RBC Global Asset Management

Global Currency Outlook

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Pandemic drives last hurrah for the U.S. dollar

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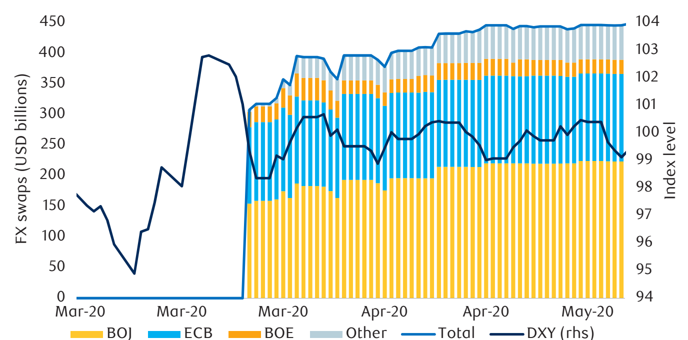
Currencies were not immune to the frantic moves experienced in other areas of the financial markets at the height of coronavirus fears in March and April. Although fluctuations subsided in May, leaving most G-10 currencies confined to relatively tight ranges, not all currencies had that respite. Emerging-market currencies, which trade by a different playbook, haven't performed as well because virus concerns still weigh more on emerging economies. It looks like the pandemic provided one last hurrah for the U.S. dollar bull market, which has been gradually running out of steam.

Many economists refer to the U.S. dollar as a "safe haven." A more correct moniker would probably be a "liquidity haven" because it is the currency in which most of the world's trade finance and global investment occurs. Given that role, the greenback experiences phases of acute demand in times of financial stress. This was clearly the case in 2008, when the dollar's strength persisted until central bankers were finally able to satisfy the world's appetite for liquidity. The first half of 2020 has offered quite a different experience. Central banks including the U.S. Federal Reserve (Fed), European Central Bank (ECB) and Bank of Canada (BOC) were far quicker in providing liquidity, acting to short-circuit the hoarding of U.S. dollars and preventing the associated increase in the cost of borrowing. Exhibit 1 shows the stabilization of the greenback alongside increased usage of

Exhibit 1: Central-bank swap lines stem acute dollar demand



Note: As at Mar. 5, 2020. Source: Federal Reserve, Bloomberg, RBC GAM

central-bank swap lines set up to lend U.S. dollars in foreign markets. With these measures in place, the dollar has risen only 4% against a basket of the world's currencies since the beginning of the year – a tiny amount in the context of recent wild fluctuations in the financial markets. However, it was likely not just the extraordinary provision of liquidity that prevented a meaningful U.S. dollar rally. The currency's overvaluation is also playing a role, as are a number of other long-term factors that likely will continue to pull the greenback lower in the years to come.

Overvaluation

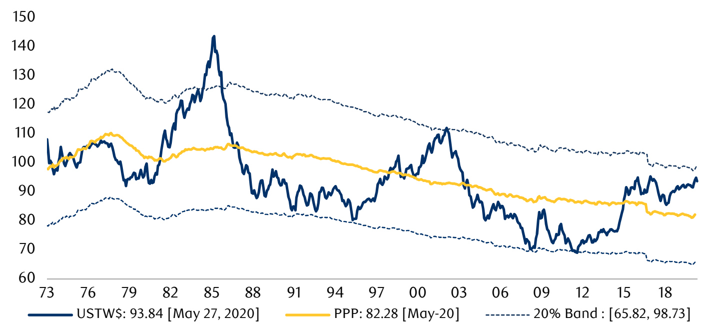
Timing is everything, and a comparison of the performance of the dollar in 2020 with 2008 shows why. At the beginning of the 2008-2009 financial crisis, the dollar was in its sixth year of a bear market and getting quite cheap relative to the currencies of its G-10 counterparts. In mid-March of this year, the trade-weighted U.S. dollar was nine years away from its 2011 bottom, and was nearing overvaluation extremes, according to our purchasing-power-parity model (Exhibit 2). In fact, the dollar was actually trading outside the 20% valuation bands against several G-10 currencies. Research shows that currency valuation is important in shaping the economic behaviour of households and businesses, causing exchange rates to spend very little time beyond these "lines in the sand" before reversing course. We know that the currency market is in the very late stages of a dollar bull market (Exhibit 3), so the recent shift into overvaluation ticks yet another box for U.S. dollar bears.

