Foreign Exchange

- USD benefits from safe-haven demand amid trade, Brexit and political uncertainties.
- CAD is a top G-10 performer in YTD terms but is struggling to respond to positives.

Persistent US dollar (USD) strength, trade frictions, slowing global growth trends and a possible dénouement (or not) to Brexit will likely shape FX trading in the major currencies in the final quarter of the year (and possibly beyond). The USD has fared better than we had expected at the start of the year and remains resilient amid softer US yields and signs that the US economy is losing momentum. A good part of the reason for the USD’s strong performance stems from the fact that trade wars, Brexit and other geo-political uncertainties have emboldened the USD’s safe-haven status and lifted investor demand for the currency.

Analysis by Scotiabank Economics estimates that uncertainty has boosted the broad effective value of the USD by some 11% relative to its pre-election level. And, with US political risk starting to rise amid the clamour over an impeachment inquiry and the slow-burn start to the US presidential cycle, it is possible, if not likely, that uncertainty will continue to affect the exchange rate for some time to come and prevent or slow the downturn in the USD that we expect to unfold from a fundamental perspective.

Even in the shorter term, we can note some upside risks for the USD, which often experiences stronger demand late in the year (especially through October and November). The USD’s typical, “seasonal” uplift in Q4, reflecting demand for USD liquidity running into year end, may be amplified this year by signs of tightness in USD funding markets that have emerged recently, prompting the Federal Reserve to restart short-term repo operations in a bid to ease liquidity tensions.

Fundamentally, we continue to feel that the long-term secular trend in the USD is geared towards softness amid rising US structural imbalances and slowing growth. Moreover, there are evident concerns—on both sides of the US political aisle—that a strengthening USD is perhaps less desirable. The caveat here is that global uncertainties need to ease in order for investors to feel comfortable enough to redeploy capital elsewhere and reduce the USD’s risk premium.

In the UK, some clarity over the Brexit situation should emerge in the next few weeks, with the UK due to exit the EU on October 31st. However, at this late stage, there remains a fair degree of uncertainty on how (or even if) the departure will unfold. We continue to assume a negotiated departure as our base case but, realistically, time is getting very short for an agreement to be reached. An extension request—mandated by UK law—should be made if no progress emerges at the EU summit meeting on October 17–18. But UK Prime Minister Johnson has insisted that the UK will leave the EU on the 31st and made it clear that he is opposed to an extension demand. This is raising concerns that the government might bypass the extension law via contingency measures and exit without a deal.

Sources: Scotiabank Economics, Scotiabank FICC Strategy, Macrobond.
The pound (GBP) is liable to vacillate in line with the evolving narrative on Brexit in the next few weeks; a no-deal exit will see the GBP retest the recent low just under 1.20 (at least) versus the USD while a delay will trigger a minor relief rally to the 1.25 area. We think that even in the event of a Brexit deal that sees the UK depart on schedule, the potential for immediate gains in what we consider to be a quite under-valued pound may be somewhat limited. Brexit—negotiated or not—may further dampen UK GDP growth and tilt the Bank of England towards more policy accommodation. We also think that Prime Minister Johnson is likely to go to the country at the earliest opportunity after Brexit is achieved in order to try and bolster the Conservatives’ position in parliament. Deeper gains in the GBP will require more sustainable signs of economic and political stability in the UK.

In Europe, growth trends have been depressed by Brexit and global trade tensions, undercutting activity in the German export machine. In the context of weak activity and persistently low inflation, the European Central Bank decision to cut rates deeper into negative territory and restart asset purchases was no surprise. Although Eurozone-US short term rate differentials continue to narrow gradually, the USD’s higher nominal and real yields leave it at a clear advantage in the competition to attract global capital. The euro (EUR) also remains subject to Brexit-related volatility, with a no-deal Brexit adding to EUR-negative forces and a delay or negotiated departure likely to lift the EUR somewhat.

