Foreign Exchange

US DOLLAR POISED TO WEAKEN AFTER CONSOLIDATION

The US dollar (USD) traded sideways for much of Q1 after falling heavily at the start of the year. Positive economic data helped steady USD losses through February and March and the US currency has also benefitted from some safe-haven demand related to the double-digit percentage point drop in the major US equity indices that developed from the end of January. The USD's liquidity premium remains intact at this point, even if at least some of the headwinds for equities have been fanned from within the US itself amid trade tensions and focus on the tech sector.

In the short-term, we note a general deterioration in USD sentiment reflected in a build-up of bearish positioning in the currency futures market and highlight that the USD is nearing a seasonally weak period of the year. April has delivered the worst returns for the US dollar index (DXY) of any month of the year since 1990 (-0.6% on average, according to Bloomberg data) and usually heralds a prolonged period of relative USD softness that only reverses late in the calendar year. Tighter Fed policy looks well discounted in the markets now and may not provide the USD with much support.

Our longer-run outlook for the USD is unchanged; we think improving growth, prospects for policy normalization and lessened political risks outside of the USA render other currencies more attractive for international investors who are perhaps somewhat over-exposed to a USD which remains close to a longer-run secular peak. Rising fiscal and current account imbalances represent another negative for the USD. The deteriorating outlook for US fiscal policy is coming at a time when traditionally active participants in the US Treasury market are showing signs of less appetite for US government debt which may add to USD headwinds going forward. China and Japan's combined ownership of total foreign holdings of US T-bonds slipped under 36% in January, down from a peak of 51% in 2004.

The Canadian dollar (CAD) was a significant under-achiever in Q1-2018, falling 2.6% against the USD, the worst performance amongst the major currencies. The Canadian economy continued to cool in Q1 and the lack of obvious progress on NAFTA talks generated more uncertainty around the outlook for the economy and monetary policy. At the same time, the domestic oil sector is awash with supply amid a dearth of pipeline capacity to export product. This has resulted in a significantly wider discount in Canadian heavy crude prices to the US WTI benchmark and a sustained disconnect between the CAD's performance and its usually strong, positive correlation with the energy complex.

We are cautiously positive on the outlook for the CAD over the balance of the year as we expect an end to the recent run of disappointing data and a modest tightening in BoC policy in the months ahead alongside the general softening in the USD. We also expect commodity prices to strengthen amid solid global growth momentum, which should add to general underpinning for the Australian and New Zealand dollars as well. A quick resolution to NAFTA renegotiations would

CONTACTS

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

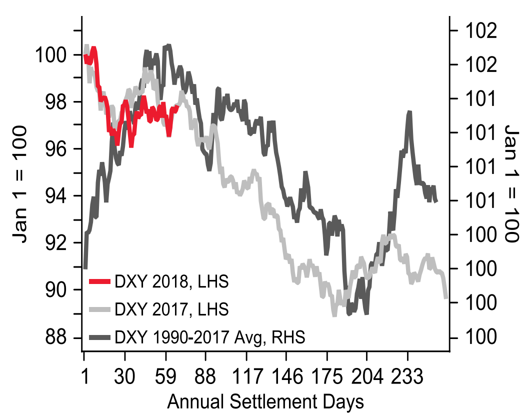
Eduardo Suárez, VP, Latin America Economics
52.55.9179.5174 (Mexico)
Scotiabank Economics
eduardo.suarez@scotiabank.com

Qi Gao
65.6305.8396 (Singapore)
Foreign Exchange Strategy
qi.gao@scotiabank.com

Eric Theoret
416.863.7030
Foreign Exchange Strategy
eric.theoret@scotiabank.com

Chart 1

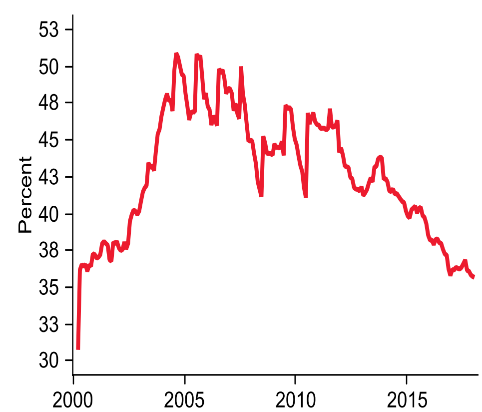
DXY Seasonal Trends Poised to Deteriorate



Sources: Macrobond, Scotiabank FICC Strategy.

