RBC Global Asset Management

Global currency outlook

SUMMER 2024

Dollar’s underwhelming rally hints at longer-term headwinds

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

Daniel Mitchell, CFA
Managing Director &
Senior Portfolio Manager
RBC Global Asset Management Inc.

A number of themes have emerged in foreign-exchange markets over the past quarter, and with them some tough questions still to be answered. Chief among these is whether our longer-term outlook for U.S.-dollar weakness should be reassessed given the resilient U.S. economy. How does the persistence of inflation globally affect this calculus? Are there important signals in the rise of gold prices? Can Japanese currency intervention arrest the greenback’s gains, and what might such action mean for investors aiming to capitalize on the wide gap between U.S. and Japanese interest rates?

Economic and market developments have been undeniably U.S. dollar-positive so far this year. The stronger-than-expected U.S. economy and more persistent inflation than in other countries have caused investors to expect that the U.S. Federal Reserve (Fed) will take longer to cut interest rates, delaying more than 100 basis points of rate reductions that were previously expected to materialize before the end of 2024. The related increase in longer-term bond yields places the U.S. dollar as one of the highest-yielding among developed nations – a position further cemented by the European Central Bank’s (ECB) rate cut in early June.

It’s notable, then, that the dollar has not performed better than it has. On a trade-weighted basis, the currency has remained within a relatively tight range for more than a year. While the dollar is 3% stronger than where it stood in January, it remains roughly 8% below its 2022 peak (Exhibit 1). Such a muted performance hardly justifies the level of enthusiasm

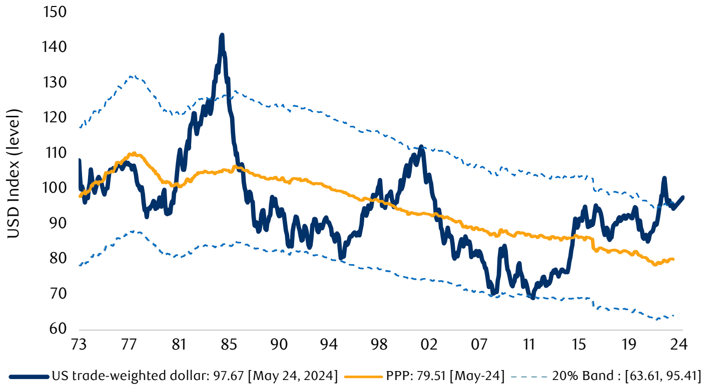
Exhibit 1: U.S. dollar still below 2022 peak

Note: As at June 4, 2024. Source: Bloomberg, RBC GAM expressed in the media for "U.S. exceptionalism." The inability of the dollar to gain better traction amid strong U.S. economic data is, we think, due to longer-term negatives that are holding back the currency. The greenback may indeed remain elevated, but the extent to which it can gain further ground is limited with valuations already so stretched. We have often cited that purchasing-power-parity models suggest that the dollar is more than 20% rich (Exhibit 2), but most other models – including those that consider a broader set of economic variables – offer the same assessment.

The reckless pace of fiscal spending is one concern that might be restraining the dollar's gains. The U.S. federal debt held by the public has climbed to nearly 100% of GDP from 35% two decades ago, and the Congressional Budget Office (CBO) expects deficits to continue. According to CBO estimates, net interest payments are set to rise to nearly 4% of GDP within 10 years, nearly three times higher than before the Fed began hiking interest rates in 2021. Conscious of the government's need to finance these larger deficits with increased bond issuance, traders are paying more heed to weekly debt auctions. Any sign that investors are demanding higher yields to own U.S. government debt would be a concern, especially as some of the largest owners of Treasurys have been reducing their holdings (Exhibit 3).

