RBC Global Asset Management

# Global currency outlook

NEW YEAR 2025

# Trump breathes life into the dollar

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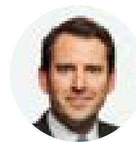

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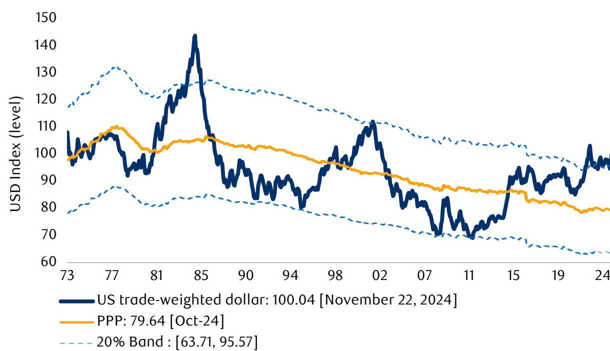
We've put our bearish U.S.-dollar outlook on pause following the November elections that resulted in Republicans winning control of the White House and both houses of Congress. Incoming President Donald Trump's proposed policies on trade, taxes, deregulation and immigration are likely to be tough on U.S. trade partners and generally inflationary. Even if these proposals are watered down, it is likely that they would keep the U.S. Federal Reserve (Fed) from cutting interest rates as much as we had previously expected. As a result, we expect the greenback to remain elevated for longer, even amid valuations that indicate a decline beyond our forecast horizon. We think that the new administration's approach, as well as a more challenging European economic outlook will pose greater headwinds for the euro while the yen, pound and Canadian dollar will be more resilient. The Chinese renminbi will also be pressured by trade tensions, though its performance depends heavily on the actions of the Chinese central bank.

### Exhibit 1: USD – PPP Valuation




Note: As at November 22, 2024. Source: U.S. Federal Reserve, Bloomberg, RBC GAM

We have long been bearish on the U.S. dollar, owing to stretched valuations (Exhibit 1). Other long-term factors, such as fiscal and current-account deficits and a shift away from use of the dollar for foreign-exchange reserves also suggest the greenback should be falling. While the Fed's campaign to raise interest rates in 2022 delayed what we expected would be the dollar's decline, this year's rate cuts by the central bank fueled speculation that the dollar could finally weaken. A government promising policy continuity would have solidified that movement.

In the wake of the U.S. election results, investors will need to wait longer for the dollar to weaken, though it is worth noting that the extent to which the greenback remains elevated will depend largely on how and when proposed policies by the

new Republican government are enacted. In the few weeks since the November elections, the dollar has risen through the upper end of its two-year range (Exhibit 2) as investors focused on policy proposals that are most relevant for currency markets:

