RBC Global Asset Management

Global currency outlook

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U.S. dollar has benefitted from risk aversion; weakness likely to materialize

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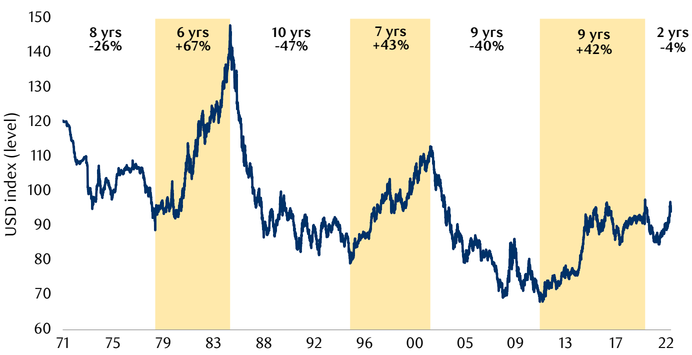
Reverting to its safe-haven status, the U.S. dollar has enjoyed a stellar run, gaining an impressive 8% against the euro in the 12 weeks since Russia invaded Ukraine. The greenback has benefited not only from risk aversion, as investors flee risky assets in other countries, but also from expectations that the U.S. Federal Reserve (Fed) will hike rates faster than its peers. In response to recent developments in Ukraine and the increasingly hawkish leanings of the Fed, we have pushed back the timing for when we think U.S.-dollar weakness might return.

Our change in outlook was prompted in part by a broadening out of the U.S. dollar's gains. We had not been altogether surprised that the dollar outperformed low-yielding currencies such as the euro and yen, because there was little prospect that central banks in those regions would be hiking rates imminently, let alone match what is currently anticipated to be nine Fed rate hikes this year. For several quarters, our calls for dollar weakness were instead focused on the outperformance of cyclical and emerging-market currencies, which would be supported by hawkish central banks, stronger economic growth and high commodity prices. These currencies had indeed performed well in the first few months of 2022, and a few even delivered double-digit gains against the U.S. dollar. More recently, however, cyclical currencies have begun to show some vulnerability. The combination of a quick rise in Treasury yields, greater volatility in equity markets and the broadening out of U.S. dollar strength have caused us to become more cautious in our positioning and trim back some of our cyclical-currency exposure after a period of healthy gains.

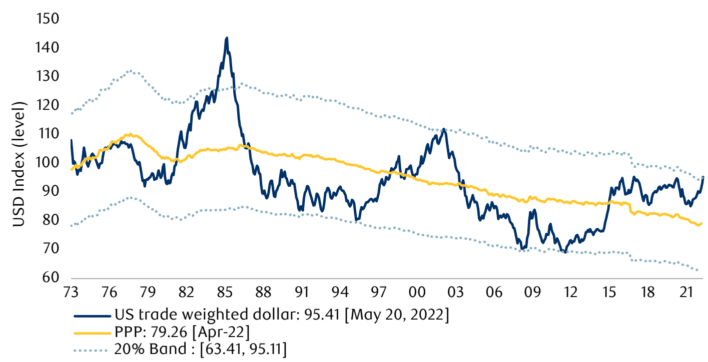
We still expect the greenback to weaken in the medium to longer term, and there is little doubt that the currency has lots of room to fall. Recent strength has brought the dollar close to its highs in the early days of the pandemic (Exhibit 1), when uncertainty around global growth was at its peak. By most valuation metrics, the dollar is also now extremely expensive. Purchasing power parity models show the greenback to be 20% too rich, levels rarely seen and which typically cannot be sustained for very long (Exhibit 2). We suspect that U.S.-dollar strength is now mostly behind us and that it has little more to gain from an already hawkish central bank and investor positioning that is already quite long (Exhibit 3). Pessimism around the economic-growth outlook for Europe and China now also seem well priced in by markets, at the same time that concerns about a

