

Foreign Exchange

US DOLLAR TRENDING LOWER

We retain a generally negative view of the outlook for the **US dollar (USD)**. The USD has weakened broadly against the major currencies over the past three months and has tended to lose ground against many Asian and Latin American currencies over the same period. Persistent market doubts about the Federal Reserve's ability to tighten monetary policy amid weak growth in measured inflation at the consumer level have undercut support for the USD. We expect a modest tightening in Federal Reserve (Fed) monetary policy in December to help arrest the USD slide through year end but the broader and longer-run outlook for the dollar is tilted firmly to the downside.

The Fed will continue to tighten monetary policy gradually in 2018 but we do not necessarily think the USD will benefit. Strongly USD-positive nominal short-term rate spreads failed to prevent the USD from falling this year against the likes of the euro (EUR), pound (GBP) and even the yen (JPY). Additionally, improving growth trends in the global economy means less compelling growth differentials to support the USD over the medium term. And finally, while the Fed is well on the way to policy normalization, other central banks—especially the European Central Bank (ECB) and the Bank of England (BoE)—are only just nearing the start of their adjustment process. The USD's experience suggests that markets will move to discount the end of extra-ordinary monetary policy in other currencies aggressively and ahead of time.

From a broader perspective, we remain of the view that the longer-term trend in the USD has rolled over and reversed; secular bull and bear trends in the USD have lasted around eight years on average since the 1970s, suggesting that, with the 2008/2017 bull phase maturing, longer-term trend risks are tilted to the downside for the USD from here.

We remain constructive on the outlook for the **Canadian dollar (CAD)** through 2018. An earlier and more aggressive start to the Bank of Canada's (BoC) tightening cycle had driven a rapid appreciation in the currency since the middle of the year but gains may now slow or even reverse modestly into year end. From a seasonal point of view, the USD typically strengthens modestly in Q4 and early in Q1 before falling sharply. We anticipate one more rate increase this year and additional BoC tightening in 2018 as the economy improves, providing a key source of support for the CAD during a period of what we expect to be generally stable oil prices. Our forecast implies, however, that the CAD rally will stall late in 2018 and reverse somewhat in the following year as currency appreciation may start to affect the external economy's performance.

The EUR will continue to appreciate through our forecast timeframe. We do expect the rapid appreciation in the single currency in the past few months to moderate or unwind somewhat into year end. Nevertheless, even at this stage, we view 2017 as being a very positive year for the EUR with strong price gains overall thus far strongly suggesting that the EUR's secular trend decline from its 2008 peak around 1.60 halted this year at 1.03 and will reverse moving forward.

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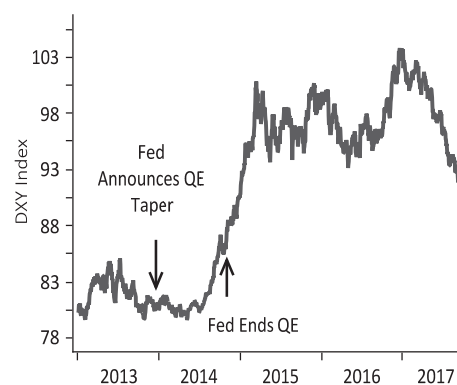
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Chart 1

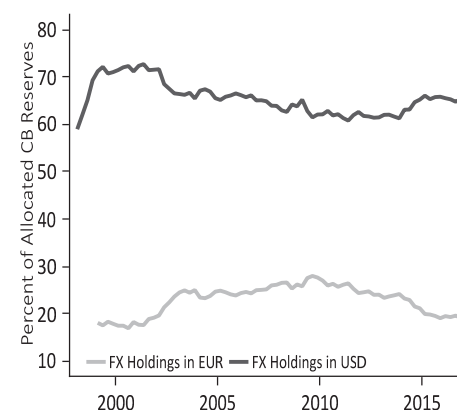
USD on the Rise Well Ahead of QE End



Sources: Macrobond, Scotiabank FICC Strategy.

Chart 2

Central Banks are Underweight EUR



Sources: Macrobond, Scotiabank FICC Strategy.

Eurozone growth momentum remains strong, which will limit near-term EUR weakness, but political risks remain obvious and a potential restraint on gains into mid-2018 (regional independence issues, Italy's general election has to be held by May of 2018). The ECB is edging closer to the end of its asset purchase programme, however, and we expect the eventual normalization of monetary policy to allow investors to refocus on one of the EUR's key structural supports—its large current account surplus relative to the US. We also note that global central banks retain a low relative and absolute exposure to the EUR in reserve asset holdings and large, institutional investors may have to adjust exposure to the EUR as growth strengthens and the ECB exits from extra-ordinary policy accommodation. We look for modest strength in the EUR next year and more obvious gains into 2019 as a result.

