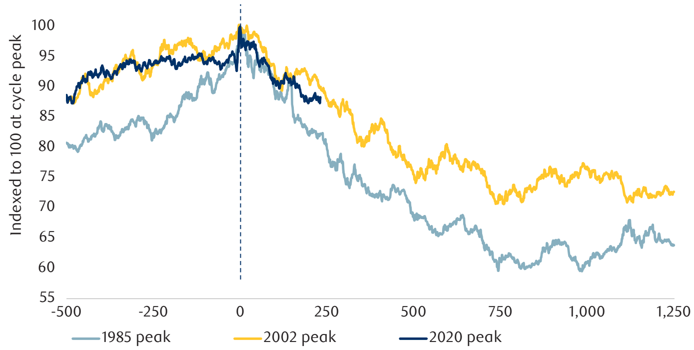
Dagmara Fijalkowski, MBA, CFA
Head, Global Fixed Income & Currencies
RBC Global Asset Management Inc.

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

The U.S. dollar has been in decline for a year following last spring's pandemic-related panic in financial markets. We expect the decline to outlast the pandemic and persist well beyond 2021, as long-term issues continue to suggest more weakness ahead for the greenback. We have raised our forecasts for developed-market currencies but suspect that emerging markets will likely benefit more from weakness in the U.S. dollar, the recovery in global growth and strength in commodities.

The path laid out by past U.S.-dollar bear markets offers some indication of what we should expect in the coming years (Exhibit 1). As with the significant long-running declines that began in 1985 and 2002, the first stage of the current U.S.-dollar bear market is proving to be robust – both in terms of the relentless pace of decline and the breadth of currencies against which the dollar is falling. Almost all developed- and emerging-market currencies have risen since the U.S. election at the beginning of November. Biden's election refocused attention on the large U.S. fiscal and current-account deficits (Exhibit 2), and his agenda includes further fiscal support that would lead total pandemic-related government spending to rise above US$4 trillion, or 16% of GDP.

Exhibit 1: U.S. dollar bear-market roadmap



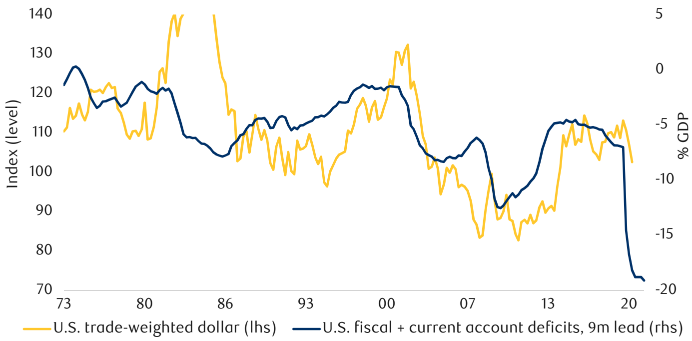
Note: As at Feb. 26, 2021. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

The U.S. dollar's lower interest-rate premium vis-à-vis rivals (Exhibit 3), and its overvaluation based on purchasing power (Exhibit 4) are other reasons for global fund managers to continue reducing the share of the U.S. dollar in their portfolios. Longer term, Europe and Asia have become more attractive investment destinations given greater political cooperation in the EU and an improved economic and technology-sector outlook in Asia. So, we think that temporary rallies in the greenback, like the one that is materializing in early 2021, are opportunities to add to bets on a continued decline in the greenback.

Until recently, the U.S. dollar's weakness in 2020 had gone relatively unopposed. This complacency is ending. Sweden, Chile, Israel and Russia are among the countries whose central banks have indicated they'll buy dollars to stem the rise of their own currencies. The Bank of Japan (BOJ) and European Central Bank (ECB) have both begun to hint at their discomfort with further currency gains, while China's central bank has loosened restrictions on outbound investment to counter appreciation of the renminbi. The concern for most of these countries lies not in a loss of competitiveness – the U.S. dollar is still overvalued, after all. The real problem faced by these central banks is that the speed of the U.S. dollar's descent reduces inflation in these countries and threatens the ability of policymakers to maintain inflation at desired levels. The dampening effect on inflation will peak in the second and third quarters of 2021, so we should expect to hear more from central bankers concerned about developments in foreign-exchange markets. In reality, there's very little these authorities can do individually to stop the powerful tide of U.S.-dollar weakness. While currency intervention and quantitative easing are huge in historical context, they are dwarfed by the US$6 trillion in daily foreign-exchange trading.