Exhibit 1: Long term cycles in the U.S. trade-weighted dollar



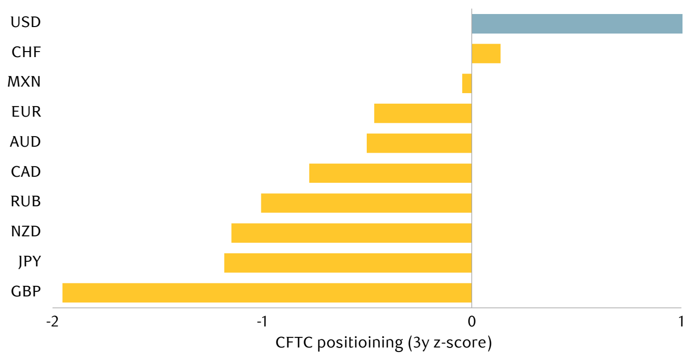
Note: As at May 31, 2022. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 2: U.S. trade-weighted dollar
PPP Valuation



Note: Uses new Fed USD index from Dec 31, 2019 onward (USTWAFE Index). As at May 30, 2022. Source: U.S. Federal Reserve, Bloomberg, RBC GAM

Exhibit 3: Investors are long U.S. dollars



Note: As at May 27, 2022. Source: CFTC, RBC GAM

> "We still expect the greenback to weaken in the medium to longer term, and there is little doubt that the currency has lots of room to fall."

looming recession in the U.S. threaten to take the wind out of the dollar's sails. Bond markets are already reacting to this dynamic, with yields on 10-year Treasuries declining to 2.70% from their 3.20% highs in the month of May. Inflation expectations are also starting to moderate, which, if validated by a reduced pace of actual inflation, might at the minimum confirm that the expected peak in the current cycle's fed funds rate is already priced in.

While the dollar has started to soften in recent days, it is not certain that we have reached a decisive turning point lower. There remains a possibility that further declines in equity markets push the greenback higher still – a move that would be compounded if a further rise in rate-hike expectations were to materially threaten economic growth. We are now watching for several developments that would raise our conviction that the U.S. dollar peak has passed:

- A significant slowdown in U.S. economic activity, which would put the Fed's path of rates hikes into question.
- A shift in tone from the European Central Bank (ECB) officials that they might begin to follow in the Fed's footsteps by hiking interest rates.
- Concrete signs from Chinese and Japanese policymakers that they might act more forcefully to arrest the decline in the renminbi and the yen.
- De-escalation of the Russian offensive in Ukraine, signs of a waning in Putin's power or an end to the war.

Japanese yen

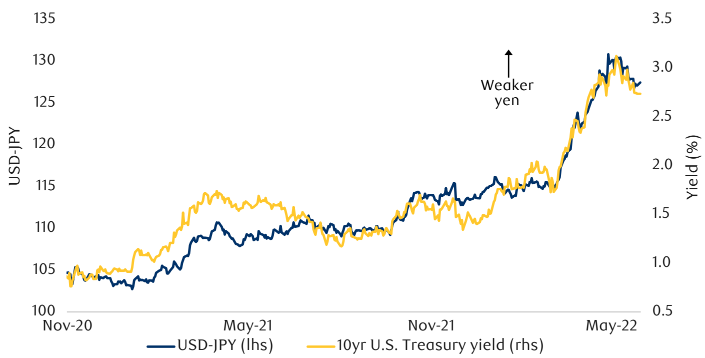
For those with longer-term investment horizons, we would advise using recent strength in the greenback as an opportunity to reduce U.S.-dollar exposure. This is especially true for investors domiciled in Japan, as the yen has fallen sharply against the dollar to new lows and is most undervalued versus the greenback. The yen is especially sensitive to movements in the U.S. bond market, and tends to weaken when bond yields abroad look more attractive than those in Japan. This has certainly been the case over the past several months, as Treasury yields have risen in response to mounting expectations for Fed rate hikes and rising U.S. inflation expectations (Exhibit 4). Now that the Japanese yen has weakened so much, we have become more positive on the currency for several reasons.

