Priced as of May 31

Dagmara Fijalkowski, MBA, CFA
Head, Global Fixed Income & Currencies
RBC Global Asset Management

The U.S. dollar has resumed its upward trend after declining for more than a year. The trade-weighted greenback has risen by 5% since early April and, in our view, has the potential for more upside. Three main factors support further dollar strength. First, the U.S. is enjoying better economic momentum relative to other major economies. Second, U.S. interest rates are more attractive than in other developed regions and are expected to increase at a faster pace. Third, the dollar has yet to reach excessive valuation levels in the current cycle. Our 12-month forecasts suggest the dollar will be strongest against the British pound and the Canadian dollar, while the euro and yen should fare better. With these forecasts, we remain much more bullish on the U.S. dollar than the consensus.

Global Currency Outlook

After more than a year of declines, the U.S. dollar has regained its footing. Since early April, the dollar has risen by 5% on a trade-weighted basis and, in our view, still has room to run. We have been among the minority of investors believing that the dollar could still strengthen. Unlike in past cycles, the dollar hasn't reached extreme levels of overvaluation (Exhibit 1). Without excessive valuations, the topping process marking the end of the dollar's uptrend will likely be an extended one (Exhibit 2). Our 12-month forecasts suggest further gains will be strongest against the British pound and Canadian dollar, while the euro and yen should fare better. With these forecasts, we remain much more bullish on the U.S. dollar than the consensus.

In the 14 months ended February, the U.S. dollar experienced a decline of 12%, a move that both helped to extend risk-taking behaviour in global asset markets and prematurely ended the debate about the dollar's direction. As 2017 progressed, investors became more emboldened in their calls for a weakening dollar. Negative sentiment toward the dollar was due, in part, to the Trump administration's preference for a weaker greenback and inflationary policies such as tariffs and sanctions, which should erode the dollar's value over time. Also responsible were America's fiscal and current-account "twin" deficits, which commanded more attention in a year when large tax cuts and trade protectionism were top of mind.

Exhibit 1. USD purchasing power parity valuation

Source: Bloomberg, RBC GAM

It was the sudden rise in U.S. interest rates in April that helped to turn the U.S. dollar around. The yield on the 10-year Treasury jumped to more than 3.0% from 2.7% in fewer than six weeks and caused the greenback to rally sharply over that period. The fact that the dollar has remained strong once yields settled speaks to some of the other reasons why we should expect further gains in the short term.

The most important of these is relative economic momentum, which has slowed much more in other major economies than in the U.S. (Exhibit 3). This development reverses the trend that had largely driven U.S. dollar weakness last year with an almost simultaneous dovish response from central banks in continental Europe, the U.K., Canada and Sweden. All have backpedaled on earlier plans to tighten policy and, in turn, offered the greenback a boost. Until European economic data accelerates more convincingly, the path of least resistance will be for continued U.S. dollar strength.

It is also important to recognize that the current policy backdrop remains supportive for the greenback. Higher fiscal spending offset by monetary tightening tends to support the U.S. dollar because such a scenario will usually reflect stronger economic growth and the higher yields that go with it. The same can be said about a bear-flattening of the yield curve, where short-term interest rates are rising faster than the longer end of the curve.

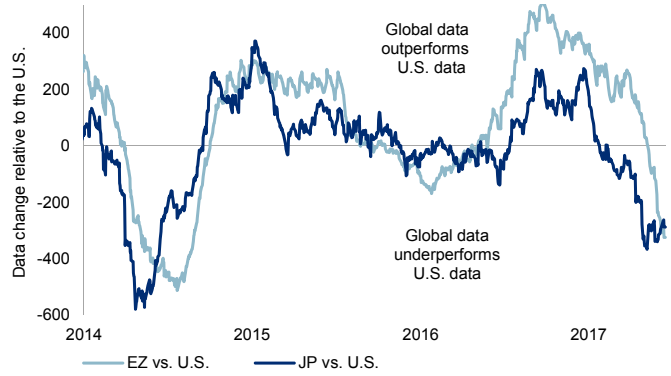
Also at play is positioning. Investors speculating on the direction of the greenback remain underweight the U.S. dollar, and the cost of maintaining those bearish bets has become prohibitive as the U.S. Federal Reserve (Fed) hikes faster than other central banks (Exhibit 4). The unwinding of these bets has amplified the dollar's gains, and will continue to do so as dollar bears are wrong-footed.

