

## Foreign Exchange

The US dollar (USD) retains a firm undertone and has rather out-performed relative to our (and others) expectations over the past quarter. The currency weakened steadily through late 2017 and into early 2018 amid fears over dysfunction in Washington and a growing appreciation among investors for the improving fundamental prospects outside of the USA. The USD's recent rebound has been quite abrupt, however, driven by position-adjustment initially but fueled more recently by a jolt of political concerns in Europe and the ongoing focus on trade discussions between the US and its major trading partners.

Moreover, the US economy retains a positive undertone and Fed policymakers now appear to be leaning towards the idea that policy tightening this year could amount to four hikes. We have added one additional rate hike to our forecast for 2018 (now four hikes in total for 2018), which will help underpin USD sentiment in the near term. We do think the USD is looking quite fully priced from a fundamental perspective at this point but we have adjusted some of our forecasts to reflect the strong USD performance recently and the threat that anticipated weakness is more of a story for 2019 than this year. Longer-term risks remain evident for the USD in the form of structural negatives (wider US fiscal imbalances) and bearish, longer-term secular pressures.

While we remain positive on the longer term outlook for the Canadian dollar (CAD), the ongoing focus on Canada's trade relationship with the USA has clearly clouded some positive developments on the fundamental front. A somewhat capricious approach to trade negotiations in Washington leaves the outlook for NAFTA uncertain and investors have cooled on the CAD as a consequence. But current CAD levels are pricing in all but the most adverse of scenarios that we can envisage on the trade front and our base case remains that a deal will be concluded eventually and that the CAD will recover.

Fundamentally, we note that tighter Canadian labour markets are driving wages and prices higher while business investment has made a strong recovery over the past year or so. This should, all else remaining equal, allow the Bank of Canada (BoC) to continue to adjust interest rates modestly higher in the coming months. The BoC does risk falling a little further behind the Fed in the next few months, however, and persistently wide short-term rate spreads suggest that USDCAD is more likely to end the year at 1.28 now (from our previous forecast of 1.25).

The global economic cycle, reflecting positive growth prospects and rising, if still low, inflation pressures, represents a "sweet spot" for commodity prices. Price gains in energy, lumber etc. have driven a significant improvement in Canada's terms of trade—fully reversing the deterioration seen in 2015/16 amid the slump in crude oil. This is a powerful economic positive for the Canadian economy and would, ordinarily, constitute a significant source of strength for the CAD. Positive terms of trade and supportive fundamental developments should restrain downside pressure on the CAD and trigger a quick rebound in the currency once the trade outlook is clearer.

### 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**

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

**Eric Theoret**

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

Chart 1

**Terms of Trade Remain CAD-Supportive**

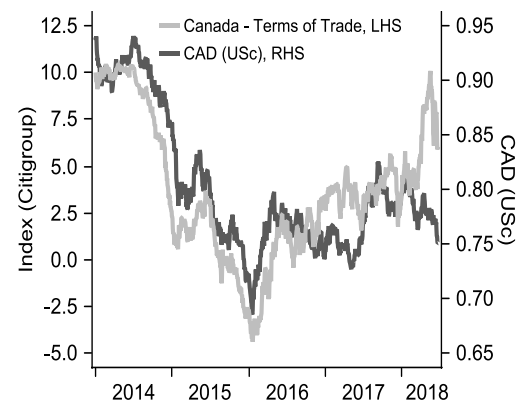
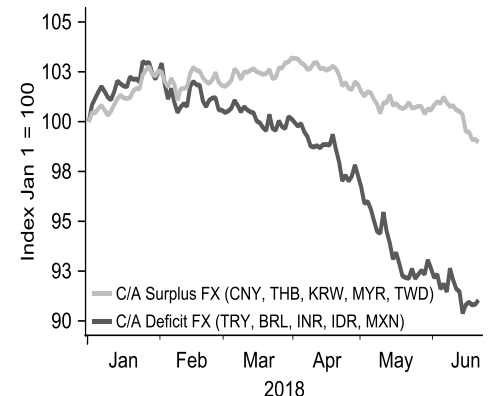


