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GLOBAL CURRENCY OUTLOOK

Dagmara Fijalkowski, MBA, CFA

Head, Global Fixed Income and Currencies (Toronto & London),

Our belief that the U.S. dollar would strengthen has been firmly in place for several years. While this is still the case, our message is becoming more nuanced. Our forecasts remain tilted toward outperformance of the greenback, but each passing month of U.S. dollar strength adds to a maturing currency cycle and implies a higher probability that the U.S. dollar peak will occur within our 12-month forecast horizon. It's even possible that the peak is already behind us, although we don't assign high odds to that turning out to be true. For now, our dominant scenarios still consider this cycle unfinished.

Our currency outlook remains tilted toward appreciation of the U.S. dollar versus other major developed-market currencies. While this has been our stance for several years, our message is now more nuanced. We are more cautious than we have been due to the maturing U.S. dollar cycle and the possibility that dollar-negative factors are playing a larger role. There remain, however, valid reasons why this cycle could extend beyond the average, and they don't require heroic assumptions about dollar-friendly Trump policies. Growth differentials; a benign current account deficit, especially given the stage of the recovery; monetary policy divergences and only moderate overvaluation are among the reasons for staying bullish on the U.S. dollar.

Our base case is for the peak in the U.S. dollar to occur at some point beyond our 12-month horizon. Our forecasts for currency weakness are intentionally less aggressive for the time being, recognizing the higher uncertainty in predicting when the U.S. dollar will reverse course. Our expectation is that this topping process will take time, unlike prior peaks in 1985 and 2001, which were prompted by global policymakers' abrupt efforts to counter the threat to economic stability from rapid and uncontrolled U.S. dollar strength. Today, we have yet to see destabilizing currency fluctuations. In fact, exchange-rate volatility currently sits at its lowest level in several years (Exhibit 1).

Our evaluation of the currency outlook begins with a review of the long-term cycles in the U.S. trade-weighted dollar. These are critical because they help define the investing landscape and often dictate the direction of individual

Exhibit 1. **Bloomberg Currency Volatility Index**

Source: Bloomberg

currencies. Looking at these cycles (Exhibit 2), we see that the current upswing in the U.S. dollar has now matched the typical bull cycle in length (6-7 years) and magnitude (40%-60%). The U.S. dollar cycle often reflects trends in economic growth and interest rates in which higher levels of both relative to trade partners will drive strength in the greenback. This cycle is no exception – American economic outperformance has fuelled huge demand for the U.S. dollar and the U.S. Federal Reserve's (Fed) three interest-rate hikes over the past year and a half have lent support to the currency with more attractive yields than elsewhere. A host of other factors continue to support the U.S. dollar, including:

- a slowdown in the growth of global foreign-exchange reserves, which limits the need to diversify holdings into other reserve currencies like the yen, euro and pound.
- the current-account deficit is quite small relative to what it has been at prior U.S. dollar peaks.
- expected repatriation of corporate earnings held abroad resulting from tax-policy changes in the U.S., and
- the safe-haven status of the greenback.

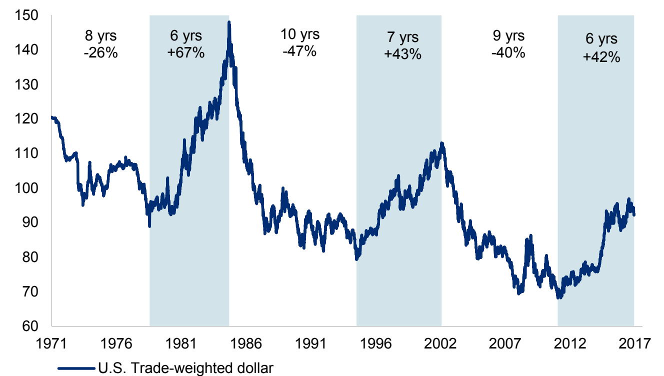
We also note that the U.S. dollar is not extremely overvalued even after six years of gains. Historically, currencies diverge from fair value by at least 20% before prompting significant and broad-based changes in economic decision-making – such as moving factories or deciding to shift purchases toward imported substitutes. On a trade-weighted basis, and also relative to most individual currencies, the U.S. dollar has not yet reached such a level of overvaluation.