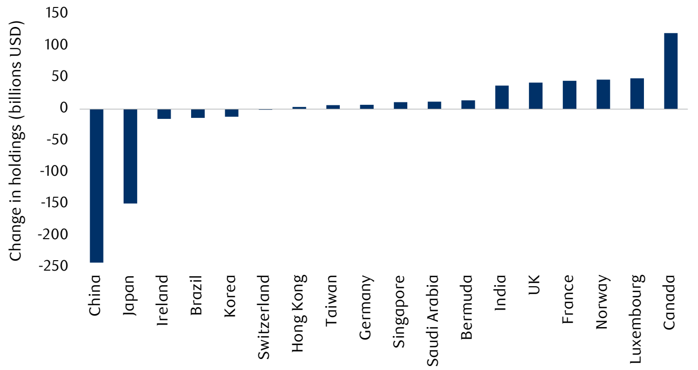
A related threat for the greenback comes from concern about policies that might be pursued if Republican Donald Trump wins November's U.S. presidential election. Press reports suggest Trump might demand, among other things, that he be consulted on interest-rate moves, explicitly target a lower U.S. dollar and attempt to punish countries that shift away from using the U.S. dollar to conduct trade. Such measures would likely stoke inflation, jeopardize the Fed's independence and accelerate the trend toward de-dollarization – prompting investors to demand higher yields in exchange for holding U.S. assets.

Exhibit 2: USD – Purchasing Power Parity Valuation



Note: As at May 24, 2024. Source: U.S. Federal Reserve, Bloomberg, RBC GAM

Exhibit 3: Change in U.S. Treasury holdings between December 2021 and March 2024

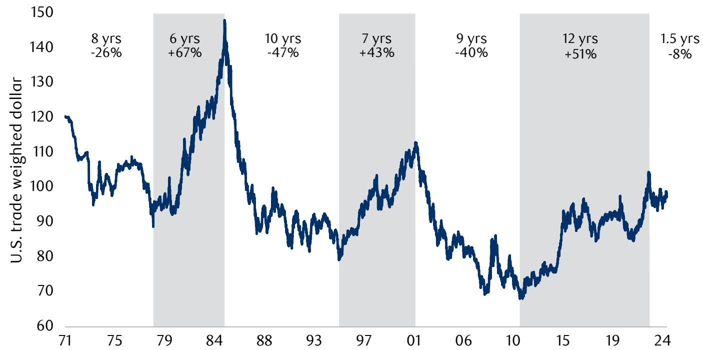


Note: As at: March 31, 2024. Source:Bloomberg, RBC GAM

We would like to think there are institutional checks on how far Trump could go with such policies. However, the fact that these ideas are even being discussed may signal that the dollar could face much more serious risks in coming years than most forecasters appreciate. Gold's 30% price increase in less than a year is likely due in part to a recognition that U.S. economic policies are not necessarily consistent with maintaining global leadership over the long term.

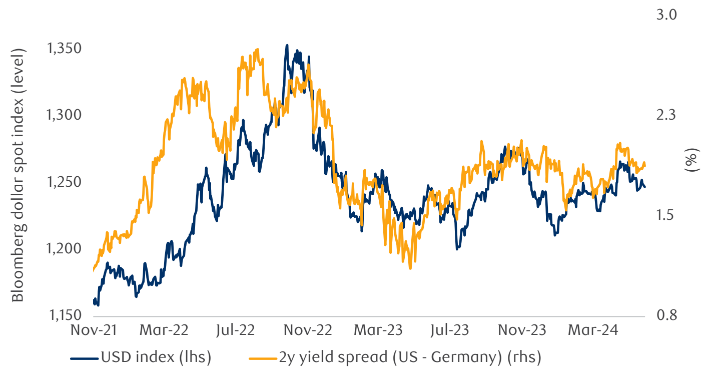
We've argued for some time that the dollar is in the beginning of a longer-term decline that could continue for several years (Exhibit 4). The currency's persistent overvaluation, relentless U.S. fiscal spending and the threats posed by a second Trump presidency seem to support this longer-term outlook. However, the impact of fiscal spending on short-term growth and inflation means that the Fed is likely to keep interest rates elevated. The U.S. interest-rate advantage over other regions has been the most important consideration for currency traders this year (Exhibit 5), and so the dollar's descent is less likely to occur without a drop in interest rates. As government spending is exhausted and as inflation moderates, we expect that the Fed will start cutting rates later this year and that it will reduce interest rates three times within our 12-month horizon. In this context, any gains in the U.S. dollar from an overvalued starting point are likely to be limited. Over the course of our 12-month forecast horizon, we think the dollar will be pulled lower by a slowdown in fiscal spending, rate cuts and rich valuations.

