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Several factors continue to support the U.S. dollar versus other key currencies. The U.S. economy remains robust relative to the rest of the world and interest rates are higher in America versus other major regions. Our model situates the U.S. dollar in overvalued territory, but not to an extreme degree that would call for significant economic adjustment in the near term. In addition, the U.S. dollar's safe-haven status means the currency generally appreciates when risk assets struggle. While many investors are questioning whether the U.S. dollar is due for a period of weakness after a nearly decade-long bull market, we think the dollar will likely follow a choppy topping process that may continue for a while longer.

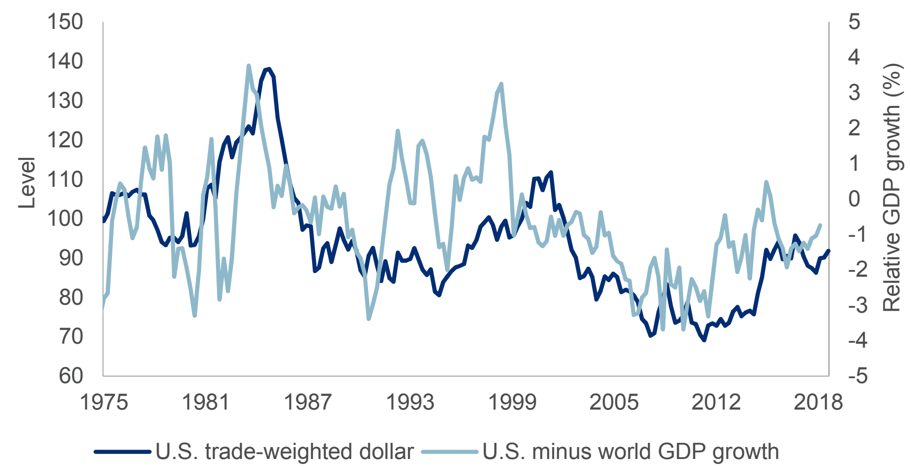
Global Currency Outlook

The time is not ripe for a U.S.-dollar bear market

The eight-year-old U.S. dollar bull market has attracted many a skeptic and raised a host of questions: Can the greenback continue to rally given America's imprudent economic policies? Should investors continue to put their faith in the currency as the White House exerts pressure on the U.S. Federal Reserve (Fed) to hold down interest rates? And what of the Trump administration's prevailing contempt for international diplomacy? These entirely valid questions are suited to a much longer-term outlook than our 12-month time horizon. We believe, however, that investors would look beyond a single presidential term before making long-term judgments about whether the U.S. dollar is headed for a multiyear decline. Instead, we focus on drawing parallels with past cyclical movements in the greenback and look to the more reliable drivers of these cycles to inform our expectations about the future. These indicators don't yet confirm the need to call for a U.S.-dollar bear market.

The first key component in our framework is the difference between U.S. economic growth and growth in other regions. The strong link between currency movements and growth (Exhibit 1) can be explained by large and persistent shifts in the world's capital flows: money tends to chase higher returns, and those higher returns are

Exhibit 1. USD and relative economic growth



Source: IMF, Bloomberg, RBC GAM

generally found where economic growth is strongest. At present, despite slowing U.S. growth, differentials with other countries along with large capital movements are still benefiting the U.S. dollar and will remain supportive at least until this relative economic momentum sustainably declines.

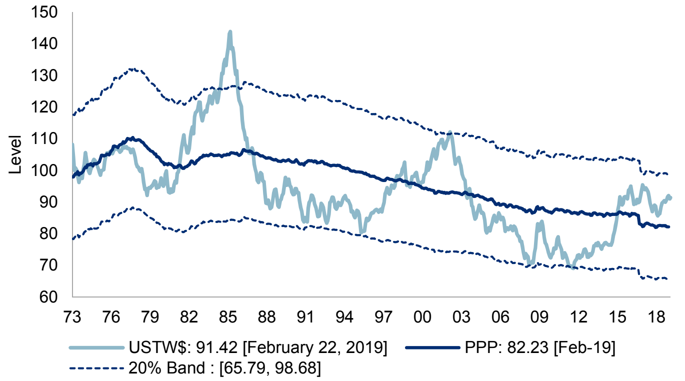
Second, the U.S. dollar is not extremely overvalued – its valuation lies within our 20 percent valuation bands (Exhibit 2). While this is not a precondition for the dollar to soften, the tendency for importers and investors to seek cheaper alternatives is generally not strong enough until a currency is more than 20 percent above its purchasing power. In the absence of such extreme overvaluation, this natural economic adjustment will simply take longer to occur, which is why we have argued that this cycle's peak will be much choppier and more extended than past turning points in 1985 and 2001 (Exhibit 3).

