RBC Global Asset Management

Global currency outlook

FALL 2021

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

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Recent strength in the U.S. dollar has not swayed us from our bearish outlook. The greenback is still in the early stages of a multi-year downtrend, and this year's resilience stems largely from short-term factors that will likely fade over the coming months. However, gains against the dollar over the next year are unlikely to be as broad-based as they were over the past 18 months. We have tempered our optimism on the low-yielding euro, and remain positive on commodity currencies and those for which central banks are raising interest rates.

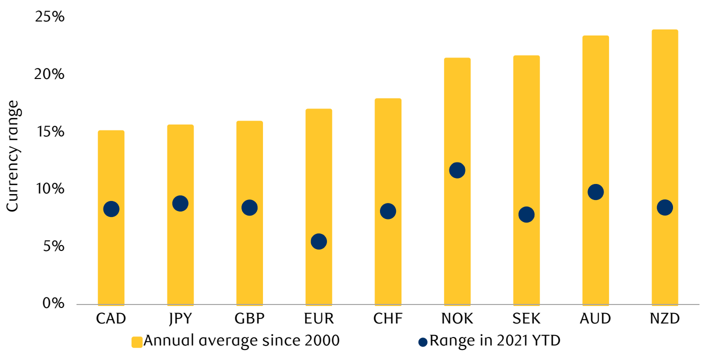
The U.S. dollar has rallied by 2.6% against a basket of developed-market currencies since the beginning of the year, which is notable for the fact that the gain has been so small. It is not unusual for currencies to fluctuate by at least 15% in a given year, and yet most currencies are posting ranges that are much smaller than that so far in 2021 (Exhibit 1). The 4% range in the U.S. dollar (exhibits 2 and 3) is particularly tight and results in a less active foreign-exchange market given that fluctuations in the greenback are important in dictating how other currencies perform.

For most of 2020, the influence of a falling dollar was reflected in generally rising prices for commodities and other risky assets, and at the end of last year, a consensus had formed that the dollar had further to fall. The greenback's gain this year, however small, has therefore felt larger than the actual 2.6% rally.

Our view is that the U.S. dollar is still in the early stages of a longer-term bear market (Exhibit 4). The currency remains overvalued based on purchasing power parity models even after last year's decline, and other long-term factors continue to suggest that more weakness lies ahead. U.S.-dollar declines are associated with global economic expansions as capital is redirected abroad in search of higher returns. This flow is likely to be magnified by the abundance of liquidity in the U.S. money markets and the low level of U.S. bond yields, particularly after adjusting for inflation.

Short-term U.S.-dollar rallies that occur in the midst of a bear market are not uncommon (Exhibit 5), and the limited size of the current rally leaves us confident in our view for a continuing bear market. The dollar's resilience amid these longer-term headwinds is due largely to temporary factors that are unlikely to persist through our forecast horizon.

Exhibit 1: Unusually tight ranges in 2021

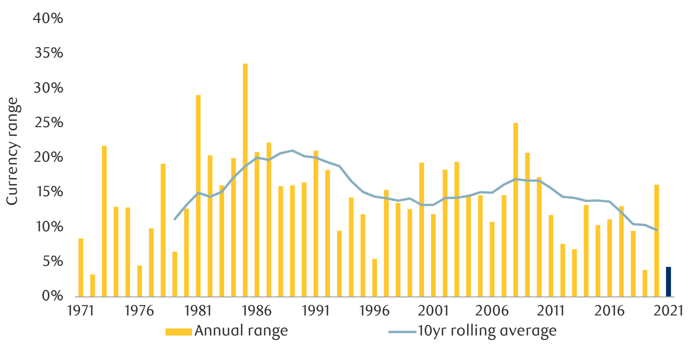


Note: As at Jul. 30, 2021. Source: Bloomberg, RBC GAM

Exhibit 2: U.S. dollar remains in tight range

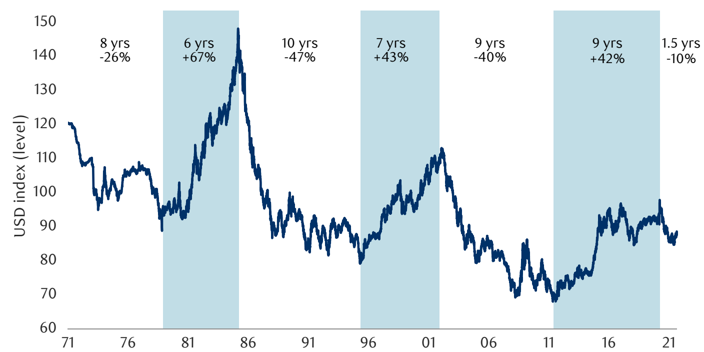
Note: As at Aug. 31, 2021. Source: Bloomberg, RBC GAM