Fiscal and monetary excess

This year's unprecedented global fiscal and monetary expansions should raise red flags for holders of fiat currency, which is likely one reason why gold prices are nearing all-time highs. The U.S. is leading the charge in this fiscal and monetary movement, with the Fed balance sheet expanding and budget deficits ballooning faster than elsewhere (exhibits 4 and 5). In the short term, these efforts will help stem the economic hit from the pandemic, but longer-term consequences will almost certainly follow because these types of policies are politically difficult to reverse. Questions about debt sustainability and the capacity to address future crises will be front of mind again. While not an immediate concern, such stimulative policies raise the prospect of higher inflation expectations down the road, and prompt some questions: Could this begin to affect

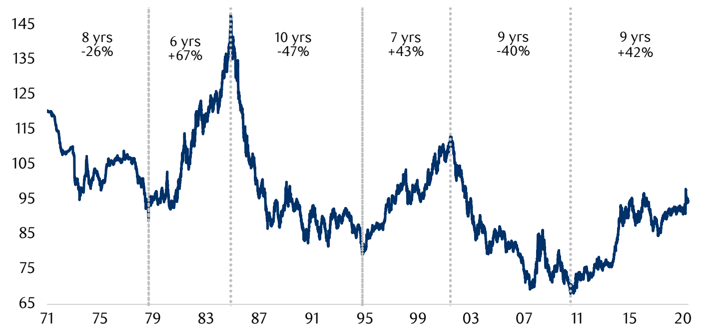
Exhibit 2: USD is expensive

PPP Valuation



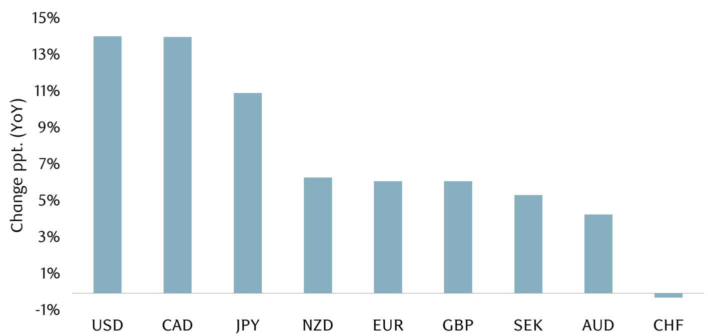
Note: As at May 27, 2020. Source: Bloomberg, RBC GAM

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



Note: As at May 22, 2020. Source: Bloomberg, RBC GAM

Exhibit 4: Change in central-bank balance sheets



Note: As at May 22, 2020. Source: Citigroup, RBC GAM

the world's appetite for U.S. assets? Is peak globalization behind us? Are these risks properly reflected in a currency that's trading near a 20% premium to its fair value?

Slow decline in U.S.-dollar hegemony

In the short term, U.S.-dollar strength, central-bank currency intervention and reserve rebalancing form a powerful feedback loop, leading emerging-market central banks to sell euros to rebalance their portfolios after spending U.S. dollars to defend their currencies in March and April. In the longer term, we have seen evidence that the dollar is losing some of its appeal for central banks, with the share of U.S. dollars held in the reserve portfolios of these large and long-term holders dropping to 61% from 66% over four years (Exhibit 6).

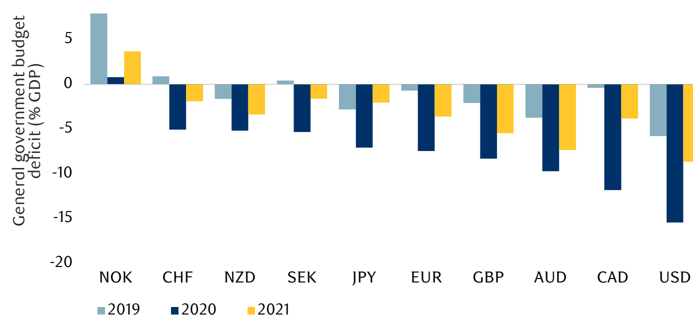
Part of the "*exorbitant privilege*" [1] enjoyed by the U.S. dollar derives from America's acceptance since the Second World War of a responsibility to ensure global order. Yet there are growing divides between the U.S. and allies such as Japan, South Korea and Saudi Arabia. The U.S., under President Trump, has threatened to withdraw support for global institutions such as the World Trade Organization, the North Atlantic Treaty Organization and the World Health Organization. The fact that the U.S. has weaponized its currency by restricting Iranian and Venezuelan access to the dollar-based payments system is a dangerous precedent that has China accelerating efforts to boost circulation of the renminbi in an effort to spread its financial influence around the globe. The renminbi likely won't replace the U.S. dollar anytime soon as the world's primary currency, but the multi-decade shift away from the U.S. is underway and represents a meaningful and persistent U.S.-dollar headwind in the decade ahead.

