Global Currency Outlook
A little too quiet?

The foreign-exchange world has been quiet. So quiet, in fact, that the lull has unsettled traders accustomed to stomach-churning swings in currency markets. Those traders are now disoriented by motionless markets as currency volatility tumbles to near multi-decade lows (Exhibit 1). Currencies are normally volatile because they are buffeted by a multitude of factors and because they are able to adjust more quickly than other financial instruments when economic and political surprises occur. While stock exchanges open and close in line with a typical work day, foreign-exchange traders never sleep: it’s a 24-hour over-the-counter market. In the course of a trading day, exchange rates are pushed and pulled as they absorb successive waves of capital flowing between countries. The fact that exchange rates are not fluctuating as wildly right now may be reflective of smaller capital flows in line with diminished global trade volumes. Low volatility may also be the product of central-bank interference – their tendency to pre-empt any sign of trouble with promises to combat tighter financial conditions. However, there’s only so much that monetary policy can do. We must also consider that presidential tweets and on-again-off-again Brexit headlines may have tempered risk appetites among currency traders. Whatever the true combination of reasons underlying the low volatility in foreign-exchange markets, experience tells us that it’s not a permanent state. Volatility cannot

The U.S. dollar has moved steadily higher against a backdrop of low currency volatility. Stronger U.S. economic growth and a yield advantage have also supported the greenback. However, these cyclical factors may be fading, making structural negatives such as fiscal and current-account deficits much more relevant for investors. We have talked about an extended U.S.-dollar topping process in the past and that view still prevails in our strategy. While the tailwinds could persist, the outlook and active management of currencies within our portfolios increasingly incorporates an expectation that further gains in the U.S. dollar will be limited. As a result, our forecasts imply a better outlook for the euro and the yen. The Canadian dollar and the British pound will likely underperform in this environment, although it will be tough for these currencies to post meaningful declines if the U.S. dollar weakens.

The foreign-exchange world has been quiet. So quiet, in fact, that the lull has unsettled traders accustomed to stomach-churning swings in currency markets. Those traders are now disoriented by motionless markets as currency volatility tumbles to near multi-decade lows (Exhibit 1). Currencies are normally volatile because they are buffeted by a multitude of factors and because they are able to adjust more quickly than other financial instruments when economic and political surprises occur. While stock exchanges open and close in line with a typical work day, foreign-exchange traders never sleep: it’s a 24-hour over-the-counter market. In the course of a trading day, exchange rates are pushed and pulled as they absorb successive waves of capital flowing between countries. The fact that exchange rates are not fluctuating as wildly right now may be reflective of smaller capital flows in line with diminished global trade volumes. Low volatility may also be the product of central-bank interference – their tendency to pre-empt any sign of trouble with promises to combat tighter financial conditions. However, there’s only so much that monetary policy can do. We must also consider that presidential tweets and on-again-off-again Brexit headlines may have tempered risk appetites among currency traders. Whatever the true combination of reasons underlying the low volatility in foreign-exchange markets, experience tells us that it’s not a permanent state. Volatility cannot
stay muted forever, and the over-parenting of markets by monetary policymakers will only amplify the inevitable turbulence when it arrives.

In the meantime, quiet markets have been friendly to the higher-yielding U.S. dollar. The greenback has been grinding steadily higher and is now the top performer among developed-market currencies this year through the end of May (Exhibit 2). In addition, the U.S. dollar has been helped by developments abroad, where central banks have kept yields low and economies have been dented by global trade wars.

We noted in prior editions of the Global Investment Outlook that the U.S. dollar’s eight-year uptrend is looking mature (Exhibit 3), but that in the absence of extreme overvaluation the greenback may take more time to complete its extended topping process. Cyclical positives such as stronger economic growth and a widening yield advantage pushed aside structural negatives like fiscal and current-account deficits. With these cyclical factors fading now, the structural negatives may garner more attention. Also noteworthy is a renewed preference among global reserve managers, who direct US$11 trillion in assets, to diversify away from the U.S. dollar into euros, Japanese yen and the Chinese renminbi (Exhibit 4). Rather than try to pinpoint the exact timing of the U.S.-dollar inflection, we highlight the metrics that we are watching and share insights on how these underlying developments are prolonging the topping process.