- **Trade policy:** Trump's proposal for a blanket 10% tariff on goods and services imported into the U.S. and a 60% levy on items produced in China will support the dollar, at least in the near term. This is partly because tariffs raise the cost of goods and services for American consumers, causing the Fed to keep policy rates higher than it might have otherwise. In general, tariffs are designed to make foreign goods more expensive and encourage foreign firms to increase manufacturing capacity in the U.S. to avoid the tax. When imported goods become more expensive for consumers, foreign currencies typically weaken, offsetting some of the pain.
- **Tax cuts, deregulation and efficiency gains**: Cutting wasteful government spending is not an original idea, but creating a department of governmental efficiency *is* a novel way to accomplish that goal. It is unlikely that spending cuts will reduce overall deficits, however, as the new administration plans an extension of the Tax Cuts & Jobs Act passed in 2018 during Trump's first presidency. Alongside deregulation, growth-supportive measures may extend a period in which the U.S. economy has outperformed other developed-market economies, keeping the dollar in demand from investors looking to benefit from higher yields and stronger corporate profits.
- **Geopolitics:** The dollar is the world's primary reserve currency because of the depth and liquidity of U.S. capital markets. U.S. military dominance that covers the policing of international shipping lanes also helps. This is the cost associated with the "exorbitant privilege" of being able to print currency that will be accepted globally without question. Trump's threat to abandon NATO and pull U.S. support for Ukraine may simply be the opening gambit to force Europe to shoulder more of the cost, which is negative for the euro in the short term because it heightens concerns about energy security and could divert already scarce fiscal resources. In the longer term, however, Trump risks pushing a greater number of countries to use other currencies to finance trade. Already, countries in the Middle East and elsewhere in Asia have been buying oil in Indian rupees or renminbi. Moreover, a proposal to introduce a common means of exchange for use by Brazil, Russia, India, China and South Africa (collectively the BRICS nations) is a sign that the U.S. may have abused its position by seizing Russian foreign-exchange reserves and blocking access to U.S.-dollar payment systems, effectively weaponizing the dollar. A rally in the gold price exceeding 30% over the past year alongside an increased weight of gold in foreign reserves shows waning confidence in the U.S. dollar as a store of value.
- **Attitude toward the dollar:** Donald Trump seems to prefer a weaker dollar. He has often complained that U.S.-dollar strength is eroding American competitiveness and has hinted that he aims to even the scales by forcing other countries to strengthen their own currencies. We're doubtful that China would ever formally agree to allow the renminbi to strengthen after reviewing the impact of the 1985 Plaza Accord, where Japan's agreement to let its currency strengthen ended up having a damaging long-term effect on Japanese industry. A more likely agreement would involve Chinese firms setting up factories in the U.S., providing jobs for American factory workers and a political win for Trump. Should this fail, Vice President-Elect JD Vance has gone so far as to suggest outright intervention to cheapen the dollar, but it doesn't appear as though the U.S. government has the available mechanism

### Exhibit 2: USD broke out of 2-year range following U.S. elections

Note: As at December 4, 2024. Source: Bloomberg, RBC GAM

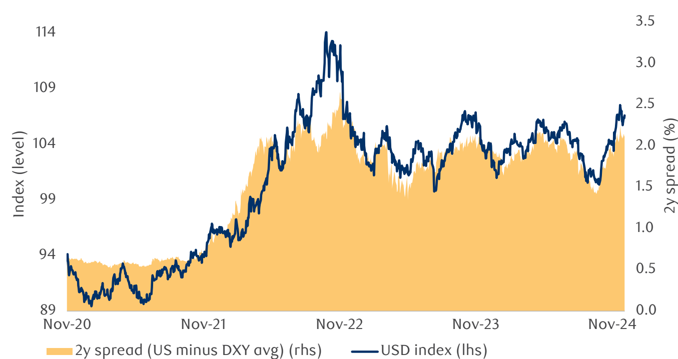
with which to take such action. Perhaps, then, the White House will resort to pressuring the Fed to keep monetary policy accommodative. By installing a more dovish Fed president when Jerome Powell's term ends in 2026, the White House could engineer an outcome with lower rates that both supports domestic economic activity and weakens the currency. This political interference could severely undermine the Fed's hard-earned inflation-fighting credibility and cause a large-scale sell-off in bond and equity markets, an outcome which would be very bad for the dollar in the longer term.

Equity, bond and foreign-exchange markets have so far been relatively calm in the weeks following the election. The greenback's initial rally to new highs was held in check by the nomination of Scott Bessent as Treasury Secretary. Bessent was clearly the safer choice and the one preferred by investors because of his known and well-articulated stance on trade and fiscal policy. If confirmed, he will likely opt for a more incremental approach to tariffs – likely providing relief for investors who fear the immediate imposition of 60% tariffs on Chinese goods on the day Trump is sworn into office. Bessent's challenge will be to persuade Trump that he should not use executive authority to unilaterally impose punitive tariffs.