When we weigh all the elements driving currency markets, we still see a greater number of supportive factors for the U.S. dollar. However, we acknowledge that many of the positives have been priced in to some extent, while the negatives are beginning to stack up against the greenback.

Emerging-market currencies

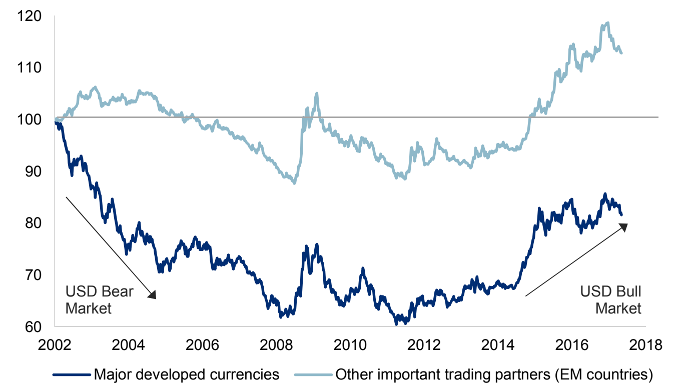
It's important to distinguish U.S. dollar strength against developed markets from its strength versus emerging-market currencies. Even as developed-market currencies weaken, emerging-market ones are likely to remain resilient. Exhibit 3 shows the U.S. dollar indexed separately against these two subsets over the last full currency cycle. The greenback suffered much larger losses against developed-market currencies during the 2002-2011 U.S. dollar bear market, and so it should naturally have more

Exhibit 2: Trade-weighted USD index



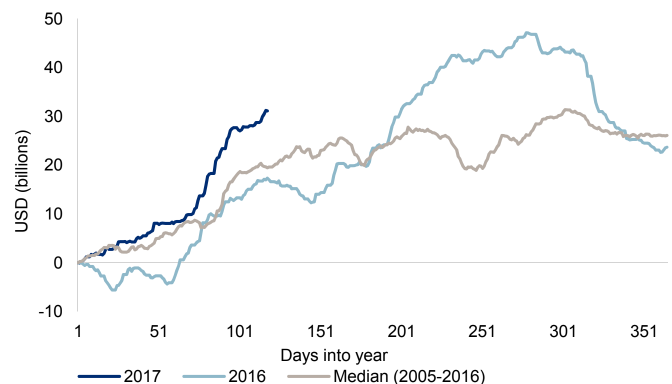
Source: Federal Reserve, Bloomberg

Exhibit 3: U.S. trade-weighted dollar weakness
Indexed to 100 on Jan. 31, 2002 (start of last USD bear market)



Source: Federal Reserve, Bloomberg

Exhibit 4: Emerging-market portfolio flows
Cumulative, YTD



Source: IIF

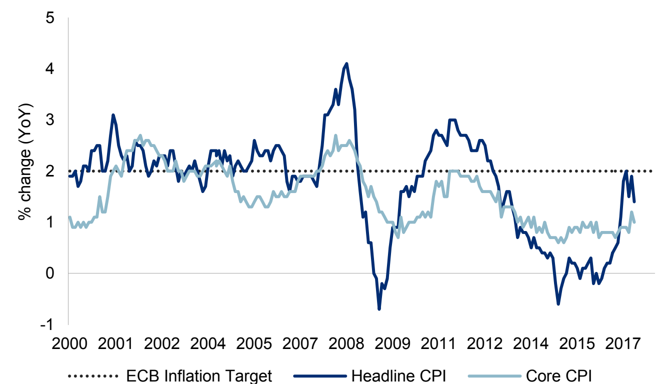
to gain against them as weakness is reversed. Yet the U.S. dollar has also strengthened substantially against emerging-market currencies over the past few years on concerns about slowing growth in China; Fed rate hikes; geopolitical worries; as well as corruption scandals and inept governments in countries such as Brazil. But, as investor fears are assuaged by the Fed's gradual approach and improvements in China, the world's second-largest economy, emerging-market currencies have begun to gain traction. While public shows of curbing corruption indicate that corruption exists, such actions can actually be a positive sign since they represent efforts to tip the scale toward greater accountability.

