RBC Global Asset Management

Global currency outlook

FALL 2023

Dollar detour: how short-term factors have interrupted the cyclical decline

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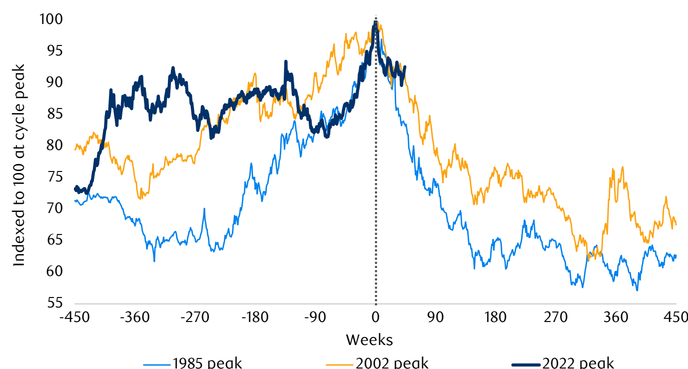
The U.S.-dollar downtrend remains intact and we continue to expect significant weakness over the coming years. However, the long-term cyclical decline embedded in our outlook has run into a few shorter-term roadblocks, and so its progress has been slower than we had anticipated. While the dollar sits roughly 7% below its September 2022 peak, the currency is unchanged since the start of 2023. Higher U.S. interest rates and disappointing economic growth abroad have interrupted the dollar's slide in 2023. Still, emerging-market currencies as a whole have fared impressively – a few even managing to post double-digit returns so far this year – and the euro, Canadian dollar and British pound have also outperformed the U.S. dollar. We remain optimistic on most emerging- and developed-market currencies over the next 12 months, as we expect the U.S. dollar to decline broadly.

The greenback has so far failed to follow through on the significant weakness experienced late last year. A quick 10% decline from October 2022 to January of this year offered a glimpse of what past cyclical declines have entailed (Exhibit 1), but the move stalled early in the year (Exhibit 2). U.S.-dollar strength this summer has caused some investors

Exhibit 1: U.S.-dollar bear market roadmap



Note: As at August 28, 2023. Uses USTWAFE index. Source: Bloomberg, RBC GAM

Exhibit 2: U.S. dollar in tight year-to-date range

Note: As at August 29, 2023. Note: Uses BBDXY index. Source: Bloomberg, RBC GAM

to question the sustainability of the downtrend. We, on the other hand, remain confident that the long-term trajectory for the U.S. dollar is lower, and we expect a multi-year period of weakness (Exhibit 3) to exert an important influence on bond, equity, commodity and currency markets.

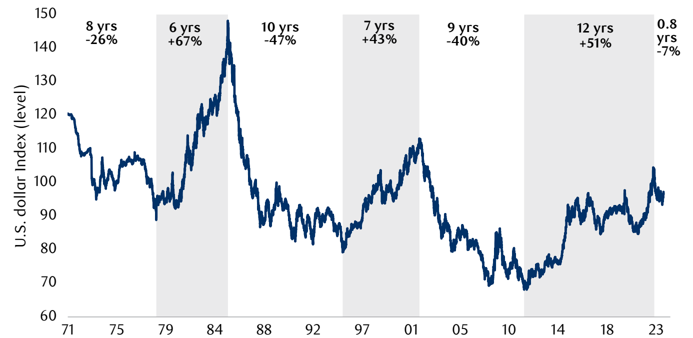
Fundamental factors continue to make the case for a weaker U.S. dollar. Most valuation models indicate that the currency has been expensive for several years, and the purchasing power parity model that we monitor places the dollar at more than 20% rich to its estimated fair value (Exhibit 4). Likewise, few would contest the link between America's deteriorating fiscal and trade deficits and U.S.- dollar movements (Exhibit 5) or the negative U.S. dollar implications from U.S. bank failures, threats of government shutdowns and credit-rating downgrades. As discussed in prior editions of the Global Investment Outlook, the theme of 'dedollarization' – a slow but gradual shift away from using the U.S. dollar for global trade and global investment - has gained traction. The theme will erode support for the dollar over the next decade, especially if the U.S. continues to weaponize the currency by restricting access to payment systems and freezing the foreign-exchange reserves of its enemies. A study[1] published by the IMF in January found that dozens of countries in Europe, the Middle East and Asia have resorted to holding more gold as a reserve asset.

