RBC Global Asset Management

Global currency outlook

NEW YEAR 2022

Volatility returning to the currency markets

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

Daniel Mitchell, CFA
Portfolio Manager
RBC Global Asset Management Inc.

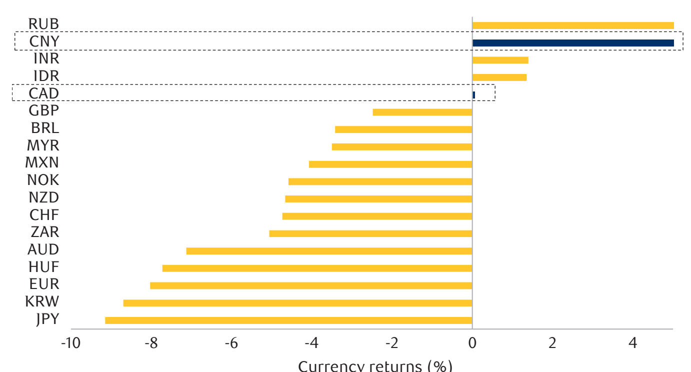
Having spent most of 2021 in a sleepy state of tight currency ranges, the foreign-exchange market awoke in November to U.S.-dollar gains against most other developed and emerging-market currencies. Moreover, the greenback's trading range widened during the quarter to an amount that was twice what it had been at any point during the year (Exhibit 1). Only a few currencies appreciated as much as the greenback – the Canadian dollar and Chinese renminbi notably among them (Exhibit 2).

The greenback's gains were driven by domestic and international factors. In the U.S., decent economic data and the passage of President Biden's infrastructure bill were somewhat positive for the U.S. dollar, but it was the persistence of consumer-price inflation that had the greatest impact on currency markets. U.S. Federal Reserve (Fed) governors had to abandon previous arguments that high inflation would be short-lived, and started planning the removal of the emergency stimulus that was injected during the pandemic. While the Fed has only just started to reduce

Exhibit 1: USD breaks out of trading range

Note: USD index is proxied by the DXY index. As at Nov. 30, 2021.
Source: Bloomberg, RBC GAM

Exhibit 2: Currency returns, year-to-date



Note: As at Nov. 29, 2021. Source: Bloomberg, RBC GAM

the pace of monthly asset purchases – a process that takes time and would need to be completed before interest-rate increases take place – financial markets are currently pricing in three rate hikes in 2022.

Another factor that makes the U.S. dollar more attractive is the deteriorating economic outlook in Europe and China. Chinese economic growth is slowing, and Europe is beset with skyrocketing COVID cases just as colder weather and fuel shortages conspire to raise energy costs. We have dialed back our optimism on the euro, mostly in response to these developments rather than the European Central Bank's (ECB) continued insistence that it will not tighten monetary policy next year.

While we have tinkered with our shorter-term forecasts, our longer-term outlook for currency markets remains broadly intact. The U.S. dollar remains overvalued against most G10 currencies and a decline of 14% is needed for it to reach fair value (and more if the greenback is to become competitive). This process takes time, and our research suggests that several more years of U.S.-dollar weakness lie ahead (exhibits 3 and 4). In this context, periods of appreciation should be viewed as opportunities to hedge U.S.-dollar exposure before the U.S. dollar resumes its decline. Given the diminished U.S. capacity for fiscal spending and the fact that global and China risks are reflected in current financial markets, the build-up of long U.S.-dollar positions should be taken as a warning sign that the greenback is more vulnerable to correction.

We have previously argued that there will be greater dispersion in the movements of the world's currencies – specifically that cyclical and commodity-oriented currencies would likely outperform low-yielding currencies such as the euro and Japanese yen (Exhibit 5). Within the G10, we continue to see greater value in the Canadian dollar, Norwegian krone and Australian dollar. These three currencies benefit from both rising prices of their exports and central banks that are likely in our view to tighten monetary policy more quickly than the Fed.

