RBC Global Asset Management

Global Currency Outlook

SUMMER 2021

Cyclical currencies to fare best as U.S. dollar weakens

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.

After a year in which the U.S. dollar lost more than 10% of its value, the No. 1 question facing investors is whether the dollar is on the verge of a rebound that reflects a U.S. recovery, successful vaccination programs and an economic reopening. Our answer remains that the U.S. dollar has further to fall as the greenback's multi-year decline is still in its early stages and longer-term drivers continue to weigh on the currency. We believe that the dollar is in the first half of a broad-based bear market, and we are particularly positive on cyclical currencies that will benefit most from the reopening.

Given the threat of inflation and uncertainty about the timing of the U.S. Federal Reserve's (Fed) withdrawal of exceptionally easy monetary policy, foreign-exchange traders are paying heed to the impact of bond markets on currency movements. Market participants are watching not only nominal interest rates but also real rates and term premiums. As each of these interest-rate components come to the fore at different times, a more nuanced interpretation of the bond-market fluctuations may be required. We note that last year's rise in nominal yields, which was driven mainly by inflation expectations, left the dollar weakened, while the rise of real rates in the first quarter of 2021 gave it a boost.

The greenback's rally in the first quarter of 2021 caught many traders flat-footed. The 3% trade-weighted gain wasn't big by historical standards, but that statistic masks more meaningful appreciation in some individual currencies. The currencies of Brazil, Colombia and Japan weakened by at least 6% while the euro – the second most actively-traded currency – dropped by 5%. Traders who were betting heavily against the U.S. dollar at the end of last year were forced to cut those positions as the greenback bounced, amplifying the dollar's ascent. Economic and political developments unfolding on both sides of the Atlantic also contributed to the move. In the U.S., optimism around economic growth was largely fed by President Joe Biden's stimulus cheques and the expectation that some infrastructure spending would be unveiled this year. Abroad, it was the sluggish pace of COVID-19 vaccinations and associated lockdowns, particularly in Europe, that made the dollar look relatively attractive. As these themes were incorporated into the dollar's value the slate was cleared by the end of March for longer-term dollar-negative factors to re-assert themselves.

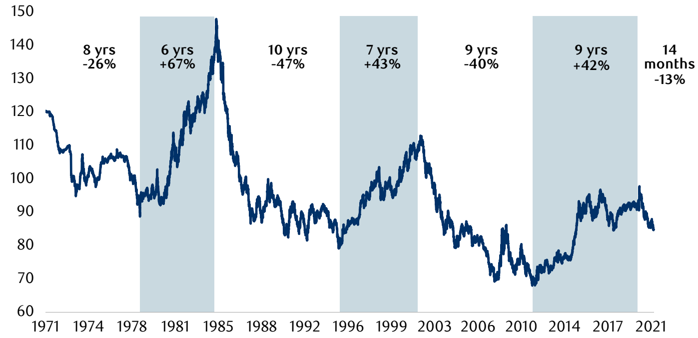
We are focused on the broad trajectory of currency markets and like to make use of long-term fundamental factors to inform our outlook. On these longer-term metrics, the dollar is clearly unattractive given that U.S. budget and trade deficits are rapidly deteriorating, reserve managers are showing a preference for the Chinese currency and the dollar remains overvalued even after the recent selloff. Our work suggests that the fourth major U.S.-dollar bear market of the past five decades began in the spring of 2020 (Exhibit 1), and that several more years of weakness lie ahead (Exhibit 2). Short-term rallies in the dollar should be expected, but investors with longer investment horizons will be rewarded for sticking with a bearish stance.

Those with a shorter investment horizon should consider political developments, trends in economic data, commodity prices and other indicators that tend to drive near-term exchange rates. Of late, it is bond markets and interest rates that have taken centre stage, due mostly to rising inflation and disparate central-bank policies. And yet the currency reaction has not been intuitive – the dollar actually declined as U.S. yields rose over the past 12 months. Even the greenback's temporary rally during the first quarter of 2021 was mild compared with the steep rise in yields accompanying it.