The U.S. dollar's resilience can largely be explained by short-term factors. A persistently hawkish U.S. Federal Reserve (Fed) has done its part in keeping the greenback strong, as higher U.S. rates continue to attract capital away

> "So long as this policy tightening doesn't cause a recession in the U.S. the greenback should depreciate."

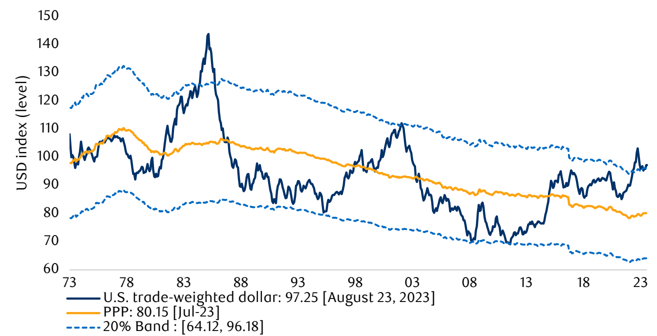
[1] Arslanalp, S., Eichengreen, B. J., & Simpson-Bell, C. (2023). "Gold as International Reserves: A Barbarous Relic No More?" IMF Working Paper No. WP/23/14

Exhibit 3: U.S. trade-weighted dollar



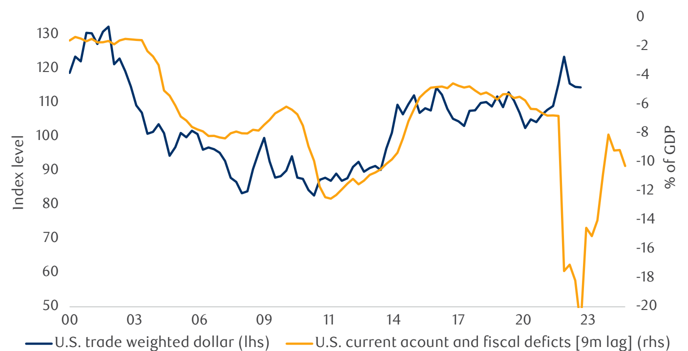
Note: As at August 25, 2023. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 4: U.S. dollar – PPP model



Note: Uses new Fed USD index from Dec 31, 2019 onward (USTWAFE Index). As at August 23, 2023. Source: U.S. Federal Reserve, Bloomberg, RBC GAM

Exhibit 5: U.S. dollar and the American twin deficits



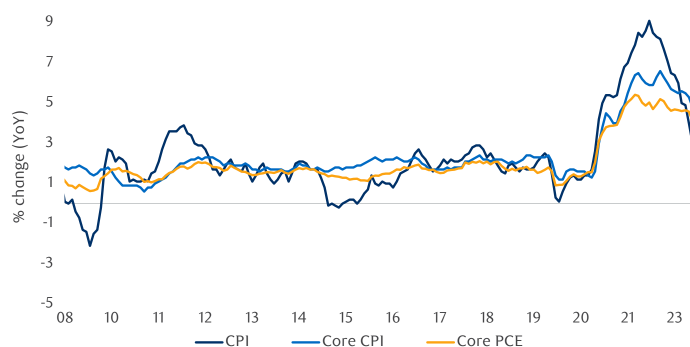
Note: As at March 31, 2023. Source: Bloomberg, RBC GAM

from lower-yielding regions such as Japan. For now, the Fed has been steadfast in asserting that monetary policy will be kept tight for as long as it takes to tame inflationary pressures. Exactly when U.S. policymakers will be able to claim victory on this task is up for debate. Overall inflation has declined to about 3% from a high of about 9% (Exhibit 6), which suggests a job nearly finished, although the Fed's preferred measure of price changes (core PCE) has not yet declined sufficiently. With the fed funds rate having risen to 5.50%, the Fed's inflation-adjusted policy rate is positive again and thus more restrictive of economic growth.

So long as this policy tightening doesn't cause a recession in the U.S., the greenback should depreciate as inflation continues to decline because it relieves pressure on the Fed to raise interest rates further and could even prompt the Fed to lower them. It's safe to say that the positive impact of higher yields on the U.S. dollar has largely played out, and that the Fed is either finished or nearly finished with rate hikes.

