Global currency outlook

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G10 and emerging market currencies to benefit from U.S. dollar's decline

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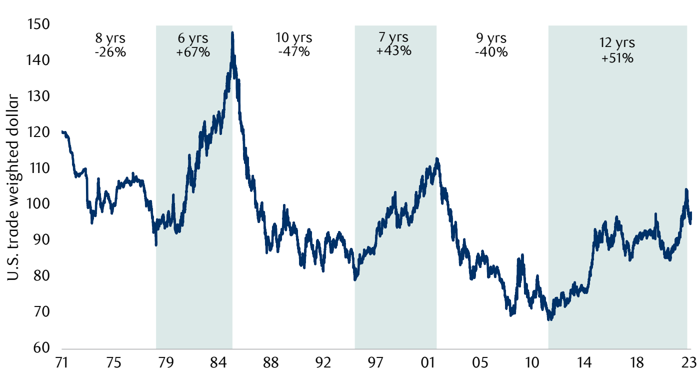
The tide is finally turning against the U.S. dollar. A reversal of the greenback's gains has been overdue for some time, and we have warned for several quarters that the currency's strength in 2022 had pushed it from already rich to levels of extreme overvaluation. As the dollar starts to retreat, and with a multitude of factors turning against it, we are growing increasingly confident that a multiyear period of U.S.-dollar weakness lies ahead. We expect most G10 and emerging-market currencies to benefit from this powerful cyclical shift.

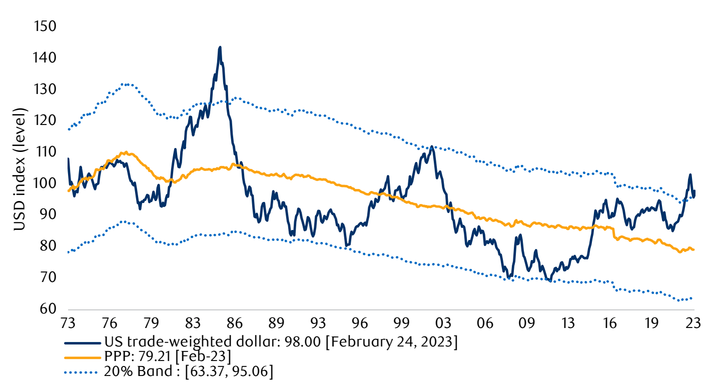
The greenback's decade-long upswing (Exhibit 1) had been extended by supply constraints during the pandemic and Russia's invasion of Ukraine, both of which increased the need for the U.S. Federal Reserve (Fed) to step up the fight against inflation. These developments provided temporary support for the greenback, stretching the U.S.-dollar bull market beyond what was seen in prior cycles both in duration and in magnitude. The trade-weighted dollar index last year reached levels that historically have capped the currency based on purchasing power parity models (Exhibit 2). Not

Exhibit 1: U.S. trade-weighted dollar



Note: As at Feb 24, 2023. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 2: PPP Valuation

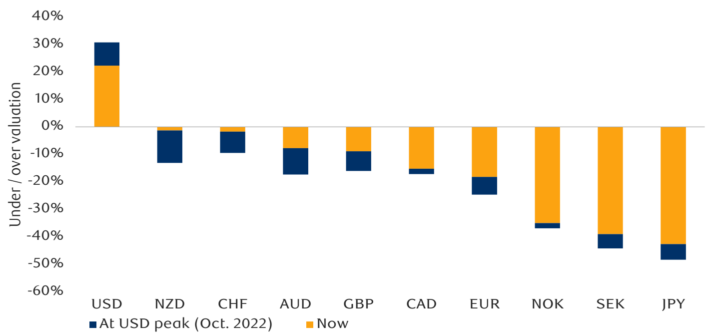


Note: As at Feb 24, 2023. Uses new Fed USD index from Dec 31, 2019 onward (USTWAFE Index). Source: U.S. Federal Reserve, Bloomberg, RBC GAM only was the currency's valuation extreme at the trade-weighted level, it was also fairly broad-based (Exhibit 3), and currently exceeds extreme thresholds against several developed-market currencies (Exhibit 4). The historical record shows that once a currency rises to such lofty levels, its strength tends to reverse in a matter of months rather than years, and this is precisely what played out over the last few months of 2022.