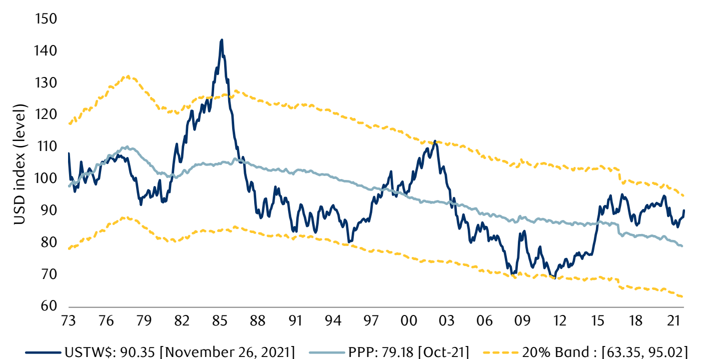
Watching inflation

The recent inflation spike that has gripped markets in the wake of the pandemic is not rooted solely in strong demand for goods and services, but also in supply-chain issues, higher energy prices and the unfortunate timing of poor weather. The Fed had described goods-price gains associated with these one-off supply shortages as "transitory," hoping perhaps to treat them similarly to volatile food and energy prices that are excluded when measuring underlying inflation. Concerned about a loss of credibility, policymakers have since backpedaled on this message and are now expected to accelerate the reduction of asset purchases so that they gradually fall to zero early in 2022. Powell said as much in his November 30 comments to Congress, which came as a surprise to us in light of a new and more transmissible COVID variant that we thought would have made the central bank more cautious in reducing stimulus. More important for the dollar is the

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

Note: As at Nov. 26, 2021. Source: Bloomberg, Federal Reserve, RBC GAM

Exhibit 4: USD purchasing power parity valuation



Note: The USD index uses the new Fed USD index from Dec.31, 2019 onward. As at Nov. 26, 2021. Source: Federal Reserve, Bloomberg, RBC GAM

eventual timing of interest-rate increases, of which three are expected in 2022 based on market indicators. Rate hikes will not of course combat colder weather, port congestion or shortages of microchips used in auto production. What they will do is something that must be done: formally recognize that monetary policy may just be too loose for a period when inflation has reached levels not seen since the early 1990s.

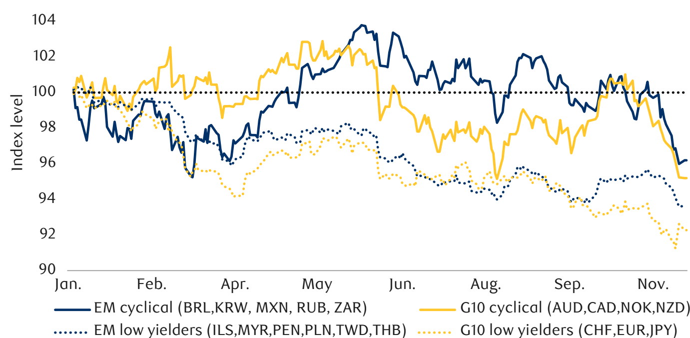
We suspect that inflation in the U.S. will settle down in the time that it takes the Fed to complete its asset purchases, easing pressure on the Fed to move quickly on interest-rate hikes next year. Expectations of a slower path to rate hikes would be negative for the greenback and might offset safe-haven support for the dollar as investors react to greater uncertainty related to COVID infections over the next few months.

The importance of the Chinese renminbi

The renminbi's stability is impressive, particularly in light of slowing economic activity, missed bond payments by large real-estate developers, tensions with Taiwan and a far-reaching regulatory crackdown that has affected a broad swath of the Chinese economy. The renminbi's stability against the U.S. dollar and its simultaneous appreciation against currencies of China's trading partners has led the Chinese trade-weighted currency basket to a six-year high (Exhibit 6). This strength has persisted as the balance of capital flows has supported the renminbi, and Chinese policymakers haven't been required to intervene. Among the reasons for these capital flows are higher yields on Chinese government bonds, the recent inclusion of China in bond and equity indexes and the reduction in tourism 'imports' given restrictions preventing Chinese citizens from travelling abroad.