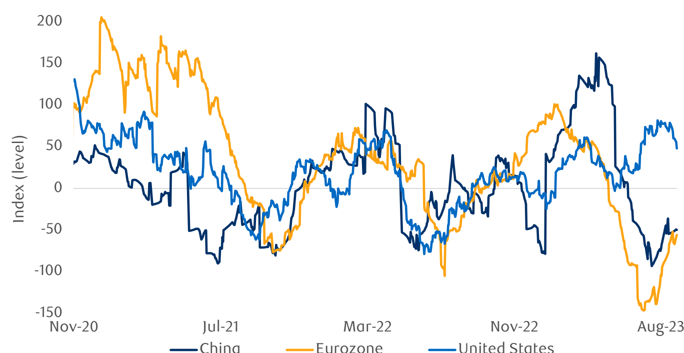
The other primary factor supporting the greenback is the relatively downbeat economic news in other regions. Europe and China stand out, not only because they are the next two biggest economies after the U.S., but because their economic data have been so disappointing (Exhibit 7). Without the prospect of superior returns luring capital abroad, it's unlikely that the euro and renminbi can make substantial gains. Having said this, sentiment toward these two currencies is extremely poor, telling us that the worst may already be factored in.

Exhibit 6: All three inflation measures falling



Note: As at August 28, 2023. Source: Bureau of Labour Statistics, Bureau of Economic Analysis, RBC GAM

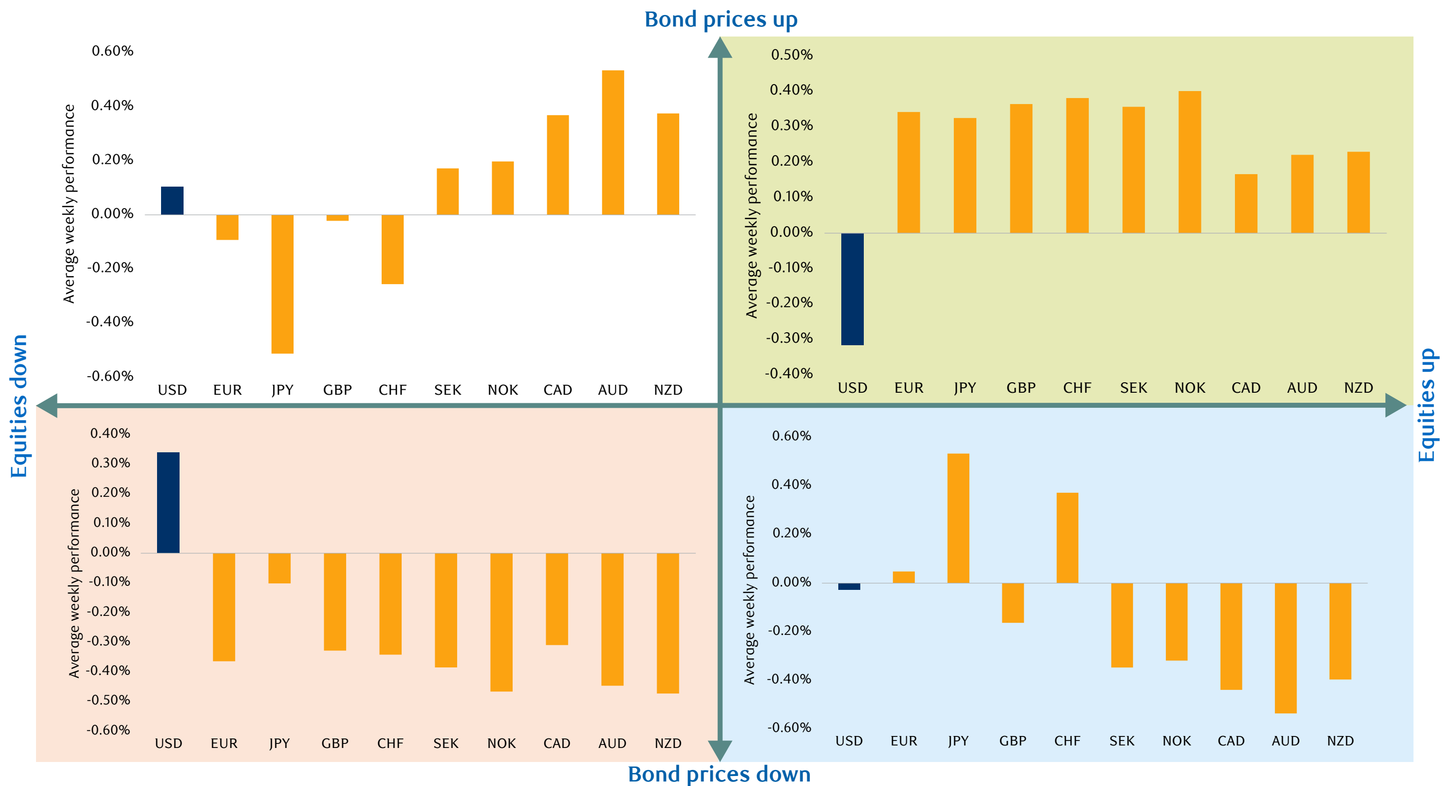
Exhibit 7: Economic-data surprises by region