Most recently, there are signs that U.S. dollar strength may get an additional safe-haven boost from European political uncertainty, which would enable the dollar to rise even in an environment where yields are falling. We acknowledge that the twin deficits and other longer-term negative factors will burden the greenback over time, but still believe that short-term elements can drive strength in the interim.

Exhibit 2: Long-term cycles in U.S. trade-weighted dollar

Source: Bloomberg, RBC GAM

Exhibit 3: Relative economic momentum



Source: Citibank, RBC GAM

Exhibit 4: Cost of hedging USD nearing two-decade highs

Source: Bloomberg, RBC GAM

Euro

We are keeping our one-year euro forecast at 1.17, in line with our view that the installation of a populist government in Italy will not lead to the break-up of the Eurozone – this type of political news causing only short-term volatility. We had grown less bearish on the euro last quarter in recognition of more muted political risks after the election of Emmanuel Macron as French president, faster European economic growth and a current-account surplus that provides steady support to the currency. After recent euro weakness, those forecasts imply an expectation that the single currency will be trading at current levels in a year's time. However, consistent with our stronger U.S. dollar view, we expect that risks to our outlook lie toward a weaker euro throughout 2018. We think that the euro's strength in 2017 far overshot the fundamental improvement in growth, politics and flows. A euro at 1.25 was not sustainable, and it appears as though investors have begun to acknowledge the eventual impact that rising oil prices, higher yields and a stronger euro would impose on economic activity.

The impact of these negatives for European growth has dampened speculation that reserve managers are buying euros instead of U.S. dollars, a much trumpeted theme cited in favour of euro strength in recent quarters (Exhibit 5). The lack of availability and overvaluation of European debt don't support increased allocations by reserve managers given that the ECB is set to purchase almost 80% of net Eurozone sovereign debt issuance in 2018.

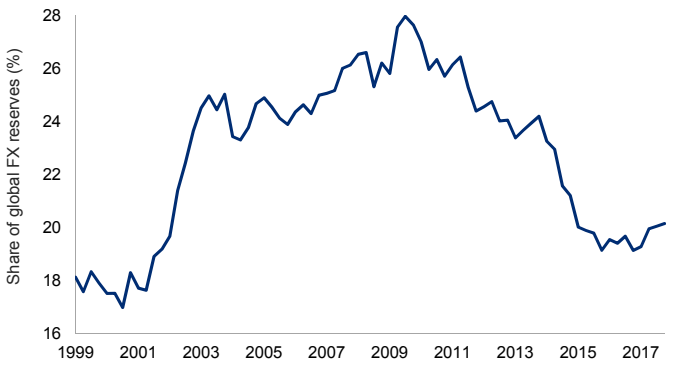
Finally, even with the plethora of euro-negative developments, we note that most forecasters haven't cut their outlooks yet, a sign of capitulation that will likely drive the euro lower still when it happens.

Japanese yen

Our view on the Japanese yen has evolved to a more positive one, based on three factors. The first of these is valuation. The Japanese yen is the most undervalued of 31 important global currencies. The fact that the yen has been so cheap acts to limit the extent to which the currency can decline further before triggering investor demand. Second, Japan enjoys one of the biggest current-account surpluses in the G10, now amounting to 4% of GDP and representing steady inflows of capital from domestic exporters and investors. Third is the yen's safe-haven qualities characterized by the tendency of Japanese investors to repatriate capital when equity, fixed-income and currency markets become more volatile.

