

## Foreign Exchange

With three quarters of the calendar year in the books now, the US dollar (USD) is maintaining a moderate gain (up around 3% since January 1) against the major currencies whilst accumulating some outsized gains against currencies in the developing market space. So far this year, the USD has swung between modest losses in aggregate against the majors (falling around 4% in terms of the DXY index through Q1) and a net gain of around 5% from the start of the year through August. USD-bearish consensus trades at the start of the year delivered positive results for currency investors but subsequent developments have proven more difficult to trade around. Managed currency investment fund returns so far in 2018 are negative (down around 4% YTD) after down years in both 2016 and 2017. The trend of choppy and somewhat indecisive trading has reduced market conviction around the direction of the USD in the near term at least, raising the risk of more choppy range trading running through Q4.

We confess to siding with the USD-bearish view of the currency outlook in January and we still rather think that medium- and longer-run odds are stacking up negatively for the USD. Even in the short run, we believe that relatively strong growth and tighter Fed policy are largely factored in to the exchange rate. Market positioning is also biased strongly towards long USDs by a number of metrics. This does not mean the USD will weaken, but it does mean that it will be hard for the USD to advance without additional supportive news or developments. From this perspective, downside risks may start to tilt against the USD after the mid-term elections in the US which could alter the political dynamics and priorities in Washington.

From a longer-run perspective, we think that the accumulation of fiscal (especially) and current account deficits—traditionally, the Achilles' heel of the USD—will weigh on the USD's valuation in the coming years as investors will require either higher yields or a lower exchange rate (or a combination of both) in order to purchase US Treasury securities. Meanwhile, we continue to believe that 2017 was the high point in the USD's secular bull cycle which started in 2008/2009, given the propensity for the USD to move in (roughly) eight-year, alternating cycles of strength and weakness since the 1970s.

The Canadian dollar (CAD) is currently trading close to where we expect it to end the year against the USD (we currently forecast a year-end rate of CAD1.28, or 78 cents US). The CAD has been supported by firm domestic growth trends and prospects for further modest Bank of Canada (BoC) tightening at the late October policy meeting amid somewhat sticky inflation.

A new trade agreement with the US and Mexico added some upward momentum in the CAD, given that the tone of trade negotiations prior to the deal had suggested little common ground on key issues. The deal removes a large uncertainty hanging over the CAD but the new agreement looks an awful lot like the old one and we see limited economic impact from USMCA replacing NAFTA—beyond a minor relief rally, we do not expect the agreement to drive significant additional gains for the CAD. The best we can say for the CAD is that the worst case trade outcome has been avoided. Steel and aluminum tariffs remain in place

### CONTACTS

**Shaun Osborne, Chief Currency Strategist**

416.945.4538  
Foreign Exchange Strategy  
[shaun.osborne@scotiabank.com](mailto:shaun.osborne@scotiabank.com)

**Eduardo Suárez, VP, Latin America Economics**

52.55.9179.5174 (Mexico)  
Scotiabank Economics  
[eduardo.suarez@scotiabank.com](mailto:eduardo.suarez@scotiabank.com)

**Qi Gao, Currency Strategist – EM Asia**

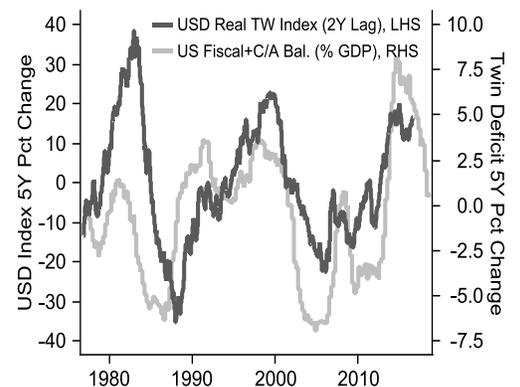
65.6305.8396 (Singapore)  
Foreign Exchange Strategy  
[qi.gao@scotiabank.com](mailto:qi.gao@scotiabank.com)

**Eric Theoret, FX Strategist, Associate Director**

416.863.7030  
Foreign Exchange Strategy  
[eric.theoret@scotiabank.com](mailto:eric.theoret@scotiabank.com)

Chart 1

Widening Deficit Threat to USD



Sources: Macrobond, Scotiabank FICC Strategy.

at writing and the CAD may garner some modest, additional gains if these are lifted but we rather view that CAD rebound as looking somewhat stretched at this point.

Commodity prices remain firm but Canada-relevant commodities have eased somewhat in recent months. Lumber prices surged in the first half of the year but have now slumped 50% from the May peak while Canadian heavy crude continues to trade at a significant discount to the WTI benchmark. This situation leaves the CAD struggling to benefit from higher energy prices generally and undermines somewhat the support the CAD can derive from the improvement in terms of trade since the low point of the commodity cycle.

Against a backdrop of a generally softer USD and still firm—if somewhat slower—global growth trends into 2019, we think the CAD, alongside the Australian and New Zealand dollars (AUD and NZD), can appreciate modestly into 2019. Near-term risks for both the AUD and NZD revolve around trade; whereas the CAD is now significantly less susceptible to trade uncertainty, we think fragile US-China relations leave both the AUD and NZD prone to softness until prospects improve.

