RBC Global Asset Management

Global currency outlook

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Currency landscape altered by Russia-Ukraine conflict

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

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

Right up until February 24, when Russia invaded Ukraine, currency markets had been unusually quiet, unfazed by expectations that central banks would hike interest rates, the related uptick in bond-market volatility or jittery equity markets. The greenback was held back by powerful long-term headwinds that are likely to prevail. On the day of the invasion, all of the normal elements that might be considered in a currency outlook were set aside as investors bought the U.S. dollar in search of safety, security and liquidity. The question is how long this scramble for such safe-haven currencies will persist. The war in Ukraine has changed expectations for growth and inflation, and at least temporarily, has changed the relative winners and losers in currency markets.

We had not expected Russia to launch a full-scale war on Ukraine, and neither had we expected that global sanctions would include a freezing of Russia's foreign-exchange reserves. These events have shocked markets. While we still expect that U.S.-dollar weakness will materialize over the longer term, we have set aside our normal long-term framework for evaluating currencies and instead evaluate this new reality through a shorter-term lens.

Below are a few immediate structural changes shaping this new environment and some associated currency-market implications:

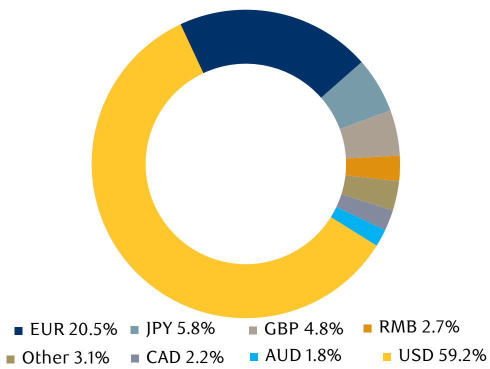
1. Freezing FX reserves

Developed nations took the unprecedented step of sanctioning Russia's central bank and freezing the country's foreign-exchange reserves so that they could not be used to fund military aggression or buffer the impact of economic sanctions. Such extreme steps must have caused policymakers' jaws to drop in Russia as well as in China, the largest holder of currency reserves. Without the implicit guarantee of safety and security for those national savings, the world's owners of reserve assets are likely to shrink their holdings.

While the knee-jerk currency reaction has been U.S.-dollar positive, this development is a significant negative for the greenback in the longer term. For years, the U.S. has been reliant on reserve-related capital inflows to fund its fiscal and current-account deficits. Without this inflow of capital, the greenback could very well be pressured lower by the persistent negative effect of the twin deficits.

Moreover, there's a good chance that these long-term reserve holders re-orient their reserve portfolios away from the greenback, which currently accounts for about 60% of total reserves (Exhibit 1), toward a more diversified basket of currencies. There is certainly room for the Chinese renminbi's 2.7% share to rise, especially given that the bulk of foreign-exchange reserves belong to Asian countries that have increasing economic and political links to China. We question, however, whether China would be any less likely than the U.S. to weaponize foreign-exchange reserves to advance its geopolitical ambitions. Investors who are looking for non-fiat alternatives could also turn to gold and cryptocurrencies as their use is more difficult to restrict in the event of geopolitical or economic conflict.

Exhibit 1: Global FX reserve composition



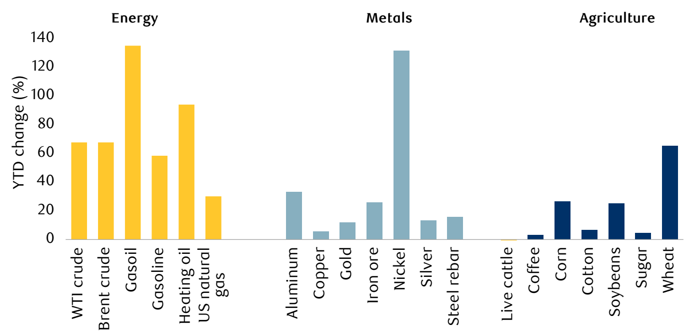
Note: As at Sep. 30, 2021 (Quarterly data). Source: COFER, RBC GAM