The dollar reached its peak in mid-October. At the time, the Fed was tightening monetary policy in 75-basis-point increments and investors had little or no grasp on when U.S. interest rates would stop rising. This state of affairs boosted the attractiveness of the greenback, both because it offered higher yields and because traders tend to flock to the safety and liquidity associated with the primary reserve currency during times of uncertainty. Between November and January, however, the greenback declined by 12% before stabilizing in early February. The final straws that sealed the dollar's decline include:

- At around the time of the dollar's peak in October, an easing of inflation and expectations that the Fed would slow the pace of rate hikes chipped away at the dollar's exuberance.
- In November, it became apparent that inventories of natural gas in Europe would likely be sufficient for the coming winter, and forecasts suggested that a warmer-than-average winter lay ahead. These developments offered hope that the impact of the energy crisis could be dulled and gave a boost to the euro through an improved economic outlook.
- In December, Chinese authorities announced that they would end virtually all restrictions imposed during the pandemic. Expectations of a resulting boost to global growth encouraged greater capital movement away from the U.S. to areas including Europe and the rest of Asia - two regions with strong economic links to China.
- Finally, in January, the market's focus turned to an increasingly hawkish bent from major central banks other than the Fed. The European Central Bank (ECB), which had only begun hiking rates in July, began to take a much more aggressive tone, setting the stage for interest-rate hikes in larger, 50-basis-point increments (Exhibit 5). Mostly, however, the dollar was pushed lower by the Bank of

Exhibit 3: G10 currency valuations



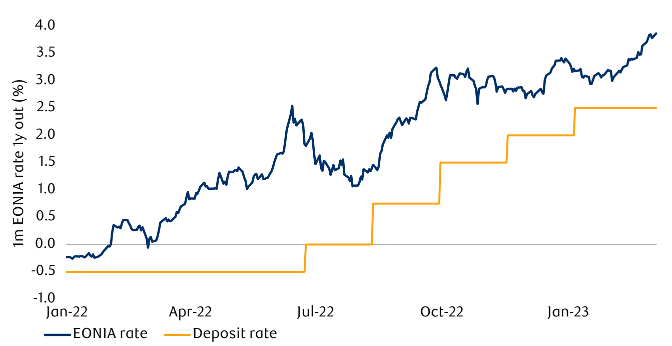
Note: As at February 24, 2023. Source: Bloomberg, RBC GAM

Exhibit 4: Currencies do not remain in extreme territory for long

Currency	% bands within which more than 90% of observations lie	Average number of months out of 20% band	Foreign currency valuation
US TW$	17.6%	5	22.3%
JPY vs. USD	34.0%	19	-42.6%
EUR vs. USD	25.4%	6	-18.2%
GBP vs. USD	22.5%	6	-8.9%
CHF vs. USD	24.7%	7	-1.7%
CAD vs. USD	19.5%	5	-15.2%
AUD vs. USD	37.0%	22	-7.7%
NZD vs. USD	33.6%	11	-1.3%
SEK vs. USD	36.8%	16	-39.0%
NOK vs. USD	24.3%	6	-35.0%

Note: As at February 24, 2023. Boxes denote currency pairs whose valuation exceeds the 90% bands. Source: Deutsche Bank, U.S. Federal Reserve, Bloomberg, RBC GAM

Exhibit 5: : Eurozone rate expectations ticked higher in 2022



Note: As at March 6, 2023. Source: Bloomberg, RBC GAM

Japan's (BOJ) December surprise announcement to tighten policy by increasing the allowable trading range on 10-year Japanese government bonds to +/-0.50% from +/-0.25%. This was seen as a possible precursor to an abandonment of the six-year policy of anchoring interest rates at low levels and turned attention to who would take over as BOJ governor when Haruhiko Kuroda's term ends in the spring.