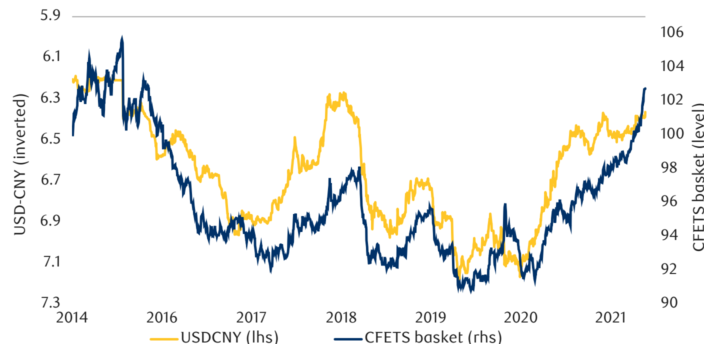
The renminbi has grown in importance for the currency markets in recent years, and its resilience has acted as a stabilizing influence on emerging-market exchange rates, particularly those of Asian countries whose economies are most tied to China. China's aspirations for global influence are reflected in efforts to secure a larger share of global foreign-exchange reserves, and it is therefore unlikely that the People's Bank of China would push back aggressively against the renminbi's appreciation, provided that such capital inflows remain orderly. Any change in the stance of the Chinese central bank would have us re-evaluate our positive stance on cyclical emerging-market currencies, especially in light of the uncertainty introduced by the new Omicron COVID variant and its impact on the economies of less vaccinated regions.

Exhibit 5: Performance of EM and G10 currency baskets this year



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

Exhibit 6: USDCNY and renminbi trade-weighted index



Note: As at Nov. 30 2021. CFETS = China Foreign Exchange Trade System. Source: Bloomberg, RBC GAM

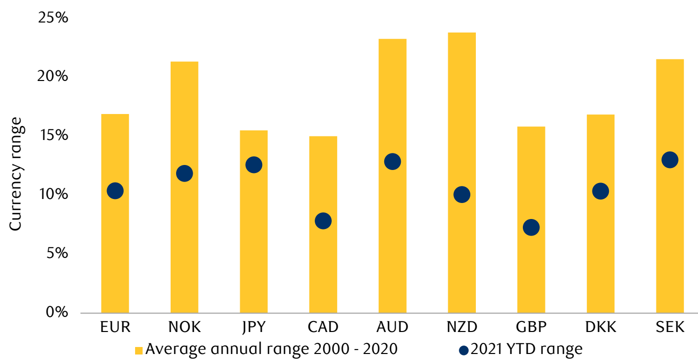
Expecting higher currency volatility

Financial-market volatility has fallen in recent years as central-bank bond purchases and low global interest rates made for a friendly and stable investment landscape. However, the narrow trading ranges (Exhibit 7) and low historical volatility to which we've become accustomed are not normal for the foreign-exchange market and are unlikely to persist. Going forward, diverging monetary policies among major central banks should drive greater capital movement across borders and, by extension, greater fluctuations in exchange rates. We know that global liquidity injections by central banks have been a major driver of stocks and other assets and so their removal is not likely to unfold smoothly.

In times of market turmoil, we often look for portfolio insurance in assets whose values tend to rise when equity markets are falling. The Japanese yen has long been regarded as such an asset, but the historical relationship between falling markets and yen strength needs to be reconsidered if we are entering a period in which equity and bond prices decline in tandem. As inflation fears threaten to depress the value of both stocks and bonds, yen strength during times of risk aversion may not be such a given.