Third, the U.S. dollar still enjoys the support of higher interest rates. Even though the absolute level of interest rates is low, a 2-year U.S. Treasury yield of 2.50 percent is much more attractive than the negative yields on offer in Germany, Japan and Switzerland. These differentials make shorting the U.S. dollar or hedging U.S. assets very expensive. In addition, U.S. 2-year bonds offer the highest real yield among all major economies, with most others having yields below current levels of inflation (Exhibit 4).

Given the extent to which the economic landscape has soured since the turn of the year, investors are now pondering whether there are any rate hikes left in this cycle and what implications this would have for the greenback. If risk aversion causes the Fed to turn more cautious, could this mean a sudden decline for the dollar?

Based on past experience, the answer is probably not. There aren't many rate-hiking cycles from which to draw parallels, and only two that occurred during environments similar to the current one, in which the U.S. dollar was both overvalued and also in the latter stages of a bull market (Exhibit 5a). But these two cycles have interesting similarities in that the dollar tends to rally for another year or two beyond the final rate hike (Exhibit 5b). Why? Perhaps because investors can't be certain that any single rate boost was the last of a cycle, and as a result the Fed can continue to provide interest-rate support to the dollar for a while longer. In addition, the U.S. dollar is a safe-haven currency, tending to rally when risky assets tumble. The "U.S.-dollar smile" (Exhibit 6) describes relationships where the dollar performs well under very positive economic scenarios – those in which

Exhibit 2: U.S. purchasing power parity valuation

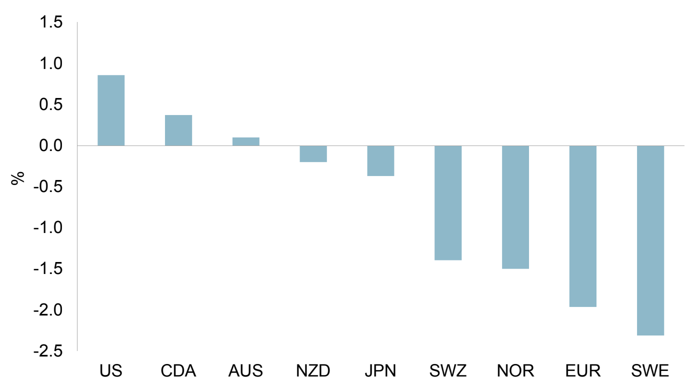


Source: RBC GAM

Exhibit 3: Long-term cycles of the U.S. trade-weighted dollar

Source: Bloomberg, RBC GAM

Exhibit 4: Developed-market 2-year real yields



Source: Bloomberg, RBC GAM

the Fed would likely be hiking rates – and also under poor economic scenarios, where risk aversion would lead the dollar to strengthen. Both interest-rate support and safe-haven scenarios dovetail with our thesis that the dollar is not ready to transition to a long-term downward trend. Our assumption is that the choppy topping process characterizing U.S.-dollar movements will continue for at least another year, or until we begin to see signs that the dollar's valuation is having an impact on current-account imbalances.

Still more life in EM currencies

Where developed-market currencies have been mostly range-bound over the past year, it has been a volatile period for emerging-market currencies. Concerns about politics and fiscal deterioration in Turkey and Argentina over the summer have severely dented investor appetite for risky assets, and both the Turkish lira and Argentine peso were among the worst-hit during last year's episode of capital flight. Other emerging-market currencies fell in sympathy rather than because of any country-specific news. Since the early-September lows, emerging-market currencies have bounced by 10 percent, while G10 currencies drifted lower. There is room for further strength in emerging-market currencies, we think, because they still enjoy the tailwind of cheap valuations and relatively high interest rates, and also because the three main issues that have worried investors are gradually diminishing.