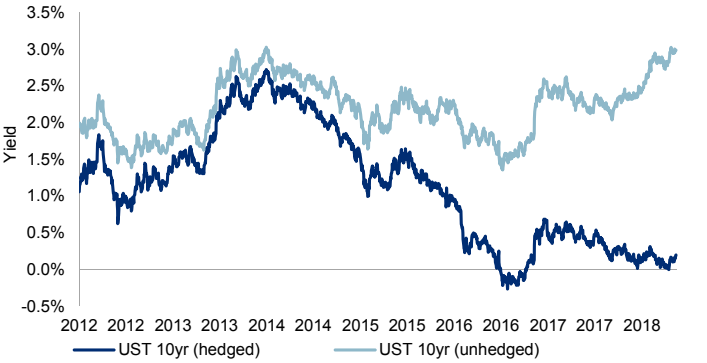
The one factor that could prevent the yen from strengthening is the increased cost of hedging borne by Japanese investors to immunize their portfolios from currency fluctuations. It is likely that some investors will choose to remove hedges on existing U.S. Treasury holdings in order to earn the much higher yields on offer (Exhibit 6). While this may limit the currency's gains beyond 100 per dollar, it hasn't deterred us from nudging our forecast in the direction of further yen strength toward 102 per dollar.

Exhibit 5: EUR share of FX reserves



Source: IMF COFER, RBC GAM

Exhibit 6: Unhedged yields now more attractive for Japanese investors



Source: Bloomberg, RBC GAM

British pound

We have been taken aback by the resilience of the pound over the past year. The currency has fallen 8% from its mid-April peak, and, in our view, should trade much lower. For one thing, Britain has a weak government and Brexit-related political uncertainty has worsened. What concerns us more, however, is the outlook for household consumption in the U.K. For several years, households have relied on uncollateralized borrowing to maintain their spending amid slower inflation-adjusted income growth. This trend has come at a time of weakness in the housing market, historically a source of wealth used to bolster spending on consumer goods. This borrow-to-spend mentality limits future economic growth, as consumers will need to deleverage in order to raise the savings rates to more sustainable levels. Several indicators, including one prepared by Visa, suggest that the deleveraging we have been expecting has finally begun. The measure shows declines in credit-card spending by consumers both online and in retail stores (Exhibit 7). What's more, the cutbacks are most pointed in discretionary segments. The onset of belt-tightening is one of the reasons our economic forecasts call for slower growth in the U.K. than in other major economies. As this consumer-led economic weakness continues, and as the March 2019 Brexit deadline nears, we expect the pound to weaken to 1.25 by this time next year.

Canadian dollar

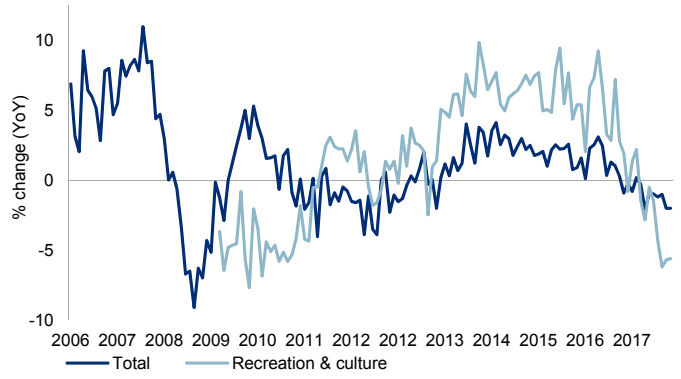
The Canadian dollar has been the least volatile of the major currencies, outperforming in the latest period simply by moving sideways. The muted price action, we think, reflects tension between some of the short- and long-term drivers of the currency. The Bank of Canada's insistence since last year that short-term interest rates will need to rise continues to surface as an argument for owning the loonie. Crude oil has also lent a helping hand of late, with prices of Canadian heavy crude trading at narrower discounts to American blends and generally stronger global oil prices. Expectations that the North American Free Trade Agreement would be successfully resolved had also been supporting the loonie. However, these hopes were dealt a blow at the end of May by Trump's decision to end the tariff exemption on Canadian steel.