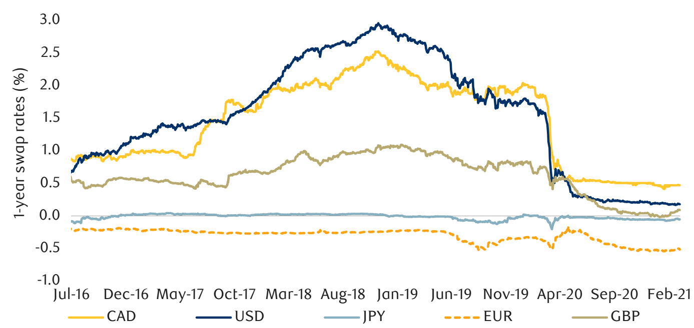
Of all central banks, it is perhaps the Bank of Canada (BOC) that should be most concerned about U.S.-dollar weakness. Canada is among the most trade-oriented economies in the G20 (Exhibit 5), with the U.S. accounting for a much larger share of the country's imports and exports than other developed nations.

Exhibit 2: Twin fiscal and current-account deficits



Note: Deficits as at Sep. 30, 2020 and U.S. trade-weighted dollar as at Feb. 26, 2021. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

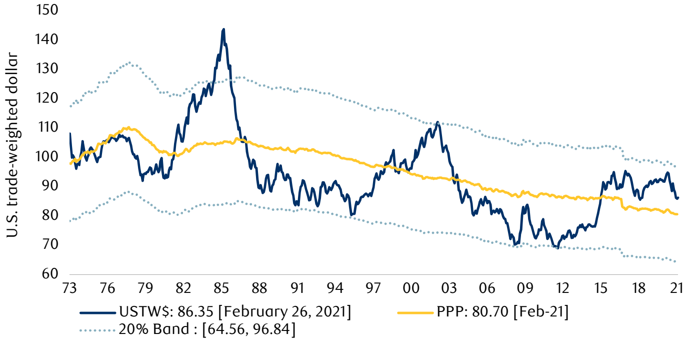
Exhibit 3: U.S. dollar's interest-rate advantage has fallen



Note: As at Mar. 2, 2021. Source: Bloomberg, ICE, RBC GAM

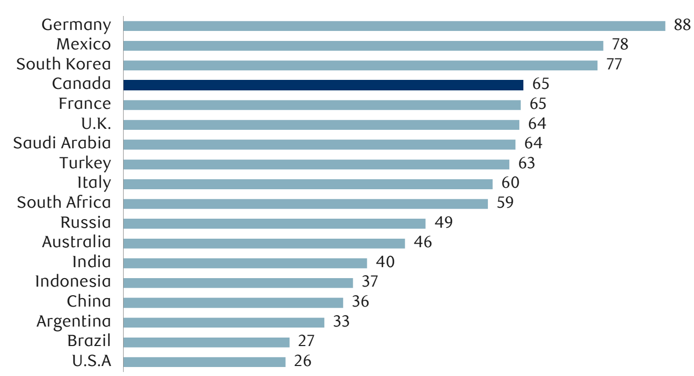
Exhibit 4: Purchasing power parity vaulation

U.S. trade-weighted dollar



Note: As at Feb. 26, 2021. Uses new Fed USD index from Dec. 31, 2019 onward. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 5: Exports and imports as a share of GDP



Note: As at Dec. 31, 2019. Source: The Global Economy, RBC GAM

Shades of 2013?

Recent volatility in the bond markets has some investors worried about weakness in emerging-market currencies and a repeat of a 2013 episode when risky assets and currencies plunged. At the time, the U.S. Federal Reserve's (Fed) announcement of a reduction in bond purchases caused interest rates to rise and pulled capital away from the emerging world. We think concerns of a similar reaction today are misplaced. For one thing, this year's rise in yields is smaller than the 140-basis-point spike during the summer of 2013. Another big difference is that, in 2013, the U.S. dollar was not in a bear market, and the greenback's prevailing strength at the time acted as a headwind for emerging-market assets. Negative real interest rates in developed markets, an abundance of liquidity and a more multilateral approach to international relations in the Biden administration also make for a friendlier environment for risky assets.