These are:

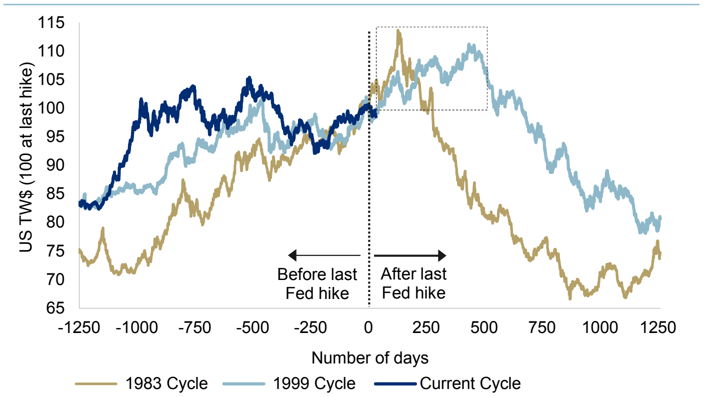
- Central banks have become more dovish. In addition to the Fed, a handful of other global monetary actors have pared expectations for tightening in 2019. If expectations about monetary policymakers keeping rates unchanged for the rest of 2019 are correct, it will be a friendly environment for emerging-market currencies.
- There are signs that U.S.-China trade negotiations will lead to a settlement of the countries' trade dispute. The conflict has weighed heavily on countries that are the most export-oriented, and a resolution of tensions between the world's two biggest economies would therefore offer huge relief to emerging-market investors.
- There are tentative signs that Chinese economic growth is stabilizing. Policy makers in the country have employed numerous tools to provide support for the economy, and targeted measures to stimulate lending, cut taxes and expedite investment projects will begin to have a greater impact in the second half of the year.

Exhibit 5a: Tightening cycles and the USD

Cycle	1st hike	Last hike	USD cycle	USD valuation	Caused recession
1972	Feb. 1972	Aug. 1973	Bear	(1%)	Yes
1976	Dec. 1976	Mar. 1980	Bear	(3%)	Yes
1980	Aug. 1980	Jan. 1981	Bull	(5%)	Yes
1983	Apr. 1983	Aug. 1984	Bull	25%	No
1986	Dec. 1986	Sept. 1987	Bear	(8%)	No
1988	Mar. 1988	Feb. 1989	Bear	(12%)	Yes
1994	Feb. 1994	Feb. 1995	Bear	(13%)	No
1999	Jun. 1999	May 2000	Bull	9%	Yes
2004	Jun. 2004	Jun. 2006	Bear	(9%)	Yes
Current	Dec. 2015	Dec. 2018	Bull	12%	???

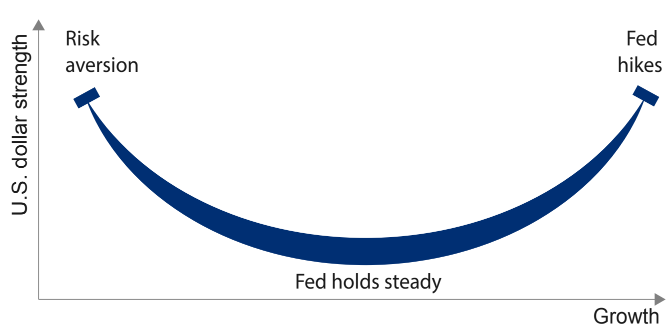
Source: RBC GAM

Exhibit 5b: USD performance before and after last Fed hike



Source: Bloomberg, RBC GAM

Exhibit 6: The US dollar smile



Source: RBC GAM

Further relief on these three concerns, particularly the last one, will go a long way toward supporting emerging-market currencies, and we believe that they could reclaim levels last reached in early 2018.