Note: As at August 28, 2023. Source: Citi, RBC GAM

Exhibit 8: Currency performance in bond/equity regimes

Weekly data 1980–2023



Note: As at August 25, 2023. Bars show average of weekly data from 1980 – 2003, excluding observations within +/- 0.5 standard deviations.
Source: RBC Capital Markets, RBC GAM

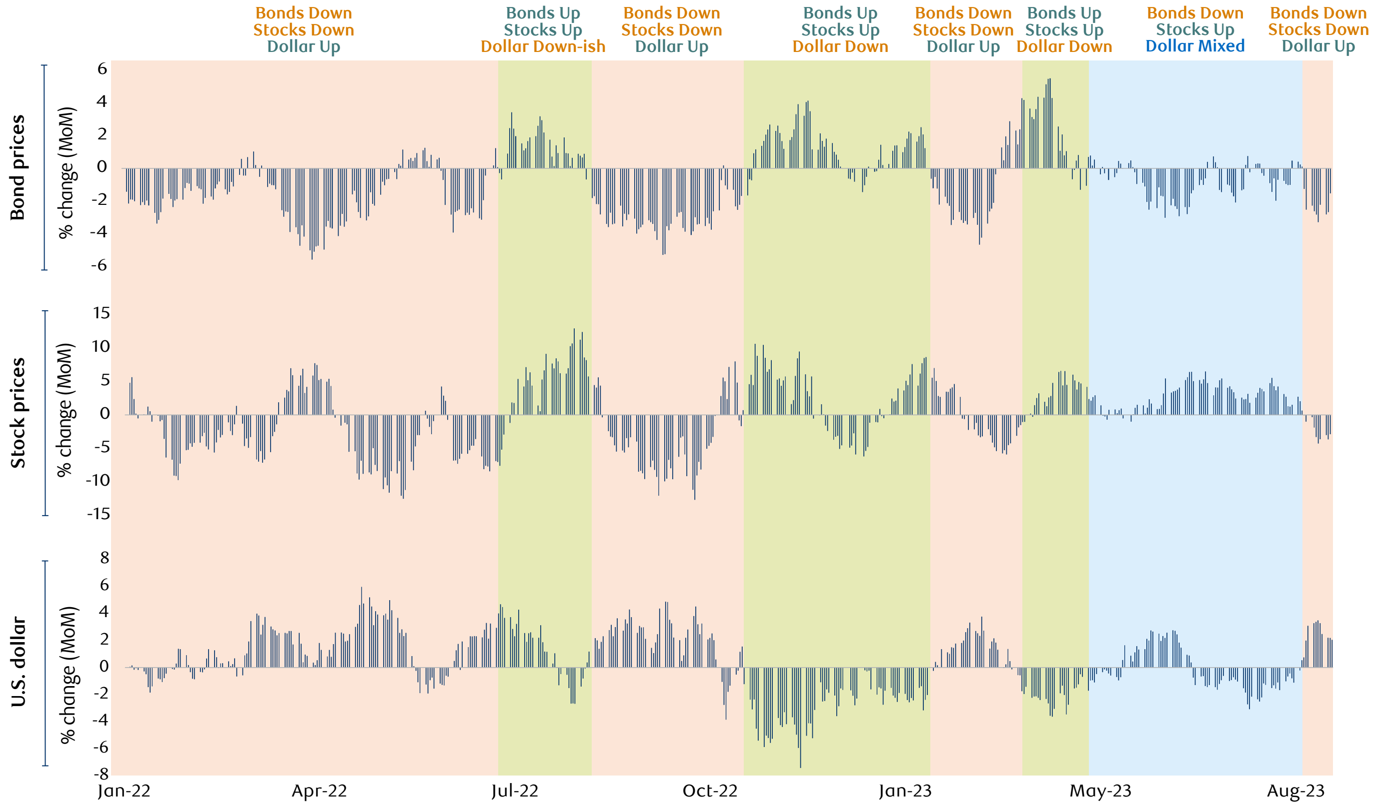
A new regime?