Exhibit 4: Long-term cycles in the U.S. trade-weighted dollar

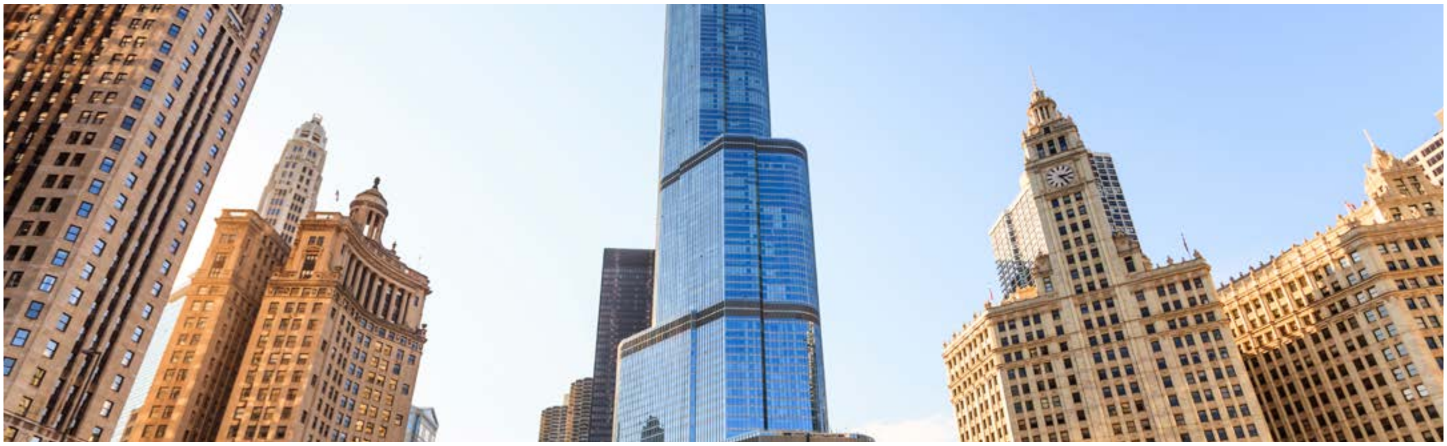


Note: As at May 17, 2024. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 5: U.S. dollar tightly linked to interest-rate spreads