Euro to rise to 1.20

Much of the outlook for the euro depends on the European Central Bank (ECB), and with softening economic data in the region, investors are pricing in little change in policy rates. However, the hurdle for tightening should be lower for a central bank employing negative rates than for one whose policy rates are closer to neutral. As wage pressure (Exhibit 7) causes inflation to rise toward the ECB's 2 percent target, the euro will become more reactive to any rhetoric that could be interpreted as hawkish. Meanwhile, any positive news on Brexit, Italy's banking system or Chinese growth would result in the euro pushing above the upper end of its 1.12 – 1.16 range.

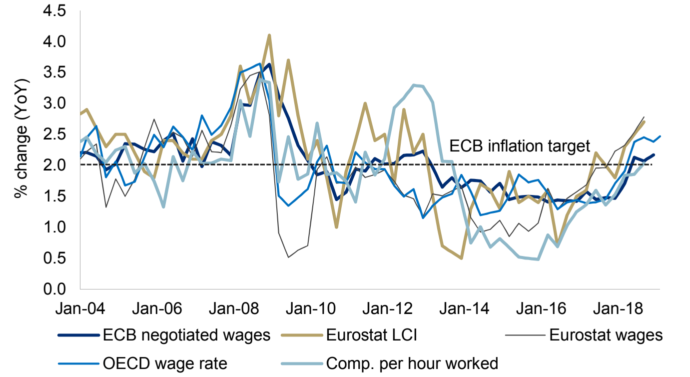
Japanese yen to rise to 102

Within the G10, we are most bullish on the yen, as long-term factors such as cheap valuations and a strong current-account balance remain positive. In the shorter term, slowing U.S. growth and risk aversion will also bolster the Japanese currency as it still enjoys safe-haven status. Holding back the yen are persistent capital outflows as Japanese investors seek higher returns outside the country. Equity outflows are now beginning to slow (Exhibit 8) as the rising cost of hedging U.S. assets and higher equity volatility have weakened the case for Japanese investors to allocate capital abroad. In the absence of these influential outflows, we expect the yen to strengthen toward 102 from about 111 currently.

British pound to fall to 1.25

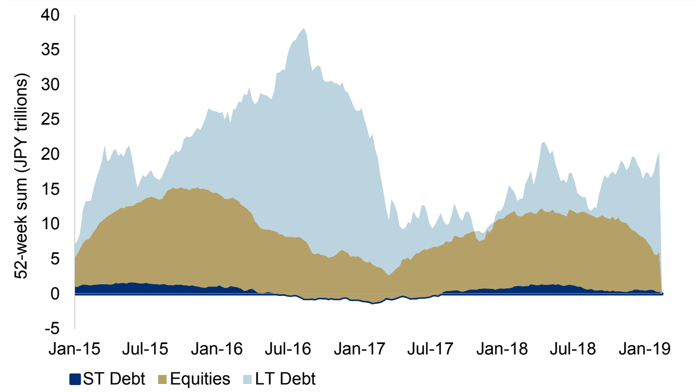
Expectations that the U.K. will avoid a disruptive Brexit have generated a rally in the pound. But sterling has risen far above what would be justified by the performance of gilts (Exhibit 9). Even with a soft-Brexit outcome, the U.K.'s economic outlook is far from rosy given weakening domestic inflation, lagging business investment, poor consumer confidence and low productivity. As a consequence, we expect the Bank of England to be on the sidelines for some time. Over both short- and longer-term horizons, the outcomes are skewed toward a lower pound given that sterling trades near 1.32.

Exhibit 7: Eurozone measures of wage inflation



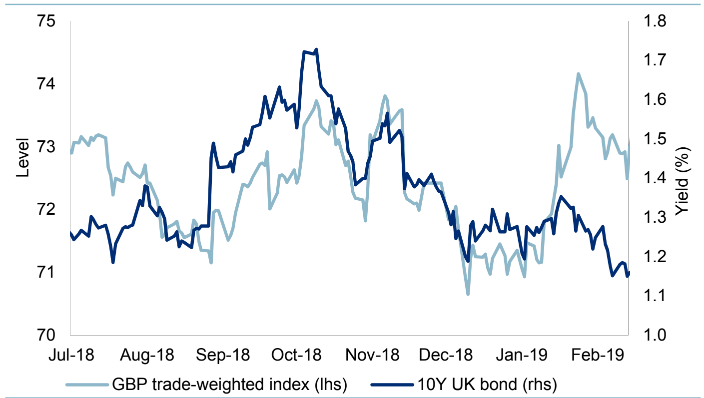
Note: LCI = Labour cost index. Source: Eurostat, OECD, Bloomberg, RBC GAM