A less supportive environment

Aside from rich valuations and unbridled balance-sheet expansion, there are several shorter-term factors that offer further reason for investors to move assets into other currencies. Whenever life returns to normal, the dollar will still be burdened by election uncertainty, and there is little doubt that we will again be reminded of the White House's preference for a weaker currency. Importantly, the pandemic has eroded the few areas of support that the greenback previously enjoyed. For one thing, the greenback's yield advantage has vanished (Exhibit 7). Falling relative U.S.

[1] A term coined by then-French Finance Minister Valéry Giscard d'Estaing in the 1960s with reference to the substantial benefit garnered by the U.S. through its ability to print the world's primary reserve currency.

Exhibit 5: Government budget deficits



Note: As at May 20, 2020. Source: Citigroup, IMF, RBC GAM

Exhibit 6: U.S. dollar share in global FX reserves

Note: As at Oct. 31, 2019. Source: Bloomberg, IMF, RBC GAM

Exhibit 7: U.S. 2-year interest-rate advantage

Note: As at May 22, 2020. Source: Bloomberg, RBC GAM

yields matter for how the greenback trades against the euro and yen, not only because they are the greenback's largest and most liquid rivals, but also because Japan and Europe have large U.S investments. Holders of these assets are likely to sell U.S. dollars in order to increase hedges as declining U.S. interest rates cheapen the cost of doing so.

Finally, in an ironic twist, the U.S. achieved energy independence in recent years just as the world started to view oil resources as more liability than asset. In addition to this long-term consideration, the short-term impact on oil prices of slower global economic growth will undermine the case for U.S. shale production - an additional headwind for the dollar.

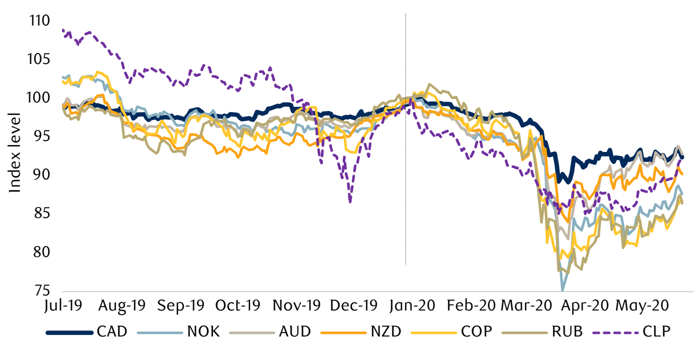
Canadian dollar

The Canadian dollar has been more resilient than other commodity currencies since the onset of the pandemic (Exhibit 8). This is partly because resource extraction forms a larger share of GDP in those other economies, and also because many are emerging-market currencies weighed down by other concerns such as capital outflows, unstable politics and scant central-bank credibility. However, there has been a notable shift in sentiment against the loonie, with most investors now acknowledging the difficult road that lies ahead for the Canadian currency. Foreign-exchange positions had swung sharply bearish amid concern that a poorly positioned oil sector, stretched consumers and a heavy reliance on foreign investors to fund budget and current-account deficits would pull the currency lower. While these positions appear to have thinned in late May, we think there is scope for the loonie to weaken again. Our base case forecast calls for 1.40 in a year's time, the level which corresponds with the loonie likely being unable to benefit from U.S.-dollar weakness, held back by a range of domestic problems.

For 10 years, Canada has run a persistent current-account deficit, a shortfall that has been funded mostly by foreign buying of Canadian bonds (Exhibit 9). The fact that Canada is also adding more to its direct investment abroad than it is attracting magnifies the country's funding burden. Inbound portfolio investment in 2019 fell 75% from just two years earlier, and occurred precisely at the time when the country's fiscal deficits are set to rise. In this context, it's a good thing that the BOC will be buying government and provincial bonds through its recently announced quantitative easing-programs. Unfortunately, efforts to depress longer-term bond yields will not prove helpful for the loonie as it caps an already dwindling interest-rate advantage. Without relatively high yields, currency weakness will be the avenue for restoring the attractiveness of Canadian assets.