The Canadian dollar (CAD) remains one of the top-performing currencies in the G-10 space year to date. But USDCAD held in a tight range through the latter part of Q3 and may remain better supported into year end, given the USD’s tendency to appreciate in Q4. The CAD has failed to gain support from firm oil prices or sharply narrower US-Canada interest rate differentials in the past few months, leaving it looking a little “under-valued” versus the USD from our perspective. We expect the CAD to gain modestly over the course of 2020, given that domestic growth should match, or slightly better US growth, notwithstanding a modest relaxation in Bank of Canada (BoC) monetary policy settings. Relatively tighter monetary conditions in Canada versus our G-10 peers suggest that the CAD will remain firm on the crosses. This is especially the case against the Australian and New Zealand dollars where benchmark interest rates are at a record low and—unusually—well below the BoC’s benchmark rate.

Despite persistently low inflation and growth prospects that have been trimmed back by global trade frictions, we expect the yen (JPY) to appreciate slightly against the USD in the coming year. Bank of Japan policy makers remain under pressure to boost inflation but may hold off on implementing additional stimulus measures until the impact of the October 1st consumption tax increase becomes clear. Scope for additional, large-scale asset purchases may be limited in any case. We expect narrower US/Japan interest rate differentials to support modest JPY appreciation in the longer run and expect Japan’s large and persistent current account surpluses (well above 3% of GDP) to cushion the exchange rate in periods of heightened market volatility or uncertainty.

Latam currencies have followed broad-based greenback strength in recent months as concerns over the global economy and better-than-expected data out of the US temporarily erased Fed policy easing odds—although US data has disappointed more recently. In the short term, we anticipate that Latam FX will continue to depreciate as the region’s central banks embark on an easing agenda while subdued commodity prices will provide little support for the currencies. Domestic and international political risks are also set to dampen regional currency strength for the remainder of 2019 and into 2020, although an easing of trade tensions in the coming year could breathe some life back into the Latam crosses.

As the country battles heavily subdued business and investor confidence, the Mexican economy has narrowly avoided a recession while it expands at its slowest pace in a decade with scarce signs of an incoming pick-up in activity. Alongside a worsening economic outlook, concerns over the fiscal sustainability of Pemex—the state-controlled oil company—loom negatively over the creditworthiness of the Mexican government and will continue to limit any MXN upside. While the risk of US tariffs on Mexican imports appears to have abated, and US-China trade talks are set to resume, investor sentiment toward Mexican assets—and EM more generally—remains weak amid sluggish growth and a less-than-market-friendly administration. We anticipate that Banxico will cut its policy rate by an additional 50 bps to 7.00%—where we expect it will remain through our forecast horizon—in the first quarter of 2020 as the Mexican central bank tracks the Fed.

The Brazilian real (BRL) has stabilised around the 4.15–4.20 mark after losing around 11% of its value against USD since a recent high in mid-July alongside a cumulative reduction of 100 bps in the Banco Central do Brasil’s policy rate and concerns over the country’s fiscal position. The BRL will prove sensitive to developments on the fiscal reform front, while positive news out of trade discussions between Brazil’s two main trading partners, the US and China, could provide a boost for BRL in the near term. While
we anticipate that the BCB will resume a tightening path over our forecast horizon, monetary policy will remain relatively accommodative as the central bank’s real rate will continue below its neutral level for the foreseeable future. For the moment, pension reform—on track for enactment in late-October—has eased immediate concerns over the public deficit. However, further progress on the fiscal front will be required to ease investor concerns with government debt totaling around 90% of GDP alongside a budget deficit of around 7% of GDP. We expect that BRL will remain on a depreciating trend alongside precarious public finances.

The Colombian economy remains a relative outperformer within Latin America with real GDP expected to grow by 3.2% this year—significantly above Mexico and Brazil (0.2% and 1.0%, respectively) while edging ahead of Chile and Peru (2.7% and 2.3%, respectively)—and average 3.6% in 2020–21. Owing to improving economic growth and around-target inflation, BanRep is part of a small club of central banks around the globe set to hold monetary conditions steady—and possibly even tighten—over this year and next. The Colombian peso (COP) is expected to edge higher from all-time lows at present as USD is expected to give back some of its recent gains and as Colombian rate differentials with the US and with its regional peers widen.