Note: As at May 28, 2024. Source: Bloomberg, RBC GAM

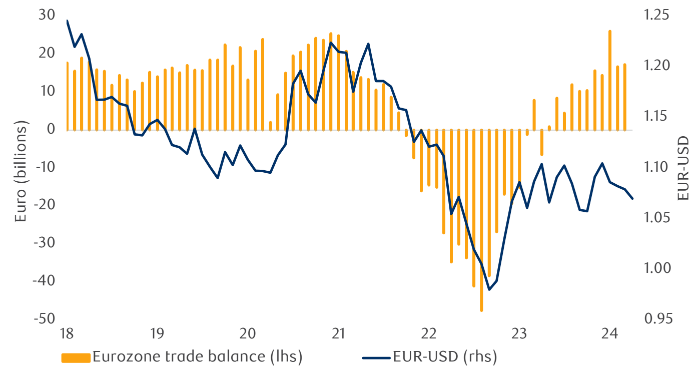


The euro

With all the focus on the U.S., it seems as though developments in the eurozone have been largely ignored. This is now changing because, just as economic trends begin to soften in the U. S., business sentiment has improved in Europe - particularly in key service sectors. Investors' focus has been further drawn away from U.S.-centric drivers of exchange rates by the eurozone's improving trade balance, which has returned to surplus (Exhibit 6) amid a recovery in Chinese demand and a decline in natural-gas prices. The euro seems so far to have lagged this improvement, as traders remain skeptical about the region's growth prospects and wary of ECB rate cuts that would reduce euro yields. We know that it will take more than a few months of stronger economic data to convert the community of euro skeptics, but the improvement has already stoked a newfound appetite for attractively valued European stocks. Investors outside the eurozone, for instance, have poured approximately 200 billion euros into European equities over the past year (Exhibit 7), and investors within the single-currency bloc have large amounts of overseas assets that could be repatriated.

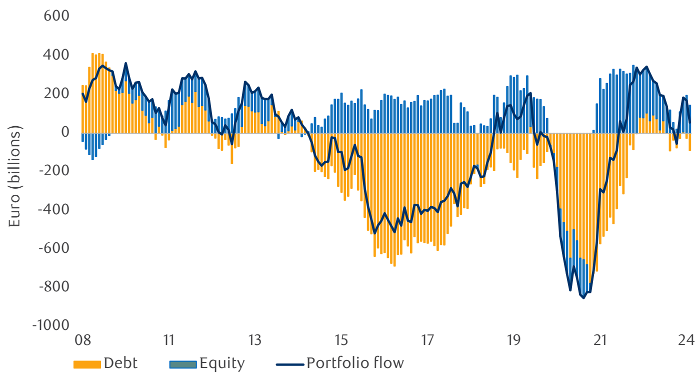
Plotting the euro against other market variables such as stocks, credit spreads and interest-rate gaps, it appears the single currency may be a bit oversold. Those factors and others suggest the euro should be trading closer to US$1.15-US$1.20 rather than the current exchange rate of US$1.08 (exhibits 8 and 9). We forecast that the single currency will reach US$1.21 within 12 months.

Exhibit 6: Eurozone trade surplus



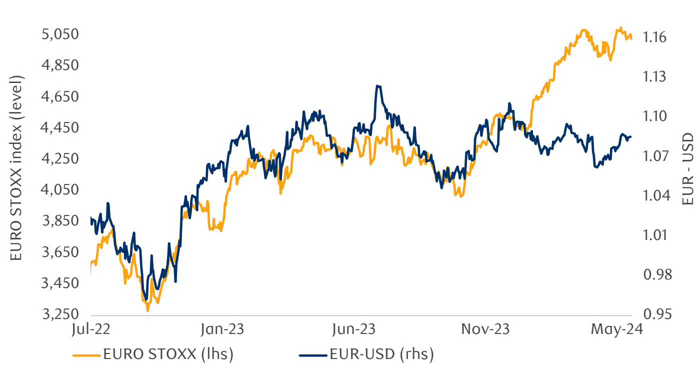
Note: As at May 31, 2024. Source: Bloomberg, Eurostat, RBC GAM

Exhibit 7: Portfolio inflows from foreign demand for European equities



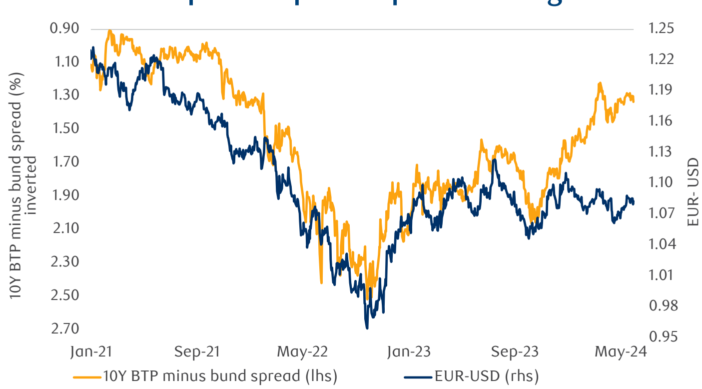
Note: 12 month rolling sum. As at March 31, 2024. Source: ECB, RBC GAM