While the yen does tend to rise when equities fall, an analysis by Spectra Markets shows that its movements are actually driven more by fluctuations in the bond market. Weeks in which equity-market sell-offs are accompanied by rising yields, for example, tend to result in yen declines – often meaningful ones (Exhibit 8). Given concerns over uncontrolled inflation, the combination of lower stocks and higher yields becomes more likely, and in such scenarios investors looking to the yen for portfolio protection would be wise to find alternative safe-haven currencies. With this in mind, we have reduced our forecasts for the yen, even though it trades slightly cheap relative to bond yields. The currency may appreciate as the greenback softens, but negative yields in Japan mean that the yen will likely underperform other major developed-market currencies.

Exhibit 7: Currencies trading in a narrower range



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

Exhibit 8: The yen does not offer protection when yields rise

	Weeks when S&P declines more than 2%	
	Classic risk off	Fed/inflation fears
	Yields ↓	Yields ↑
Mean yen move	0.91%	(0.22%)
Median yen move	0.83%	(0.29%)
% of time yen rises	76%	44%

Note: Analysis covers period since 2003. As at Nov. 26, 2021. Source: Spectra Markets, RBC GAM

Commodity currencies and the Canadian dollar

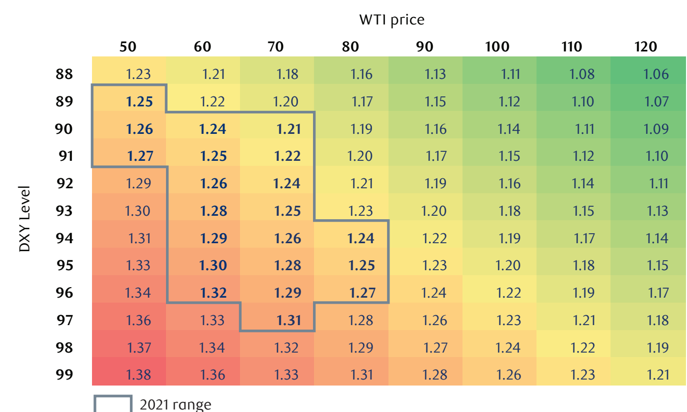
This year's strength in commodities has become increasingly important for exchange rates. The oil-linked currencies of Norway, Russia and Canada are among the top performers in 2021, as higher export prices have supported trade balances in those countries. This rise in export prices relative to import prices points to a further rise in the Canadian dollar, but the recent loonie weakness in part reflects overall strength in the U.S. dollar. Fluctuations in both the U.S. dollar and commodity prices have largely explained exchange-rate movements between the two currencies this year as other drivers, such as equities and interest-rate spreads, took a back seat. Exhibit 9 offers guidance on how the Canadian dollar might perform based on historical relationships with these two factors. Should the U.S. dollar give back some of its overall strength and oil prices remain elevated, the loonie could reasonably settle below 1.20 per U.S. dollar. However, we recognize that elevated oil prices are only really beneficial to the Canadian economy when they result in business investment that generates spending and job creation. To date, capital expenditures in the oil patch have been restrained by the government's efforts to tighten environmental standards and by a preference among investors for capital to be returned through dividends and stock buybacks rather than investments in new projects.

Even without energy-related business investment, the Canadian economy seems to be doing fine. The economy managed to grow at an annualized clip of 5.4% in the third quarter, labour markets have recovered to their pre-pandemic peak and spending on services rebounded. Relatively strong economic data should continue in 2022, as higher vaccination rates and broad public support for social distancing lower the odds of renewed lockdowns in Canada.

Among the other themes we are monitoring for the trajectory of the Canadian economy are:

- A continued push for immigration after temporary workers and students already in the country were integrated during border closures. Student permits rose 63% in the first nine months of 2021 versus the same period last year, and the Trudeau government is processing applications at a faster pace to achieve its