To understand this new dynamic, we need to look beyond the level of nominal Treasury yields and instead break down that U.S. 10-year yield into its components. First, a portion of the yield represents compensation for the expected level of inflation over that 10-year horizon. You might be reluctant to make an investment if you expect its value to buy you fewer goods and services at the end of the investment's lifetime. Another component is the "real yield" – the yield you might expect to take home once inflation has eroded the purchasing power of your capital. The U.S. dollar's performance is much more closely linked to fluctuations in real yields than nominal yields. This makes sense: a rise in nominal yields caused by higher inflation expectations would hardly be dollar-positive because it represents a quicker erosion in the currency's value. In contrast, rising real yields indicate increased optimism among investors for the U.S. economy and U.S. assets, bolstering the value of the greenback.

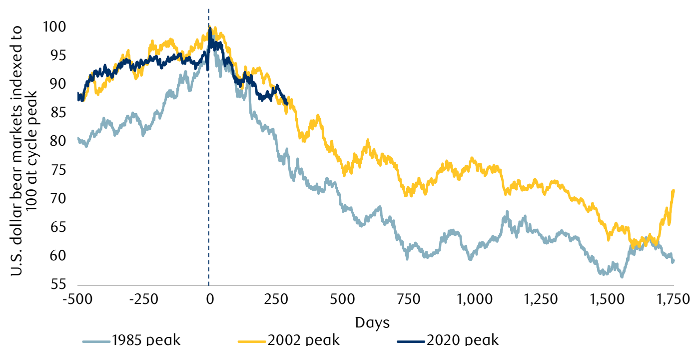
A Morgan Stanley framework that we have adapted helps us visualize how the dollar has historically performed in four environments where interest rates and inflation expectations are fluctuating (Exhibit 3). Looking back over a full U.S.-dollar cycle, we can make a few observations:

Exhibit 1: Long-term cycles in the U.S. trade-weighted dollar



Note: As at May 28, 2021. Source: Bloomberg, RBC GAM

Exhibit 2: U.S. dollar bear-market roadmap



Note: As at May 27, 2021. Source: Bloomberg, RBC GAM

Exhibit 3: Medium-term framework for the U.S. dollar

Regime		vs. G10	vs. EMFX	Commo-dities	U.S. equities
1	Real yields ↓ Inflation expectations ↑	USD ▼	USD ▼	Stronger	Stronger
2	Real yields ↑ Inflation expectations ↑	USD ▲	USD ▼	Stronger	Stronger
3	Real yields ↑ Inflation expectations ↓	USD ▲	USD ▲	Weaker	Weaker
4	Real yields ↓ Inflation expectations ↓	USD ▼	USD ▲	Weaker	Weaker

Source: RBC GAM

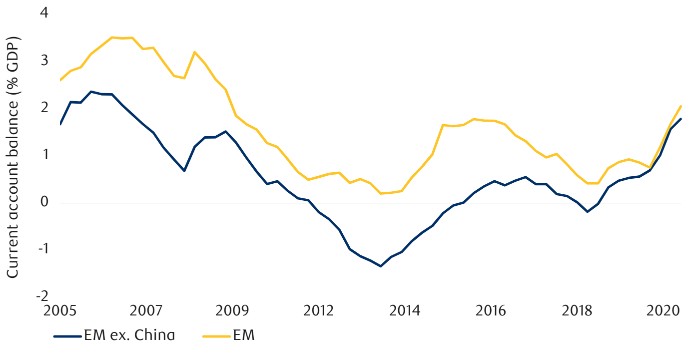
- The dollar's performance against developed-market currencies is driven by fluctuations in real yields. Regime 1 is most negative for the greenback because it combines less interest-rate support from real yields and an increasing expectation that the dollar's value will be eroded by inflation. This is the current environment, and one that supports our view for continued U.S.-dollar weakness.
- The dollar follows a slightly different pattern against emerging-market currencies. The rise in real yields in Regime 2, for example, tends to be less threatening for emerging-market currencies because that environment is one where economic growth is strong, commodities are rallying and risk sentiment is positive. This would be very much in tune with our expectation for cyclical currencies to continue to outperform the U.S. dollar for a few years.
- A third observation is the tendency for the environment to shift in line with economic conditions. As economic growth continues to recover and inflation pressures build, we will likely see a shift into Regime 2 as real yields begin to rise, followed by a transition to Regime 3 as Fed interest-rate hikes temper inflation expectations. Finally, the rotation through the four regimes is completed later in the economic cycle as economic growth fades and rate cuts follow. While an eventual move into Regime 3 would prompt us to re-evaluate our view, we are comfortable that real yields remain capped for now by a laundry list of factors, including low Fed policy rates, quantitative easing and ample global liquidity.