It is worth acknowledging that emerging-market currency weakness in 2013 was mostly confined to the currencies of Brazil, Turkey, South Africa, India and Indonesia. The "Fragile Five" were the countries that were most reliant on foreign-capital inflows because they were running large current-account deficits and had limited reserves to defend their currencies. Today, these countries and other emerging markets are in much stronger shape, with better external balances, larger foreign-exchange reserves and more credible central banks (Exhibit 6). The large outflows from emerging markets last year, in the wake of the pandemic, have not yet fully returned and we think there's room for further appreciation as positions are rebuilt (Exhibit 7).

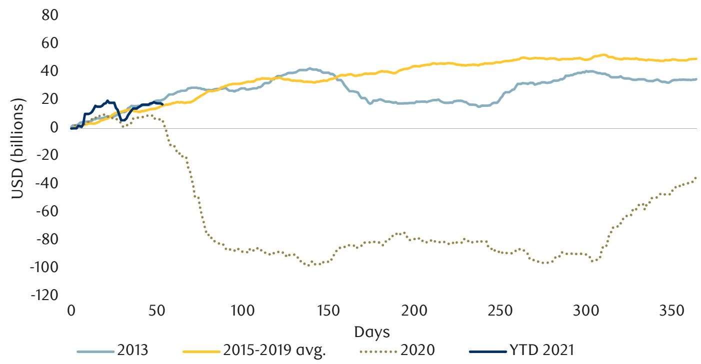
While optimistic about emerging-market currencies as a whole, we expect the performance among individual countries to vary more than last year. Among the more important factors driving relative performance this year will be differences in fiscal health. Some governments responded to lockdowns with large debt-financed spending programs that will weigh on future growth through the increased burden of interest payments. Brazil, South Africa and Argentina stand out in this regard, not only because they ramped up spending aggressively (Exhibit 8) but also because the aid came mostly in the form of cash handouts, which are politically difficult to unwind. A study by the International Institute of Finance found that countries rarely return to pre-crisis fiscal balances after large increases in government spending. The most vulnerable countries with large debt loads and a poor history of fiscal discipline will likely see their currencies underperform relative to countries like India and Mexico,

Exhibit 6: Emerging-market fundamentals are stronger than 2013

	2013	2020
Current account (% GDP)	-5%	1%
Over / (under valuation)	8%	-18%
Foreign debt (% of total debt)	33%	28%
Reserves (% GDP)	12%	17%

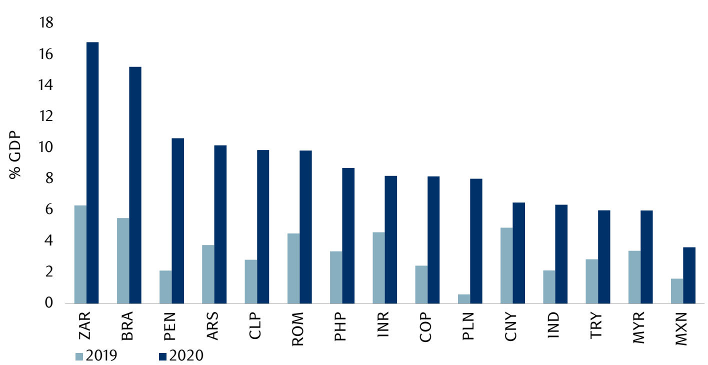
Note: As at Dec 31, 2020. Data is an average of Brazil, India, Indonesia, South Africa and Turkey. Source: Macrobond, Bloomberg, IMF, RBC GAM

Exhibit 7: Estimated capital flows into emerging-market assets



Note: As at Feb. 22, 2021. Source: IIF, RBC GAM

Exhibit 8: Emerging market fiscal spending



Note: As at Dec. 31, 2020. Source: IIF, RBC GAM which spent more responsibly last year. Another cause for differences in performance will come from regional strengths. Asia is benefiting from booming sales of technology and consumer products as well as links to stronger Chinese economic activity. Emerging markets that rely on commodity exports will get a boost from the increase in prices of metals, energy and agricultural products.