Exhibit 8: European equities point to a higher euro



Note: As at May 28, 2024. Source: Bloomberg, RBC GAM

Exhibit 9: Peripheral spreads point to a higher euro



Note: As at May 30, 2024. Source: Bloomberg, RBC GAM

Yen

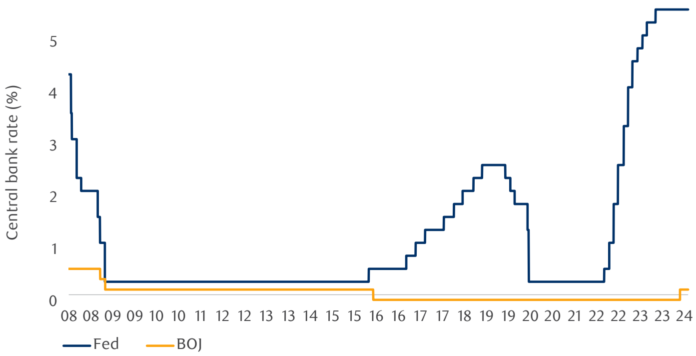
Japanese authorities have been warning for several months that the yen's weakness was unwelcome. So it was hardly a surprise when the Ministry of Finance intervened in currency markets following the yen's weakness to 160 per dollar in late April. What was surprising was that the US$63 billion in foreign-exchange spent to prop up the yen had hardly any impact. The yen's appreciation to 152 per dollar was mostly unwound within a few weeks.

The limited impact of Japanese intervention was due, in our view, to the failure of authorities to align the move with a supportive shift in monetary policy. In fact, the wide gap between Japanese policy rates (now at 0%) and those in the U.S. (5.50%) is the principal reason why the yen is weaker in the first place (Exhibit 10).

We are now slightly less bullish on the yen, not because we had been expecting anything more than the miniscule 0.10% incremental shifts in Bank of Japan's policy rate, but because the delay in Fed rate cuts has maintained the gap in yields between the two currencies.

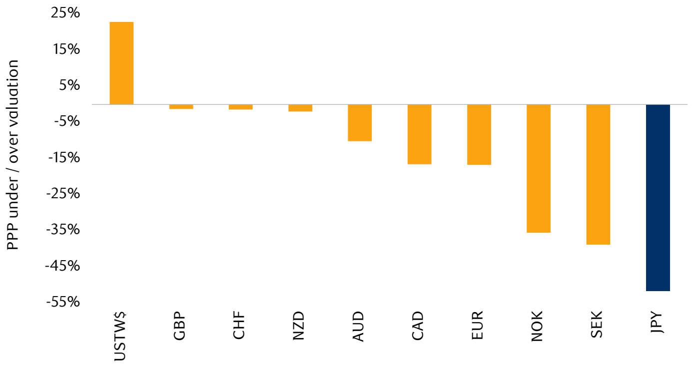
Valuation metrics rank the yen as one of the world's cheapest currencies based on purchasing power (Exhibit 11). The discount is unlikely to outweigh the yen's steep yield disadvantage, but it does set a floor below which traders will be reluctant to sell. Our forecast for the yen to strengthen back to 140 hinges on broad weakness in the U.S. dollar –which we think will begin to materialize this year alongside Fed rate cuts.