Exhibit 9: Oil and the USD pull the loonie in opposite directions



DXY Level \ WTI price	50	60	70	80	90	100	110	120
88	1.23	1.21	1.18	1.16	1.13	1.11	1.08	1.06
89	**1.25**	1.22	1.20	1.17	1.15	1.12	1.10	1.07
90	**1.26**	**1.24**	**1.21**	1.19	1.16	1.14	1.11	1.09
91	**1.27**	**1.25**	**1.22**	1.20	1.17	1.15	1.12	1.10
92	1.29	**1.26**	**1.24**	1.21	1.19	1.16	1.14	1.11
93	1.30	**1.28**	**1.25**	1.23	1.20	1.18	1.15	1.13
94	1.31	**1.29**	**1.26**	**1.24**	1.22	1.19	1.17	1.14
95	1.33	**1.30**	**1.28**	**1.25**	1.23	1.20	1.18	1.15
96	1.34	**1.32**	**1.29**	**1.27**	1.24	1.22	1.19	1.17
97	1.36	1.33	**1.31**	1.28	1.26	1.23	1.21	1.18
98	1.37	1.34	1.32	1.29	1.27	1.24	1.22	1.19
99	1.38	1.36	1.33	1.31	1.28	1.26	1.23	1.21

2021 range

Note: Table calculated from coefficients of regression with a 1-year lookback period. As at Nov. 30, 2021. Source: Bloomberg, RBC GAM

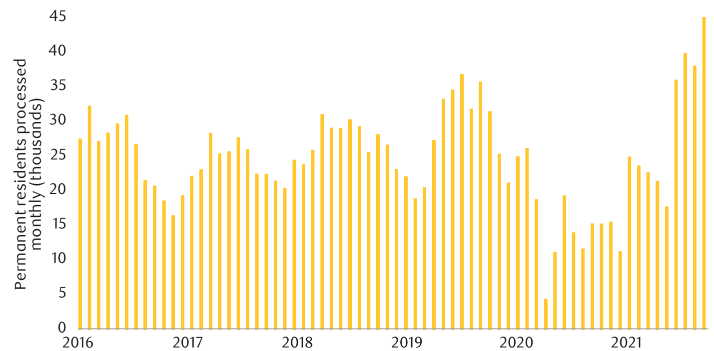
recently increased target of admitting 401,000 permanent residents this year (Exhibit 10).

- The easing of bottlenecks in the global supply chain, which has led to a shortage of the memory chips used in cars and trucks. Canada is the world's 12th-largest automobile producer, and an easing of the disruptions would be a welcome sign for the Canadian auto-parts industry as well. The shortage of chips has forced automakers around the world to prioritize production of higher-margin vehicles produced abroad.
- Devastating floods in British Columbia, which limited access to Canada's busiest port, in Vancouver, and hindered economic activity in the country's third-largest province by population.

The Bank of Canada (BOC) has already begun removing economic stimulus through the completion of its plan to end asset purchases well ahead of other developed-market central banks. Many investors believe that the BOC won't get too far ahead of the Fed on interest-rate hikes – presumably because any resulting rise in the Canadian dollar would make the country's non-oil exports less competitive. While it is true that efforts by the BOC to raise interest rates before the Fed would cause the loonie to rise, the currency is cheap and has room to strengthen before it begins to constrain economic activity. We point to the hiking cycles of 2002 and 2010 (Exhibit 11) as examples when the BOC was similarly undeterred from taking a more hawkish stance than the Fed.

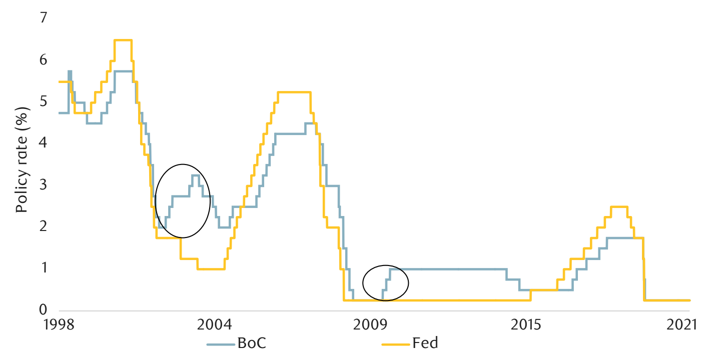
The loonie stands out as one of the few G-10 currencies to strengthen in a year when the U.S. dollar has gained. Still, the 10-cent range between $1.20 and $1.30 is unusually small in the context of exchange rates that are usually quite volatile. We continue to expect outperformance of the Canadian dollar over other developed-market currencies with a 12-month forecast of $1.17 per U.S. dollar. In the shorter term, the emergence of a new COVID variant and the associated weakness in oil and stocks may see the exchange rate test the year's highs. Further gains in the U.S. dollar are likely to be met by selling pressure, however, as Canadian investors have been waiting for greenback rallies that allow them to hedge U.S.-dollar exposure. These periods of strength would represent an opportune time for investors to accumulate Canadian dollars.