Exhibit 8: Japanese portfolio investment abroad



Source: Japanese Ministry of Finance, Macrobond, RBC GAM

Exhibit 9: Trade-weighted GBP versus 10-year gilts



Source: GfK, Bank of England, Bloomberg, RBC GAM

Canadian dollar to fall to 1.37

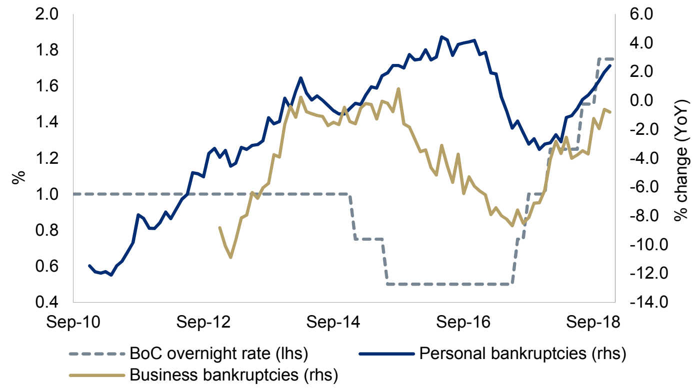
There has been a marked deterioration in domestic economic data since 2017. Canada's economic growth rang in at a disappointing 1.8 percent in 2018, more than a full percentage point below the comparable U.S. rate of 2.9 percent. The outlook for Canadian growth over our forecast horizon is not much better, as weakening consumer and investment spending have combined with a worsening balance of payments to suppress economic activity.

It is well known that debt levels have been rising in Canada and that higher rates will have an adverse impact on Canadians. As the tide of cheap money recedes, we expect to see increased defaults on loans that were extended to fund poor business models (Exhibit 10). Household disposable incomes will likely be squeezed too. As a result, job creation and wage gains will be required to maintain consumption growth this year. Should employment begin to soften or house prices to decline, there could be a sharp deterioration in consumer spending.

For over 30 years Canada has consistently lagged the U.S. in investment in productive capacity. Over the past 10 years that gap has widened with current Canadian investment at half that of U.S. levels (Exhibit 11). Rising taxes, higher minimum wages and petroleum-pipeline delays are not making the business environment any easier, serving as impediments to growth and also to global competitiveness. Evidence of Canada's declining competitiveness can be seen in persistently weak foreign direct investment (FDI), which has been falling for 10 years despite Canadian dollar depreciation of almost 28 percent over six years – an indication that foreigners are reticent to invest in Canada.

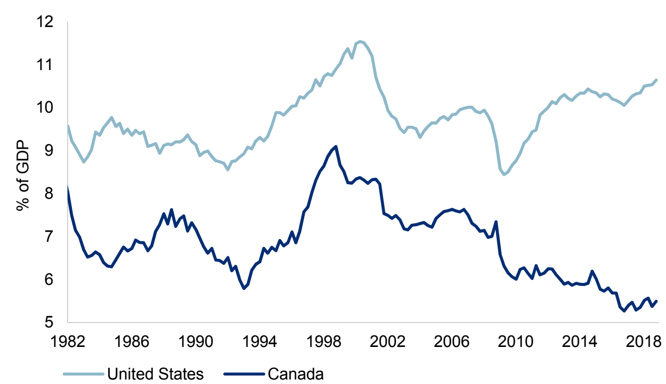
While some of these policies have been partly reversed (minimum wages, corporate taxation), the damage will take years to correct. This places the burden of adjustment on the currency, which is often relied upon as a relief valve. Given that the Canadian dollar is undervalued, we might expect that Canadian assets or goods would be attractive to foreign investors. However, portfolio flows into the country have plummeted from approximately 6 percent of GDP in the third quarter of 2017 to 0.5 percent at the end of 2018 (Exhibit 12). Furthermore, the current-account deficit remains wide, suggesting that past loonie weakness has not been enough to make the country's goods and services sufficiently cheap either. Taken together, FDI, portfolio flows and the current account form the basic balance of payments, which is at its worst level in 20 years.