2. The commodity / currency relationship

Investors usually associate commodity strength with U.S.-dollar weakness, but the notion of an inverse relationship between the two is being challenged in the short term. Commodity prices have spiked to impressive heights (Exhibit 2) and the dollar has risen simultaneously. To some extent, this relationship was already present before war broke out in Ukraine, in part due to strong demand as economies recovered from the pandemic, and in part from a transition to clean-energy alternatives that rely heavily on certain industrial metals. But in much the same way that access to global payment systems can be withdrawn or foreign-exchange reserves frozen, the reaction to Russia's invasion heightens concerns about export bans on key industrial and technological inputs to production. China's reluctance to denounce Russia's military incursion threatens the creation of fault lines and additional tension with the West, hinting that an accelerated retreat from globalization is underway. To prevent being locked out of key industries, countries will increasingly be looking to secure long-term interests in key commodities.

While the U.S. dollar may get a short-term boost from the geopolitical situation, the lasting effect of the Ukraine war may be to solidify the appeal of commodity currencies in this new environment of hoarding and scarcity. We have been bullish on cyclical currencies for the past year – including those with rising interest rates and higher exposure to global growth. But we are narrowing the list of attractive currencies to those that are also naturally endowed with resources. The Canadian dollar, Norwegian krone, Australian dollar should outperform within the developed world, while the currencies of Colombia, Chile, Brazil and Mexico will fare better than those of commodity importers in Asia and Eastern Europe.

Exhibit 2: Commodities have rallied sharply



Note: As at Mar. 8, 2022. Source: Bloomberg, RBC GAM

3. Central banks will still hike

In the days following the February 24 invasion, market focus quickly shifted away from the U.S. Federal Reserve's (Fed) campaign to raise interest rates toward the more pressing issue of energy-price gains and the related shock to global economic growth. We note, however, that the inflationary impact of the war will only increase the urgency for the Fed to act. As the war began, fears of weaker growth drove a reduction in the number of U.S. interest-rate hikes expected in 2022 to five from seven, but this sentiment quickly reversed as markets realized that the Fed will still need to hike if it is to contain inflation expectations.

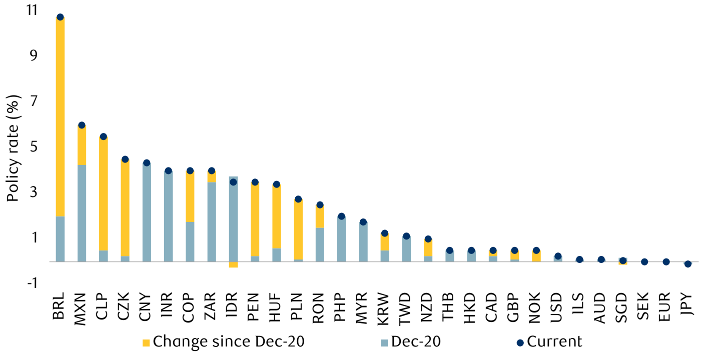
The Fed will not be the first central bank to raise interest rates. The Bank of Canada hiked by a quarter percentage point in early March and central banks in Norway, New Zealand and the U.K. have also done so. The list of emerging-market currencies with hawkish central banks is much longer, and these have been more aggressive. Brazil, for example, has raised its benchmark interest rate by a whopping 8.25 percentage points to 10.75% in just the past year, and at least 10 others have hiked over the past six months to fight inflation and support their currencies (Exhibit 3).

The term "currency wars" was coined over a decade ago in reference to countries seeking to weaken their currencies as a way of boosting export competitiveness. These days, monetary authorities are experiencing more currency weakness than they'd like. In fact, the "currency wars" label could be used to describe a battle for stronger currencies as a way of boosting purchasing power and reducing imported inflation. Several emerging-market countries have intervened directly in support of their currencies, and we expect this to become a more common occurrence as long as geopolitical risks and strong oil prices exert upward pressure on inflation. Currency intervention does not typically have a meaningful impact on the broader direction of foreign-exchange markets unless the largest central banks coordinate efforts to achieve a desired outcome. Owing to the strong signalling effect and the combined firepower of central banks, co-ordinated interventions do tend to meaningfully shift investor sentiment. It was this type of effort that altered the trajectory of the U.S. dollar in in the mid-1980s and again in the early 2000s (Exhibit 4).