Exhibit 3: Low volatility in U.S. dollar unlikely to last



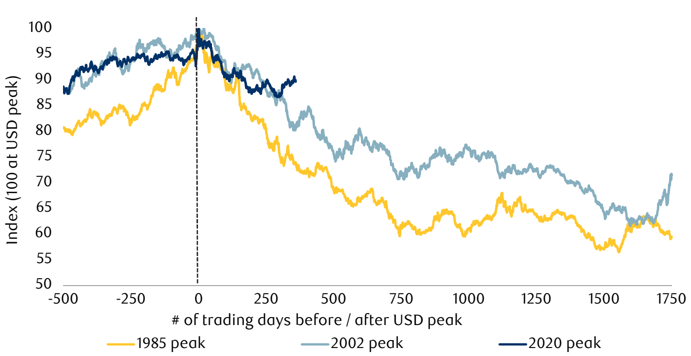
Note: USD index comprised of DXY index prior to 2015 and BBDXY from 2015 onwards. As at Aug. 30, 2021. Source: Bloomberg, RBC GAM

Exhibit 4: U.S. trade-weighted dollar



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

Exhibit 5: U.S. dollar bear-market roadmap

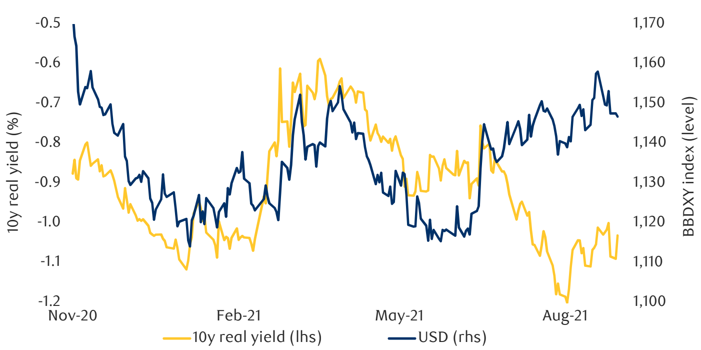


Note: As at Aug. 27, 2021. Source: Bloomberg, RBC GAM

These transient factors include:

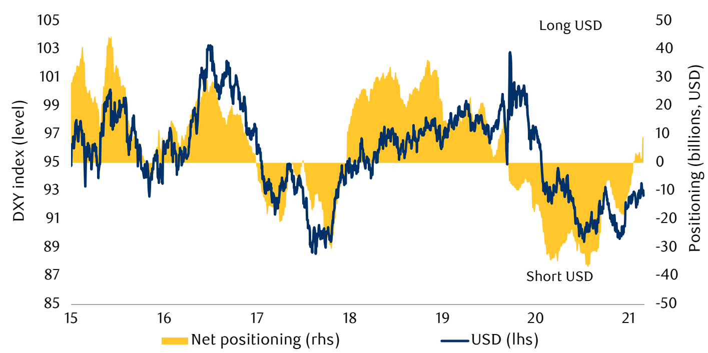
1. An unwinding of bets that the U.S. dollar would continue to fall into 2021. Traders had come to expect the dollar to trade in tandem with U.S. bond yields (Exhibit 6) – a bet that the U.S. Federal Reserve (Fed) would not be eager to unwind stimulus, that cyclical stocks would outperform and that long-term bond yields would rise faster than short-term yields (a steepening yield curve). The fact that the greenback rose during a time when longer-term interest rates were falling caused some initial confusion because falling yields and a stronger dollar are normally a product of capital seeking safer havens – and a flight to safety was not consistent with equity markets pushing to all-time highs. The adjustment to positioning that caused this divergence was temporary, however, and currency markets are now much more neutrally positioned (Exhibit 7).