Whether the new Treasury secretary will dull the dollar-positive impact of Trump's agenda is still to be seen. Will Bessent be given the leeway to manage matters without being overruled by Trump? If so, how will individual currencies and economies fare? We suspect the regions that will be hardest hit by the new trade and geopolitical regime include China, Europe and Mexico. Other Asian nations are also likely to be targeted owing to their tightly managed currencies and large trade surpluses with the U.S. "Friendly" trade partners like Canada may also fall prey to a rising U.S. dollar but could suffer less because the U.S. relies on Canadian energy and the two economies are intertwined on many levels. We think the new president will opt to negotiate more quickly with Canada than with China or Mexico, which run larger surpluses with the U.S. and are increasingly stealing market share from American industry. It appears that, for Canadians, success in these negotiations will depend largely on a commitment from Canada to better police the U.S. border.

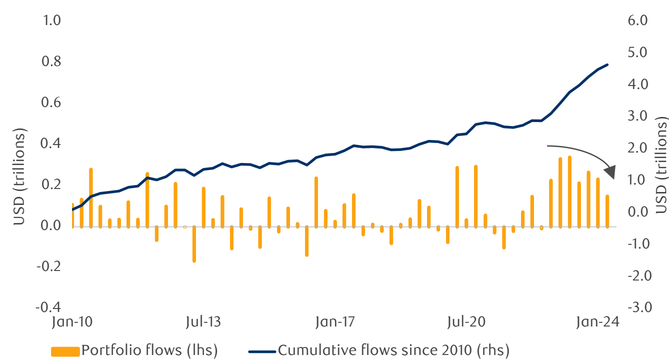
It is clear, however, that as long as Trump's policies are seen to boost investor returns through stronger equity markets and elevated bond yields, the dollar will continue to benefit from capital inflows. The relatively higher interest rates available in the U.S. act as a magnet for capital and explain the lion's share of the U.S. dollar's fluctuations over the past two years (Exhibit 3). While capital inflows slowed somewhat in the first half of 2024 in response to expectations that the Fed would cut interest rates (Exhibit 4), a less dovish Fed next year could prompt a reacceleration of demand for the greenback due to relatively high U.S. yields.

### Exhibit 3: USD closely tracks policy interest-rate differential




Note: As at December 4, 2024. Source: Bloomberg, RBC GAM

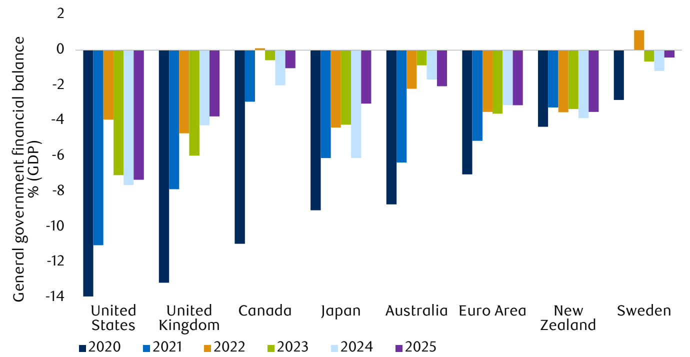
### Exhibit 4: Portfolio flows into U.S. assets




Note: Quarterly data as at June 30, 2024. Source: US Bureau of Economic Analysis, RBC GAM

There are limits to how far the dollar can rise given its long-term fundamentals. The currency is already significantly overvalued based on a number of models, and history shows that currencies rarely exceed 20% deviations from fair value. The U.S. fiscal deficit is also troubling, coming in at 6%-7% of GDP, and it's expected to remain much higher than its peers' (Exhibit 5). Yes, the U.S. has the ability to simply print more U.S. dollars in order to repay debt, but it's hard not to question how sustainable current spending levels are without higher taxes. We also caution that, while inflationary policies such as tariffs and fiscal spending may be positive for the greenback in the short term, they risk elevating yields to an extent that economic growth is threatened. So, while it seems likely that the dollar will remain elevated as Trump again assumes the presidency, he may get the weaker dollar he wants without the economic strength that has usually underpinned it.