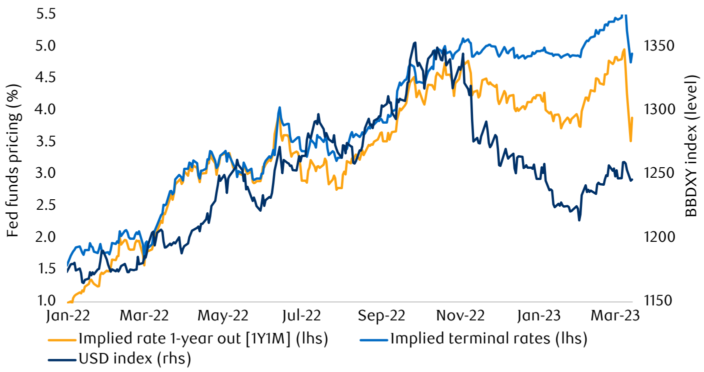
The most important themes for foreign-exchange markets last year were the Russia-Ukraine war, its impact on inflation and, ultimately, the necessary response from the Fed. It's clear, however, that the story so far in 2023 is much less focused on a single driving factor. Exhibit 6 highlights that, for most of 2022, the greenback traded largely in line with the interest rate at which the Fed was expected to stop hiking (the terminal rate). Since October, the dollar has fallen by much more than is implied by interest-rate expectations – even those that account for what happens after the Fed stops raising rates. The 12% fall in the dollar is evidence that other factors are beginning to weigh on the greenback. Even as yields shot higher in February, the dollar did not follow with enthusiasm. While the dollar's initial reaction to the failure of Silicon Valley Bank has been to weaken, it has done so by much less than the massive move in interest rates would suggest.

The early stages of the greenback's cyclical sell-off have removed some of its extreme overvaluation, but there is lots of room for the currency to fall further. Exhibit 7 puts this scope for further declines into context by aligning past cycle peaks at an index level of 100. From this perspective, the sell-off to date looks tiny, and the roadmap for the long-term U.S.-dollar bear market suggests another 25% to 30% in declines over the next few years. Counter-trend rallies, like the one in February, do occur, but they tend to be small and fleeting relative to the longer-term cyclical moves. The broader downward trend will prevail, we think, partly because other central banks are catching up to the Fed's hawkishness and partly because the improved global growth outlook adds appeal to foreign assets.

Complementing these drivers are the more traditional dollar-negatives: budget shortfalls, trade deficits and debt-ceiling concerns. Also adding weight to the dollar downtrend is the idea that global usage of the dollar is waning because of deglobalization and a lower volume of trade that is conducted in U.S. dollars. The greenback's falling share of foreign-exchange reserves hints that overall trust in the dollar is waning, a move likely accelerated by U.S. efforts to block Russia, Iran and North Korea from global payments systems. China, the largest foreign holder of Treasuries, would no doubt have regarded America's seizure of Russian foreign-exchange reserves as a threat.

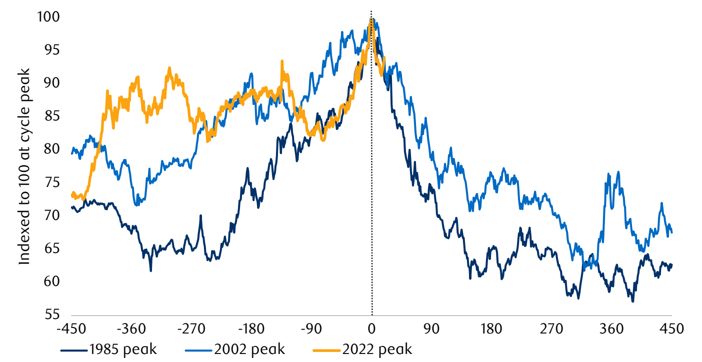
With so many arguments stacking up against the dollar, we have grown more confident in our call that the currency's long-term downtrend has begun. We forecast stronger currencies in G10 and in emerging-markets, as both would benefit from a falling U.S. dollar.