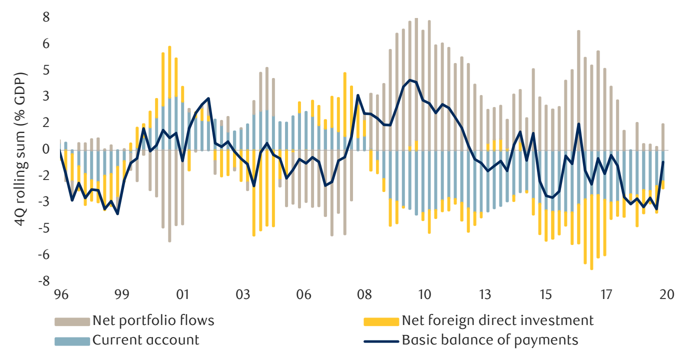
The Canadian dollar should eventually benefit from a U.S. dollar sell-off, but we think it will generally underperform other major currencies given intensifying domestic and external headwinds. The country's high sensitivity to global trade will present challenges in a post-pandemic world, with tighter borders and globalization slowing down or reversing. The oil industry, plagued by transportation constraints and environmental disputes, is being dealt the heavy blow of crude-oil prices that are below the cost of production. Even before the pandemic, small businesses were experiencing an uptick in bankruptcies, and Canada's reliance on small business for 70% of employment therefore bodes ill, as do highly indebted households poorly prepared for the double-hit of job losses and wealth destruction. We expect

Exhibit 8: Commodity currencies



Note: Indexed to 100 on Dec. 31, 2019. As at May 22, 2020. Source: Bloomberg, RBC GAM

Exhibit 9: Canada basic balance of payments



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

Canadian economic data to lag improvements elsewhere and weigh on the loonie in this recovery.

Euro

We continue to like the euro and believe the region's current-account surplus will at some point support the single currency now that the U.S. interest-rate advantage has been dramatically reduced. A large and positive current-account surplus may have been one factor preventing euro weakness during the market's plunge amid tight global liquidity and sovereign-debt concerns. On the latter, we believe that European policymakers will eventually do what is necessary to maintain Eurozone solidarity as they did with Greece, Ireland and Portugal a decade ago. Northern states may grumble, but the costs of breakup are so unbearable that rescue funds and new Eurozone-backed debt dubbed "coronabonds" are less painful routes. The recent proposal from Germany and France on a 500-billion euro European Recovery Fund shows that compromise on this issue may be closer than widely believed.

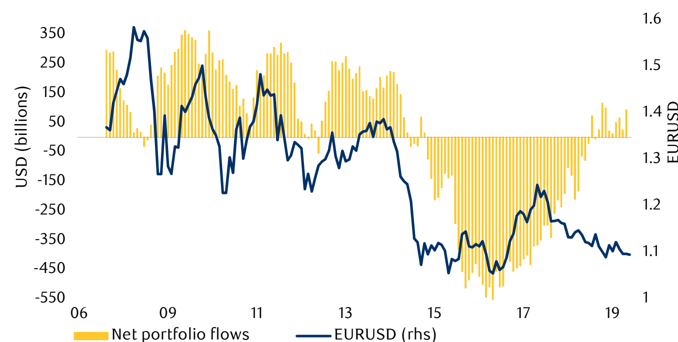
One important question is whether the resumption of the ECB's asset-purchase program encourages investors to increase holdings of foreign assets. This could be negative for the euro, as it was when the ECB initiated quantitative easing in 2015 (Exhibit 10). However, the appeal of foreign investments may be declining as falling interest rates elsewhere have narrowed the yield gap. On both a hedged and unhedged basis, the yield available to European investors buying U.S. Treasuries has collapsed (Exhibit 11). Some argue that the recent rise in volatility actually supports the single currency, as investors are forced to sell emerging-market positions funded with the euro. Others assert that investors will prefer to invest in their home markets after the crisis subsides, indicating that a portion of Europe's large holdings of foreign assets could be repatriated. Adding these factors to a starting point of euro undervaluation makes a case for a gain in the single currency.