A study of the relationship between financial markets and the U.S. dollar also suggests that the greenback could enter a period of weakness. The four-quadrant framework illustrated in Exhibit 8, devised by Adam Cole and Elsa Lignos at RBC Capital Markets, displays currency returns in different bond/equity environments over the past four decades. As one would expect, a rising greenback correlates most closely with declines in both stocks and bonds (bottom left-hand quadrant) because the dollar benefits from higher yields as bonds weaken and from safe-haven demand when stocks falter. This was the prevailing market environment for much of 2022, and in retrospect the dollar would have served as a good hedge for investors grappling with the very difficult investment landscape at the time. Periods where bonds and stocks fall in unison are fairly rare, however, and are typically characterized by periods when Fed interest-rate hikes threaten to interrupt equity bull markets. As the Fed nears the end of its rate-hiking cycle, we don't expect this difficult environment to persist, and indeed have noticed a weaker link between bonds and stocks (bottom right quadrant) in recent months (Exhibit 9). Provided that a hard economic landing can be avoided, we suspect that bonds and stocks could both experience relief as the Fed pauses rate hikes, an environment in which the dollar would be expected to sell off broadly against its peers.

Emerging markets

Many of the world's best performing currencies over the past year have been emerging-market ones offering much higher interest rates than even the U.S. dollar. A number of emerging-market central banks, including Hungary, Mexico and Brazil, were more aggressive than the Fed about raising rates last year in response to rising inflation, and such policy

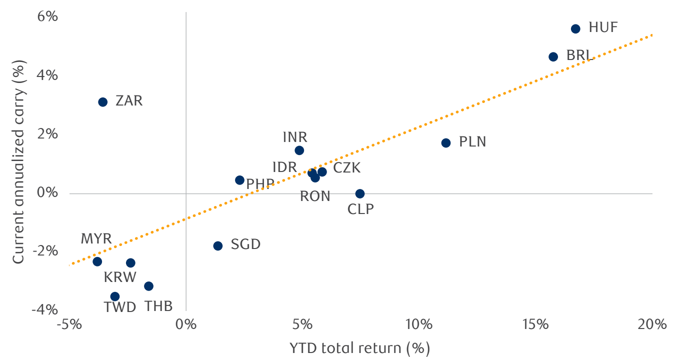
Exhibit 9: Rolling 1-month price returns (bonds, stocks, $)



Note: As at August 25, 2023. Source: RBC GAM

saved these countries from experiencing sudden capital outflows as U.S. rates rose. In fact, the higher yields – double digits in some countries – have led to substantial emerging-market currency total returns (Exhibit 10) comprised of both healthy yields and exchange-rate gains. The success of such yield-seeking strategies has been fueled by low market volatility, strong equity markets and a wide gap in rates between high- and low-yielding currencies. Emerging-market currencies may continue to outperform as the dollar falters, but we are growing more cautious as valuations converge and as some emerging-market central banks, notably those in Brazil and Chile, begin cutting rates. While U.S.-dollar weakness represents a broad-based tailwind for emerging-market currencies, we are likely to be more selective in which emerging markets to own. We look to own currencies of countries with better growth and fiscal profiles while avoiding those with central banks that are cutting interest rates before inflation has subsided.