The Peruvian sol (PEN) and Chilean peso (CLP) will be at the mercy of commodity prices and developments on the US-China trade negotiations front through our forecast horizon. The CLP is nearing a four-year low alongside declining copper prices amid weaker global demand, particularly from China. We see some upside room for CLP into year-end as the domestic economy gathers steam on the back of fiscal stimulus and relatively accommodative monetary policy. Although the slump in copper has also put some downward pressure on PEN, it has traded within an especially narrow range of between 3.20 and 3.40 soles per USD since early 2016; we forecast it will remain around the upper bound of this range through the forecast horizon alongside only a slight improvement in copper prices.

The outcome of US-China trade talks and the October FOMC monetary policy decision will drive EM Asian currencies in 4Q2019. Both the US and China have made conciliatory gestures, raising expectations that the 13th round of the high-level trade negotiations could deliver a minor breakthrough. The Chinese yuan (CNY & CNH) will likely trade towards 7.0 and 6.9 if the US and China agree to a trade deal. An agreement would also buoy export-driven currencies such as the South Korean won (KRW) and Taiwanese dollar (TWD). The Thai baht (THB) could advance as well but to a lesser extent given its year-to-date outperformance and the Thai regulator’s concern that THB strength is eroding the nation’s export competitiveness. Rising amounts of negative-yielding debt will prompt investors to chase the high-yielding regional currencies should the US-China trade tensions de-escalate. Alternatively, a breakdown in the upcoming trade talks will drive USDCNY towards 7.20 with the PBoC’s acquiescence, and undermine other regional currencies amid intensifying risk aversion.

Continued civil unrest in Hong Kong is expected to keep weighing on the Hong Kong dollar (HKD). Meanwhile, the Singapore dollar (SGD) will likely stay soft amid expectations that the Monetary Authority of Singapore will ease policy via the exchange rate, its main monetary policy tool, in response to sluggish growth.
This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a “call to action” or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with “Global Banking and Markets”, is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.
Foreign Exchange Strategy

This publication has been prepared by The Bank of Nova Scotia (Scotiabank) for informational and marketing purposes only. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable, but no representation or warranty, express or implied, is made as to their accuracy or completeness and neither the information nor the forecast shall be taken as a representation for which Scotiabank, its affiliates or any of their employees incur any responsibility. Neither Scotiabank nor its affiliates accept any liability whatsoever for any loss arising from any use of this information. This publication is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any of the currencies referred to herein, nor shall this publication be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The general transaction, financial, educational and market information contained herein is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a “call to action” or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. You should note that the manner in which you implement any of the strategies set out in this publication may expose you to significant risk and you should carefully consider your ability to bear such risks through consultation with your own independent financial, legal, accounting, tax and other professional advisors. Scotiabank, its affiliates and/or their respective officers, directors or employees may from time to time take positions in the currencies mentioned herein as principal or agent, and may have received remuneration as financial advisor and/or underwriter for certain of the corporations mentioned herein. Directors, officers or employees of Scotiabank and its affiliates may serve as directors of corporations referred to herein. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. This publication and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced in whole or in part, or referred to in any manner whatsoever nor may the information, opinions and conclusions contained in it be referred to without the prior express written consent of Scotiabank.

™Trademark of The Bank of Nova Scotia. Used under license, where applicable. Scotiabank, together with “Global Banking and Markets”, is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, all members of the Scotiabank group and authorized users of the mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia and Scotiabank Europe plc are authorised by the UK Prudential Regulation Authority. The Bank of Nova Scotia is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia’s regulation by the UK Prudential Regulation Authority are available on request. Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Inverlat Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities. Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.

Visit our website at scotiabank.com/economics | Follow us on Twitter at @ScotiaEconomics | Contact us by email at scotia.economics@scotiabank.com