Investors can earn an extra 3 percent by using hedging contracts that swap euros for dollars, an attractive proposition for U.S. holders of European bonds. Such carry strategies are popular, not only for bondholders but also for currency-focused investors who remain overweight the U.S. dollar against virtually all lower-yielding developed-market currencies (Exhibit 5). The risk to this strategy is that the U.S. interest-rate advantage begins to narrow.

For Asian and European investors, on the other hand, to invest in higher-yielding U.S. bonds means taking currency

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**Exhibit 1: Volatility implied by 3-month options contracts**

![Graph showing volatility implied by 3-month options contracts](image)

Source: Bloomberg, UBS, RBC GAM

**Exhibit 2: G10 total returns**

![Graph showing G10 total returns](image)

Note: Returns as of May 31, 2019. Source: J.P. Morgan, RBC GAM

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

![Graph showing long-term cycles of the U.S. dollar](image)

Source: RBC GAM

**Exhibit 4: 1-year change in FX reserve composition**

![Graph showing 1-year change in FX reserve composition](image)

Source: IMF COFER, RBC GAM
risk because the cost of hedging would wipe out the extra yield. These unhedged carry trades would suffer losses if currency volatility returned. Even a relatively modest decline in the U.S. dollar could trigger outflows as it would quickly outweigh the interest-rate advantage. Such a move would likely widen euro ranges, which have been at their tightest in several decades (Exhibit 6). We’re keeping an eye on volatility measures as a precursor to position unwinds and quick, short-term selloffs in the U.S. dollar.

For several years, negative yields and quantitative easing by the European Central Bank (ECB) have driven Europeans to invest abroad. Over the past decade, they have accumulated some 2 trillion euros in foreign bonds and equities (Exhibit 7), almost half of which is invested in the U.S. As we discussed above, most of these investments are not currency-hedged and therefore vulnerable to a turn in the U.S. dollar. What else could put the tide of capital flows in reverse? A sustained demand for European stocks and bonds would require higher returns on assets in the eurozone fueled by better economic prospects. Instead, the greenback has benefited since the eurozone crisis from a U.S. expansion whose momentum has outstripped other economies (Exhibit 8). Europe’s underperformance has been amplified by its higher sensitivity to global trade tensions, and in particular to Chinese demand. This was demonstrated most strikingly by recent weak German trade data.

ECB President Mario Draghi has conceded that Europe is going through a soft patch but counters that, aside from trade, domestic economic activity in the eurozone has actually been fairly resilient. Lending support to his argument are Citibank’s “hard” data-change indexes which are based on industrial activity and production volumes. These indicators show much more robust activity than do the “soft” economic indicators, which gauge business and consumer confidence and which can be negatively affected by trade headlines or geopolitical uncertainty (Exhibit 9). Given higher projected fiscal spending, a cheap euro and
low interest rates, we have reason to doubt claims that Europe is doomed to sluggish growth. In an environment of depressed expectations, a positive surprise from Europe would not be a difficult hurdle to meet and could certainly boost investment inflows and drive the euro higher.

Our outlook and active management of currencies within our portfolios increasingly incorporates an expectation that the U.S. dollar has already peaked or that further gains will be limited. Many of the factors supporting the greenback are losing their effectiveness in propelling further strength at the same time as new U.S.-dollar negatives emerge. As a result, our forecasts imply a brighter picture for the euro and yen. The Canadian dollar and British pound will likely underperform in this environment, although it will be tough for these currencies to post meaningful declines if the U.S. dollar weakens.

**Euro**

In addition to the growth dynamics mentioned above, the euro is being depressed by a series of never ending political dramas, including Brexit negotiations to the north and an Italian fiscal standoff to the south. Across the Atlantic, a trade spat between Europe and the U.S. looms, though auto tariffs have been sidelined until mid-December. While these three issues are well known, the more pressing concern for investors may be the turnover of power within Europe as German Chancellor Merkel weighs stepping down and as key leadership posts come up for renewal in the European Parliament, the European Commission and ECB. With the currency market betting so heavily against the single currency, we wonder whether these political concerns are overdone. Finally, we observe Europe's sensitivity to Chinese economic data and domestic consumption, in particular. Germany's exports to China have doubled over the past decade, so the 2018 slowdown reverberated in Europe for sure. But as China implemented a number of measures to stimulate domestic consumption, further weakness from that source is unlikely. While the spot exchange rate has been depressed by the confluence of these negatives, options markets seem to be looking beyond the fog (Exhibit 10) with the difference in cost of calls versus puts no longer showing as much pessimism.