First, it tends to perform well during times of risk aversion, when Japanese investors are most active in repatriating foreign investments. The prevailing uncertainty and rising fluctuations in equity markets warrant some portfolio protection by holding the Japanese yen. Adding potency to this safe-haven status is that severe risk aversion would likely be accompanied by a partial reversal of Fed rate-hike expectations, from which the yen would have more to gain than other global currencies given its tight link to changes in Treasury yields.

Second, there are some hints that Japanese policymakers are becoming more concerned with yen weakness, with officials at the Ministry of Finance and Bank of Japan (BOJ) ratcheting up threats to intervene if the currency continues its slide. While interventions are unlikely to have lasting influence on currency markets without the support of other central banks, they can have a pronounced influence over short periods of time, especially by wrong-footing investors who have bet heavily against the yen (Exhibit 5).

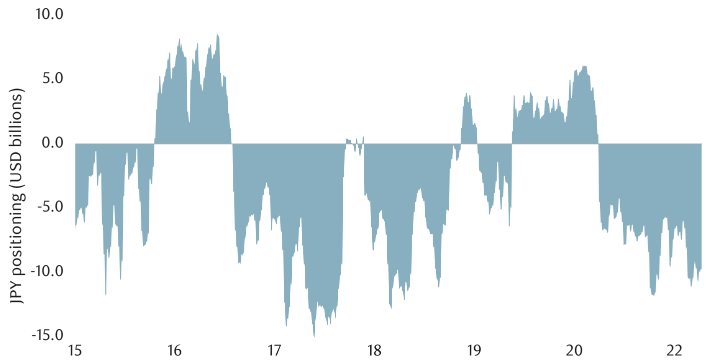
Third, we expect that the BOJ may finally exit its uber-dovish yield-curve-control framework, where it has anchored both short-term and long-term bond yields within a tight range. Rising global inflation has prompted

Exhibit 4: Treasury yields drive yen movement



Note: As at May 30, 2022. Source: Bloomberg, RBC GAM

Exhibit 5: Investors are substantially short the yen



Note: As at May 27, 2022. Source: CFTC, Bloomberg, RBC GAM other central banks to tighten policy while the BOJ has remained firm in its easy monetary-policy stance. In essence, the BOJ has prioritized stability in interest rates over stability in the currency – an approach that will quickly help the central bank achieve its 2% inflation target as the weakening yen elevates prices for imported goods. Few would consider this method of achieving inflation targets to be a success, however, as higher import prices and rising energy costs simply leave households with less disposable income to spend on goods produced domestically. At some point, the BOJ will relax the cap on Japanese government-bond yields and the currency will likely rally as a result. Our forecast for 12 months ahead is for the yen to strengthen to 118 per dollar.

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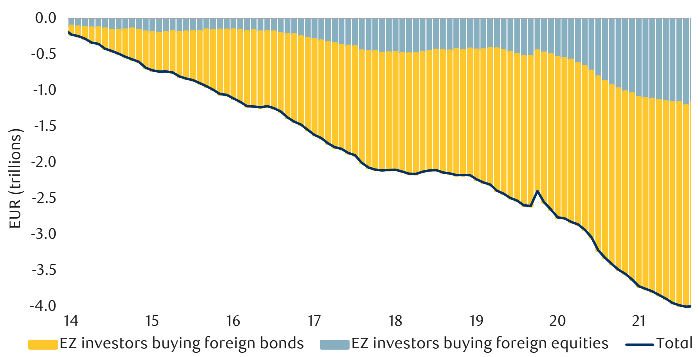
Euro