### Exhibit 5: U.S. consistently the biggest fiscal offender

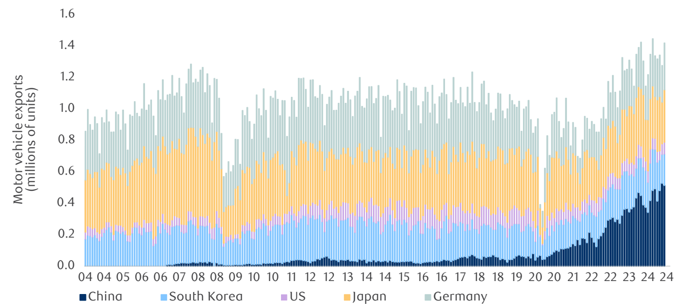



Note: As at December 31, 2023. Source: IMF, RBC GAM

### Euro

The euro doesn't have many factors working in its favour. Households and companies lack the confidence to spend, demand for exports is soft and eurozone nations can't seem to agree on whether to relax limits on fiscal spending. Economic growth has faltered as a consequence, adding to the structural woes that include a decline in the working-age population, energy insecurity and a loss of market share to Chinese auto manufacturers (Exhibit 6). Germany, the region's biggest automaker, is particularly affected by competition from cheaper Chinese electric vehicles and the country's economy is the same size as it was in 2019 when adjusted for inflation (Exhibit 7).

### Exhibit 6: China rapidly gaining share in motor-vehicle exports



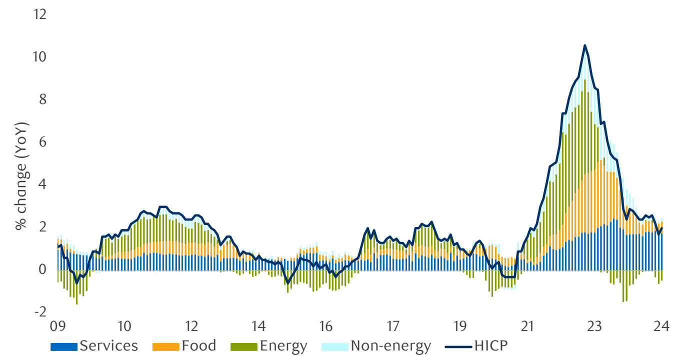

Note: As at September 30, 2024. Source: China General Administration of Customs, Korea Automobile Manufacturers Association, BEA, Japan Automobile Manufacturers Association, German Association of the Automotive Industry, RBC GAM

### Exhibit 7: German GDP has been stagnant for the past five years

Note: Quarterly data, as at September 30, 2024. Source: German Federal Statistical Office, RBC GAM

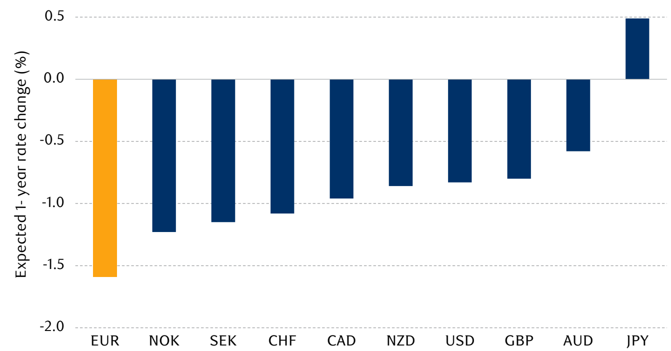
Europe's weaker growth outlook poses an interesting challenge for the European Central Bank (ECB). Unlike the Fed, which must by law pay attention to inflation and growth, the ECB's mandate is singular: to keep inflation at or below 2%. As it happens, the region's October inflation reading came in at exactly 2% after having declined substantially over the past year due to disinflation in food, energy and industrial prices (Exhibit 8). What remains is services inflation, which is much stickier and being propped up by higher wages. It's possible that auto-sector layoffs will temper wage pressures, but it seems unlikely that inflation will continue to fall at a pace that encourages the ECB to cut rates as aggressively as investors expect (Exhibit 9). A scaling back of rate-cut expectations would likely stop the euro from falling to parity with the dollar as many investment banks are now forecasting. We expect that the single currency will remain weak as Trump takes office and as tariff talks intensify. But the euro's attractive valuation and the fact that investor capital has been flowing back into eurozone equities (Exhibit 10) suggest to us that sell-offs beyond parity would be short-lived. By this time next year, we expect the euro to have bottomed and for it to trade at a rate of US$1.09.