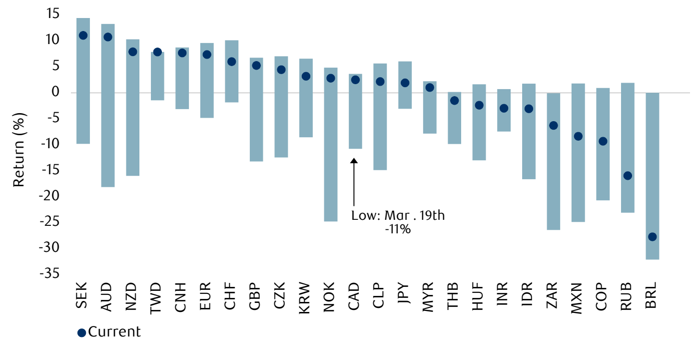
Canadian dollar

We are positive on the prospects for the Canadian dollar. The recovering global economy, exceptional policy support and rising commodity prices represent a powerful combination of tailwinds for the loonie. While the Canadian currency has more than regained its pandemic-related losses, it has notably underperformed other commodity currencies such as the Australian dollar (Exhibit 9). Part of the reason may be that energy prices have been slower to return to pre-pandemic levels than industrial metals and agricultural commodities. In any case, we expect the loonie to catch up to other economically sensitive currencies with the help of large fiscal-stimulus programs in both Canada and the U.S.

Also supporting the Canadian dollar will likely be President Biden's overall policy approach. Plans to tighten business regulations could bolster the loonie by slowing the erosion in Canadian competitiveness that occurred during the business-friendly Trump presidency. Moreover, Canada's trade balance has been improving in recent quarters – reflecting an undervalued currency – and foreign buyers of Canadian assets have helped bring the basic balance of payments into surplus (Exhibit 10).

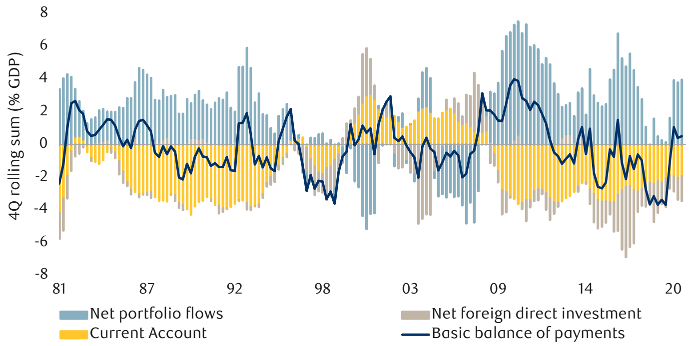
Canada also enjoys higher immigration levels than many of its peer countries. While the closing of borders slowed growth in the Canadian workforce in 2020, the government has unveiled higher annual immigration quotas for the next three years (Exhibit 11), steps that should improve medium-term economic growth and offset some of Canada's lagging productivity. According to Canadian government statistics, immigrants tend to be more educated than the local population and their integration raises the overall rate of participation in the workforce. The list of Canadian-dollar positives includes a growing stock of foreign assets relative to liabilities (lower net debt), relatively light investor positioning and lower asset valuations than in the U.S. A weak greenback is also a critical component of our more optimistic Canadian-dollar outlook.

Exhibit 9: Range of returns since the beginning of 2020



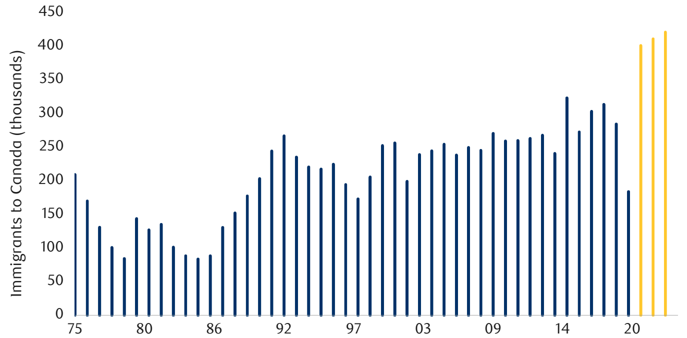
Note: As at Mar. 1, 2021. Blue bars represent each currencies range of cumulative returns since Jan.1, 2020. Source: Bloomberg, RBC GAM

Exhibit 10: Canadian basic balance of payments



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

Exhibit 11: Canadian immigration set to rise



Note: Bars shaded in yellow are government estimates. 2020 data is our immigration estimate. As at: Oct. 30, 2020. Source: Statistics Canada, Government of Canada, RBC GAM

Not all is positive for the Canadian dollar. The government's relatively slow progress in vaccinating Canadians likely translates into a delayed economic re-opening, and the extent to which Canada is lagging its peers and trade partners is becoming a hotter topic in the press and a bigger concern for small businesses. The cancellation of the Keystone pipeline is another negative, underscoring the challenges ahead for provinces that rely on heavy crude and other commodities in an increasingly "green" investment landscape. Finally, Canada's long-term problem of business underinvestment is evident in statistics that show companies are boosting capital investments abroad at the expense of domestic investment. The long-running issues causing this widening gap are unlikely to change quickly.