Exhibit 6: Market is looking beyond terminal rates



Note: As at March 14, 2023. Source: Morgan Stanley, Bloomberg, RBC GAM

Exhibit 7: U.S. dollar can still fall further



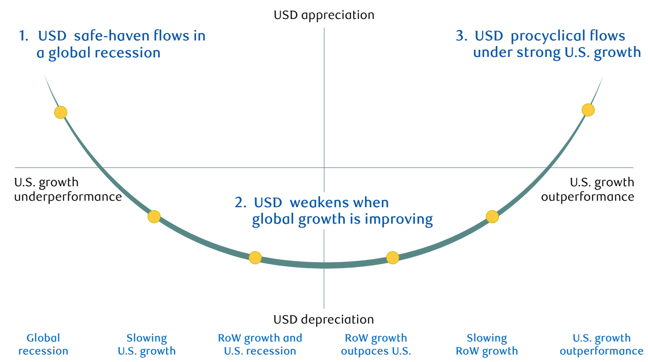
Note: As at March 1, 2023. Source: Bloomberg, RBC GAM

The USD "Smile" Framework

The "U.S. Dollar Smile" describes the dollar's tendency to rally either when things are very good or when they're very bad. On one side of the smile we find superior U.S. economic performance and equity-market returns, while the other side involves capital flight to the safety of Treasuries and the greenback. It is the period in between where the dollar weakens (Exhibit 8). This framework can aid in forecasting the direction of the dollar in different economic environments and can help answer the question of how the greenback might react to the economy entering a recession. A hard landing would likely result in a stronger dollar (very bad) while a mild recession would result in dollar depreciation (not too bad). The so-called "no landing" scenario, where economic growth remains strong, is more difficult to handicap. In this case, the dollar's direction would likely depend on whether a strong economy (very good) is accompanied by persistent inflation – which would prompt the Fed to start another round of aggressive interest-rate hikes. This is the biggest threat to our call for a weaker dollar, as another repricing higher of U.S. short-term interest rates would tend to support the greenback. This outcome looks much less likely in light of the recent bank failures in the U.S.

In any case, it is not just the U.S. economic situation that matters. In fact, it is the state of economic activity abroad that's more important in determining the dollar's direction. Exhibit 9 demonstrates how the greenback falls most when expectations for global growth are rising. Analysis shows that dollar weakness is also the most consistent result during those times. Capital flows support the idea that global growth helps drive the direction of the dollar. European investors, which until last year had bought trillions worth of foreign assets to avoid negative interest rates imposed by the ECB, have started to repatriate some of that money now that yields in Europe are positive and the economy has improved. A similar dynamic exists in Japan, and it is one that will accelerate dramatically if the Bank of Japan (BOJ) abandons its efforts to keep interest rates low within a tight band. U.S. investors have begun to move money abroad given the improved economic situation in Europe and in China. U.S.-listed ETFs that invest in European equities, for instance, have started to report that inflows have picked up notably (Exhibit 10) – a vote of confidence in the European economy.

Exhibit 8: U.S. dollar smile



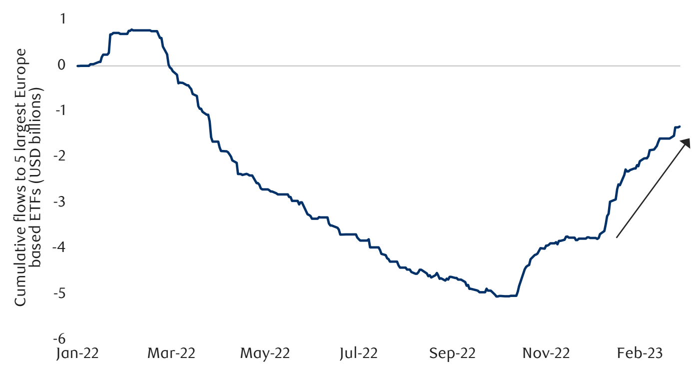
Source: Credit Suisse, RBC GAM

Exhibit 9: U.S. dollar performance in various economic regimes

Change in U.S. growth forecasts	Change in RoW growth forecast: Down	Change in RoW growth forecast: Up
Down	0.88%	-1.27%
Up	0.52%	-1.17%