## Exhibit 8: Eurozone disinflation may stall



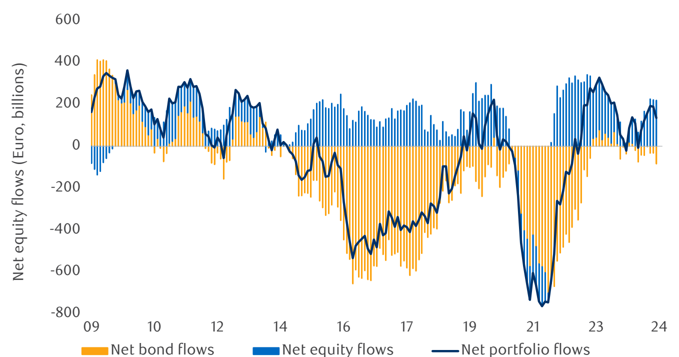

Note: As at October 31, 2024. Source: ECB , RBC GAM

## Exhibit 9: ECB priced for most cuts in G10




Note: As at: December 3, 2024. Source: Bloomberg, RBC GAM

## Exhibit 10: Continued interest in eurozone equities to support the euro




Note: As at September 30, 2024. Source: ECB, RBC GAM

## Japanese yen

Japan has yet to be named as a target of U.S. tariffs, even though the cheap currency makes the Asian nation an easy choice. Perhaps this is because Trump is working down the list of largest surplus trading partners (Japan's surpluses with the U.S. rank sixth behind China, Mexico, Canada, Vietnam and Germany). Or perhaps the White House sees an opportunity to partner with Japan to strengthen the yen and weaken the dollar. Indeed, this would be aligned with Japanese interests, as the Bank of Japan and Ministry of Finance have intervened on several occasions in 2024 to stem yen declines.

It is questionable whether such intervention would continue to prove successful, however, as it likely would be countered by an increase in U.S. bond yields relative to Japanese yields. The yen is more tightly linked to the gap in yields than any other currency (Exhibit 11), and so is vulnerable to weakness if U.S. interest rates rise on account of higher U.S. inflation. This effect may be muted somewhat by developments in the Japanese bond market where the landscape has quietly changed in a way that allows Japanese yields to rise. The BOJ, for instance, has stopped buying Japanese government bonds and has begun raising interest rates, two forces that had anchored yields at very low levels. A further rise in interest rates could be stoked by mounting wage pressure (Exhibit 12) and the impact of prior yen depreciation that gets passed through to higher import prices.

A modest increase in the yield of Japanese government bonds could be enough to change the calculus behind investment decisions at some of the country's largest investors. Nomura[1] has outlined plans by Japanese life-insurance companies to repatriate capital and increase allocations to domestic assets. The nine major life insurers are also said to be weighing an increase to hedging on foreign assets now that the cost of doing so has fallen. For now, overall capital flows are still biased toward yen-selling (Exhibit 13), and the yen will struggle to make significant gains until this situation reverses. We have penciled in a more modest gain for the Japanese currency than in our previous outlook and now see the yen appreciating to 142 per dollar from 150 at writing.