Emerging-market currencies

The current environment is close to what one would consider the sweet spot for emerging-market currencies. A weaker dollar, healthy risk appetite and strong commodity prices all support appreciation in emerging-market currencies, as do fiscal and monetary trends. Both fiscal and monetary policy are being kept extremely accommodative in the developed world even as the world's major economies recover. Cheap loans and stimulus checks, combined with a move toward online spending have emerging-market economies experiencing a boom in exports that far outweighs any hit to tourism revenues. The resulting improvement in current-account balances (Exhibit 4) over the past year has reduced their reliance on short-term borrowing and places emerging-market countries in a better position to withstand the threat of rising Treasury yields. What's more, many emerging-market countries have been relatively conservative in their pandemic spending, have large foreign-exchange reserve buffers and have manageable levels of debt. All the while, emerging-market currencies remain undervalued (Exhibit 5). In addition to these factors, there are two others that could contribute to further emerging-market currency gains this year:

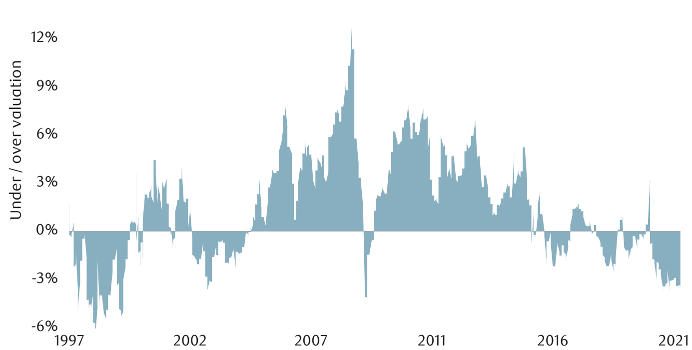
1. Authorities in several emerging markets have already tightened monetary policy or have signaled that they plan to. Central banks in Russia, Turkey (until President Erdogan's intervention) and Brazil hiked rates earlier this year and investors expect that Hungary, Colombia and South Korea are among the countries that will follow.

Exhibit 4: Emerging-market external positions are stronger



Note: As at Dec. 31, 2020. Balance is a GDP weighted average of countries in the J.P. Morgan ELMI+ index. Source: IMF, RBC GAM

Exhibit 5: Emerging-market currencies remain undervalued



Note: As at May 28, 2021. Valuation from RBC GAM behavioral model. Currency weights are based on the J.P. Morgan ELMI+ index. Source: Bloomberg, BIS, RBC GAM

Higher interest rates are positive for these currencies because they attract capital inflows.

2. Chinese policymakers appear content to let the renminbi rise. The currency has made new highs not only against the greenback but also against the basket of trading-partner currencies against which it is measured by the Chinese central bank. A stronger renminbi has become a bellwether for the performance of other emerging-market currencies, particularly those in Asia.

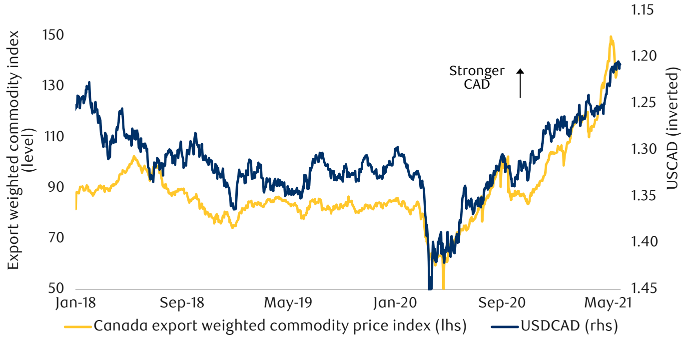
Emerging-market currencies have outperformed their developed-market peers this year and we expect this trend to continue. However, picking the right currencies to own has become increasingly important because country-specific factors are now playing a bigger role in currency fluctuations. Political developments, COVID-19 vaccination rates and exposure to commodity exports will all play a part in determining which currencies fare best in the coming year.