Exhibit 10: Policy-rate gap underpins yen weakness



Note: As at June 05, 2024. Source: BOJ, Federal Reserve, RBC GAM

Exhibit 11: Yen is the most undervalued G10 currency

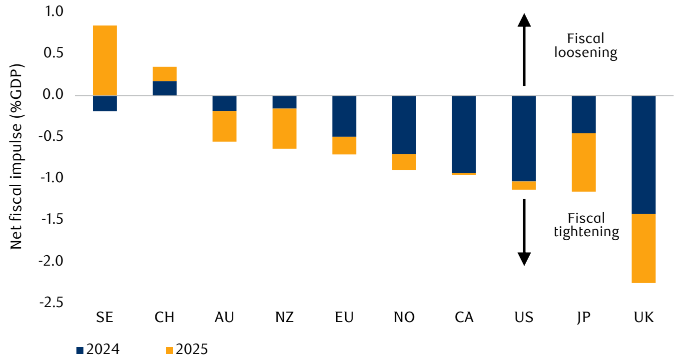


Note: As at May 30, 2024. Source:Bloomberg, RBC GAM

British pound

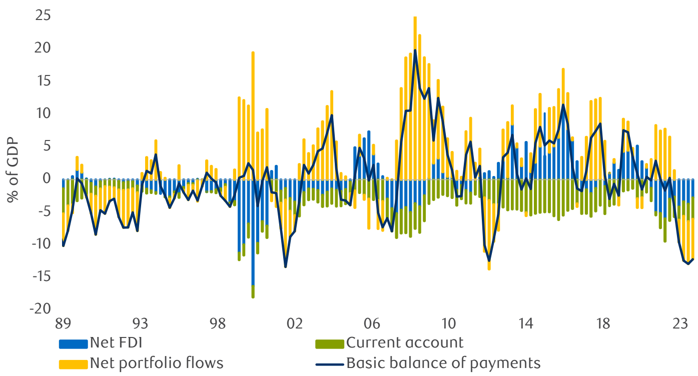
Several factors indicate that the pound should weaken relative to other developed-market currencies. First, economists seem to agree that the UK will be the slowest-growing major economy in 2024 and 2025. The roll-off of spending measures that are not being renewed amounts to a hit to growth of more than 2% of GDP, almost double that in other developed-market economies (Exhibit 12). UK inflation is also expected to be higher than peers' at the end of 2024, which is nothing new given that increases in UK price levels have been larger than the G10 average for decades. Greater inflationary pressure lessens the pound's attractiveness at a time when capital inflows are needed to help plug the country's balance-of-payments deficits. The UK's basic balance, which combines outflows in the current account, foreign direct investment and portfolio investment, sits at a staggering 10% of GDP (Exhibit 13). The pound needs to cheapen in order for the UK to attract capital, though such weakness needs to materialize relative to the currency of its biggest trade and investment partner, the eurozone, rather than against the greenback. We forecast the pound to trade at US$1.31 within the next year.

Exhibit 12: UK faces largest fiscal headwind among developed-market peers



Note: As at March 2, 2024. Change in cyclically adjusted general government balance. Source: OECD, RBC Captial Markets, RBC GAM

Exhibit 13: UK balance of payment defict



Note: As at December 31, 2023. 4 quarter rolling sum. Source: U.K. ONS, RBC GAM

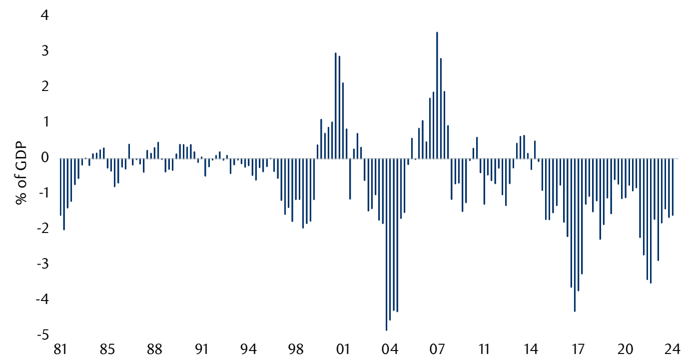
Canadian dollar

A negative tone has surrounded the Canadian dollar in recent months, reflecting three economic trends. The first involves Canada's greater economic sensitivity to elevated mortgage rates and expectations that household discretionary spending may be squeezed as Canadians renew their mortgages. The situation has prompted calls for the Bank of Canada (BOC) to reduce interest rates further in order to avoid a more pronounced economic slowdown. Given that relative shifts in monetary policy are such a dominant driver of foreign-exchange markets, a wider divergence in policy between the BOC and Fed could result in short-term weakness in the loonie.

