# Foreign Exchange

## US DOLLAR TO TRADE MORE DEFENSIVELY IN 2018

We are more convinced that the longer-term bull trend in the US dollar (USD) is poised to moderate or reverse following its poor overall performance over the course of 2017. While USD losses moderated into the end of last year, it closed out the year with a 10% loss versus its DXY (market-weighted) index, its weakest performance since 2003. Weak price action in the USD over the course of 2017 echoes market movement at previous, major secular USD peaks and supports our contention that medium- to longer-term risks are tilting lower for the USD overall.

The global economy continues to enjoy a broad upswing and central bank policy is becoming more active again; we think this situation will deliver a two-pronged assault on the USD. Firstly, faster growth elsewhere should draw investment flows away from the US economy, especially if US growth in the early part of the year disappoints again. Secondly, more active central bank policy elsewhere will tend to support their own currencies via higher interest rates—or market expectations thereof. We think additional pressure on the USD will stem from the perception of less political risk in the Eurozone whereas political risks may increase in the US. We also feel that the recent tax cut legislation in the US will do little to drive growth higher in 2018/19 but investors may start to focus on US structural imbalances—the USD's "Achilles Heel"—once again. Combined fiscal and external deficits are widening and weighing on the USD's performance which is usually bad news for the currency.

The Canadian dollar (CAD) rallied strongly in late 2017, reflecting a rebound in domestic inflation data (and markets pricing in the strong probability of a January rate increase by the Bank of Canada—BoC). CAD strength leaves us in something of a predicament as we are already at our year-end 2018 forecast point. We expect the CAD to retreat somewhat in the next few weeks on profit-taking if the BoC confirms our expectation of a rate hike (it will fall a bit further and quite a lot faster if tightening speculation is disappointed).

But we think scope for sustained CAD losses should be limited. Strengthening global growth momentum is helping bolster commodity prices and stronger commodities have helped propel the CAD higher in the last month or so. The rise in commodity prices and the resulting improvement in Canada's terms of trade are perhaps not yet fully reflected in the CAD, we feel. Higher commodity prices may give the CAD some protection from clear risks around the outlook (NAFTA, housing, etc.) which remain obvious, if hard to quantify at this point. In other words, the CAD may not be able to rally much more for now but we don't think it will fall too far either at the moment and expect it to remain well supported on dips overall this year.

The Euro (EUR) is trading near its highest in three years as the Eurozone economy continues to gain momentum. Recent PMI survey data suggests economic momentum has picked up to its strongest level since 2011. Inflation continues to lag, and the most recent data highlights the fact that price growth remains well below the European Central Bank's (ECB) 2% target. However, robust economic growth suggests that the European Central Bank will wind down

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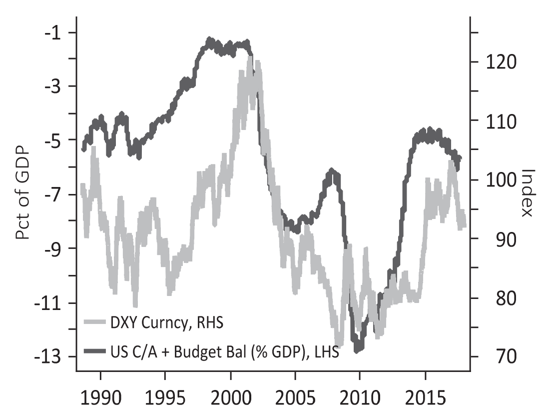
**Chart 1**

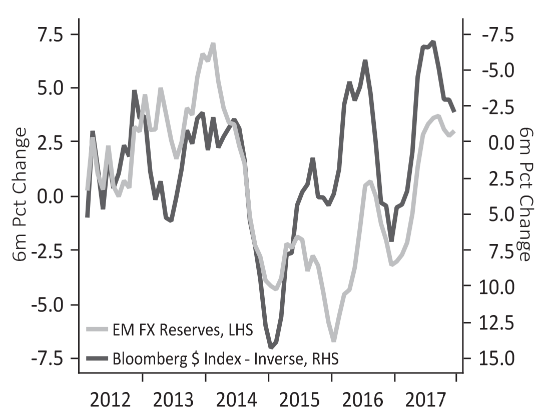
**US Twin Deficit Story Re-Emerging?**




Sources: Macrobond, Scotiabank FICC Strategy.