Pacific Alliance currencies have been buffeted by a difficult international trade environment, a generally stronger USD and tighter US monetary conditions which have contributed to heightened volatility in the more structurally vulnerable currencies in the region. The Argentine peso has declined by 50% over the year so far while the Brazilian real has fallen 16% against the USD. Against that backdrop, the Mexican peso performance (MXN, up nearly 5% on the year) looks positive. We expect modest losses for the MXN into year-end as markets focus on the presidential transition and the potential for economic activity to slow somewhat as the new government sorts out its fiscal priorities. The Colombian peso (COP) is currently outperforming relative to year-end expectations (and is more or less flat on the year) thanks to firm oil and domestic growth trends. The Chilean peso (CLP) weakened through mid-year, in line with the drop in copper prices. We look for the CLP to steady and improve somewhat in Q4, providing the international backdrop remains calm. The Peruvian sol (PEN) weakened modestly from mid-year despite supportive domestic fundamentals. USDPEN gains through the sensitive 3.30 level suggest risks may be tilting towards more PEN weakness.

In Europe, the euro (EUR) remains relatively stable despite widely negative interest rate differentials versus the USD. The European Central Bank (ECB) will wrap up its asset purchase programme at year-end amid rising confidence that the underlying strength in the economy will deliver higher inflation over time. We do not expect any shift in the ECB's key policy rate until H2 of next year, however. Eurozone-US short-term rate spreads reached a record of -336bps (for 2-year cash bond spreads) in early October—a significant yield premium for the USD which, ordinarily, we would expect to have led to a significantly weaker EUR and stronger USD. The fact that the single currency is resilient in the face of wide, negative spreads reflects renewed portfolio and foreign direct investment net inflows into the Eurozone this year, we think. It might also reflect the market's underlying concerns about the structural challenges facing the USD. We see potential for modest gains in the EUR initially next year and more significant appreciation in the second half of the year on the assumption that the ECB will start to reverse out of negative policy rates at that point.

The British government's attempts to formulate a plan that will allow it to smoothly decouple from the European Union (EU) by March 2019 remain a risk for the pound (GBP), meanwhile. Thus far, negotiations have not made progress towards an agreement that will be acceptable for the EU or workable for the varying political interests in the UK. The risk of a "cliff edge Brexit"—one that would see the UK out of the EU but with no arrangements made for trade and border issues—remains uncomfortably high from our point of view. Our base case view is that an agreement will be reached but that still implies relatively subdued growth and an exchange rate that will rise modestly against the USD but fall against the EUR next year. Time is running very short, however, and uncertainty alone risks driving the GBP sharply lower into 2019 absent a clearer Brexit path.

We anticipate slower growth in Japan next year, alongside subdued inflation. We expect the Bank of Japan (BoJ) to retain a substantial degree of policy accommodation, even if settings are tweaked and asset purchases reduced. The yen (JPY) will remain relatively soft as a consequence. The Chinese yuan (CNY & CNH) will remain vulnerable to depreciation amid an escalation in the US-China trade war but we expect the authorities will curb one-way speculation on the yuan if necessary, with the 7.00 level remaining China's bottom line for the yuan this year. The South Korean won (KRW), Taiwanese dollar (TWD) and Thai baht (THB) are more susceptible to external demand shocks than other regional currencies but we remain bearish on the Indian rupee (INR), Indonesian rupiah (IDR) and Philippine peso (PHP) as all the three economies are facing twin deficit problems. Firm crude oil prices will weigh on the struggling INR while bolstering the Malaysian ringgit (MYR) somewhat. Bank Indonesia (BI) will retain its hawkish stance as the Indonesian government and central bank are prioritizing economic stability over economic growth. Monetary Authority of Singapore (MAS) is likely to maintain its existing S\$NEER policy band for now as the US-China trade dispute could shape up as a notable drag on global growth next year.

This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a "call to action" or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

**This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.**

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with "Global Banking and Markets", is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.

## Foreign Exchange Strategy

This publication has been prepared by The Bank of Nova Scotia (Scotiabank) for informational and marketing purposes only. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable, but no representation or warranty, express or implied, is made as to their accuracy or completeness and neither the information nor the forecast shall be taken as a representation for which Scotiabank, its affiliates or any of their employees incur any responsibility. Neither Scotiabank nor its affiliates accept any liability whatsoever for any loss arising from any use of this information. This publication is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any of the currencies referred to herein, nor shall this publication be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The general transaction, financial, educational and market information contained herein is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a "call to action" or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. You should note that the manner in which you implement any of the strategies set out in this publication may expose you to significant risk and you should carefully consider your ability to bear such risks through consultation with your own independent financial, legal, accounting, tax and other professional advisors. Scotiabank, its affiliates and/or their respective officers, directors or employees may from time to time take positions in the currencies mentioned herein as principal or agent, and may have received remuneration as financial advisor and/or underwriter for certain of the corporations mentioned herein. Directors, officers or employees of Scotiabank and its affiliates may serve as directors of corporations referred to herein. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. This publication and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced in whole or in part, or referred to in any manner whatsoever nor may the information, opinions and conclusions contained in it be referred to without the prior express written consent of Scotiabank.

<sup>TM</sup>Trademark of The Bank of Nova Scotia. Used under license, where applicable. Scotiabank, together with "Global Banking and Markets", is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, all members of the Scotiabank group and authorized users of the mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia and Scotiabank Europe plc are authorised by the UK Prudential Regulation Authority. The Bank of Nova Scotia is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available on request. Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Inverlat Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities. Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.