Implications for the U.S. dollar

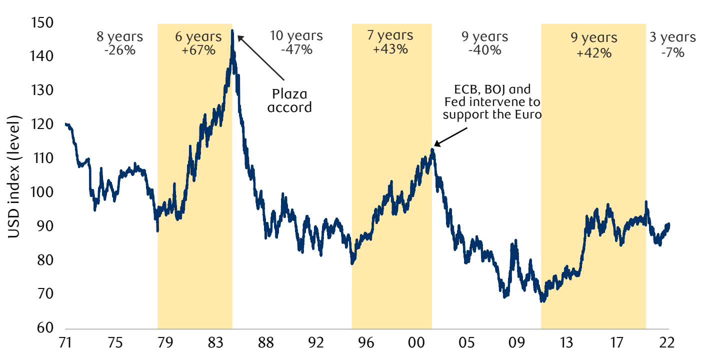
Our usual framework for evaluating the currency outlook has been voided by short-term developments in Ukraine and the imposition of harsh sanctions on Russia. The sanctions are likely to persist well beyond any end in the fighting, so we're focusing on what we know and on understanding the structural shifts that are likely to result from this new investment landscape. The U.S. dollar has strengthened as investors flock to more liquid U.S. assets and the safe-haven currency, so the resumption of the long-term dollar bear market could be delayed by at least several months. But the elements of this regime shift introduce additional challenges for the greenback and support our view that the dollar will weaken in the long term.

Exhibit 3: High (and rising) policy rates in emerging markets



Note: As at: Mar. 5, 2022. Source: Macrobond, RBC GAM

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

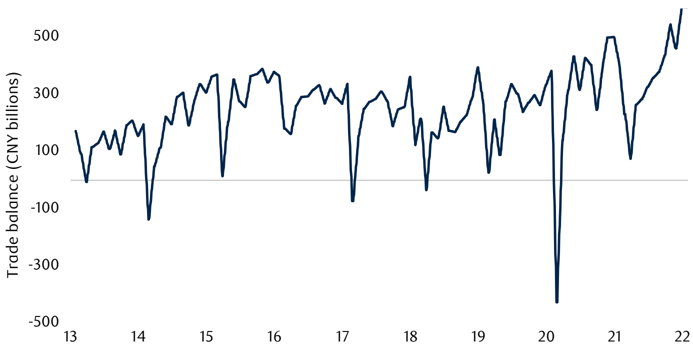


Note: As at Mar. 01, 2022. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Chinese renminbi

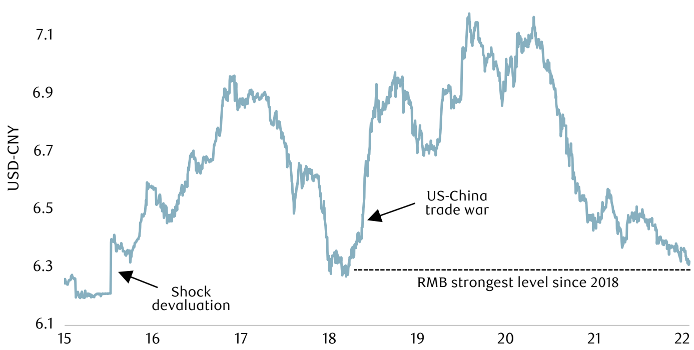
The Chinese renminbi is one of the few emerging-market currencies to outperform the greenback over the past year. Chinese policymakers have always kept a firm grip on the currency's value, but the renminbi's relative stability has puzzled investors because it means that the currency is strengthening against those of China's other trading partners. We don't yet see evidence of waning competitiveness as the trade balance remains in surplus (Exhibit 5), but Chinese authorities have begun to gently push back against currency gains through commentary in state-owned media and more direct methods of influencing the currency. We have become more cautious on the renminbi as the currency nears its highest levels since the 2018 trade war (Exhibit 6), and are closely monitoring how the central bank uses its tools to influence exchange rates. A global drop in COVID cases suggests that China will at some point roll back its restrictions, leading to increased domestic economic activity and a resumption of international travel by Chinese citizens. Such easing would likely lead to currency weakness by raising imports and reducing the country's trade surplus. Given the country's ever-expanding global influence, these risks to the renminbi are also important for the broader outlook on emerging-market currencies. On the other hand, renminbi may benefit from the determination of some Asian countries to diversify their reserves away from the dollar and the euro.