Our **GBP** forecast has been upgraded to reflect our call for the BoE to tighten monetary policy later this year in response to high domestic inflation. We expect only a slow tightening in policy, however, with a second hike unlikely before mid-2018—we think May. But considering that few major central banks are even close to raising benchmark rates, even a slight increase in the benchmark rate will help lift the GBP broadly. Brexit remains a risk in the GBP's background but, assuming no significant changes on the domestic political front, we also think a lot of bad news has already been factored in to the GBP at current levels and we rather view the GBP as looking quite cheap still from a longer-term valuation perspective.

The **JPY** will underperform broadly in the coming year. Domestic growth trends remain weak and the BoJ remains far from achieving its 2% inflation goal. This means policy accommodation remaining in place for an extended period as other central banks prepare to exit extra-ordinary accommodation or nudge policy tighter. Relatively weaker growth and accommodative monetary policy settings will weigh on the JPY. We expect the USD to trade up to the 120 area through late-2019 but longer-term charts suggest a risk of more rapid USD appreciation in the medium term if the USD pushes through the 115 area on a sustained basis in the next couple of quarters.

It may still be a bit premature to start worrying about the impact of **LATAM** elections on FX, outside of **Chile**, which is holding its elections in November. Most polls and analysts believe that former President Piñera is likely going to win the election, although there is also uncertainty about whether he will be able to secure a large enough legislative coalition to push forward his agenda, which investors seem to like. Accordingly, over the coming weeks, we expect the Chilean peso will react to polls and what they suggest about the legislative composition. In **Colombia**, fiscal concerns are one of the drivers of recent softness not only in the Colombian peso (COP), but also domestic rates, meaning comments from rating agencies and fiscal and growth numbers should be the major drivers of the COP's price action. Our take is that COP is now somewhat "cheap" from a fundamental perspective (about 5%–10%), but volatility is likely from both fiscal/growth considerations (short term), as well as electoral campaigns (starting early 2018). On the electoral front, we expect both Uribe & Santos aligned candidates to be seen as positive by markets (macro policy continuity). In **Mexico**, the three factors that should determine price action are likely to be: inflation and monetary policy, NAFTA negotiations, and the 2018 elections. We expect NAFTA and monetary policy to be the key drivers in the near term, while elections should kick in as a major driver early in 2018. However, there are still some aspects of the elections that markets need to be mindful of right now, namely who the main parties select as their candidates. We expect those candidates to start emerging late October–mid-November. On NAFTA, even though we expect the final outcome will be positive, it should still be a volatility driver as issues of contention emerge. Our take is that the Mexican peso (MXN) remains about 5% undervalued. However, even though it is cheap, we expect uncertainty related to the NAFTA renegotiation and the 2018 elections to keep the peso on its back foot. **Peruvian** markets seem to be increasingly immune to the domestic political drama playing out, with the reaction to President PPK's cabinet shuffle being quite modest. Behind this market stability, is the view that Peru has already undertaken a lot of the key reforms, meaning that as long as we have a functional government, risks are relatively modest.

Asian EM FX will trade in line with risk sentiment over the remainder of the year. External uncertainties including the stance of the ECB, US macro data, the US debt ceiling issue, US tax reforms as well as geopolitical risks are all issues that may affect regional FX into year end.

The **Chinese yuan (CNY)**'s implied volatility has been rising along with the sliding risk reversal since late August. A neutral risk reversal has paved the way for the regulators to increase two-way flexibility in the yuan exchange rate and push for reforms, such as a wider trading band. The China Finance 40 Forum (CF40), a Beijing-based quasi-governmental think tank, said in a report that it is a good time now for China to carry out further FX reforms and the nation should allow the yuan to become more flexible.

Meanwhile, the PBoC is expected to properly manage market expectations ahead of the ruling party's 19th national congress and US President Trump's visit to China scheduled for early November.

We see downside potential for the **Indian rupee (INR)** in the weeks ahead on rising concern over domestic stimulus plans and possible unwinding of long INR carry position. USD/INR is likely to head for the 66.0 mark. In the medium term, the INR will recoup its losses when the market is convinced of the proposed stimulus package's ability to prop up economic growth.

The Korean won (**KRW**) remains susceptible to downward pressure related to the geopolitical situation on the Peninsula. We are closely monitoring the Taiwanese dollar (**TWD**) and expect USD/TWD to rise towards the 30.5 level should stock outflows continue. The Thai baht (**THB**) will trade along with a broader market tone but outperform somewhat given the nation's solid fundamentals. The BoT has committed to intervening intermittently to curb an excessively strong THB—the best performing currency this year in the region.

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