Exhibit 10: Strong relationship between yield and FX performance



Note: Data as at August 28, 2023. Source: Bloomberg, RBC GAM

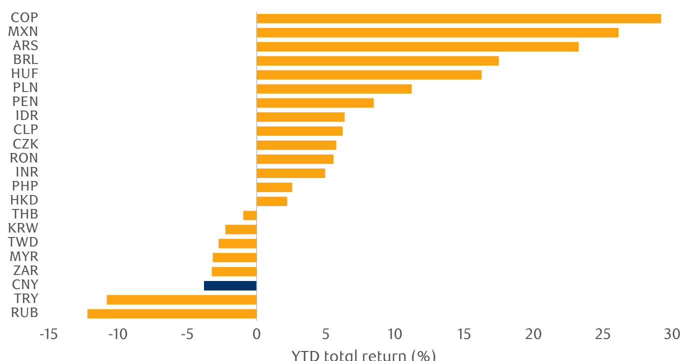
Chinese renminbi

The Chinese renminbi has been one of the worst performing currencies this year, ranking third worst among 25 major emerging markets and just ahead of the Russian ruble and Turkish lira (Exhibit 11). A rebound in economic growth failed to materialize after COVID restrictions were relaxed late last year, and these disappointing results are reflected in currency performance. Moreover, with Chinese interest rates among the lowest in emerging markets and with policy rates being cut twice this summer, the renminbi has been shunned by investors seeking currencies offering higher yields. The softer renminbi and the general ill-health of the Chinese economy has weighed on investor appetite for all emerging-market currencies, but there's hope that this currency headwind may lighten as the Chinese central bank starts to push back against the renminbi's decline. For Chinese policymakers, who prioritize stability and control, the yuan's near-10% fall since January threatens to attract speculation about further declines, a dynamic that could erode confidence in the currency and disrupt efforts to encourage investment. As the currency nears lows not seen since the global financial crisis (Exhibit 12), the People's Bank of China has used many of its tools to support the renminbi. These include:

- providing guidance through a daily reference rate that is stronger than the prevailing exchange rate,
- engineering higher short-term interest rates aimed at dissuading short positions in the renminbi,
- coercing banks and state-owned exporters to convert their foreign cash holdings and cutting reserve requirements on foreign-exchange dealings to free up more assets for repatriation.

The bank is well-armed with additional and more powerful tools that it has yet to tap, including direct purchases of renminbi. Our view is that the current round of renminbi depreciation is nearly complete and that the bad economic news has been factored into the exchange-rate level. We don't expect the renminbi to rebound sharply, but the absence of further weakness would remove an important negative influence on emerging-market currencies and thus is a negative for the U.S. dollar overall.

Exhibit 11: Renminbi one of the worst EM peformers for the year



Note: As at August 28, 2023. Source: Bloomberg, RBC GAM

Exhibit 12: Renminbi approaching levels not seen since the global financial crisis

Note: As at August 25, 2023. Source: Bloomberg, RBC GAM

Euro

The euro strengthened in early summer, rising above US$1.12 in mid-July from US$1.065 at the beginning of June. The rally was partly attributable to the European Central Bank's (ECB) determined efforts to fight inflation, though it also reflected a broad sell-off in the U.S. dollar at that time. Since then, sentiment toward the single currency has soured because of a trio of factors: (i) disappointing European economic data, (ii) a weak Chinese economy that spends less on European exports and (iii) lower odds of a U.S. recession and a reversal of next year's Fed rate-cut expectations. The pessimism around economic growth outside of the U.S. is already widespread, so there's room for this sentiment to recover. Indeed, the economies of both Europe and China have already begun to show unexpected signs of improvement.

The next several months will offer important insights into the trajectory of monetary policy in all major regions. For now, we can be relatively certain that the Fed has hiked interest rates sufficiently, lessening the support that the dollar receives from higher rates. Many investors think the ECB is almost done with its rate-hike cycle given perceptions that Europe's growth slump will bring inflation down without the need for much in the way of further rate hikes. Unlike the Fed, however, the ECB is not tasked with targeting growth and employment when setting policy rates. Will the ECB's past hikes be enough to bring down the stubbornly high core inflation in Europe? Could China's recent efforts to stimulate growth support the euro? ECB President Lagarde didn't provide her views on these questions in a recent appearance at the Jackson Hole central-banker conference in Wyoming, but her comments did lean more hawkish – a sign that that the ECB isn't yet claiming victory in its fight against rising prices. A recovery in the euro will require more than just a hawkish central bank, however. We expect that the European economy will be on better footing in a year's time and that a weaker U.S. dollar overall will help the euro to strengthen. Our forecast is for the single currency to rise to US$1.21 in 12 months' time.

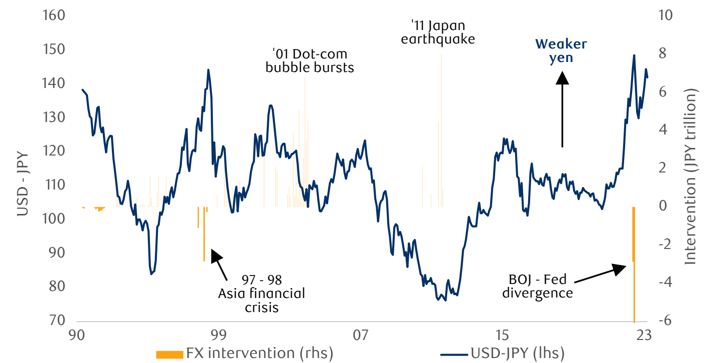
> "Will the ECB's past hikes be enough to bring down the stubbornly high core inflation in Europe?"