Note: As at February 8, 2023. Includes data from 2002 onwards.
Source: JP Morgan

Exhibit 10: Inflows into ETFs that invest in European equities



Note: As at March 3, 2023. Data from 5 ETFs VGK, EZU, FEZ, EWG, IEV.
Source: Bloomberg, RBC GAM

Emerging markets

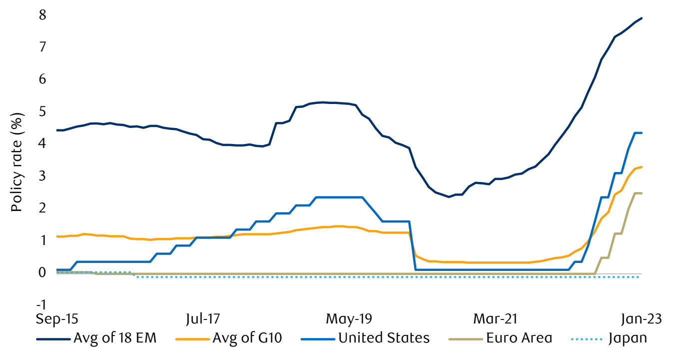
Emerging-market currencies fared much better than the euro or the yen last year, even though Fed hikes and dollar strength would typically spell trouble for assets in developing nations. A few currencies, including those of Mexico, Brazil and Peru, even managed to deliver double-digit returns last year. Others have outperformed developed-market currencies since the U.S. dollar turned lower this past fall. The principal reason for the resilience was that emerging-market central banks were quicker and more aggressive even than the Fed in raising interest rates to combat rising prices (Exhibit 11). Monetary conditions are being kept tight across emerging markets even as inflation begins to ebb, pushing inflation-adjusted yields higher and attracting capital in the process. We think emerging-market currencies are set to keep outperforming given a combination of cheap valuations, better growth prospects (thanks to China and Europe), a weaker dollar and a less threatening Fed outlook. After a long period where emerging-market currencies were under-owned, positioning indicators now suggest that investors are starting to increase their allocations to emerging-market assets as risk sentiment improves.

Canadian dollar

The Canadian dollar was the best performing G10 currency versus the U.S. dollar for most of 2022, but has ceded that relative strength as other currencies have caught up since the U.S. dollar peaked in late October. Part of the blame for the Canadian dollar's recent weakness was the Bank of Canada's January announcement that it would keep rates steady at 4.5%, diminishing the loonie's interest-rate advantage as its peers continue hiking. This pause in rate hikes has likely been cemented by a weaker GDP report for 2022's fourth quarter, and the loonie has declined against the greenback in recent weeks as the market ramps up speculation that the Fed might continue raising rates beyond 5%.

Also to blame for the Canadian dollar's underperformance are concerns about the negative impact of interest-rate hikes on the Canadian housing market. Last year's aggressive monetary tightening will take time to reverberate through the economy as mortgages are reset at higher rates, and will undoubtedly act as a headwind this year. We don't expect a large-scale crisis to cripple the economy, though. The gradual pace at which Canadian mortgages are reset means that the reduction in disposable income due to higher loan payments should take time to play out and thus be more muted than what is anticipated by investors.

Exhibit 11: Emerging market policy rates have been consistently higher than in the G10



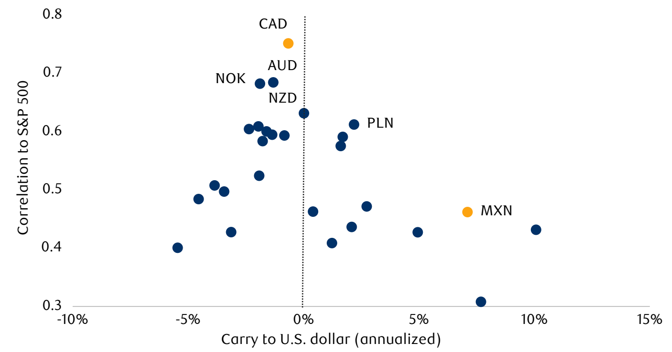
Note: As March 1, 2023. Source: Macrobond, RBC GAM