Canadian dollar

There is lots to love about the loonie these days: the currency has risen 5% this year and ranks among the world's best-performing currencies in 2021. What makes the Canadian dollar particularly attractive is its exposure to commodities and their link to global economic growth, particularly the strong U.S. recovery. Not only do President Biden's stimulus checks raise optimism among Canadian consumers and businesses, but they also offer the potential for a more sustained boost to exports. Indexes of Canadian export prices have risen by 60% since the end of 2019 (Exhibit 6), and the boon for exporters is more broad-based than one might expect. According to Deutsche Bank, oil prices make up a fraction of the rise in aggregate export prices over the past year. A more than tripling in lumber prices over the past year is the largest contributor to overall gains, while a host of other metals, energy and agricultural commodities are also up considerably. We have often pointed to Canada's large current-account deficits as a negative for the loonie, but this headwind seems to be fading with the improvement in exports and the reduction of overseas spending by Canadians stemming from the pause in travel abroad. Greater cooperation with the U.S. on trade and geopolitical issues will likely lead to further improvement in the Canadian current account, as will several of Biden's proposed environmental, regulatory and labour-market policies, which could help restore Canada's export competitiveness relative to its largest trading partner.

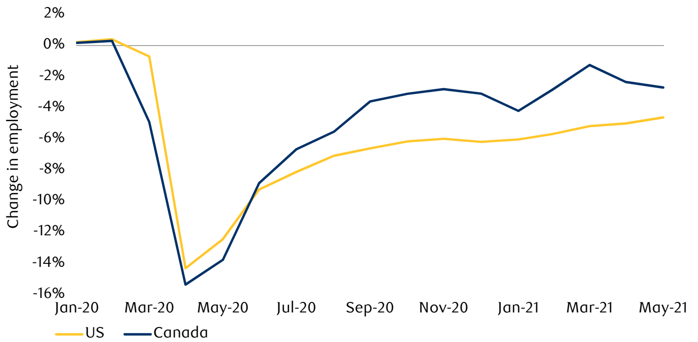
The domestic economy is also strong. Pandemic-linked income support, brisk house-price gains, Canadian fiscal spending and a labour-market recovery that is outpacing the U.S (Exhibit 7) have Canada on track to close its output gap – the maximum level of production that can be sustained without excess inflation – sooner than most other developed economies (Exhibit 8). A ramp-up in the pace of COVID-19 vaccinations has also given the loonie a boost and should allow some lifting of lockdowns now that Canada has caught up to the U.S and U.K in the number of people who have received at least one dose (Exhibit 9).

Exhibit 6: Canadian export prices on the rise



Note: As at May 28, 2021. Source: Bloomberg, Deutsche Bank, RBC GAM

Exhibit 7: Canadian employment rebound leads the U.S.



Note: As at May 28, 2021. Source: Bloomberg, Deutsche Bank, RBC GAM

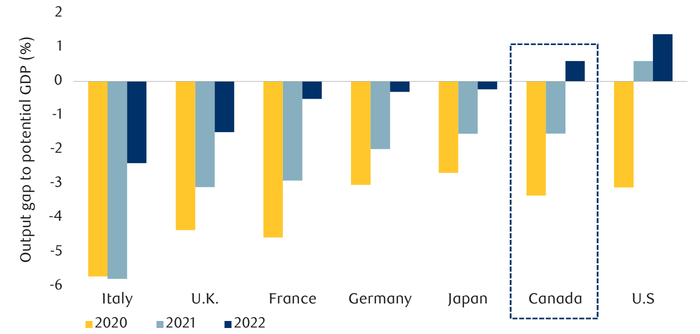
Favourable trade trends, improving domestic activity and the prospect of easing lockdowns have prompted the Bank of Canada (BOC) to substantially raise its 2021 economic-growth forecasts. The BOC's expectations for inflation this year were also bumped higher, increasing speculation that the central bank is more open to an overall tightening in monetary policy. The BOC has already started the process of reducing the amount of bonds it will buy each week to $3 billion from $5 billion, and rate hikes in Canada are widely expected to materialize sooner than in other major economies (Exhibit 10). The combination of BOC policy changes and Canada's sensitivity to global economic growth is contributing to robust foreign portfolio flows into equities and bonds. It is possible, absent another significant jump in commodity prices, that the loonie's appreciation slows in the near term ahead of the key technical level of C$1.20 per U.S. dollar. On a 12-month horizon, however, we think that the Canadian dollar has room to strengthen, and we are revising our base-case expectation to C$1.15 per U.S. dollar now that our previous forecast has nearly been achieved.