Stronger economic growth and higher yields relative to developed economies, combined with still inexpensive currencies, have underpinned capital flows into emerging-market assets, amounting to an impressive US$30 billion during the first four months of 2017, almost double that of the equivalent period last year (Exhibit 4). These inflows reflect that emerging-market assets and currencies are showing some immunity to negative headlines. Even highly uncertain events like the French elections, the Turkish referendum on increasing presidential power and the rising frequency of North Korean missile tests have done little to temper risk-on sentiment.

Euro

Our bearish stance on the euro has been among our most firmly held views. We still believe the single currency may test parity with the U.S. dollar within the forecast horizon, but have revised our 12-month forecast to 1.02. This change recognizes a slightly better outlook for the euro in line with the aging U.S. dollar cycle and improving European fundamentals. Political risk, for instance, has fallen markedly with the election of pro-European Macron in the French presidential election and the Dutch rejection of more extreme political options in March elections. A large part of the fundamental improvement can also be attributed to a strengthening of economic data in the Eurozone, where our growth forecasts are slightly higher than consensus. This strength is not confined to core European countries. Indexes of economic sentiment are rising in peripheral countries too, while lending activity firms and employment continues to exceed European Commission estimates. The outlook for certain individual countries is still troubled: the main Italian populist party is essentially tied in the polls with the incumbent centrist party, but improvement in growth dynamics for the Eurozone as a whole cannot be ignored.

Exhibit 5: ECB inflation measures below target



Source: Haver Analytics

The most important factor for the euro is the continued divergence in monetary policy between the European Central Bank (ECB) and the Fed. The gap in interest rates determined by the two central banks will continue to widen in favour of the greenback even if the ECB reduces the size of its monthly round of quantitative easing. We expect that ECB President Mario Draghi will keep rates on hold for at least the next 12 months. Unlike the Fed, the ECB has only a single mandate – price stability. So, even with a steady and gradual economic recovery, the ECB is unlikely to be swayed as long as underlying inflation in the region remains weak. Overall inflation had been rising earlier in the year, but this was the result of a transitory boost from energy prices and prior currency weakness. Core measures of price changes, which exclude these effects, remain well below the ECB's 2% mandate (Exhibit 5). We can recall two separate occasions, in 2008 and 2011, where the ECB hastily raised interest rates in reaction to surging oil prices and temporary high headline inflation. Both cases subsequently resulted in an embarrassing reversal when economic growth faltered and the central bank was forced to subsequently cut rates. Amid similar conditions today, we believe that the ECB will be wary of committing a similar policy mistake. Indeed, Draghi has already firmly rejected the notion that rates could be increased before quantitative easing is stopped. This supports our belief that monetary-policy divergence can still drive further euro weakness.

British pound

As Britons headed to the polls last week, investors were squarely focused on U.K. politics. Theresa May's unexpected call for an election brought a lot of hope that

the U.K. may avoid a disorderly departure from the EU. Those concerns aside, we caution that recent data proves that economic malaise appears to have already set in. Consequently, the pound has quickly become one of our favoured shorts, and our 1.15 forecast implies a larger depreciation of the pound than of other developed-market currencies.

We are primarily concerned about weak consumer spending in an economy that is driven 60% by consumption. The fall in the pound last year has caused prices to rise on imported items, many of which don't have domestically produced substitutes. In addition, employment growth is weak and wage growth hasn't kept up with inflation (Exhibit 6). These trends reduce the disposable income available for spending on domestically produced goods and services. Households are now forced to either save less or borrow more in order to maintain their spending habits. In fact, both of these developments are occurring (exhibits 7 and 8) and both represent an unsustainable trend of borrowing from future consumption.