[1] Yujiro Goto, Jin Moteki, Yusuke Miyairi, Tomoki Hideshima. "Major lifers' FX hedge ratios have shown signs of bottoming out", *Nomura JPY Flow Special Report*, November 25, 2024

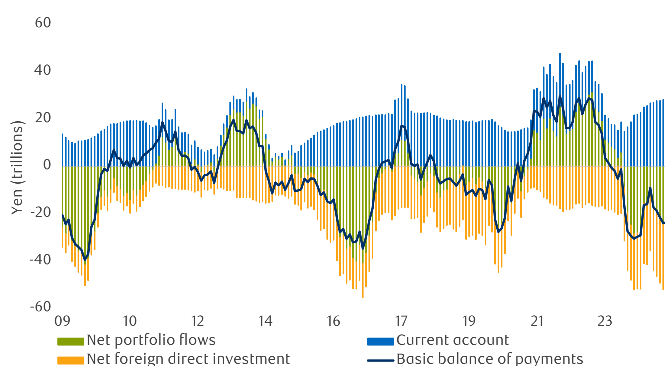
### Exhibit 11: The yen remains closely tied to real yield spreads

Note: As at December 4, 2024. Source: Bloomberg, RBC GAM

### Exhibit 12: Wage pressures remain strong in Japan

Note: Cash earnings for establishments with over 5 employees. As at September 30, 2024. Source: Japanese Ministry of Health, Labour & Welfare, RBC GAM

### Exhibit 13: Capital flows still reflect a bias to sell the yen




Note: As at September 30, 2024. Source: BOJ, RBC GAM

This represents a slightly larger gain than is expected by Bloomberg's survey of forecasters. Concrete evidence of a more supportive shift in capital flows would prompt us to increase our forecast for the yen's advance.

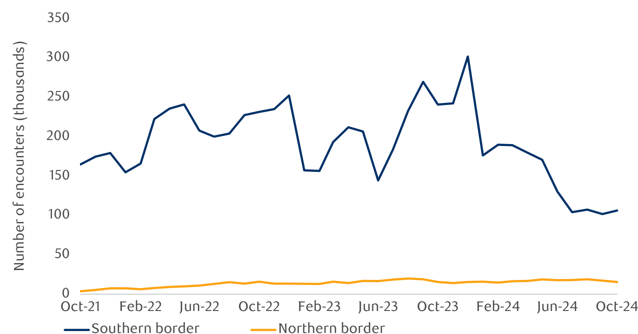
## Canadian dollar

The Canadian dollar has weakened by about 3.5% over the past quarter and in November traded outside its well-established range of C$1.32-C$1.40 per U.S. dollar. Most of this weakness occurred prior to the beginning of November, indicating that the currency's move had less to do with the outcome of U.S. elections than the Bank of Canada's (BOC) quickening pace of interest-rate reductions. The BOC started cutting rates sooner than most other developed-market central banks and has eased policy by a percentage point more than the Fed since the summer. This places Canada's short-term interest-rate disadvantage at roughly 1.3%, enough that investors are encouraged to shift investments to the U.S. from Canada.

We are not overly concerned that this depreciation will continue unabated, even in light of Trump's threat to apply a blanket 25% tariff on all Canadian exports to the U.S. Following that threat, the Canadian government was quick to express its willingness to work with the incoming administration to tighten border controls. We wonder how much of that threat was simply showmanship given that Canada hardly registers when compared with Mexico on illegal-immigrant encounters and the influx of fentanyl (Exhibits 14 & 15). It's more likely, we think, that the U.S. would take a targeted approach toward applying tariffs on certain industries such as dairy and lumber. Not only does this approach better fit the narrow set of sectors that make up the bulk of trade between the two countries, but it also avoids scuttling long-standing partnerships in the energy and auto industries.

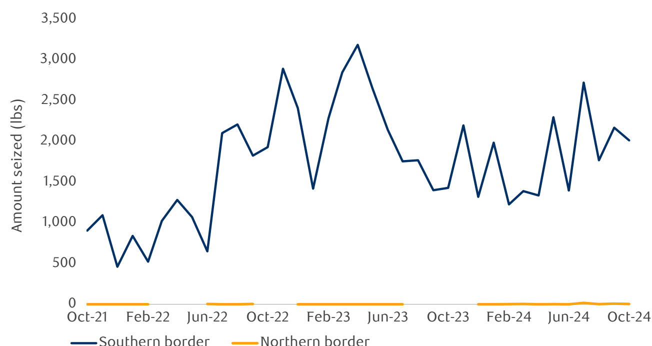
We are not alone in believing that the Canadian dollar will be more stable than other developed-market currencies, with option markets suggesting that the Canadian dollar will experience much less volatility next year (Exhibit 16).