Exhibit 6: Yields and the U.S. dollar



Note: As at Aug. 30, 2021. Source: Bloomberg, RBC GAM

Exhibit 7: Neutral dollar positioning



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

2. Concerns about the spread of the delta variant dented confidence in the global economic recovery and made U.S. investors more reluctant to allocate funds abroad. While there exists a huge disparity in each country's ability to withstand the spread of the virus, we have seen encouraging signs of limited hospitalizations and dramatically fewer deaths in highly vaccinated regions. To this end, lockdowns should be less severe and the economic hit experienced from the current wave should not be enough to derail the global recovery. Emerging-market assets remain attractive, particularly those in high-growth and high-yielding regions.

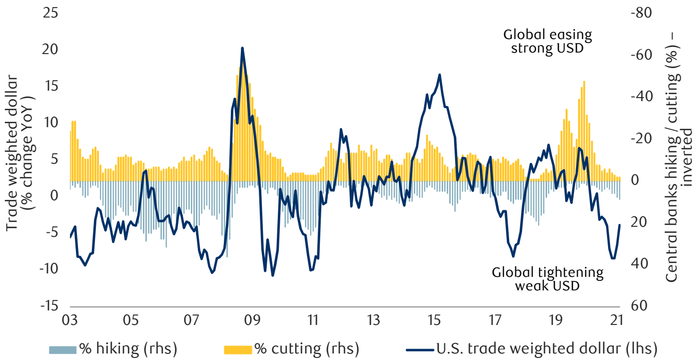
3. Debate surrounding the summertime rise in prices for goods also contributed to a stronger dollar, largely from speculation that the Fed might soon begin to tighten monetary policy. We are skeptical that this bump in inflation will continue to support the dollar. For one thing, the Fed has said it believes that today's higher inflation is "transitory" – the effect of short-term shipping and production bottlenecks associated with the pandemic as well as from a reversal of last year's commodity gains. Fed Chair Powell has argued for patience in allowing these cost pressures to subside and to support continued gains in the labour market, and any moves to scale back monetary easing will be tentative. Second, while most investors are focused on when the Fed will begin to reduce its US$120-billion-a-month pace of bond purchases, we argue that it's the timing of interest-rate hikes that matters much more. Not only are rate increases likely a distant prospect (markets expect the first one in March 2023), but the odds of a hike even that soon are questionable given the Fed's intention to fully wind down asset purchases prior to raising rates while ensuring that asset markets aren't disrupted as stimulus is withdrawn.

With the Fed being top of mind for many traders, it's natural that spreads between short-term interest rates among regions (a proxy for differences in monetary-policy expectations) are playing a greater role in driving currencies. Indeed, recent hints by the European Central Bank (ECB) of an extended period of low rates has weighed on the euro and is one reason we've dialed down our optimism on the single currency. At the same time, monetary authorities in several countries whose currencies are tied to strong global growth (Norway, Canada and New Zealand) have broadcast their intentions to hike sooner and more aggressively than markets currently expect from the Fed. Interest-rate hikes have already materialized in several emerging-market countries, and should keep downward pressure on the U.S. dollar (Exhibit 8). Policy rates in Russia have been raised by 2.25 percentage points, for example, and in Brazil by 3.25 points. Central banks in Chile, South Korea, Mexico, Peru, Hungary and Czechia have been raising interest rates as well.

Higher bond yields and the capital flows they attract are not the only reasons we like emerging-market and cyclical currencies. These currencies are undervalued on multiple measures and under-owned after a difficult year. They also carry a higher sensitivity to commodities and global economic activity at a time when governments are learning how to properly lift lockdowns. While it's true that emerging markets have been slower to vaccinate their populations, research by Goldman Sachs indicates that they may have equally high levels of immunity (Exhibit 9) owing to antibodies developed during prior waves and a population with greater natural resistance to the virus. Moreover, the economic damage in many emerging markets was cushioned in part by a shift in global demand toward goods, many of which are produced in developing countries.