On balance, we think the Canadian dollar is attractive. For the 12 months ahead, we are placing more weight on a global economic recovery, the rebound in commodity prices and our expectation that the U.S. dollar will weaken broadly. Given this backdrop and the fact that the loonie is among the most undervalued of G10 currencies based on purchasing power parity, we expect that it will appreciate to $1.18 per U.S. dollar over the next 12 months.

Euro

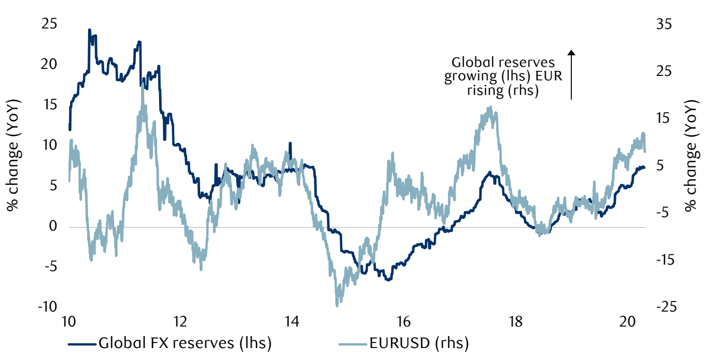
The euro is the primary vehicle that investors use to avoid holding U.S. dollars, and its behaviour has increasingly been a function of the greenback's movements rather than any glowing economic fundamentals in Europe. Historically speaking, this is not unusual, because the euro offers the most liquid alternative as the second-most traded currency in the world. As sentiment on the U.S. dollar soured last year, the euro rose above 1.23 – a 16% rally from 2020 lows.

In this light, the behaviour of global foreign-exchange reserve managers creates a momentum loop that supports the euro (Exhibit 12). As the U.S. dollar declines, reserve managers have been buying foreign currencies to slow the appreciation of their own exchange rates. Since most of this intervention occurs in the form of U.S.-dollar purchases, reserve portfolios quickly accumulate too many greenbacks. Managers of these funds then have little choice but to convert U.S. dollars into euros, yen and renminbi. Such flows further depress the value of the dollar and offer a boost to the single currency.

Another factor favouring the euro is the persistence of relatively low inflation in Europe (Exhibit 13) given more than a decade of slower economic growth in the eurozone than in the U.S. Higher inflation in the U.S. means that the purchasing power of the U.S. dollar is eroding faster than the euro's. This process should be accelerated by the Fed's Average Inflation Targeting policy, which promises to keep stimulative policy intact even if inflation rises above the central bank's 2% target.

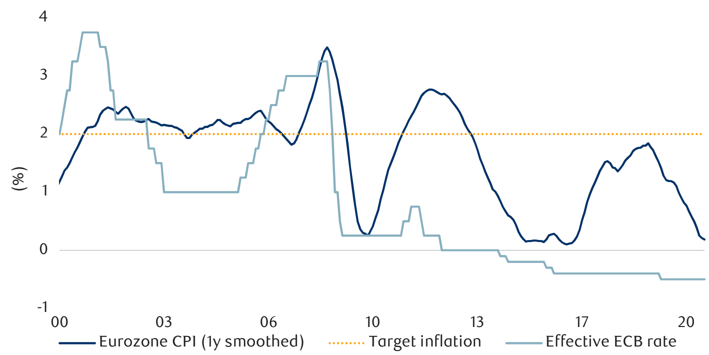
The ECB's greater aversion to above-target inflation suggests to us that inflation in Europe will continue to undershoot the U.S. We very much doubt that the ECB would ever follow the Fed down the path of average inflation targeting.