### Exhibit 14: Border encounters at the southern border outstrip those at the northern border



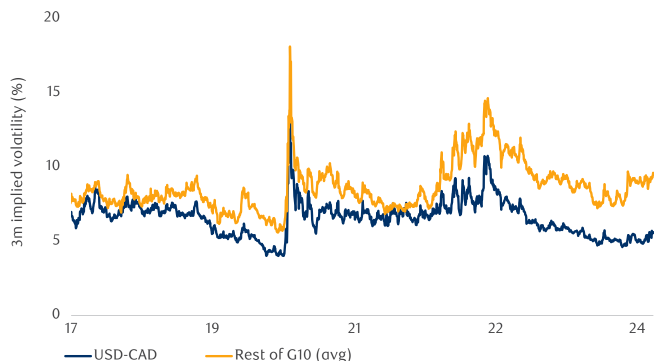

Note: As at October 31, 2024. Source: U.S. Customs and Border Control, Bloomberg, RBC GAM

### Exhibit 15: Fentanyl seizures at the Mexican border eclipse those at the Canadian border




Note: As at October 31, 2024. Source: U.S. Customs and Border Control, Bloomberg, RBC GAM

### Exhibit 16: Option markets price lower volatility for the loonie



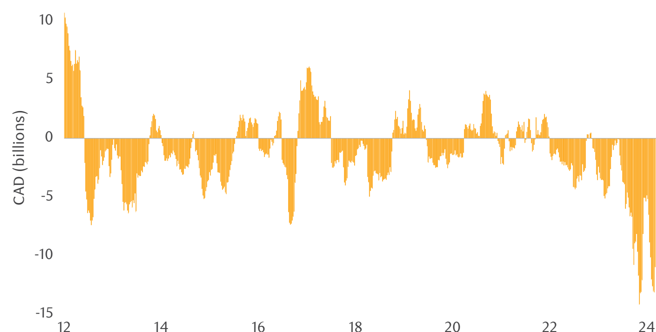

Note: As at December 3, 2024. Source: Bloomberg, RBC GAM

This may reflect the fact that the currency is unlikely to weaken much further from already cheap levels, or simply that Canada is too intertwined with the U.S. economy for its currency to diverge meaningfully.

Another item that could limit the loonie's losses this year is the fact that investors are already bearish on the currency. There has been a clear preference among investors to shun Canadian stocks – visible both in the way domestic investors are allocating money abroad and the pace at which foreigners are liquidating their Canadian holdings. This can be seen as a vote of non-confidence in the Canadian outlook and fits with the prevailing short positions in Canadian-dollar futures (Exhibit 17). But Canada's net balance of capital flows, which combines cross-border trade, foreign direct investment and international financial transactions, has begun to recover in a sign that the intensity of overall Canadian dollars selling pressure has subsided.

We are more optimistic about the outlook for Canada's currency. We note that Canada has smaller fiscal deficits, a skilled workforce and a sturdy banking system, and the expansion of pipeline capacity to west-coast export terminals narrows the discount that Canadian producers must accept for their crude oil. We forecast that the Canadian dollar will strengthen modestly to C$1.36 per U.S. dollar over the next 12 months.