**Chart 2**

**EM FX Reserves Grow as Dollar Slips**




Sources: Macrobond, Scotiabank FICC Strategy.

its asset purchase programme later this year regardless, even if rate hikes remain a 2019 story at this point. The past year was characterized by heightened political risk that focussed on a number of key, national elections in the Eurozone. All of these votes have passed, leaving the political centre—and pro-European consensus—largely intact. The looming Italian election, due on March 4th, had been seen as a potential constraint on the EUR but, with the major parties all backing the EUR, the risk of a significant shock has perhaps diminished. The EUR should benefit from capital being redeployed to Europe and global investors rebuilding exposure to the single currency again as political risks subside.

The pound (GBP) remains generally soft but has sustained a steady rise versus most major currencies, excluding the EUR, over the past year as the Brexit fall-out has been less severe than imagined in the immediate aftermath of the 2016 vote. Still, the economy is hardly robust; consumer demand and housing are two key sectors of the economy that look somewhat fragile amid weak real wage gains. UK inflation has been rising, partly due to the weak exchange rate, forcing the Bank of England (BoE) to tighten monetary policy modestly. We think further, modest rate increases are likely in 2018 to keep inflation in check but Brexit risks are likely to restrain the pound and uncertainty may still force the exchange rate back from current levels versus the USD. We maintain, however, that a pronounced drop in the GBP would leave the currency looking somewhat stretched in terms of its longer-run valuation.

We are bearish on the yen (JPY) and expect it to remain a relative under-performer in the major currency space this year. The JPY will remain vulnerable to firmer nominal yields elsewhere as we do not expect the Bank of Japan (BoJ) to alter its aggressively accommodative policy stance through 2018, given that domestic inflation at 0.6% remains very distant from the central bank's objective. Stronger global growth, rising global equity markets and a pervading sense of risk-seeking investment strategies suggest that "safe haven" demand for the JPY will remain muted for the moment as well.

Strengthening global growth trends are supportive of Asian Emerging Market FX broadly but regional central banks will be conscious of the need to remain regionally competitive with each other as exports recover. Strong current account surpluses are supportive of the Korean won, Thai baht and Taiwan dollar while rising export growth is supportive of the Malaysian ringgit, which we feel remains undervalued in nominal and real effective terms. We expect the Chinese yuan to rise modestly this year on rising foreign interest in yuan-denominated assets while high yields leave the Indonesian rupiah looking attractive. Markets appear to have discounted India's weaker fiscal position as recovering growth momentum supports the rupee. With the USD expected to remain on the defensive, Asian regional central banks may have to become a little more active in managing domestic currency appreciation in 2018. FX reserve accumulation may add more support to the EUR in the coming year as FX purchases are diversified into other currency holdings. We expect the Chinese yuan to trade narrowly around current levels in the early part of this year and appreciate modestly over the balance of 2018 towards 6.45 versus the USD.

The Mexican peso (MXN) ended 2017 on a soft note, falling back to near the 20 level amid continued uncertainty over trade relations with the US and the impact of US tax reform on domestic growth. Upward pressure on inflation should abate somewhat in early 2018 but markets continue to price in the risk of tighter monetary policy. However, in Mexico—and other regional economies—political developments are poised to influence exchange rate developments significantly in the coming year. Polling suggests the main candidates for Mexico's July presidential election are in a three-way tie at the moment. We expect the MXN to remain largely stable through 2018, however. We anticipate modest appreciation for the Peruvian sol (PEN) though domestic politics does inject some downside risks to the growth outlook which is somewhat contingent on public investment; we see USDPEN ending this year at 3.18. We expect the Chilean peso (CLP) to remain firm this year amid strengthening domestic growth and firm copper prices. Markets may also be influenced by the shape of incoming President Pinera's government. Pension reform and October's presidential election may keep the Brazilian real trading more defensively this year, however.

**Foreign Exchange Strategy**