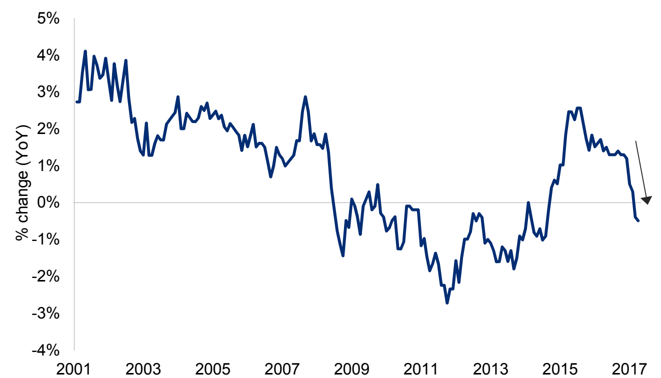
Another ongoing issue we have with the pound is the U.K.'s large current-account deficit – an outflow of capital that continues to worsen and is now the largest among the countries we follow. To date, this funding requirement has been more than covered by a healthy appetite for U.K. assets by foreigners. Analysis by Deutsche Bank shows that much of these inflows have come from European investors who, discouraged by negative rates and quantitative easing at home, parked their money in higher-yielding U.K. government bonds instead. Eventually, this could become a major problem for the pound as the ECB reduces the pace of quantitative easing. In any event, a cheaper currency may be just the tool needed to attract foreign purchases of U.K. assets.

Japanese yen

In this environment of broad U.S. dollar strength, we find ourselves less concerned about yen weakness, in part because the currency is relatively cheap. According to our purchasing-power-parity metric (Exhibit 9) and most other valuation measures we follow, the yen is among the most undervalued currencies in the developed world.

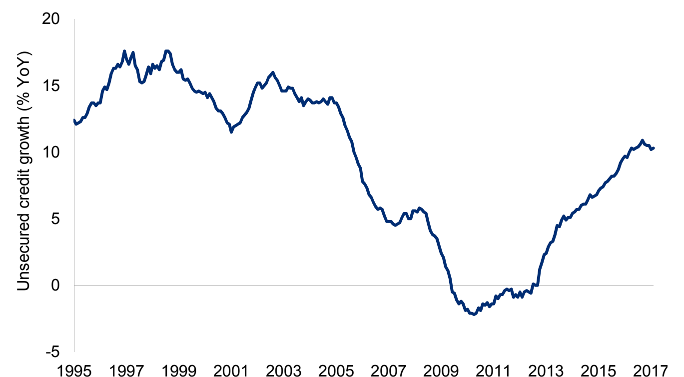
Moreover, we don't expect the yen's other traditional drivers to exert meaningful downward pressure on the currency. Interest-rate differentials have historically been the primary determinant of yen fluctuations, but unlike the euro and other major currencies, the yen has been

Exhibit 6: U.K. real wage growth



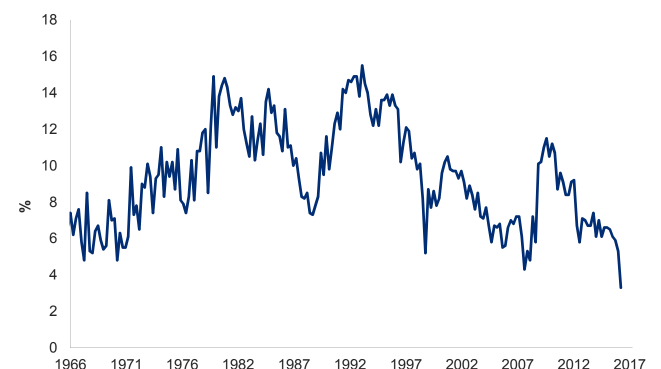
Source: Haver Analytics

Exhibit 7: U.K. consumers already borrowing to sustain consumption



Source: BOE, Macrobond

Exhibit 8: U.K. – Household-savings rate



Source: U.K. Office for National Statistics, Macrobond

more heavily influenced recently by differences in longer-term, not shorter-term, yields. And, with the Bank of Japan (BOJ) having committed to keeping 10-year yields between 0% and 0.1%, we are left with a currency that is almost entirely driven by changes in U.S. government-bond yields (Exhibit 10). Our fixed-income specialists expect the yield on the 10-year Treasury bond to rise only slightly, and this expectation is consistent with our forecast for only moderate yen weakness.