Exhibit 10: Canadian immigration



Note: As at Sep. 30, 2021. Source: Government of Canada, RBC GAM

Exhibit 11: Bank of Canada has hiked before the Fed in the past



Note: As at Nov. 30, 2021. Source: Bank of Canada, Federal Reserve, RBC GAM

Euro

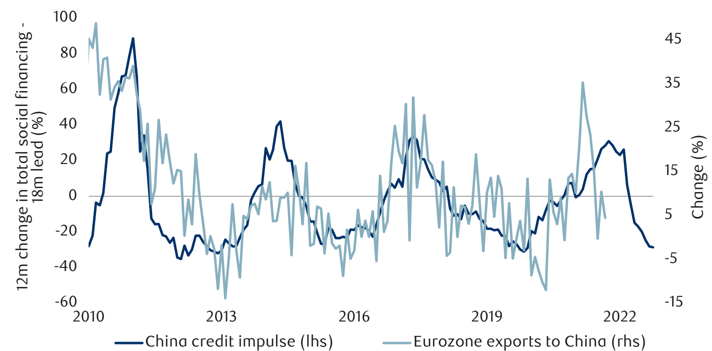
We have reined in our optimism on the euro, pulling our forecasts lower for a second consecutive quarter, as the single currency weakened by 5% since August to its current level of 1.13. Negative yields make the euro a favourite short for funding positions in higher-yielding currencies, a dynamic that is unlikely to change given the ECB's inclination to leave interest rates on hold at a time when other central banks have been hinting at rate hikes next year.

Three other developments limit the euro's prospects and are largely responsible for our change in forecast:

1. Slower Chinese economic activity and a slowdown in loan growth hint at a meaningful reduction in European exports to China (Exhibit 12).
2. Germans voted in a more conservative coalition government, which will likely push back against plans for European nations to increase fiscal spending. This adds extra pressure on the ECB to keep monetary policy loose.
3. Europe's higher exposure to imported energy makes the region's economy more vulnerable to shocks like the spike in natural-gas prices (Exhibit 13). Not only is this hard on consumer wallets and corporate profits, but the higher import cost also erodes Europe's current-account surplus.

Even with these negatives, we are penciling in a rise in the euro as the greenback weakens and because we think the Fed will hike fewer times next year than market indicators suggest. We have dropped our 12-month forecast this quarter to US$1.24 per euro.

Exhibit 12: Weaker demand from China



Note: As at Oct. 29 2021. Source: China General Administration of Customs, Eurostat, RBC GAM

Exhibit 13: Rising energy prices weigh on Eurozone economic growth

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

Conclusion

Volatility is returning to the foreign-exchange markets, fueled in part by a new COVID variant and in part by diverging central-bank monetary policies. The U.S. dollar has benefited from market expectations that interest rates will be raised next year, but may soon reverse some of its gains as moderating U.S. inflation would suggest less upward pressure on rates. While we have reined in our optimism on the low-yielding euro and Japanese yen, we remain positive on cyclical currencies such as the Canadian dollar. The resilience of the Chinese renminbi amid otherwise negative Chinese developments has been a stabilizing factor for currency markets and is a theme worth monitoring in the year ahead.

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