Exhibit 10: Canadian bankruptcies and Bank of Canada rate



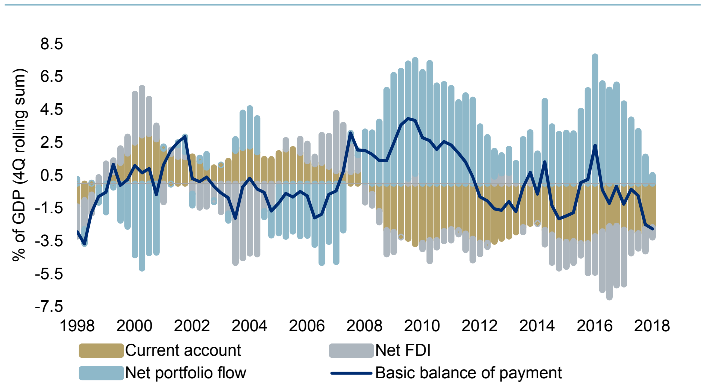
Source: StatsCan, Bloomberg, RBC GAM

Exhibit 11: Business investment in machinery, equipment and intellectual property



Source: Macrobond, RBC GAM

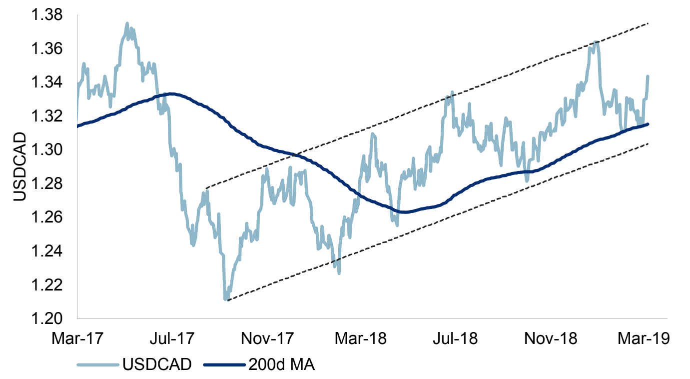
Exhibit 12: Canadian basic balance of payments



Source: Macrobond, StatsCan, RBC GAM

We acknowledge a few important Canadian-dollar positives: strong immigration, especially of highly skilled workers; cutting-edge research being conducted in Canadian hospitals and universities; and increasing evidence that Toronto is becoming one of North America's fastest growing technology centers. However, we don't think these positive factors have gained enough momentum to outweigh the economic drag posed by the trends mentioned above. The Bank of Canada (BOC) expects investment and exports to drive economic growth in 2019, but there is little evidence that either is accelerating. Furthermore, underlying inflation remains stubbornly low, registering 1.4 percent year over year in January, down from 2.0 percent in December. Given these factors, it is unlikely that the BOC will be the loonie's saviour. Most of our shorter-term models and metrics suggest that the Canadian dollar should fall against the U.S. dollar, which would be an encouraging sign for chartists watching the most recent trend channel (Exhibit 13). Risks to our forecasts are skewed toward a weaker loonie and include a U.S. economic slowdown, doubts about the passage of the U.S.-Mexico-Canada trade deal, the potential for economic fallout from the possible extradition of a Chinese business executive and domestic political uncertainty linked to the SNC-Lavalin scandal. Any of these factors could push the currency toward the upper end of our expected range of 1.30 to 1.40.

Exhibit 13: USDCAD ascending channel



Source: Bloomberg, RBC GAM

For more on our current view and outlook, please consult the full version of The Global Investment Outlook posted on our website at http://www.rbcgam.com/investment-insights/investment-outlook/index.html

A note on forward-looking statements

Global Asset Management

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