**Japan**

We are less sanguine about Japan's economic outlook than we are about Europe's. The Bank of Japan (BOJ) has cut its growth and inflation forecasts again, making clear that it will maintain loose monetary policy indefinitely. As a consequence, the Japanese currency is unlikely to stand out on central-bank policy. What makes the yen attractive to us is a large current-account surplus that provides consistent support for the currency. The yen is also among the most undervalued currencies in the G10 based on the BOJ's own metric (Exhibit 11) and its safe-haven qualities make it a good place to hide during times when risk sentiment sours, as it did in late May. Slowing global growth and a pick-up in volatility could trigger renewed appreciation of the yen.

**British pound**

U.K. businesses have held back making new investments as they await resolution of the three-year-old Brexit drama. There will no doubt be a wave of hiring and capital expenditures once an agreement is struck with the EU, prompting at least one 25-basis-point interest-rate hike from the Bank of England. Beyond the short-term boost of a Brexit resolution, the longer-term consequences of the previous uncertainty will continue to weigh on growth as

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**Exhibit 9: Eurozone hard- and soft-data changes**

Source: Citigroup, RBC GAM

**Exhibit 10: Option skew vs. EUR-USD**

Source: Bloomberg, RBC GAM
consumers have depleted savings and policymakers have neglected other important national issues. In the meantime, U.K. inventories have been increased ahead of the Brexit deadline, a development that borrowed economic growth from subsequent quarters. This would make for a dour outlook on the pound if not for our expectation that the U.S. dollar will give up some ground later in the year. Our forecast of 1.27 is still lower than the consensus and implies a currency roughly unchanged over the next 12 months.

Canada
We have long been bearish on the Canadian dollar and still believe it will weaken over the course of the year. However, our stance has softened considerably as economic green shoots emerge and as the market acknowledges the structural negatives we had been touting. Among our concerns has been Canada’s lagging competitiveness, with lower R&D spending and fewer patents per capita than other developed nations. That said, the country’s well-established liberal democracy and welcoming attitude toward immigrants has put Canada in position to be the first choice for those with the skills to push forward in areas like artificial intelligence. We refer to this as Canada’s immigration dividend. While a growing technology focus in some of the country’s biggest cities is a positive sign, Canada continues to lose successful start-ups to the U.S. This is evident in outbound foreign direct investment flows, where start-ups and other established Canadian businesses have been finding better opportunities abroad (Exhibit 12). For the immigration dividend to pay off, more-business-friendly government policies may be required.

A shorter-term concern is the impact on consumers of interest-rate hikes over the past year and measures aimed at reining in housing excesses. Even with relatively low interest rates, household debt-servicing costs are nearing their highest levels in two decades (Exhibit 13). Acknowledging that consumers won’t be able to sustain economic growth by themselves, the Bank of Canada (BOC) had been forecasting a pickup in two other areas of the economy: business investment and exports. With little improvement in either category thus far, the central bank has cut its 2019 growth forecast to 1.2 percent from 1.7 percent and abandoned its preference for higher interest rates. That removed a layer of support from under the loonie. These forecast changes and the BOC’s pivot toward a less optimistic stance now looks to be untimely, given it has been followed by the recent removal of steel and aluminum tariffs by the U.S. and reports that the three parties to the U.S.-Canada-Mexico trade deal are nearing ratification of the agreement.
Market participants have also lowered their expectations for both the Canadian economy and currency in acknowledgement of the country’s long-standing economic challenges. Exhibit 14 shows an increase in the number of forecasters calling for a stronger U.S. dollar over the past year. The Canadian dollar may be undervalued at a current exchange rate of C$1.35 per U.S. dollar based on short-term drivers such as interest rates, oil prices and equity markets, giving us greater confidence that the prevailing Canadian-dollar negatives are largely priced in. We keep our C$1.37 forecast unchanged with an expectation that the loonie will remain mostly within a C$1.30-C$1.40 range over the next 12 months.

### Exhibit 14: Number of investment-bank forecasts by USD-CAD bracket

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<th>USD-CAD brackets</th>
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<tr>
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<td>May 2018</td>
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<tr>
<td></td>
<td>Aug. 2018</td>
</tr>
<tr>
<td></td>
<td>Nov. 2019</td>
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<td></td>
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Source: Bloomberg, RBC GAM
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