The Japanese currency is now near the middle of its three-year range between 100 and 120 per U.S. dollar (Exhibit 11). Given the low levels of foreign-exchange volatility and the anchoring of longer-term yields through BOJ monetary policy, we think it reasonable for this trading range to be maintained. The investment activity of domestic investors further supports this thesis. Reports by Nomura and Mizuho suggest that all nine of Japan's major life insurers have increased allocations to foreign bonds and plan to add more in 2017, with the amount and pace of this outward investment quite significant (Exhibit 12). Importantly, some of these foreign assets are unhedged, so buying of assets overseas does exert downward pressure on the yen. However, we would not expect the yen to weaken much beyond 120 because Japanese institutional investors are likely to start buying back the yen if it reaches that level.

Canadian dollar

There is no shortage of negative factors weighing on the Canadian economy and the Canadian dollar. One of those is the severe reduction in manufacturing between 2006 and

Exhibit 9: USDJPY: Purchasing-power-parity valuations

Source: Deutsche Bank, RBC GAM

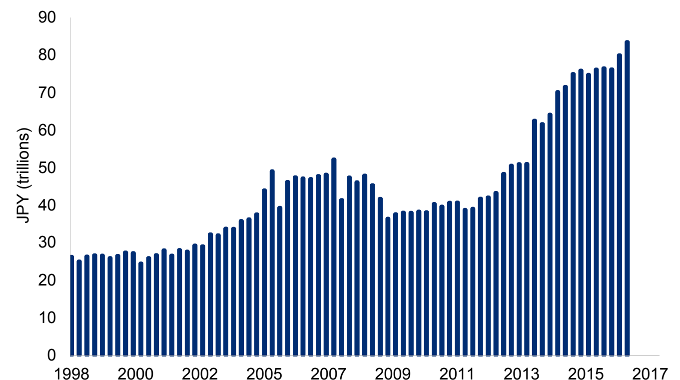
Exhibit 10: JPY moves are now driven by U.S. yields

Source: Bloomberg, RBC GAM

Exhibit 11: JPY trading in the 100-120 range

Source: Bloomberg

Exhibit 12: Foreign securities held by Japanese life insurers



Source: Nomura, BOJ

2013, when the loonie was exceptionally strong. The fact that our trade balance has not yet recovered is evidence of lost competitiveness relative to the U.S., Mexico and other trade partners. While a weaker loonie is seen as a necessary ingredient for a manufacturing revival, we believe that goods trade will never fully regain its standing as a major contributor to Canadian economic growth. Reflective of this reality is Canada's persistent current-account deficit (Exhibit 13), which, at over 3% of GDP, exerts a continued downward influence on the loonie.

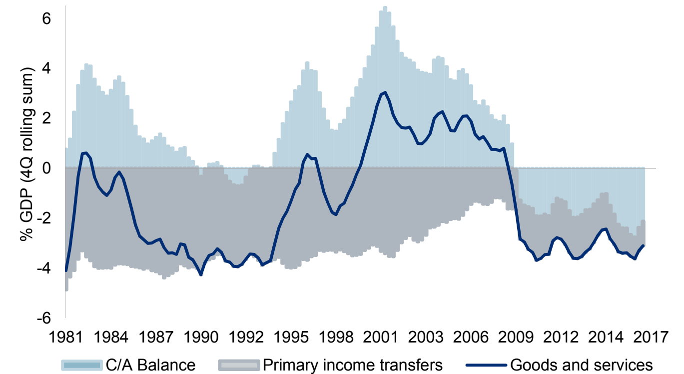
Monetary-policy divergence also weighs on the currency. While the Fed gradually raises short-term interest rates toward more neutral levels, the Bank of Canada (BOC) remains firmly on hold. All three of the BOC's measures show that core inflation is well below the central bank's official 2% target and is also trending lower (Exhibit 14). Recent speeches by BOC Governor Poloz suggest concern about weak exports and the very tentative improvements in business investment. Poloz's somewhat dovish stance translates directly to a weaker Canadian dollar in the form of relatively unattractive yields.