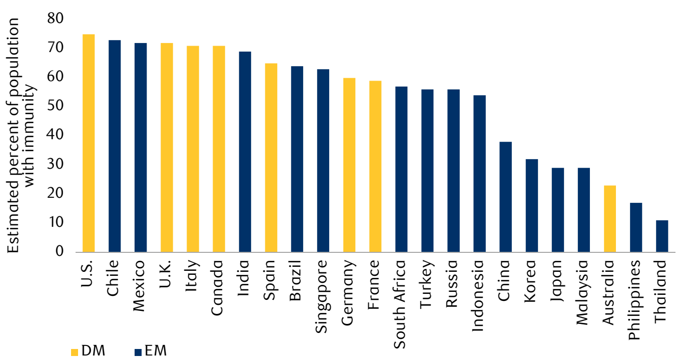
That said, we are being more selective in our approach to investing in emerging markets and expect outperformance from currencies with hawkish central banks, strong fiscal dynamics and higher sensitivity to global economic activity.

Exhibit 8: More emerging-market central banks are now hiking



Note: Hiking / cutting is 3m rolling average. As at Jul. 30, 2021. Source: TD Securities

Exhibit 9: Emerging markets have relatively high levels of immunity



Note: As at Jul. 26, 2021. Source: Goldman Sachs

Euro

The euro has underperformed our expectations over the past few months, unable to push beyond January's 1.2350 high and falling to 1.1700 in mid-August. Aside from temporary U.S.-dollar strength, another reason for the euro's recent weakness is the ECB's differing approach to monetary policy compared with central banks in the U.S. and Canada. While the Fed has started a discussion on reducing bond purchases, the ECB is likely to continue with asset purchases for the foreseeable future. As part of a recent strategic review, the ECB also unveiled a set of tough-to-meet criteria (Exhibit 10) guiding any eventual increase in European interest rates. For context, the harmonized CPI index preferred by policymakers has exceeded 2% only a handful of times since 2012. Moreover, there is sufficient leeway in how these rules are interpreted that the bank could keep policy easy even if inflation were to rise.

Even so, the prevailing pessimism on the euro seems to us to be inconsistent with economic developments in the Eurozone. According to Citibank indexes, for example, economic data in Europe has been more positive relative to expectations than it has in the U.S. (Exhibit 11). The currency has decoupled from this economic indicator, perhaps for fear that the delta variant could cause a reversal of reopening efforts in Europe. To date, however, the more infectious strain hasn't kept Europeans indoors and nor has it held back consumer spending – Google's mobility data show a quicker return to normal in Europe than the U.S. since April (Exhibit 12).

Balancing domestic developments with the more dovish ECB stance, we have trimmed our 12-month forecast for the euro versus the greenback to US$1.27 from US$1.30.

Exhibit 10: ECB's new criteria for rate hikes

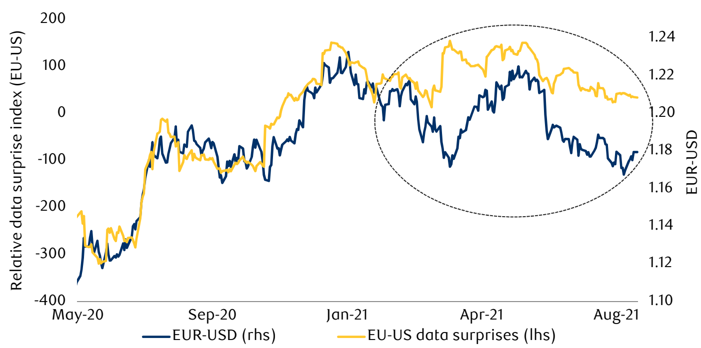
Condition A: Inflation reaches 2% by midpoint of forecast horizon

Condition B: Inflation sustainably remains at 2% durably for the latter half of forecast horizon

Condition C: Underlying inflation dynamics consistent with stable inflation at 2% beyond forecast horizon