Chart 2

**C/A Deficit FX Underperforms**



European currencies have borne the brunt of the USD rebound over the past quarter but we think the euro (EUR) in particular is looking somewhat oversold. Italian and Spanish political developments weighed on sentiment recently but concerns have moderated for now. We are constructive on Eurozone growth despite a “soft patch” in activity at the start of the year. Meanwhile, measured inflation and inflation expectations are ticking higher, supported by rising energy prices. The European Central Bank confirmed that its asset purchase program will conclude at year-end, ahead of a modest tightening in interest rates in 2019. Surprisingly, this message (while not unexpected) was greeted with renewed pressure on the currency. We have reduced our near-term outlook for the EUR and now expect spot to end 2018 at 1.20; our 2019 forecast remains unchanged (1.35).

The pound (GBP) is soft and looks somewhat vulnerable still in the near-term. UK rate hike expectations have receded after the Bank of England balked at raising rates in May and the UK government is struggling to develop a workable Brexit policy. We rather think near-term risks for the GBP remain negative but we also think that longer run valuation considerations should help limit GBP losses below 1.30 versus the USD. We have reduced our 2018 year-end forecast for GBPUSD to 1.32 and our end 2019 forecast to 1.40.

We expect the Mexican peso (MXN) to end this year near current levels but the MXN's recent performance has been soft, with the USD testing the MXN21 area amid a rise in broader market volatility and NAFTA-related concerns. The July Presidential election is also starting to factor in investor decision-making on the MXN. Domestic and external risks suggest that the MXN will struggle to improve materially in the near-term. Despite heightened regional FX volatility (centered on Brazil and Argentina) most other major Latin American currencies had been somewhat more resilient to the recent gains in the USD. The Peruvian sol (PEN) has been supported by positive economic data that have helped keep the PEN's losses contained around 1.5% versus the USD over the past quarter. More recently, heightened global trade tensions and somewhat softer crude oil and copper prices have tended to weigh more on the Colombian and Chilean pesos, respectively.

We are bearish on the Japanese yen (JPY), primarily because we expect the Bank of Japan will retain significant policy accommodation over our forecast horizon amid stubbornly low inflation. The JPY may continue to attract temporary, safe-haven demand. Regional currency prospects continue to be clouded by geo-political and trade risks. However, rising interest rates and generally tighter monetary conditions do represent a clear and present threat to the more highly leveraged (current account deficit) economies, as economies have to compete more aggressively for funding and investors shift exposure to “safer”, surplus currencies which have tended to out-perform in recent months.

We expect the Chinese yuan to remain in a broader range in the near-term but trends in the currency generally are liable to mirror developments in the major currencies' performance versus the USD. The offshore Chinese yuan (CNH) will likely continue to trade at a discount to the onshore yuan (CNY) amid an escalation in US-China trade tensions. We do not expect the Chinese authorities to engineer a weaker yuan to retaliate against the US at this stage. Meanwhile, the South Korean won (KRW), Taiwanese dollar (TWD) and Thai baht (THB) are more susceptible to external demand shocks than other regional currencies.

Taiwan's listed companies are set to pay cash dividends worth around TWD 1.29tn in the June–August period, which will impose upward pressure on USDTWD. India's trade deficit widened to USD 14.62bn in May from a month ago, intensifying ongoing concern over the nation's deteriorated external balance. 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. Bank Indonesia (BI) will raise its policy rate again on 28 June to defend the IDR exchange rate in our opinion. The Malaysian ringgit (MYR) will continue to follow a broader market tone with a relatively lower volatility, while benefitting somewhat from resilient oil prices.

Given that the Fed will stick to its gradual path of tightening and the ECB has pledged to remain accommodative, regional market sentiment will improve sharply should China successfully de-escalate trade tensions with the US and avert tit-for-tat trade measures. In the medium term, however, we remain cautious on prospects as global liquidity tightens.

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.