The euro

Much of the pessimism surrounding European assets and the decline of the euro in the first few months of 2021 was based on the slower pace of vaccinations and associated lockdowns in Continental Europe. This situation has largely improved and is one of the reasons why the single currency rebounded in April and May. We note, however, that differences in vaccination rates and lockdowns represent temporary factors that are unlikely to drive meaningful shifts in the longer-term valuation of currencies. Like other regions, the eurozone will survive the pandemic, perhaps with higher levels of debt, but without much lasting damage to productive capacity. In fact, European countries were among those that made the most use of wage subsidies and job-retention measures to keep people employed and prevent a loss of workers' skills.

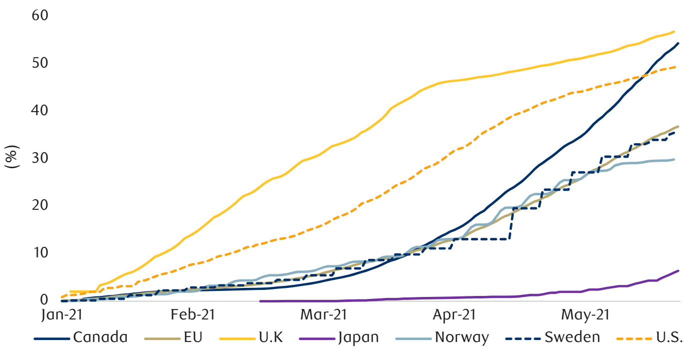
The U.S. economic outperformance that fueled U.S.-dollar strength earlier this year was also temporary in that it was driven in part by more fiscal support in the U.S. than in Europe and most other developed nations. It appears that this could reverse in coming quarters as fiscal spending rises in Europe. In this vein, German elections in September will be important, as a loss in popularity for Angela Merkel's fiscally conservative political party (Exhibit 11) likely means that a more fiscally loose coalition partner will be required to govern – possibly paving the way for more fiscal support across the continent. Most economists expect that the eurozone economy will grow at a quicker pace than its peers

Exhibit 8: Canadian output gap to close by 2022



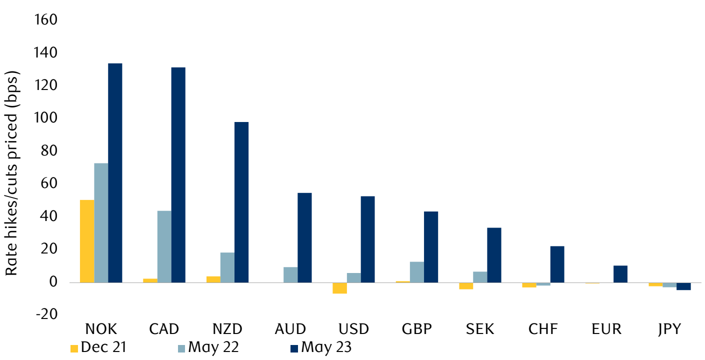
Note: As at Dec. 31, 2020. Source: IMF, RBC GAM

Exhibit 9: Share of people that have received at least one dose



Note: As at May 27, 2021. Source: Our World in Data, RBC GAM

Exhibit 10: G10 central-bank rate-hike expectations



Note: As at Jun. 3, 2021. Note: implied by xm1m OIS forwards.
Source: Bloomberg, BNP, RBC GAM

beginning in early 2022, a powerful magnet for capital inflows and a definite positive for the currency.

Two other developments during the quarter have also improved the outlook for the euro:

1. The German Constitutional Court struck down legal objections to a 750 billion-euro EU recovery fund, bringing it closer to ratification and to an eventual disbursement of funds for European nations to battle the economic impact of the pandemic.
2. U.S. Treasury Secretary Janet Yellen's apparent reluctance to single out currency manipulators suggests that we may see greater foreign-exchange intervention activity, particularly by the most active Asian central banks. Growth in global foreign-exchange reserves is usually euro-positive as it is accompanied by a diversification away from the greenback and into euros.