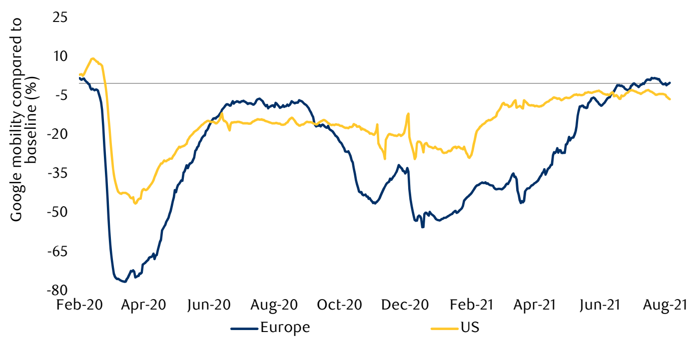
Source: RBC GAM

Exhibit 11: Euro disconnected from economic data



Note: As at Aug. 30, 2021. Source: Bloomberg, Citigroup, RBC GAM

Exhibit 12: Eurozone mobility back to pre-COVID levels



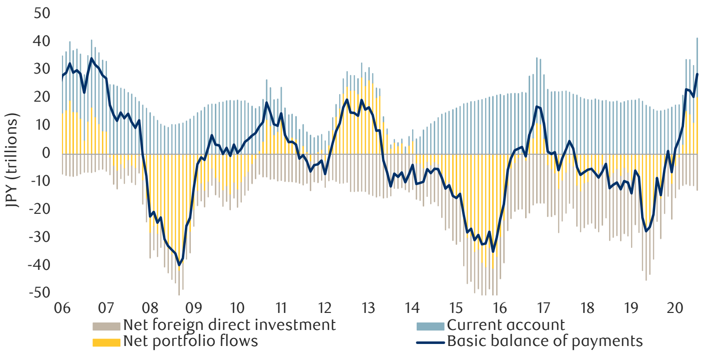
Note: Europe is an average of Germany, France, Austria, Italy, Spain, Belgium and Netherlands. As at Aug. 25, 2021. Source: Google, RBC GAM

Japanese yen

Japan has enjoyed a stable current-account surplus for years, a positive inflow that is only partially offset by capital leaving the country to finance foreign direct investment (Exhibit 13). The swing factor in the balance of payments comes in the form of newfound demand for Japanese assets. Domestic investors seem more enthusiastic about Japanese equities, and foreigners are keen on the country's bonds, though a portion of the bond flows is currency-hedged. The inflows coincide with news that the US$1.7 trillion Government Pension Investment Fund (GPIF) has completed its shift into global assets from domestic bonds, removing a key negative for the yen.

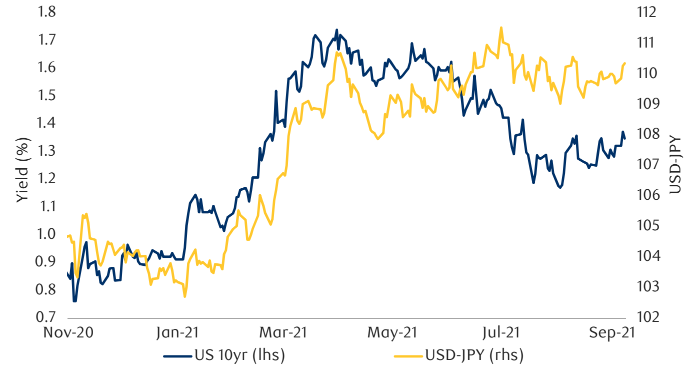
The yen's performance has for now deviated from what we would expect given bond-yield differences and other factors that usually determine its direction. The gap between U.S. bond yields and where they suggest the yen should trade (Exhibit 14) is particularly wide and we look for some yen strength as the two converge. Our forecast for the yen to trade at 103 per dollar remains unchanged from last quarter.

Exhibit 13: Japan's basic balance of payments



Note: As at Jun. 30, 2021. Source: Bank of Japan, RBC GAM

Exhibit 14: U.S. yields versus U.S. dollar-yen exchange rate



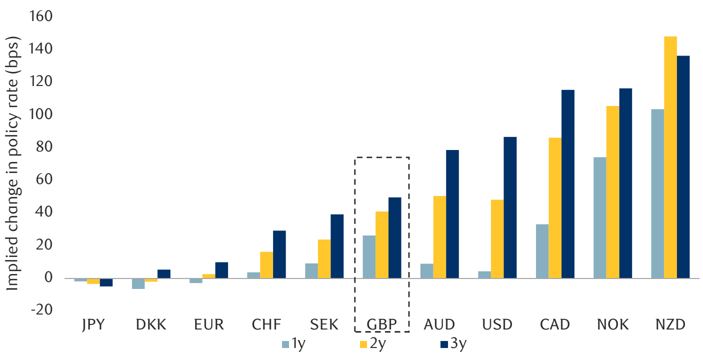
Note: As at Sep. 8, 2021. Source: Bloomberg, RBC GAM