Plagued by higher energy prices after Russia's invasion of Ukraine, the outlook for Eurozone economic growth has been meaningfully dented, even though increased government spending in Europe contrasts with fiscal drag in the U.S. Weaker growth gives the ECB leeway to keep policy loose for longer than other central banks and will have the Frankfurt-based institution hiking more slowly after asset purchases have ended. With so much focus on relative monetary policy, the euro will have trouble sustaining gains until the ECB makes a move on interest rates. Any ECB move to raise rates would be an important signal for bond investors and a sign that the tide has turned on capital flight from Europe. Trillions of euros of investment capital have been shifted abroad by European investors looking to avoid negative yields (Exhibit 6). With yields in Europe beginning to rise, support should re-emerge for the euro as a portion of the expatriated money returns. How swiftly capital returns to Europe once rates climb above zero is a topic of much debate, with some expecting a more energetic reaction from investors once the important zero-threshold is crossed. With the euro having tested and bounced from its cycle lows at US$1.0350, we now have more comfort in our call that the single currency can rally to our 12-month forecast of US$1.16.

Exhibit 6: Negative yields are driving portfolio outflows



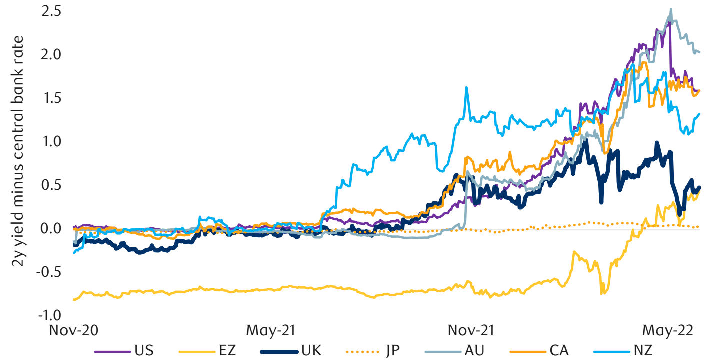
Note: As at Mar. 31, 2022. Source: ECB, Macrobond, RBC GAM

British Pound

The U.K. is among the most self-sufficient of energy importers and relies less on Russia for natural gas and oil than does the rest of Europe. But the smaller economic shock from the war does not necessarily translate into a bullish outlook for the pound. While recent hikes by the Bank of England (BOE) strengthened the pound somewhat, it has become clear that the BOE won't hike interest rates as much or as quickly as many of its peers (Exhibit 7). As U.K. inflation rises beyond levels in other developed nations, the BOE has been signaling concerns about the negative impact that higher interest rates will have on economic growth and perhaps suggesting fewer rate hikes. Also feeding investor perceptions that the central bank is less focused on inflation than its peers are the BOE's reiterations that it expects the impact of supply-chain disruptions and geopolitical events to be temporary.

The currency trades slightly rich to the euro and is weighed down by persistent current-account deficits. We are also concerned about a decline in household spending, as lower real incomes, tax increases and rate hikes pose a threat to one of the main engines of U.K. economic growth: consumption. Our 12-month forecast for the pound was lowered this quarter to US$1.35 from US$1.39, reflecting this increased concern.