Exhibit 5: China trade balance



Note: As at Mar. 02, 2022. 30 day smoothing applied to the data.
Source: Customs General Administration, Bloomberg, RBC GAM

Exhibit 6: Renminbi approaching important levels



Note: As at Mar. 02, 2022. Source: Bloomberg, RBC GAM

Euro

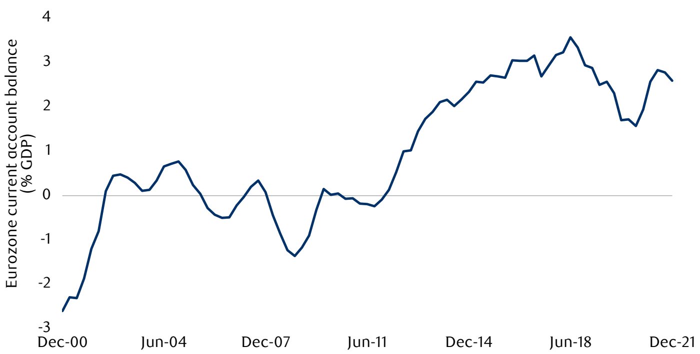
We are lowering our forecast for the euro to US$1.16 from US$1.24 to acknowledge elevated geopolitical risks and the deterioration in the eurozone's economic prospects. Our longer-term outlook is for the euro to regain its footing, but we expect commodity currencies to benefit more from dollar weakness than the euro in coming months. Gains in the single currency will be capped by concerns about high energy prices and their impact on economic growth and trade balances. The combination of a weaker euro and higher crude-oil prices have pushed oil to record highs in euro terms (Exhibit 7), eating into households' disposable incomes and potentially wiping out the currency bloc's large and persistent current-account surpluses (Exhibit 8). The upward pressure on energy prices could be further exacerbated should Russia shut off the supply of natural gas to Europe in response to economic sanctions. This becomes a bigger threat as major developed-market leaders restrict Russia's access to the financial-payments system.

If there is a positive to be found, it is that Europe has been united by the crisis and is now more emboldened to engage in fiscal stimulus. In early March, Germany announced 100 billion euros of emergency defense spending and committed to lifting annual defense expenditures above 2% of GDP. This is just the beginning as Europeans usually require a crisis to act decisively. There are hints that the EU is considering large-scale joint issuance of bonds to fund eurozone-wide investment in energy with the aim of weaning the region away from its dependence on Russian gas. Such a step would leave Europe with a much more growth-supportive fiscal backdrop at a time when government spending elsewhere, particularly in the U.S., is on the decline.