Japanese yen

Japanese authorities last intervened to support the yen in October 2022, and it appears increasingly likely that they may do so again. G20 central banks have generally condoned the practice of tamping down excessive currency volatility but have frowned on targeting specific exchange-rate levels that would result in unfair trade advantages. Japanese authorities intervened by selling U.S. dollars following last year's near-40% decline in the yen (Exhibit 13), and as the Japanese currency weakens back to those intervention levels (140-150 per U.S. dollar), the market is growing more anxious about shorting the yen. The impact of any intervention would probably be fleeting, though, because the government is unlikely to enjoy the coordinated support of other countries and because such actions conflict with Japan's relatively low interest rates – a more powerful influence on exchange rates. A change in the Bank of Japan (BOJ) monetary policy and/or more persistent U.S.-dollar weakness is needed for the yen to rally in earnest.

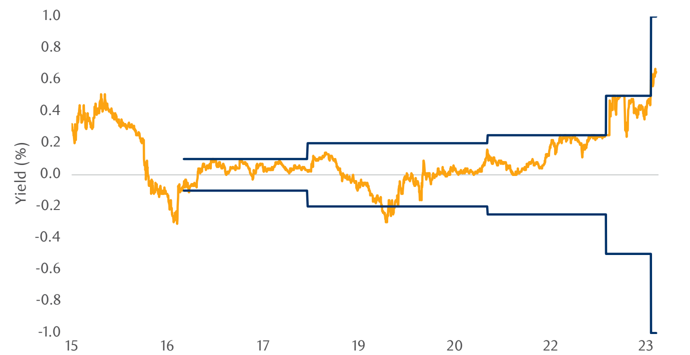
A change in BOJ policy may soon be on its way. The bank allowed 10-year JGB yields to rise above the +/-50-basis-point range established by its so-called yield curve control (YCC) policy. Initially set at +/- 10 bps around 0%, the policy has been widened a few times since it was introduced in September 2016 (Exhibit 14). With core inflation at a 40-year high of 4.3%, pressure is mounting on the central bank to widen the band further or even to abandon the policy. The bank has bought itself some time by announcing a formal review of monetary policy over the next year, but we suspect that some action will take place within our 12-month forecast horizon. Our 120 yen per US-dollar forecast is built on expectations that the BOJ allows interest rates to fluctuate more freely.

Exhibit 13: BOJ intervention history



Note: As at July 31, 2023. Source: Japan Ministry of Finance, RBC GAM

Exhibit 14: 10-year Japanese bond yields and yield-curve-control bands

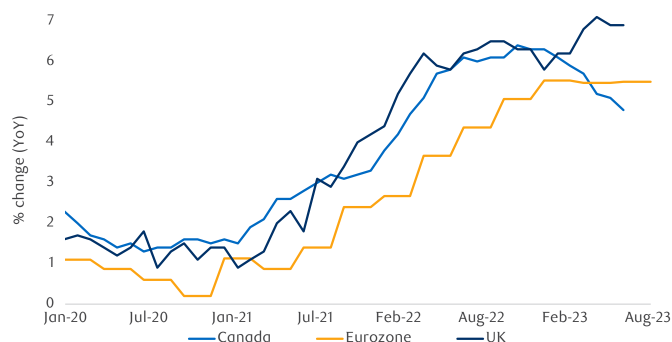


Note: As at August 29, 2023. Source: Bank of Japan, RBC GAM

British pound

The pound, this year's best performing G10 currency, has been surprisingly resilient as persistently high inflation pushed the Bank of England (BOE) to continue hiking interest rates (Exhibit 15). The increase in policy rates has helped support the pound in the face of concerns about weak consumer spending, trade deficits and the fact that British companies are investing more abroad at the same time that foreign companies are pulling back on their U.K. investments. The BOE is now expected to raise interest rates to almost 6%, 2 full percentage points higher than the market's expectation in March. This looks overdone: Investors, in our view, are too optimistic in their views that the pound will be able to sustain its gains. While sterling may continue to rally against a weak U.S. dollar, we expect the pound to fall versus other major currencies this year. Our view is that the currency will appreciate only modestly to US$1.33.