### Exhibit 17: Investors are very short the loonie




Note: As at December 3, 2024. Source: CFTC, RBC GAM

## British pound

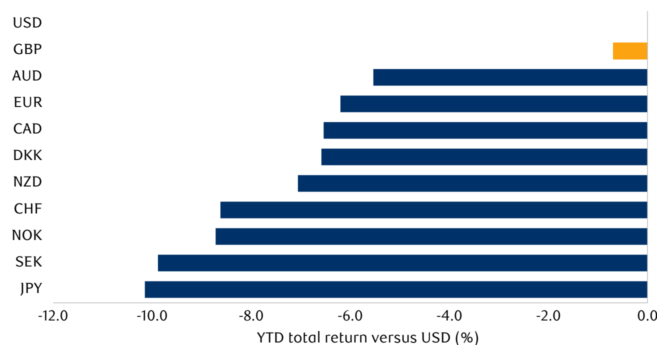
Among major currencies, Britain's pound trails only the U.S. dollar in performance this year (Exhibit 18). The pound has gained on the euro due to expectations that the Bank of England (BOE) will not cut interest rates as quickly as the ECB, and it's notable that the UK 2-year yield has risen since the summer while the equivalent German yield has fallen (Exhibit 19). The BOE's lack of eagerness to consider rate cuts relative to the ECB reflects an underlying inflation rate that is higher than in other regions (Exhibit 20) and the fact that economic growth has been buoyed by fiscal spending. The government will continue to provide a boost to growth in the next fiscal year, thanks to a 70-billion-pound increase in public expenditures in the October budget. The increase in government spending, however, is being financed by higher taxes and more debt – and the risk of higher interest rates that result from this scenario will crimp business investment. But these negatives likely won't weigh on the pound until after our 12-month forecast horizon.

More immediately, the UK stands as an outperformer because its economy is less hampered by many of the elements plaguing continental Europe:

- the UK is less dependent on auto manufacturing and therefore not as threatened by the increase in market share by cheap Chinese electric vehicles.
- With fewer goods exports to the U.S. than big European economies, the UK has largely avoided being the subject of tariff threats by the incoming Trump administration.
- The UK has a healthier mix of energy sources, with a larger amount of domestic nuclear production and relies less on imported energy than other large European economies such as Germany and Italy.

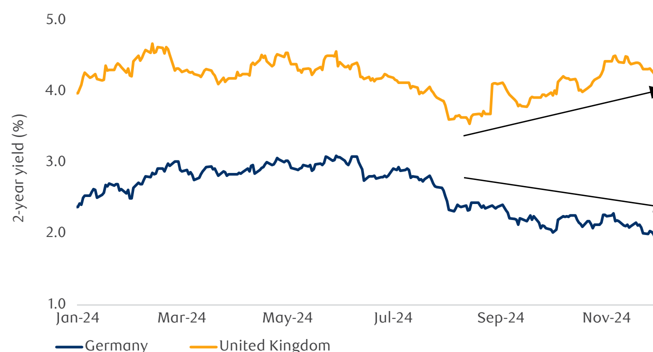
Our main reservations on the pound involve the negative balance of capital flows and the overall strength of the U.S. dollar. We place less emphasis on these two factors and more weight on impact of relative monetary policies, which is one of the most reliable driver of exchange rates. Our forecast for the pound to rise to 1.33 per U.S. dollar from the current 1.26 would make it a marginal outperformer among G10 currencies.

### Exhibit 18: British pound stands out from peers



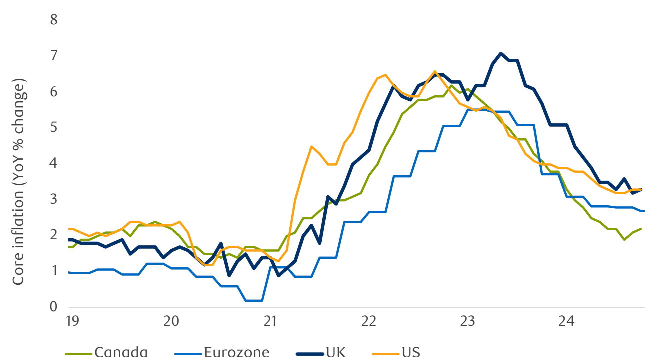

Note: As at December 3, 2024. Source: Bloomberg, RBC GAM

### Exhibit 19: UK and German yields began to diverge in the summer




Note: As at December 3, 2024. Source: Bloomberg, RBC GAM

### Exhibit 20: Inflation stickier in the UK




Note: As at December 3, 2024. Source: BoC, Eurostat, U.K. ONS, BLS, RBC GAM

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