Japanese yen

It is puzzling that the yen hasn't risen more in the current risk-off environment. A temporary pause in the currency's safe-haven appeal may have been related to a stronger appetite for foreign assets among Japanese pension funds (Exhibit 12). As in Europe, the behavior of domestic investors is an important determinant of the yen's performance.

The Government Pension Investment Fund (GPIF), Japan's largest pension fund at US$1.5 trillion in assets, recently

Exhibit 10: European portfolio flows and the single currency

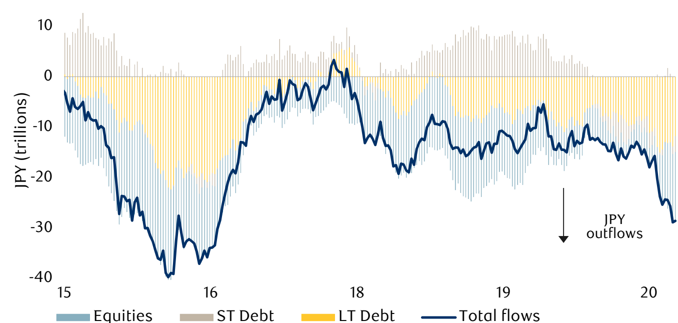


Note: As at Dec. 31, 2019. Source: Bloomberg, ECB, RBC GAM

Exhibit 11: 10-year yield available to European investors

Note: As at May 27, 2020. Source: Bloomberg, Macrobond, RBC GAM

Exhibit 12: Net Japanese portfolio flows



Note: As at Oct. 31, 2019. Bloomberg, RBC GAM

reclassified hedged foreign bonds into a domestic category to increase available capacity for buying unhedged foreign bonds. The move, mirrored by smaller Japanese pension funds, temporarily capped how far the yen could rally. Could the fact that the GPIF is now publicly announcing its bond purchases mean that they have finished the transition into foreign bonds? If so, the yen's long-term fundamentals can again support the currency, which benefits from undervaluation and Japan's healthy current-account surplus. As mentioned earlier, the convergence of interest rates in recent months may encourage other Japanese investors, particularly those that are more sensitive to currency movements, to hedge more of their U.S.-dollar currency exposure.

British pound

Britain's combination of large current-account deficits, overly indebted consumers and lack of domestic corporate investment puts the pound in the same league as the Canadian dollar. In place of lower oil prices, the pound must contend with Brexit, a saga that has fallen out of focus during the pandemic. We note that the end of 2020 still looms as the deadline for when the U.K. and the EU are slated to agree on an exit agreement. The odds that the two sides will be able to hammer out a deal are falling with each passing day.

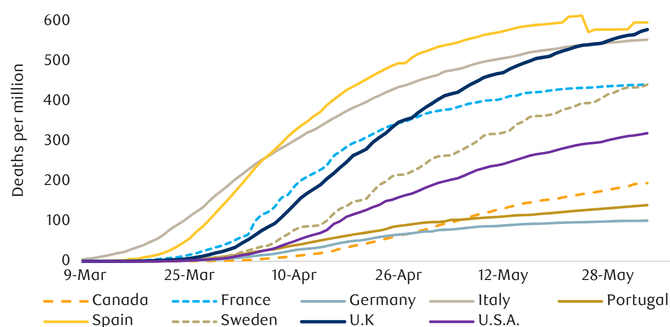
The U.K has been especially hard-hit by the pandemic, with one of the highest per-capita death rates in Europe (Exhibit 13). In the aftermath of the lockdown, U.K. consumers are less likely to spend as they shore up their savings. As a result, the outlook for U.K. economic growth remains relatively dire, even accounting for the sizable government stimulus that is planned.

Mixed outlook for emerging markets

Emerging-market investors have had plenty to worry about since the arrival of the coronavirus: weak global growth, rising U.S.-dollar liabilities, worsening terms of trade, lower worker remittances, the collapse of tourism and a relative dearth of fiscal resources to combat the crisis. Central banks in emerging markets would typically raise interest rates to keep capital onshore, but have instead loosened monetary policy to support domestic demand. While the Fed's efforts to reduce the scarcity of dollars has helped ease financial stress, investors have continued to relentlessly sell emerging-market assets (Exhibit 14).