Exhibit 7: Bank of England unlikely to keep pace with other central banks



Note: As at May 27, 2022. Source: Bloomberg, RBC GAM

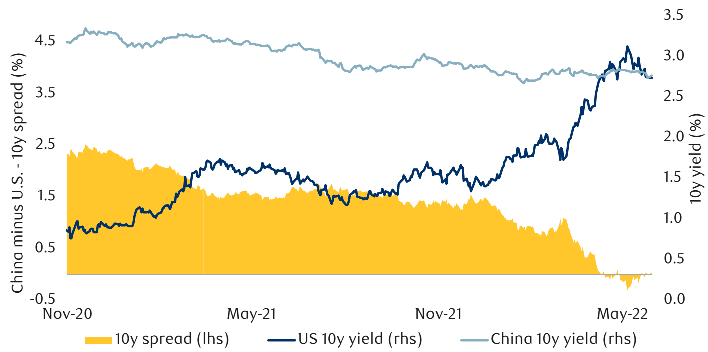
Chinese renminbi

Having kept to a tight 10-point trading range for the first few months of the year (between 6.30 and 6.40), the Chinese renminbi weakened quickly to 6.85 per U.S. dollar in a few short weeks (Exhibit 8). Lockdowns in major Chinese cities and the associated impact on Chinese economic activity was largely to blame for the currency's decline. Also important was a rise in U.S. Treasury yields, which undermined China's interest-rate advantage (Exhibit 9), causing investors to accelerate the exodus from Chinese markets. Foreign investors had already been selling Chinese assets due to an increasingly challenged outlook for the country's technology companies. Capital outflows from China amounted to US$35billion in March, reversing roughly two-thirds of the total capital accumulated during the entirety of 2021. While some

Exhibit 8: Renminbi has seen a sharp sell off

Note: As at May 27, 2022. Source: Bloomberg, RBC GAM press commentators are forecasting that the renminbi will fall further to 7.00 per dollar, investors don't seem to be positioned for such a move. Weakness in the Chinese currency could have far-reaching implications for other emerging markets, which rely on China for much of their trade and are therefore highly sensitive to fluctuations in the renminbi. The potential for instability caused by a renminbi decline is another reason we have become more cautious on cyclical currencies, though recent moves by policymakers to stimulate the Chinese economy and stem further weakness in the renminbi partly address those concerns. A more forceful approach by policymakers and/or an easing of restrictions in Beijing and Shanghai would have us upgrade our view on the currency.

Exhibit 9: China no longer has a yield advantage over Treasuries



Note: As at May 27, 2022. Source: Bloomberg, RBC GAM

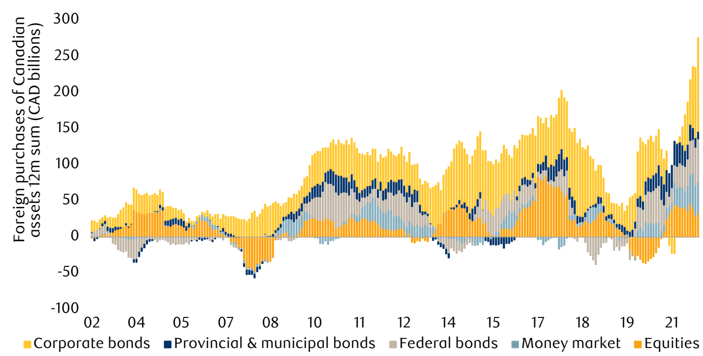
Canadian dollar

The Canadian dollar has largely kept to a tight trading range of $1.25-$1.30 per U.S. dollar this year, pushed lower, on one hand, by a strong U.S. dollar and pulled higher, on the other hand, by high commodity prices. In recent weeks, the loonie declined as a result of a third signal, a decline in equities, which caused the loonie to fall to the bottom of the recent range of $1.30. We remain positive on the loonie despite the test of this key chart point, and prefer owning the Canadian dollar to many of the world's other cyclical and low-yielding currencies. There are three main reasons for our positive outlook on the Canadian dollar:

Unlike central banks in Europe, Japan or China, the Bank of Canada (BOC) is set to match the Fed's pace of interest-rate hikes. The BOC got an early start to tightening policy by ending its quantitative easing prior to the Fed and is expected to hike rates another seven times beyond the 125 basis points already delivered.

Canada's balance of trade and capital flows remain supportive for the loonie, not only from the improvement in terms of trade as commodity prices rally, but also from an increase in volumes traded in non-commodity exports and from general demand for Canadian assets. The country's current-account balance has registered its first annual surplus in 13 years and foreigners have hoovered up more than $275 billion of Canadian assets over the past 12 months (Exhibit 10) – the highest levels on record and more than 2.5 times the average over the past decade.