The state of the U.S. economy is also highly relevant for the loonie's prospects. Some investors, fretting over the risk of a U.S. recession, have sold the Canadian dollar and the Mexican peso to profit in the event that economic data worsens. Both currencies have strong trade ties with the U.S. and both are positively correlated to risk sentiment, but the Canadian dollar is seen as the cleaner bet because it offers a higher sensitivity to stocks and a much cheaper cost of hedging (lower interest rates than in Mexico, Exhibit 12). Even still, the loonie seems to be holding within its six-month-old range between 1.32 and 1.40 per U.S. dollar, helped by the avoidance of big declines in stock markets and the surprisingly robust U.S. economic data. Continued improvement in the economic performances of Europe and China would be supportive for commodities and raise the possibility that short-Canadian-dollar positions are abandoned.

Capital flows are perhaps another reason why the loonie hasn't weakened more. The net basic balance, the broadest measure of capital flows, remains supportive for the loonie at 3% of GDP (Exhibit 13). Arguably the most important component of this measure is the current account, which recently begun to post surpluses thanks to improvement in trade and income categories. The one area of weakness is negative foreign direct investment, where deterioration has mostly been driven by Canadian firms investing abroad rather than foreign firms retreating from Canada. This reflects preferences for business investment in the U.S. as well as large global infrastructure investments by Canadian pension funds (Exhibit 14). Early signs suggest that this net outflow may subside as oil and gas producers in Canada work together to reduce emissions to zero by 2050. The joint plan is expected to drive $75 billion of investment over the next few decades, which would not only boost economic activity but also help correct the perception that Canada's oil sands are a source of dirty energy.

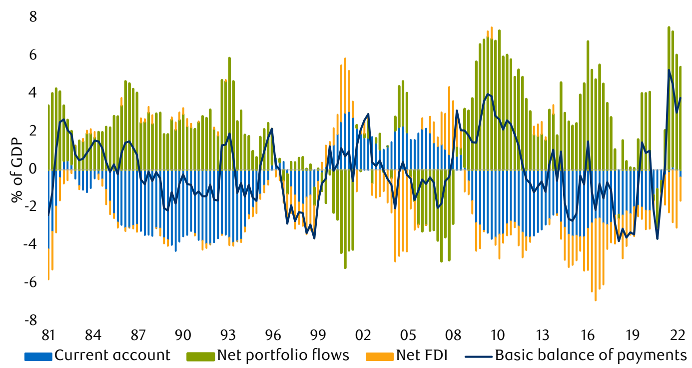
The loonie's near-term underperformance should prove limited, we think, so long as a hard landing in the U.S. is avoided. Supportive flows, strong immigration and elevated commodity prices should help the Canadian dollar keep pace with its peers over the next 12 months. At some point within the coming year, we forecast that the loonie will touch C$1.23 per U.S. dollar.

Exhibit 12: Loonie closely tied to stocks and has low carry vs. U.S. dollar



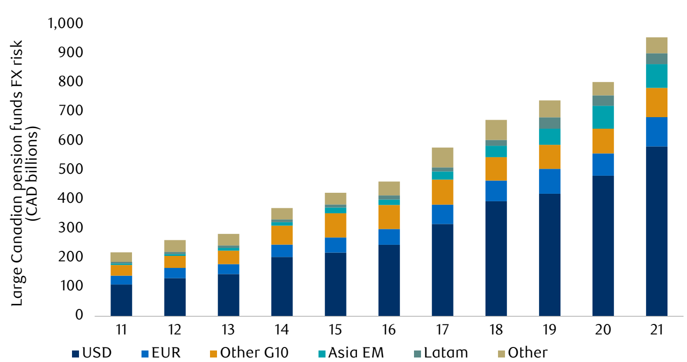
Note: As at March 3, 2023. Source: Bloomberg, RBC GAM

Exhibit 13: Canada basic balance of payments



Note: As at December 31, 2022. Source: Statistics Canada, RBC GAM

Exhibit 14: FDI outflows from Canadian pensions



Note: As at year end 2021. Data from pension fund annual reports.
Source: UBS, RBC GAM

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