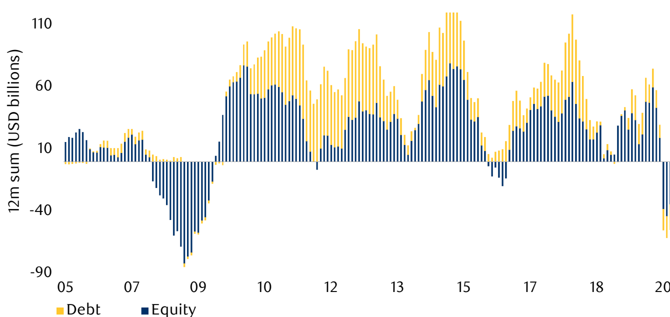
What options remain for these countries to support their markets and economies? Some countries have tried currency intervention, without much success. Others have wandered into quantitative easing (Exhibit 15), but many countries lack the fiscal and monetary credibility to successfully execute these programs. There is a risk that investors see these unconventional policies as a slippery slope of governments being reliant on central banks for funding fiscal deficits and the possibility of runaway inflation leading to currency debasement. Additional measures could include capital controls and appeals for financial help from the IMF, though we think these measures are unlikely for the larger and more stable emerging markets. Emerging-market currencies responded to the crisis as we would expect, weakening 11% collectively in two months, but the declines ranged from 1% for the Philippine peso to 26% for the Mexican peso. Will this weakness be enough to pique investor appetite given the delayed arrival of COVID-19 in many countries? It's too early to tell, so caution is warranted in the near term, even if the dollar weakens versus major developed-market currencies.

Exhibit 13: Trajectory of COVID deaths



Note: As at Jun. 3, 2020. Source: University of Oxford, RBC GAM

Exhibit 14: Capital flows to emerging markets



Note: As at May 21, 2020. Source: IIF, RBC GAM

The impact of the pandemic will vary across emerging-market countries, depending on the capacity of health-care systems, population age and density, access to fresh water and the structure of individual economies including the degree of dependence on tourism. Recoveries will be more difficult for open economies tied closely to global supply chains, and for those with large numbers of informal workers beyond the reach of government assistance. We are more optimistic about countries such as China and South Korea, which have large national savings and are reporting few, if any, new COVID-19 cases. There is also scope to boost allocations to countries such as Russia, Colombia and Mexico, which have exposure to commodities, as they are sufficiently cheap. We remain bearish on India and Brazil, where we expect the pandemic to have the most negative longer-term consequences, as well as Turkey and South Africa, where the benefits of cheaper oil imports are outweighed by a broad range of systemic problems.

Conclusion

The liquidity shortage experienced during the early days of the COVID-19 crisis has led to one final rally in the greenback, ending a nine-year stretch of gains. Subsequent weakness in late May and early June signaled that investors have begun to factor in the U.S. dollar's overvaluation, as well as the country's fiscal and monetary excesses. Shorter-term considerations, such as lower U.S. interest rates and election uncertainty may also be weighing on the currency. The euro and yen are likely to benefit most strongly during this initial phase of the U.S.-dollar decline, while the Canadian dollar and British pound lag. In the months to come, the performance of individual emerging-market currencies will depend largely on the evolution of the pandemic.

Exhibit 15: Quantitative easing in emerging markets

Date announced	Country	Purchases	Stated purpose
15-Mar	Israel	Govt. bonds	Liquidity
17-Mar	Poland	Govt. bonds	Liquidity
18-Mar	India	Govt. bonds	Liquidity
19-Mar	Chile	Corp. bonds	Liquidity
20-Mar	Romania	Govt. bonds	Liquidity
23-Mar	Colombia	Private debt	Monetary easing
25-Mar	South Africa	Govt. bonds	Liquidity
25-Mar	Korea	T-bills, Corp. bonds	Liquidity
31-Mar	Turkey	Govt. bonds	Monetary easing
01-Apr	Indonesia	Govt. bonds	Fiscal stimulus
07-Apr	Hungary	Govt., Corp., Mortg. bonds	Liquidity
07-Apr	Thailand	Govt., Corp. bonds	Liquidity
10-Apr	Philippines	Govt. bonds	Liquidity
21-Apr	Mexico	Govt. bonds	Liquidity

Note: As at April 30, 2020. Source: BIS, Barclays, RBC GAM

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