Foreign Exchange

The US dollar (USD) ended 2018 having accumulated broad gains against all of its major currency peers except the yen (JPY) since January 1. In contrast to our expectation that the USD would extend the reversal and decline seen in 2017, the currency has found support from rising US interest rates and stronger US growth dynamics amid fiscal stimulus. Less robust growth or rising uncertainties elsewhere—reflecting trade or Brexit concerns, for example—have weighed on sentiment amongst other currencies but supported demand for the safe-haven JPY, meanwhile. Rather surprisingly, the USD was one of last year's best investments. A recent Bloomberg report noted that risk-adjusted returns for the world's most significant assets reflected the "worst cross asset performance in more than a century" but the USD was one of the few global investment vehicles that offered a positive, risk-adjusted return in 2018.

We have moderated our outlook for the USD somewhat for the year ahead but we still rather expect the currency to resume the secular slide that we think began with 2017's significant decline. While the USD has benefitted from rising interest rates and solid US growth dynamics, we think a lot of good news is factored into the exchange rate at current levels from an economic perspective. Our forecast calls for a gradual slowing in US growth this year, extending more markedly into 2020 to below 2%. We do expect the Fed to tighten interest rates a little more in 2019 but markets are skeptical and the forward yield curve reflects a strengthening conviction that the Fed is nearing the end of its tightening cycle now.

We think there are some longer run headwinds accumulating for the USD which support our bearish assessment of its outlook. Firstly, the USD remains relatively elevated against most of its major currency peers from a purchasing power parity perspective and we expect the USD to "mean revert" lower as domestic growth slows and the Fed tightening cycle peaks. Interest rate differentials will narrow against the USD as other central banks "catch up" with the Fed. Secondly, we think the accumulation of US current account and (especially) fiscal deficits will weaken the USD in the medium- to longer run, reflecting the pattern of trade in the USD over the past 30 years or more; when US structural imbalances have deteriorated, the USD has generally under-performed. We expect combined deficits to reach around 7%/GDP this year. Finally, we continue to believe that the 2017 peak represented the high point in the longer-term USD bull trend. Price action then turned negative for the USD overall and signaled a major trend reversal in our opinion.

Given these structural and secular challenges, international investors may already be edging away from the USD. While currency investors usually favour currencies with high or rising interest rates, the flat yield curve means that USD-denominated assets are much less attractive for foreign investors when taking into account the cost of hedging against USD depreciation. Also, the International Monetary Fund's Q3 data on global FX reserves showed that the USD's proportion of FX reserve assets declined to 61.9%, down from 62.4% in Q2, over a period in which the USD itself strengthened broadly. The USD's share of reported FX reserves has declined to its lowest in nearly five years.

We expect the Canadian dollar CAD to improve after a disappointing 2018, where its return versus the USD (-7.5% at writing) is no better than the S&P 500. While the economy has held up quite well after slowing from a strong start to the year, the

CONTACTS

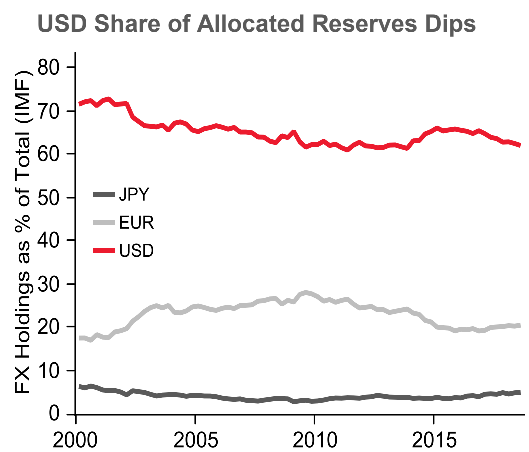
Shaun Osborne, Chief Currency Strategist
416.945.4538
Foreign Exchange Strategy
shaun.osborne@scotiabank.com

Eduardo Suárez, VP, Latin America Economics
52.55.9179.5174 (Mexico)
Scotiabank Economics
eduardo.suarez@scotiabank.com

Qi Gao, Currency Strategist – EM Asia
65.6305.8396 (Singapore)
Foreign Exchange Strategy
qi.gao@scotiabank.com

Eric Theoret, FX Strategist, Associate Director
416.863.7030
Foreign Exchange Strategy
eric.theoret@scotiabank.com

Chart 1



Sources: Macrobond, Scotiabank FICC Strategy.

renegotiation of NAFTA and, more recently, the slide in oil prices have weighed on the CAD's performance generally. Weak equity markets, with a number of the world's major stock indices in or near "bear market" territory, has further weighed on the higher beta commodity currencies as investors mark down global growth expectations. The CAD may start soft in the early part of the New Year (on average over the past 20 years, January has delivered the strongest monthly USD returns versus the CAD of the year) but we think USD gains towards the 1.38 area (near the 2017 high) should see bargain-hunting demand for the CAD. We expect oil prices to recover as global supply/demand rebalances and, despite the recent dovish lilt to its communications, we expect the Bank of Canada (BoC) to tighten interest rates a little more aggressively than the Fed (three 25bps hikes in 2019 for the BoC versus just two more from the Fed). Higher energy prices and a narrowing in US-Canada rate differentials will support CAD gains over the balance of the year.