Exhibit 12: FX reserve growth is positve for the euro



Note: As at Feb. 26, 2021. Source: Bloomberg, RBC GAM

Exhibit 13: Eurozone suffers from chronically low inflation-



Note: As at Feb. 26, 2021. Source: Bloomberg, ECB, RBC GAM

Other long-term factors also compare favourably with the U.S., including cheaper valuations and a stronger current-account balance (Exhibit 14). We expect the euro to appreciate to US$1.30 over the next 12 months.

British pound

The pound has enjoyed a nice rally in recent months, due in part to a broadly weaker U.S. dollar. However, sterling has also appreciated against the euro, by approximately 4%, since the year began and is the top-performing major currency so far in 2021. The following developments are supporting the pound:

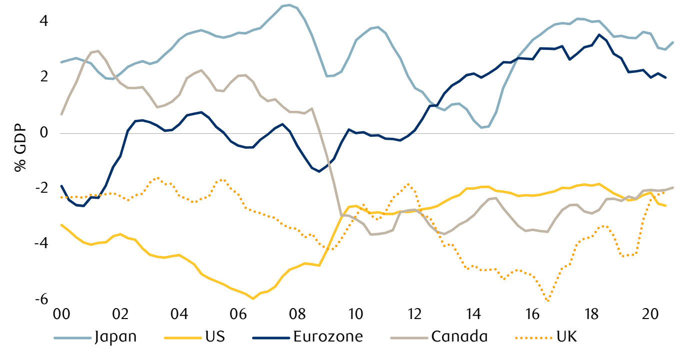
1. Uncertainty associated with Brexit has largely disappeared now that the half-decade saga is settled.
2. Vaccinations have been among the fastest in the world (Exhibit 15), raising hope of a quicker economic recovery in the U.K.
3. Britain's service-oriented economy would benefit more than many of its peers from a return to "normal."

The pound, currently trading near three-year highs, more than reflects the optimism engendered by these improvements. Questions remain about the efficacy of vaccines for faster-spreading variants, the Bank of England continues to threaten to impose negative interest rates and another Scottish election is just around the corner. From a longer-term perspective, we agree in general with arguments that a weaker currency will be needed to help engineer a post-Brexit shift in the economy toward goods from services. The financial-services industry is poised to shrink and the two-decade rise in services exports has likely come to an end (Exhibit 16). The U.K.'s exports outside Europe have risen somewhat, but they are offset by weakness in exports to Europe. So, the fact that the pound is cheap relative to the U.S. dollar is not that helpful – it needs to weaken relative to the currency of its biggest trading partner – the EU. Therefore, while we think the pound could hold its ground against a falling U.S. dollar, sterling will likely underperform other major currencies such as the euro, Canadian dollar and Japanese yen. We expect the pound to trade at US$1.36 in a year's time.

Japanese yen

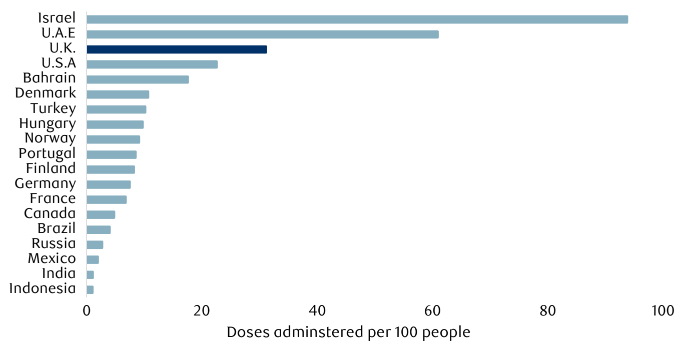
Until very recently, the yen had been rising along with other major currencies against the U.S. dollar. The yen has pulled back, however, as the recent rise in U.S. bond yields made Treasuries more attractive to Japanese investors, with their huge pool of savings and dearth of attractive domestic investment prospects. Our fixed-income colleagues believe it's unlikely that U.S. yields will rise much more in the short term, so we aren't expecting further yen weakness even if this link between U.S. interest rates and the yen persists.