A discussion on the Canadian dollar cannot omit Canada's obvious connection to commodities. Even with the deflating of the oil-sands craze, commodities remain an important element to consider for the currency's outlook. On this note, the recovery of crude prices from their nadir early last year has been welcomed by the western provinces. However, the recent bounce is hardly game-changing for the country's producers, many of which have break-even costs that are higher than the current oil-price range of US$45-US$55 per barrel. Recent commitments by OPEC to retain supply reductions until March 2018 should keep oil prices afloat in the short term, but we remain skeptical that these efforts can have much of a lasting impact given the increasingly agile and competitive nature of U.S. shale producers. Without even more innovative ways to improve the oil-sands extraction process, the degree to which resources can contribute to economic growth is limited.

A more recent issue for Canadian oil producers is that new governments in Alberta and British Columbia are not friendly to the industry. Those governments are increasingly resistant to further development in the oil sands and to pipeline construction. In addition to the difficulties posed by high extraction costs, oil producers must now also deal with emission caps and increases in carbon taxes. Some producers, many of whom are foreign players, have chosen instead to simply sell their Canadian oil-sands assets. This is a theme worth following for currency investors, as it represents a potential capital outflow on the order of tens of billions of dollars.

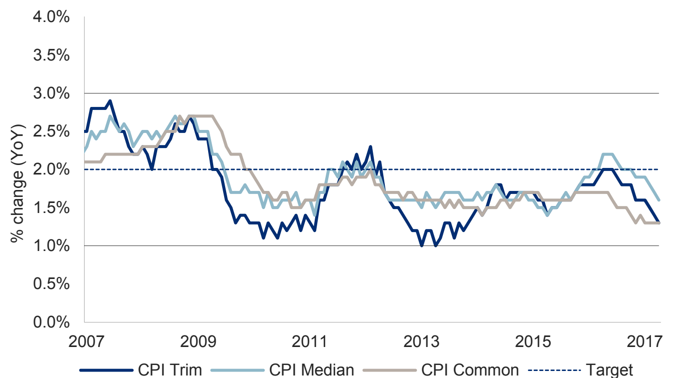
More recently, it is fears about hot housing markets in Toronto and Vancouver that have begun to negatively affect the exchange rate. While relatively high prices and low affordability are not new, troubles at a small lender brought fears of a housing-market collapse back to the fore. The housing concerns, coupled with protectionist tariffs slapped on Canadian lumber by the Trump administration, temporarily pushed the U.S. dollar up through the high end of the well-entrenched 1.30-1.36 range. We don't believe that housing is on the verge of collapse or that protectionist measures will dominate headlines forever, but we do

Exhibit 13: Canada current-account balance



Source: Macrobond, RBC GAM

Exhibit 14: Canada inflation measures



Source: Bank of Canada

acknowledge that these developments add to the list of Canadian-dollar negatives weighing on performance during the final stages of U.S. dollar strength. Our forecast is for the Canadian dollar to weaken to 1.44 per U.S. dollar.

To conclude

Currency forecasting is a dangerous occupation at the best of times, but particularly so during the inflection points of the cycle. The average U.S. dollar cycle is seven years long, and prior phases of strength and weakness have ranged from five to 10 years. We are more cautious than we were because of the maturing U.S. dollar cycle and the possibility that negative factors are playing a larger role. There remain, however, valid reasons why this cycle could extend beyond the average, and they don't require heroic assumptions about dollar-friendly Trump policies. Growth differentials, monetary-policy divergences, a historically low current-account deficit and only moderate overvaluation are among the reasons for staying bullish on the U.S. dollar.

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