Without these short-term positives, the Canadian dollar would almost certainly be weaker given the longer-term headwinds. Rising interest rates and stricter mortgage rules will make it more challenging for consumers to finance home renovations and other purchases, even as wages rise.

Second, economic drag will come from businesses, as Canadian companies choose to invest in manufacturing capacity south of the border rather than in Canada, where regulations, business taxes and wages are all rising.

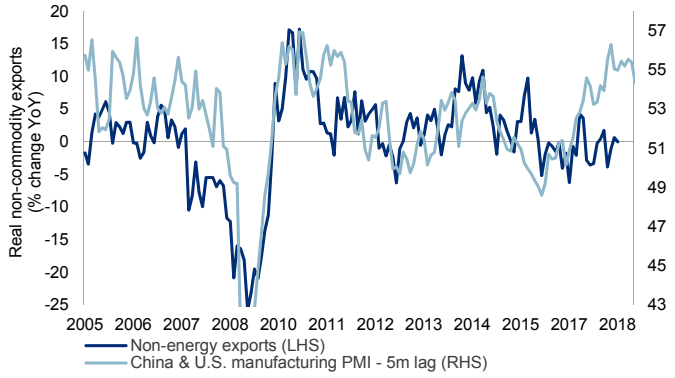
Exports are also a problem. Excluding the impact of commodities, Canadian exports are lower than we would expect given improvement in manufacturing indexes in the U.S. and China, Canada's two largest export destinations (Exhibit 8). We attribute the export weakness to factors such as the U.S. government's efforts to stimulate demand for U.S. goods over imports, as well as the continued decline in Canada's competitiveness. The competitiveness challenge is evident in Canada's current-account balance, which has

Exhibit 7: Visa U.K. Consumer Sentiment Index



Source: Visa, Macrobond, RBC GAM

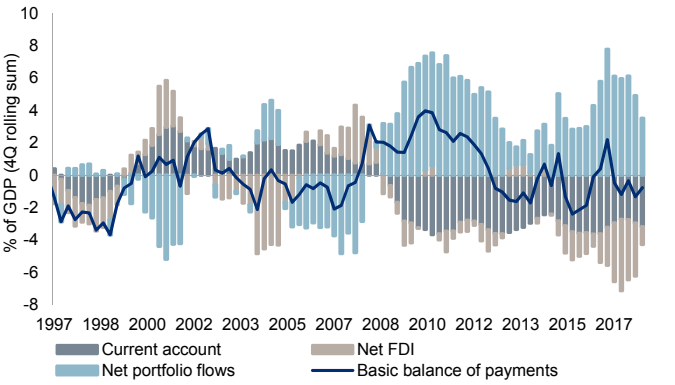
Exhibit 8: Canadian exports lagging global economic improvement



Source: CANSIM, Bloomberg, RBC GAM

hovered around a deficit of 3%-4% of GDP for almost a decade (Exhibit 9). Coupled with the growing outflows from foreign direct investment, Canada's current-account deficit represents a consistent outflow of capital and vulnerability for the currency should foreign demand for Canadian bonds falter. We expect that these longer-term themes will result in the loonie's decline against the U.S. dollar toward our 1.35 forecast, which lies closer to levels of extreme undervaluation of the Canadian dollar.