Exhibit 10: Strong foreign demand for Canadian assets



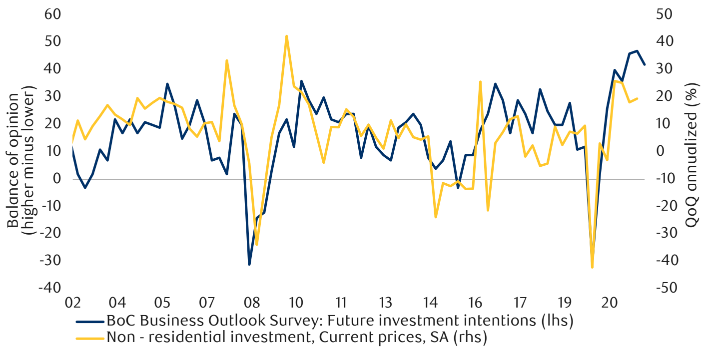
Note: As at March 31, 2022. Source: Statistics Canada, RBC GAM

> "We forecast that the Canadian dollar will strengthen to $1.19 per U.S. dollar in 12 months' time."

The Canadian economy is in good shape and is expected to be one of the strongest performers in 2022, according to RBC GAM forecasts and the consensus of international economists. Canadian economic growth remains supported by a strong labour market and aggressive immigration targets that were raised to 431,000 new entrants for 2022, representing an additional boost to population growth of roughly 1%. One additional item that we're watching closely is capital spending, which could begin to pick up after years of underinvestment. We have pointed out in the past that high oil prices only truly benefit economic growth when firms decide to hire additional workers and invest in new plants and equipment. Canada has lagged in this regard for many years, though there are signs that companies in both resources and non-commodity sectors are starting to commit to capital expenditures, perhaps spurred by the rising cost of labour. One survey by the BOC found that the number of firms planning investments outstripped those that were not by 40% (Exhibit 11).

There are, of course, risks to the positive Canadian-dollar outlook. We are mindful of heavily leveraged households and the impact on the housing market of the central bank's steep rate-hiking path. But we find more arguments to be positive on the Canadian dollar than not (Exhibit 12) and our valuation models show that the loonie remains particularly cheap at current levels. We forecast that the Canadian dollar will strengthen to $1.19 per U.S. dollar in 12 months' time.

Exhibit 11: Canadian investment intentions



Note: As at March 31, 2022. Source: Bank of Canada, Bloomberg, RBC GAM

Exhibit 12: Factors favouring loonie strength

PROS	CONS
√ BoC keeping pace with Fed hikes	x Hawkish Fed / strong USD
√ Strong WTI crude prices	x Shakier risk sentiment
√ Benefits from scarcity pricing in base metals	x Larger fiscal drag than other G10
√ CAD is cheap on most valuation metrics	x Higher household leverage as rates rise
√ Strong labour market	x Negative foreign direct investment flows
√ Trade balance at 13-year high	x Long term underinvestment in productive assets
√ Population growth leadership via strong immigration	x Oil sands controversial in an increasingly green-conscious world
√ Large foreign asset position reduces CAD's vulnerability	x Vulnerability to crop yields from climate variability
√ Long term USD bear market to resume	x Global warming may increase geopolitical risks for Canada (Northwest Passage)
√ Larger oil export capacity with restart of line 3 & Trans Mountain	
√ High vaccination rates make lockdowns less likely	

Note: As at May 31, 2022. Source: RBC GAM

Conclusion

The greenback has benefited from risk aversion amid Russia's invasion of Ukraine, as well as expectations that the Fed will hike interest rates faster than its peers. Although we have pushed back the timing for when we think U.S.-dollar weakness might return, we still expect the greenback to weaken in the medium to longer term given that the dollar is now extremely expensive and that much of the Fed hawkishness and expected economic weakness abroad is already priced in. Key markers that would strengthen our conviction that the U.S. dollar may have peaked include a slowdown of U.S. economic activity, a hawkish shift in tone from the ECB, signs that Asian policy makers may step in to support their currencies and/or a de-escalation of the war in Ukraine. Our forecasts look for the U.S. dollar to depreciate against a basket of major developed-world currencies over the year ahead.

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