Chart 2

China/Japan Share of Foreign UST Holdings



Sources: Macrobond, Scotiabank FICC Strategy.

represent an important, positive shock for the CAD as market expectations have been conditioned by Washington's belligerent posturing on trade. We retain a forecast of CAD1.25 for year end.

The euro (EUR) traded sideways for much of Q1, consolidating the strong gains seen through late 2017/early 2018. Eurozone growth momentum may moderate somewhat from the relatively elevated levels seen in the past few months and, although inflationary pressures remain subdued, European Central Bank (ECB) policy makers are clearing the path for a move away from policy accommodation later this year. The EUR has been largely insensitive to significantly adverse yield spreads versus the USD and we expect that trend to continue. A calmer political backdrop over the past year (ex-Italy, where a government remains elusive after last month's election) and generally underweight sovereign portfolios in EUR suggest to us that the EUR can benefit further from signs of improving capital inflows into the Eurozone in the months ahead. As a result of the more rapid and sustained EUR gains seen through the turn of the year and the still-constructive outlook, we have upgraded our forecast for EURUSD for the balance of the year and look for spot to end 2018 at USD1.30.

The pound sterling (GBP) has benefitted from some welcome clarity on the UK's Brexit arrangements as well as indications that the tight labour market is finally translating into higher wages that will ease pressure on domestic consumers who have been squeezed by weak real wage growth. The UK and its EU partners have made progress on the UK's terms of withdrawal from the EU which avoids the "cliff edge" risk for next year (and helps businesses plan ahead). There is an awful lot of work still to do but a calmer backdrop to Brexit for now and the steady gains in average weekly earnings over the past year provide a clearer backdrop for the Bank of England to nudge monetary policy a little tighter in May which should support the pound. We had expected a bumpier Brexit ride for the GBP and, while setbacks are still possible, we think the GBP can build on gains over the next few months. We now anticipate a year-end rate of USD1.47 for GBPUSD.

The yen (JPY) has traded strongly over the past few months in defiance of widening yield spreads versus the USD. Heightened equity market volatility has also supported the JPY amid safe-haven flows while the JPY has also strengthened in response to rising speculation regarding the position of Prime Minister Abe (if Mr. Abe is forced to resign as a result of his involvement in a local land sale scandal, markets reason that "Abenomics", which favours a softer yen, may go with him). The JPY's insensitivity to short-term rate spreads—and evidence that Japanese investors are shunning US Treasury bonds as rising US short-term rates and relatively low longer-term yields sink returns net of currency hedge costs—has forced us to reduce our bearish call on the JPY for the balance of the year. We now look for USDJPY to end this year at JPY110.

We retain a bearish outlook for the USD against the regional Asian currencies—but we also expect Asian FX to under-perform if risk aversion increases. We remain bullish on the outlook for the renminbi (CNY) despite concerns about slowing Chinese growth. We expect the USD to fall towards CNY6.20 this year. Easing tensions on the Korean peninsula, an improved trade relationship with the US and prospects for closer bilateral ties between China and South Korea are positive developments for the Korean won. The Indian rupee (INR) is expected to range trade between INR64.50–65.50 in the near-term but improved bond market sentiment amid easing inflation pressures may prompt more inflows from offshore, tilting risks towards a stronger currency. We think the Malaysian ringgit still looks somewhat undervalued prior to the upcoming 14th Malaysian General Election and we remain positive on the Thai baht and Taiwanese dollar due to sound fundamentals.

The Mexican peso (MXN) strengthened significantly in Q1, albeit from a record low against the USD, delivering the best spot returns (8.1%) against the USD of any of the majors in gross terms (and even more net of yields at 10.3%). The peso remains volatile, however, and subject to headline (US presidential tweets) and event risk (equity market volatility). Progress on NAFTA—and the sense that the US is pushing for a quick agreement now the Mexican presidential election is looming on the horizon—will add to near-term pro-MXN momentum though gains will perhaps be checked in the 17.00/50 range ahead of the July vote itself. The Peruvian sol has stabilized near its 2018 starting level versus the USD following the volatility around the presidential impeachment process. The transfer of power has been orderly and key cabinet appointments lean towards the "market friendly". The ordeal may curb public sector investment and weigh on growth prospects modestly, however. The Colombian (COP) and Chilean pesos remain influenced by global trade deliberations and risks around the near-term outlook for commodities. Mid/late cycle global economic activity should, however, support demand for commodities broadly. The emergence of a market-friendly candidate in polling ahead of Colombia's May presidential election has helped lift the COP in the past few weeks.

Foreign Exchange Strategy