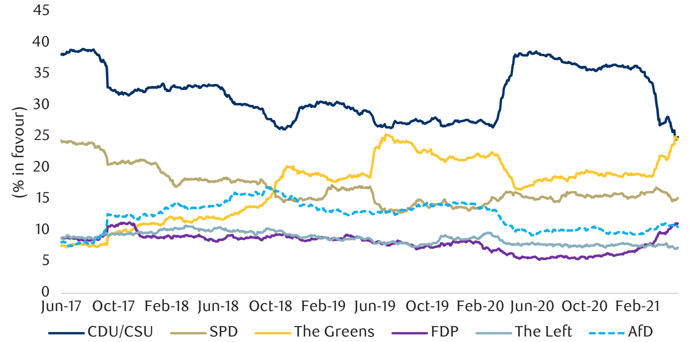
The next chart point eyed by traders is a euro exchange rate of US$1.25, which may stall appreciation in the near term. On a slightly longer horizon, however, we think the euro can reach US$1.30 within the next 12 months.

British pound

Business optimism and consumer confidence have risen in the U.K., likely from the reduced uncertainty around Brexit outcomes, substantial savings built up during the pandemic and an efficient roll-out of the vaccine program. U.K. growth should get a boost from business investment and would benefit more than other countries from a rebound in retail spending given the large share of consumption in the U.K. economy.

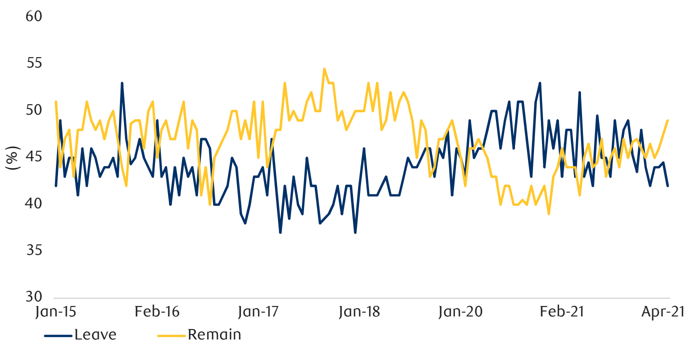
The pound has, however, already strengthened a great deal in recent months, and above US$1.40, looks to have run ahead of its fundamentals. One risk we're monitoring is the potential for a Scottish move toward independence. The Scottish National Party has pledged to hold another referendum in the first half of its five-year term and polls show that the population remains divided on the issue of independence (Exhibit 12). Scotland matters because it has sizable oil production without which the U.K. current-account deficit would worsen by approximately 2% of GDP (Exhibit 13). We think the pound will hold its ground relative to a falling U.S. dollar, but will likely underperform other developed-market currencies. Our 12-month forecast is US$1.40 per pound.

Exhibit 11: Merkel's CDU/CSU coalition is losing support



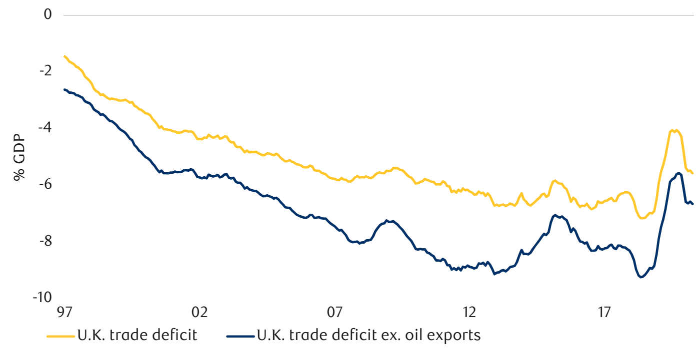
Note: As at May 13, 2021. Source: Wahlrect.de, Macrobond, RBC GAM

Exhibit 12: Scottish referendum polling



Note: As at May 14, 2021. Note: Question asked how would you vote in a Scottish independence referendum if held now? Source: ScotCen Social Reserach, RBC GAM

Exhibit 13: Scottish independence could lead to wider U.K. trade deficit



Note: As at Mar. 31, 2021. Data is smoothed using a 1-yr moving averageSource: U.K.ONS, RBC GAM

Japan

A number of headwinds faced the Japanese yen this year. Among them were a stubborn rise in COVID-19 cases and related mobility restrictions in major population centres including Tokyo. More consequential is the possibility that the Summer Olympics are cancelled – a development that would have a disproportionate impact on Japan's service sector. According to Bloomberg, a last-minute ditching of the Games would wipe out most of the economic growth projected for the country this year.