Exhibit 9: Canada basic balance of payments



Source: Statistics Canada, RBC GAM

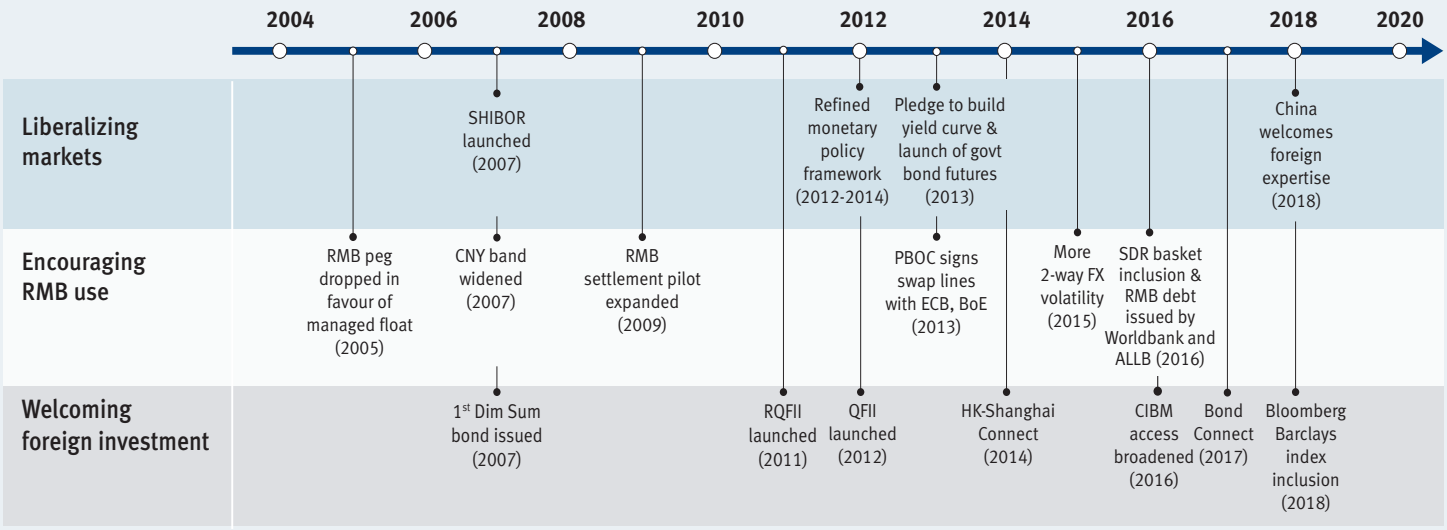
Negotiating trade with Trump: How China will get what it wants

Trade wars have been all over the news lately. While various aspects of the NAFTA negotiations have been discussed before in the *Global Investment Outlook*, we want to put the spotlight on the China-U.S. trade negotiations. The current White House administration has been putting pressure on China to reduce its trade surplus with the U.S. That surplus is responsible for 60% of the U.S. trade deficit, so the attention is understandable. To that end, the U.S. imposed tariffs first on Chinese aluminum (10%) and steel (25%), and then announced them on a long list of other products, trying to find a way to punish Chinese trade practices without hurting American consumers. That's a tall order and even though the new tariffs have been suspended for now, markets have been rocked by waves of concerns about the potentially negative impact on inflation and interest rates.

There were rumours a few weeks ago that China offered ways to reduce its annual trade surplus with the U.S. to US$200 billion from the current US$350 billion. The number seemed ambitious, and the rumours were denied. In this case, we are inclined to think that where there is smoke, there is fire. That's because we view these trade tribulations in a longer-term context and within longer-term Chinese objectives. President Xi's goal is to solidify China's ascendancy as a global superpower. Recent policy shifts through the Belt & Road initiative and the 'Made in China 2025' plan hint at these strategic aims to increase China's global political and economic influence. This also includes a special role for its currency. Plans to promote the use of the renminbi outside China consist of increasing the country's role in international payment systems, international reserves and international capital markets. To that end, China has been executing incremental steps since 2005 (Exhibit A), pushed for inclusion in the IMF's basket of currencies in 2015 and, more recently, has gradually started to open its equity and bond markets.