The second issue is that the Canadian dollar has for now lost its link to oil and so isn't fluctuating alongside crude prices. The main channel for currency appreciation from a rally in energy prices is not solely through better terms of trade but to a greater extent through hiring and business spending that results from resource exploration and extraction. Concerns that carbon taxes will crimp demand and that Canada's oil-sands reserves are too "dirty" pose a threat to the domestic oil industry and have prompted many companies to opt for returning capital to shareholders instead of reinvesting in shovel-ready projects that drive Canadian economic growth.

The third major headwind relates to Canadian productivity, which suffers from low investment in key sectors that drive innovation. This topic has resurfaced in recent weeks following a proposed increase in the capital-gains tax that threatens to deter investment and chase away companies and entrepreneurs that create intellectual property. Policies that structurally dent the country's competitiveness may be one reason the currency has remained undervalued. For years, technology workers have fled to the U.S. and firms have found more attractive investment opportunities abroad (Exhibit 14). Adding to this outflow are small deficits in the current account and in cross-border portfolio investment leading to an overall basic balance deficit equal to 3% of GDP that frustrates any sustainable currency strength.

Exhibit 14: Persistent foreign direct investment outflows



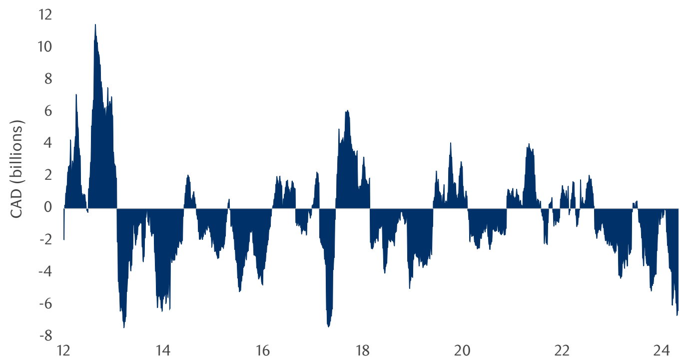
Note: As at March 31 2024. 4 quarter rolling sum. Source: Statistics Canada, RBC GAM

We should also remember that the Canadian dollar is 17% undervalued versus the U.S. dollar based on purchasing power parity and has a host of long-term positives on its side. Canada is well-endowed with natural resources, has a strong banking system, a well-educated workforce, and is on better fiscal footing than most of its peers.

In the shorter term, the Canadian currency has also been supported by this year's metals rally – which, unlike the oil industry, faces fewer tax and environmental deterrents to investment. Mostly, it is Canada's proximity to the U.S. and the tight trading relationship between the two countries that has distinguished the loonie. During periods of strong U.S. economic growth, Canadian growth generally outperforms most other developed-market economies, a scenario that often results in the currency outperforming those of Japan and Europe as the U.S. dollar declines.

In sum, we believe that offsetting tensions affecting the Canadian dollar augur a stable exchange rate, and the Canadian dollar has indeed stayed in a relatively tight trading range of C$1.32 and C$1.40 per U.S. dollar over the past 18 months. We expect the Canadian dollar to strengthen beyond the lower end of this range but acknowledge an outlook for the Canadian dollar that's moderately less bullish than before. We've tempered our view over the past few quarters and now expect the currency to hit C$1.27 per U.S. dollar over the next 12 months. With investors leaning bearish toward the loonie (Exhibit 15) and additional BOC rate cuts already anticipated, we think the Canadian dollar is well placed to benefit from U.S.-dollar weakness.

Exhibit 15: Investor positioning bearish on the loonie



Note: As at May 31, 2024. Source: CFTC, Macrobond, 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 RBC Indigo Asset Management Inc. which are separate, but affiliated subsidiaries of RBC.

In Canada, this document is provided by RBC Global Asset Management Inc. (including PH&N Institutional) and/or RBC Indigo Asset Management Inc. 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 such 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, 2024

103073 (06/2024)