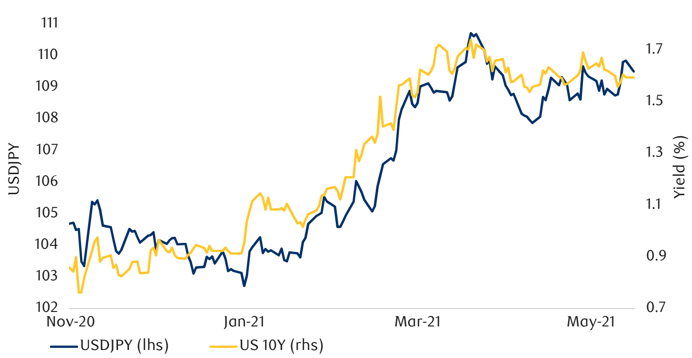
The Japanese yen has been the G10's worst-performing currency this year, as its link to rising Treasury yields was re-established (Exhibit 14). This link should ease going forward as the volatility in U.S. 10-year yields subsides. A number of other factors supporting the yen are its cheap valuation, Japan's improved balance of payments and large short yen positions that we expect will get squeezed as the U.S. dollar declines. Japanese inflation-adjusted yields may also attract capital or stem capital outflows, as they are higher than in any other G10 country due to the country's persistently low inflation rate (Exhibit 15).

We remain optimistic on the yen, but have learned not to get overly excited about the prospects for large gains in the currency. During this phase of U.S.-dollar weakness, it is the cyclical currencies that should outperform traditional funding currencies such as the yen and Swiss franc, and so we temper our forecast for the coming 12 months to 103 yen per U.S. dollar.

Conclusion

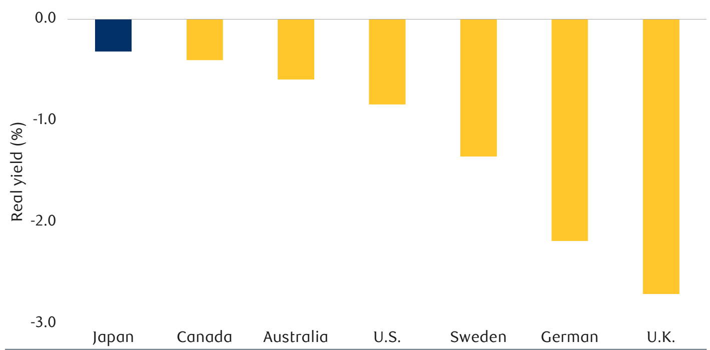
This has been a year of two very different quarters so far – a strong U.S. dollar in the first quarter and a weak one in the second. Our expectations are for the dollar weakness to prevail. The U.S.-dollar bear market began just last year and has a few years to run. Currencies move within cycles, from overvalued to undervalued, and the dollar remains rich despite the weakness of the past year. The stimulative fiscal and monetary policies pursued by the U.S. don't stand in the way of the weakening trend, but instead support it. Cyclical periods of strength, like the one seen in the first quarter, whether driven by real rates in the U.S. or economic weakness in Europe, are good opportunities to position portfolios for a further U.S.-dollar decline. While the early stages of the bear market in the greenback benefits all currencies, it is cyclical currencies, including the Canadian dollar, that benefit most from the global economic recovery underway. Broadly speaking, emerging-market currencies should also continue to gain, although careful monitoring of idiosyncratic risks is necessary to avoid individual currency underperformance.

Exhibit 14: Yen moves in lockstep with U.S. yields



Note: As at May 31, 2021. Source: Bloomberg, RBC GAM

Exhibit 15: Japan offers the highest inflation-adjusted yield among developed countries



Note: As at May 31, 2021. Source: Bloomberg, RBC GAM

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: June 15, 2021

103073 (06/2021)
GLOBAL CURRENCY OUTLOOK_SUMMER 2021_E 06/09/2021