Exhibit 7: Brent in euro terms is at a multi-decade high

Note: As at Mar. 8, 2022. Source: Bloomberg, RBC GAM

Exhibit 8: Eurozone current-account surplus

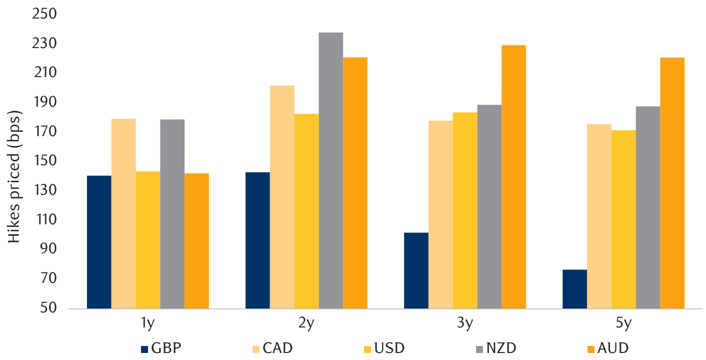


Note: As at: Dec. 31, 2021. Quarterly data. Source: Bloomberg, RBC GAM

British pound

The U.K. will be the first developed nation to emerge from the winter COVID-19 wave, and, barring any new and more transmissible variants, the economy will be free of restrictions and lockdowns. This development bodes well for economic activity and the outlook for rate hikes in the near term, though we note that the Bank of England has already hiked twice and is not expected to keep up with its global peers beyond this year (Exhibit 9). The pound outperformed the euro last year, and it appears that the two rate hikes and other sterling-positive factors are already priced in. Moreover, households face a tougher environment given lower real incomes, rate hikes and tax increases; and inflation-adjusted bond yields in the U.K. are the lowest in the G10, making it harder to attract the capital needed to finance the country's persistent budget and current-account deficits.

Exhibit 9: Bank of England will not raise rates along with peers



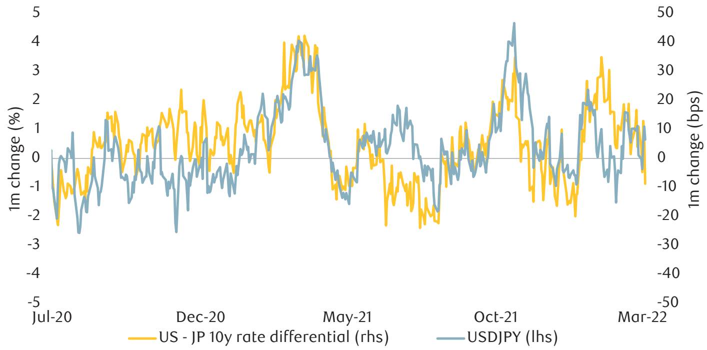
Note: As at Mar. 01, 2022. Source: Bloomberg, RBC GAM

Japanese yen

Speculation that the Bank of Japan would shift to a more hawkish monetary-policy stance led to a temporary rise in the yen, but the most recent monetary-policy meeting dashed those hopes. The central bank's inflation forecasts remain below the 2% target, though inflation may have a chance of reaching that level given global supply-chain constraints.

While the values of most major currencies are determined largely by short-term rates, the yen is typically driven by movements in yields on 10-year U.S. Treasury bonds (Exhibit 10). Given the inability of U.S. 10-year yields to push materially above 2%, it's difficult to see any significant yen weakness ahead – especially given the currency's undervaluation, Japan's current-account surplus and a large overhang of short positions.

Exhibit 10: Rate differentials remains the main driver for the yen



Note: As at Mar. 6, 2022. Source: Bloomberg, RBC GAM

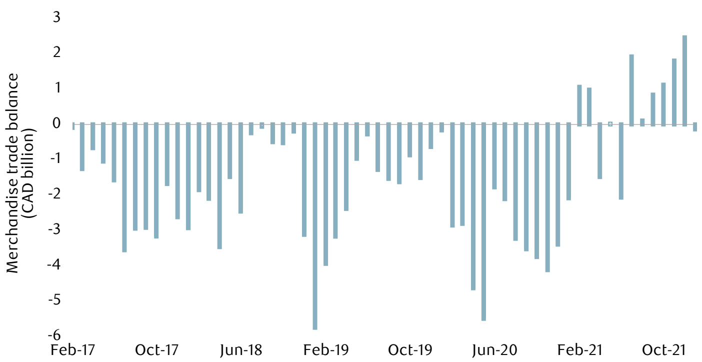
Canadian dollar

The direction of the Canadian dollar seems torn between two of its main driving factors – oil prices and global equity markets. Supporting the loonie are elevated crude-oil prices, which are benefiting from strong demand and fears that Russian output will be taken offline. At the same time, the Ukraine war has raised the kind of geopolitical risks that are often associated with a decline in the loonie and weaker global equity markets. Also limiting loonie gains is skepticism that the Bank of Canada will live up to expectations of an aggressive round of rate hikes, allowing the U.S. interest-rate advantage to weaken the loonie over the past few months.