We remain broadly positive on prospects for the euro (EUR), pound (GBP) and yen (JPY). The Eurozone economy slowed in the latter half of 2018 and policy makers are sounding increasingly cautious on the outlook. But we look for above-potential rates of expansion in the coming quarters, keeping inflation on an upward track and the European Central Bank on course to shift—gradually—towards policy normalization later next year. We expect this process to help boost the EUR more materially in H2 2019 towards USD1.30. Downside risks to that view revolve around any escalation in EU/US trade tensions and the impact of Brexit on the European economy. We assume a relatively smooth Brexit which will allow the GBP to improve into 2019 as "worst-case" fears subside—even if the economic impact of leaving the Eurozone is likely to be negative. However, we continue to acknowledge the considerable risks and uncertainties —for both the UK and the Eurozone—associated with a "no deal" Brexit which the UK government is presenting as the only alternative to its highly unpopular divorce plan.

We expect the JPY to strengthen modestly against a broadly softer USD this year but to underperform against the EUR and GBP. The Bank of Japan (BoJ) is liable to maintain policy accommodation for some time to come. Recent comments from central bank policy makers suggest growing concerns that the BoJ will not achieve its inflation target. As a consequence, we expect the BoJ to continue targeting a 0% nominal rate for 10-year government bonds. While that might suggest the JPY is susceptible to the USD against the backdrop of a tightening Fed, the JPY has been immune to wider US-Japan yield spreads this year. Reflecting declining Japanese participation in the US Treasury bond market, Japanese holdings of US Treasury bonds have weakened to the smallest since late 2011. Given the significant risks and uncertainties that lie ahead, the JPY's role as the "go to" safe haven in times of market volatility cannot be ignored.

The Mexican peso (MXN) remains well supported into the start of 2019 with an impressive 7% gain from its early December low. Sentiment has recovered following the airport referendum from Q4 and market participants have responded positively to the most recent Banxico hike and communication flagging upside risk to inflation. We anticipate one additional Banxico hike in Q1 2019 but foresee MXN weakening throughout our forecast horizon, reflecting a challenging outlook for global financial conditions in the context of continued balance sheet normalization from the Fed. The Brazilian real (BRL) is up over 4% in the first few sessions of 2019, reflecting solid sentiment and hopes relating to the new administration's reform agenda. Fiscal developments will be closely scrutinized; however, much of the recent strength in the currency has been attributed to expectations for greater central bank independence. We remain cautious on the reform agenda and maintain a bearish outlook for BRL into the end of 2020. We have a neutral outlook for the Colombian peso (COP), reflecting a constructive forecast for oil prices offset by concerns that the central bank (BanRep) may be falling behind the curve on inflation. We are constructive on the outlook for the Chilean peso (CLP) given our expectations for solid growth, stabilizing inflation and a recovery in copper prices. Peru is expected to lead its Pacific Alliance peers in real GDP growth throughout our forecast horizon, which should deliver strength in the sol (PEN) through 2019 and into 2020.

Easing US-China trade tensions will likely boost risk appetite and buoy EM Asian currencies in the first quarter, particularly export-driven currencies such as the South Korean won (KRW), Taiwanese dollar (TWD) and Thai baht (THB). The PBoC has pledged again to keep the yuan exchange rate basically stable and we expect the Chinese yuan (CNY & CNH) to trade towards 6.60–6.70 on expectations of the US and China reaching a trade deal by the March 1 deadline. While the geopolitical situation on the Korean Peninsula could weigh on the KRW intermittently, the TWD is prone to weakness if cross-strait relations deteriorate ahead of the island's general election due in early 2020.

The high-yielding Indian rupee (INR) and Indonesian rupiah (IDR) will advance if investors are more convinced that the Fed policy cycle is close to a peak. Weak oil prices are also supportive. However, we note that volatility may increase in the INR, IDR and THB ahead of general elections scheduled for April–May, 17 April and 24 February respectively in India, Indonesia and Thailand. While the Hong Kong dollar (HKD) is likely to rally on narrowing yield advantage of the USD, the EUR's potential strength will prop up the Singapore dollar (SGD) given a tight correlation between them. The Malaysian ringgit (MYR) and Philippine peso (PHP) will likely underperform regional peers in the first quarter on account of soft oil prices and deteriorating current account balances respectively.