British pound

The British pound has not been among our favourite currencies over the past few years due to Brexit uncertainty, a sizable current-account deficit and a lack of competitiveness relative to its largest trading partners. This pessimism has softened, perhaps more from our bearish outlook on the U.S. dollar than for any U.K.-specific reasons. The macroeconomic landscape continues to suggest that the pound will underperform versus the euro, the yen and cyclical currencies – whether because of muted expectations for economic growth or from the slow pace at which interest rates are expected to rise. It is possible that the Bank of England will hike rates as early as 2022, although we believe that any subsequent hikes would be slow to materialize (Exhibit 15). We are also mindful of tensions with Europe over the implementation of a post-Brexit arrangement concerning Northern Ireland and of another possible referendum on Scottish independence.

Our forecast is that the pound will appreciate against the U.S. dollar within the next year to US$1.40 from US$1.38 currently.

Exhibit 15: Slower and smaller rate hikes from Bank of England

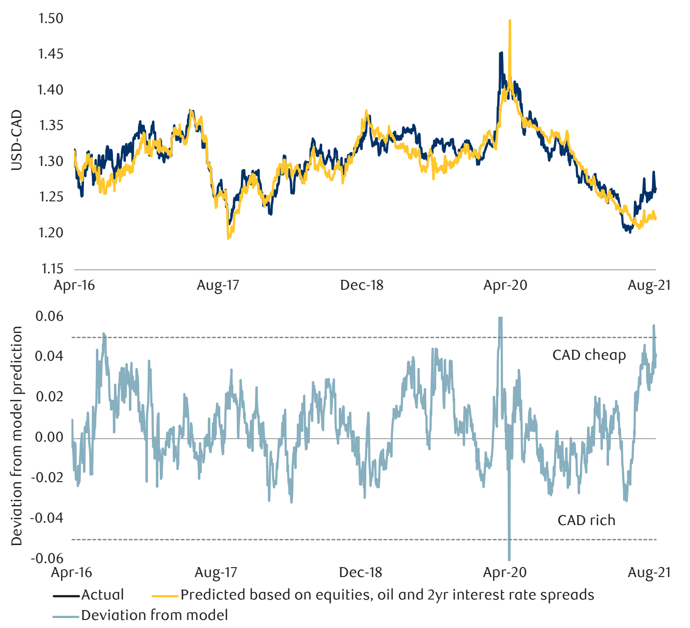


Note: As at Aug. 30, 2021. Source: Bloomberg, RBC GAM

Canadian dollar

The Canadian dollar has fallen 5% since the beginning of June. Weaker global economic data and broad U.S.-dollar strength are partly to blame for the depreciation, though can't fully explain it. Even with the decline, the Canadian dollar is the best-performing G10 currency this year, and statistical models (Exhibit 16) suggest the currency should strengthen if it is to realign with the factors that tend to influence its value (equities, oil and 2-year interest-rate spreads). Indeed, the resilience of equity markets and commodities amid the surge in the delta variant indicates that wobbles in fixed-income and foreign-exchange markets were driven by investors unwinding bets that the loonie would rise rather than anything fundamental. The snap-back in commodity currencies has already begun, a trend that will be further supported by relatively hawkish monetary policy in Norway, New Zealand and Canada, where earlier and more aggressive rate hikes are expected.

Exhibit 16: Canadian dollar has deviated from short-term models

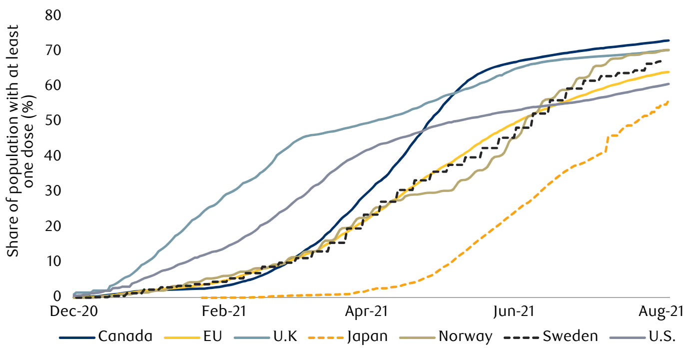


Note: As at Aug. 27, 2021. Source: Bloomberg, RBC GAM

The following factors should keep the currency relatively strong in 2022:

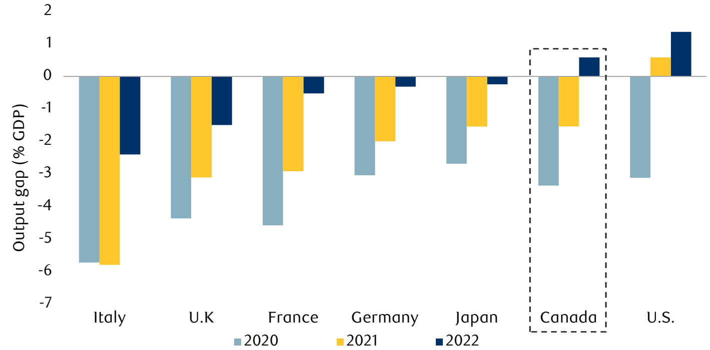
- Canada's impressive record of vaccinating its population (Exhibit 17) means that there has been a relatively small number of COVID-19 cases during this most recent wave, and bodes well for the future.
- Labour markets in Canada are closer to reaching pre-pandemic levels than in the U.S., and the IMF expects the output gap to close more quickly in Canada than in other major developed economies (Exhibit 18).
- A reduction in bond purchases by the Bank of Canada has investors expecting rate hikes in Canada sooner than in many other developed-market countries.
- A boom in residential investment supports economic activity amid a long-term decline in business investment.
- Immigration that is set to accelerate with the reopening of borders.
- News of renewed investment activity in stalled pipeline and infrastructure projects such as the Trans-Mountain pipeline and Muskrat Falls hydro-electric dam.

Exhibit 17: Vaccination rates in Canada remain high



Note: As at Aug. 29, 2021. Source: Our world in data, RBC GAM

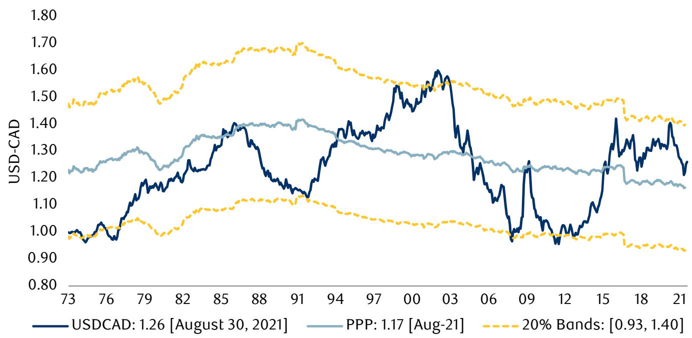
Exhibit 18: Canadian output gap to close before many developed-market economies



Note: As at Apr. 26, 2021. Source: IMF World Economic Outlook, RBC GAM

The Canadian dollar remains undervalued (Exhibit 19) based on purchasing power and we expect the loonie to appreciate against most major currencies in the coming year. U.S.-dollar weakness – though helpful – will not be the only force driving loonie strength. We expect the market to pay more heed to factors that tend to support the Canadian dollar at a time when bets on Canadian-dollar strength have been pared. Our forecast is for the loonie to trade at $1.15 per U.S. dollar in a year's time. A move of this magnitude might seem implausible from the current level of $1.25, but it is one that we think is reasonable given an overvalued U.S. dollar, a Fed that will be slow to tighten monetary policy and global economic strength that continues to support commodity prices.

Exhibit 19: Purchasing power parity valuation



Note: As at Aug. 30, 2021. Source: Bloomberg, RBC GAM

Conclusion

Support from a few short-term themes helped the U.S. dollar trade sideways this year within a very tight 4% band. We believe that the greenback remains in a longer-term downtrend, however, and that further weakness will persist in the years ahead. The dollar decline should be most helpful for cyclical currencies that benefit from rising commodity prices and the ongoing global economic reopening, and we are particularly positive on those currencies with central banks that will likely hike interest rates faster than the Fed. While our optimism on the euro has been tempered slightly, we remain positive on other G10 and emerging-market currencies.

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