The long-term objective is for the renminbi to become truly floating, but the fear is that, without adequate preparation, opening the door to capital outflows will lead to massive currency depreciation. We need only remember what happened in 2015/2016, when outflow pressure was so heavy (Exhibit B) that it caused currency weakness of 10% despite capital controls and other government interventions to prop it up. The problem lies in very low ownership of Chinese assets by foreigners who, for example, hold less

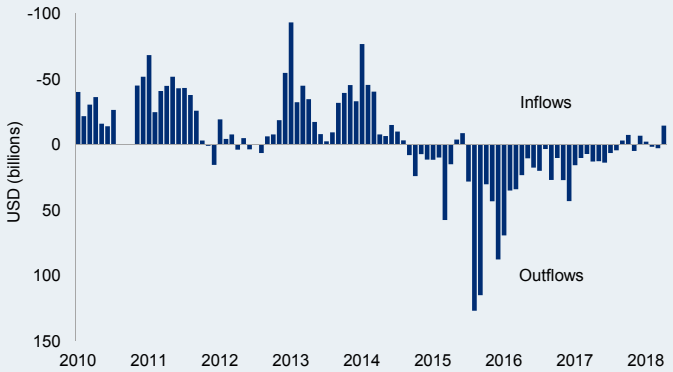
Exhibit A: Chinese reforms to internationalize the renminbi



than 3% of renminbi-denominated government bonds. So the master plan is simply to allow for greater foreign ownership of renminbi assets in China to pave the way for liberalizing outbound flows. Chinese nationals want to be able to invest globally, but the Chinese government can't allow that without offsetting inflows, so it has a strong motivation to have the renminbi's role as an international currency enhanced. The complexity comes from the sheer size of the inflows required to offset the amount of renminbi that would flood out of the country should barriers be relaxed, and a desire to avoid excessive currency fluctuation.

China's commitment to acting in what its leaders see as the country's long-term interests suggest that China is more likely to be patient and even accommodating to U.S. demands. China has the power to accommodate by substituting U.S. imports for those of other countries, like Boeing for Airbus, or U.S. soybeans for Brazilian soybeans. The Chinese government has the advantage of wielding stronger control than other countries, which is why a true trade war is not our base case scenario. China's efforts to appease the U.S., at least in the short term, however, would be negative for the currencies of U.S. export competitors.

Exhibit B: Net FX transactions by banks on behalf of clients



Source: SAFE, RBC GAM

For more on our current view and outlook, please consult the full version of *The Global Investment Outlook* posted on our website at http://www.rbcgam.com/investment-insights/investment-outlook/index.html

A note on forward-looking statements

This report may contain forward-looking statements about future performance, strategies or prospects, and possible future action. The words "may," "could," "should," "would," "suspect," "outlook," "believe," "plan," "anticipate," "estimate," "expect," "intend," "forecast," "objective" and similar expressions are intended to identify forward-looking statements. Forward-looking statements are not guarantees of future performance. Forward-looking statements involve inherent risks and uncertainties about general economic factors, so it is possible that predictions, forecasts, projections and other forward-looking statements will not be achieved. We caution you not to place undue reliance on these statements as a number of important factors could cause actual events or results to differ materially from those expressed or implied in any forward-looking statement made. These factors include, but are not limited to, general economic, political and market factors in Canada, the United States and internationally, interest and foreign exchange rates, global equity and capital markets, business competition, technological changes, changes in laws and regulations, judicial or regulatory judgments, legal proceedings and catastrophic events. The above list of important factors that may affect future results is not exhaustive. Before making any investment decisions, we encourage you to consider these and other factors carefully. All opinions contained in forward-looking statements are subject to change without notice and are provided in good faith but without legal responsibility.

Global Asset Management

103073 (06/2018)
CURRENCY OUTLOOK SUMMER 2018 06/27/2018