Exhibit 14: Persistent eurozone current-account surplus



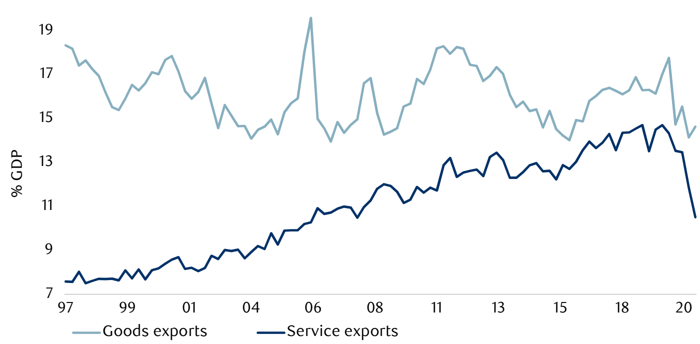
Note: As at Oct. 31, 2020. Source: Bloomberg, RBC GAM

Exhibit 15: U.K. vaccination rate among the best in the world



Note: As at Feb. 28, 2021. Source: Our world in data, RBC GAM

Exhibit 16: U.K. export breakdown



Note: As at Dec. 31, 2020. Source: U.K. Office of National Statistics, RBC GAM

Speculation in Japan continues to swirl around whether the new prime minister, Yoshihide Suga, will continue his predecessor's stimulative and reform-oriented policies (so far he has) and whether falling currency-hedging costs will prompt large investors to increasingly protect their portfolios against currency movements (yen-positive). There is also speculation that the BOJ could allow interest rates to float higher, a move that could boost the yen as it would encourage repatriation of money invested abroad. For now, the yen should receive support from the currency's undervaluation, a strong equity market and a large current-account surplus. We think the gradual pace of yen gains can continue in the year ahead. Our 12-month forecast is for the yen to strengthen to 99 per dollar.

Conclusion

The U.S.-dollar bear market is still in its early stages and longer-term factors point to further declines. The recent rise in U.S. bond yields has given the greenback a short-term boost, offering investors a more attractive opportunity to sell the dollar. An environment of stronger global economic growth and higher commodity prices is supportive for cyclical currencies. We expect emerging-market currencies to outperform their developed-market peers and think that the Canadian dollar can outperform among its G10 counterparts.

Disclosure

This document is provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM or its affiliated entities listed herein. This document does not constitute an offer or a solicitation to buy or to sell any security, product or service in any jurisdiction; nor is it intended to provide investment, financial, legal, accounting, tax, or other advice and such information should not be relied or acted upon for providing such advice. This document is not available for distribution to investors in jurisdictions where such distribution would be prohibited.

RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC Global Asset Management Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited, RBC Global Asset Management (Asia) Limited, and BlueBay Asset Management LLP, which are separate, but affiliated subsidiaries of RBC.

In Canada, this document is provided by RBC Global Asset Management Inc. (including PH&N Institutional) which is regulated by each provincial and territorial securities commission with which it is registered. In the United States, this document is provided by RBC Global Asset Management (U.S.) Inc., a federally registered investment adviser. In Europe this document is provided by RBC Global Asset Management (UK) Limited, which is authorised and regulated by the UK Financial Conduct Authority. In Asia, this document is provided by RBC Global Asset Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong.

Additional information about RBC GAM may be found at www.rbcgam.com.

This document has not been reviewed by, and is not registered with any securities or other regulatory authority, and may, where appropriate and permissible, be distributed by the above-listed entities in their respective jurisdictions.

Any investment and economic outlook information contained in this document has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

Opinions contained herein reflect the judgment and thought leadership of RBC GAM and are subject to change at any time. Such opinions are for informational purposes only and are not intended to be investment or financial advice and should not be relied or acted upon for providing such advice. RBC GAM does not undertake any obligation or responsibility to update such opinions.

RBC GAM reserves the right at any time and without notice to change, amend or cease publication of this information.

Past performance is not indicative of future results. With all investments there is a risk of loss of all or a portion of the amount invested. Where return estimates are shown, these are provided for illustrative purposes only and should not be construed as a prediction of returns; actual returns may be higher or lower than those shown and may vary substantially, especially over shorter time periods. It is not possible to invest directly in an index.

Some of the statements contained in this document may be considered forward-looking statements which provide current expectations or forecasts of future results or events. Forward-looking statements are not guarantees of future performance or events and involve risks and uncertainties. Do not place undue reliance on these statements because actual results or events may differ materially from those described in such forward-looking statements as a result of various factors. Before making any investment decisions, we encourage you to consider all relevant factors carefully.

Publication date: March 15, 2021

103073 (03/2021)
GLOBAL CURRENCY OUTLOOK_SPRING 2021_E 03/19/2021