Outside of short-term developments, we see a lot of Canadian-dollar positives that should help the currency outperform over a longer horizon:

- Strong commodity prices should support Canadian economic growth. Industrial metals such as copper, zinc and aluminum are essential ingredients in the transition to cleaner electricity generation and energy storage.
- Canada has begun posting a trade surplus in goods after a long stretch of deficits (Exhibit 11), helping to pull the broader current-account balance into surplus. Improvement in the current account will partly reverse as Canadians begin to travel abroad, but this segment of spending won't fully offset the upward trend.
- Canada leads the G7 in population growth (Exhibit 12) after 1.9 million newcomers arrived over the past five years. The welcoming attitude of Canada, with a total population of 38 million, results in labour force growth that stands in stark contrast to the U.S. (Exhibit 13).
- The Canadian labour market has experienced a faster recovery than its peers, with a rebound that has brought total employment back above pre-COVID highs.

Exhibit 11: Canada – merchandise trade balance

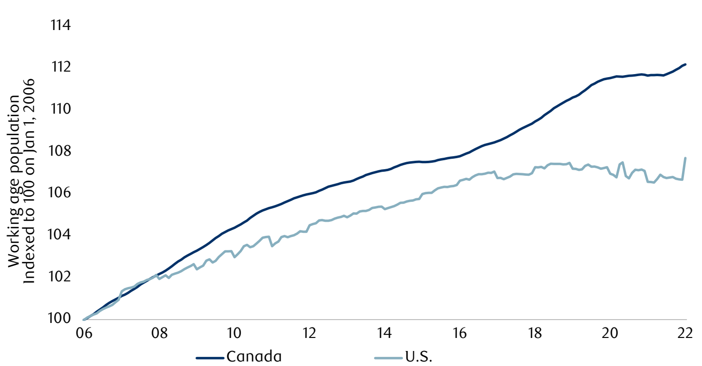


Note: Data is seasonally adjusted. As at Dec. 31, 2021 (Quarterly data). Source: Statistics Canada, RBC GAM

Exhibit 12: Canada's population growth was fastest among G7 in 2021

Note: As at Dec. 31, 2021. Source: Statistics Canada, U.S. Census Bureau, World population review, National Bank, RBC GAM

Exhibit 13: Canada vs. U.S. working-age population

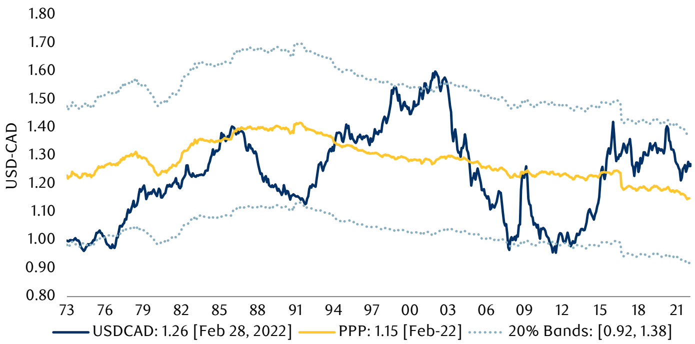


Note: As at Jan. 31, 2022. Source: OECD, RBC GAM

- The loonie is cheap based on models that measure relative purchasing power (Exhibit 14).

The Canadian dollar has stayed in a relatively tight range of $1.20 to $1.30 per U.S. dollar since late 2020 and an even tighter range of $1.25 to $1.30 over the past three months. This stability is unusual given that commodities prices are so strong. We expect the positive longer-term factors listed above will keep the market focused on prospects for Canadian-dollar appreciation and forecast a $1.19 exchange rate in 12 months' time.

Exhibit 14: USDCAD
PPP Valuation



Note: As at Feb. 28,2022. Source: Bloomberg, RBC GAM

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