Exhibit 15: Sticky U.K. inflation



Note: As at July 31, 2023. Source: Macrobond, RBC GAM

Canadian dollar

Until recently, shorting the Canadian dollar was a popular strategy for hedging against scenarios involving a U.S. economic slowdown, owing to the loonie's tight link with oil prices and the U.S. economy. The paring of these short positions alongside better U.S. economic data helped the loonie strengthen toward the lower end of this year's $1.32-$1.40 per U.S.-dollar range before generalized U.S.- dollar gains caused the exchange rate to bounce again (Exhibit 16). As the Canadian dollar nears $1.32 per U.S. dollar, the loonie may have trouble keeping up with gains we expect from the euro and the yen given the persistence of the trading range. Over a 12-month horizon, though, we expect the loonie to strengthen to $1.24 per U.S. dollar as cyclical currencies benefit most from greenback weakness.

Exhibit 16: USD – CAD range

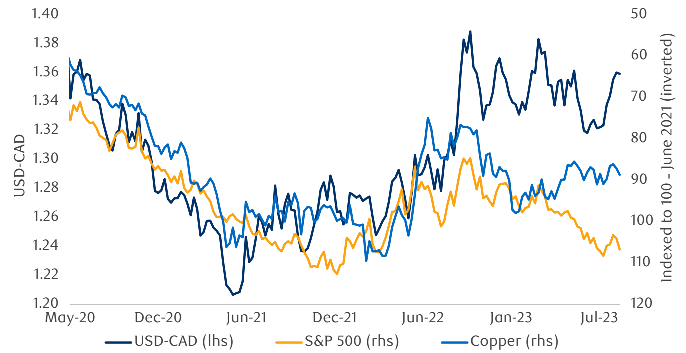
Note: As at August 29, 2023. Source: Bloomberg, RBC GAM

There are plenty of other reasons to be positive on the Canadian dollar. From a longer-term viewpoint, the currency is undervalued, Canada is well endowed with natural resources and the loonie enjoys support from foreign demand for Canadian corporate bonds and from healthy immigration. The country also has a stable political environment and a strong banking system that hasn't

experienced the same kind of deposit flight as in the U.S. Shorter-term factors are mostly supportive as well, with stock-market movements, copper prices and general U.S.-dollar weakness all pointing toward a stronger Canadian dollar (Exhibit 17).

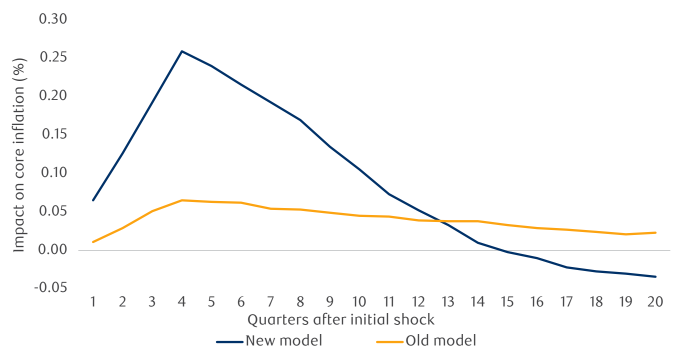
Partly countering these short- and long-term positives are intermediate concerns about how tighter financial conditions might impact household finances. The Bank of Canada (BOC) paused its rate-hiking cycle earlier in the year, only to learn that consumer spending had been surprisingly strong. It's likely that a breakneck pace of immigration and low unemployment rate are responsible for supporting consumer demand and boosting inflation. The BOC noted in July that prices excluding food and energy were higher than it would like, so, while the bank paused in early September, the emphasis remains on further policy tightening. On the other hand, the newest version of the bank's economic model (Exhibit 18) shows that the Canadian dollar has a greater impact on core inflation than previously thought. Given the importance of this model in the BOC's decision making, it's possible that further Canadian dollar strength is seen as a welcome and complementary tool in containing consumer-price gains.

Exhibit 17: Short-term drivers suggest USD-CAD below 1.30



Note: As at August 28, 2023. Source: Bloomberg, RBC GAM

Exhibit 18: Inflation senstivities



Note: As at June 30, 2021. Source: CIBC, Bank of Canada, RBC GAM

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