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Our currency outlook has been shifting in recent quarters away from double-digit returns for the U.S. dollar as we recognize changes in economic and monetary trends. Uncertainty associated with turns in long-term trends justifies our patient approach in calling the start of a downtrend, which, once firmly established, we expect to last for many years. Past turning points in broad dollar trends have unfolded through a process whereby the greenback makes highs versus different currencies in sequence rather than all at once. This pattern is repeating, and we see an environment that is shifting in favour of the euro and yen, while we retain a less rosy outlook on the British pound and Canadian dollar.

Global Currency Outlook

The U.S. dollar has been on the minds of many investors lately, not just currency traders. Equity strategists used its weakness as a justification of higher return expectations, and bond traders added its weakness to the long list of reasons to expect higher inflation. This keen interest is natural in the wake of a year that witnessed a 10% decline in the currency (Exhibit 1). Our currency outlook has been shifting in recent quarters away from double-digit returns for the U.S. dollar as we recognize changes in economic and monetary trends. Uncertainty associated with turns in long-term trends justifies our patient approach in calling the start of a downtrend, which, once firmly established, we expect to last for many years. Calling inflection points is a challenge: the peak in the U.S. dollar will be obvious only in hindsight, encouraging us to focus our efforts instead on individual currencies and opportunities within a shorter-term horizon.

The U.S. dollar weakness of 2017 made us review our assumptions. Over the course of the year, we recognized that the U.S. dollar's upswing was maturing but downplayed the risks of weakening because the U.S enjoyed the advantage of stronger economic growth and higher bond yields – traditionally the two main drivers of exchange rates – than other regions. Also consequential were the new U.S. administration's policies, which had the potential to boost demand for the greenback in the form of capital inflows. These three longer-term positives have fallen by the wayside due to improving economic conditions elsewhere.

Exhibit 1. Long-term cycles in U.S. trade-weighted dollar

Source: U.S. Federal Reserve, Bloomberg

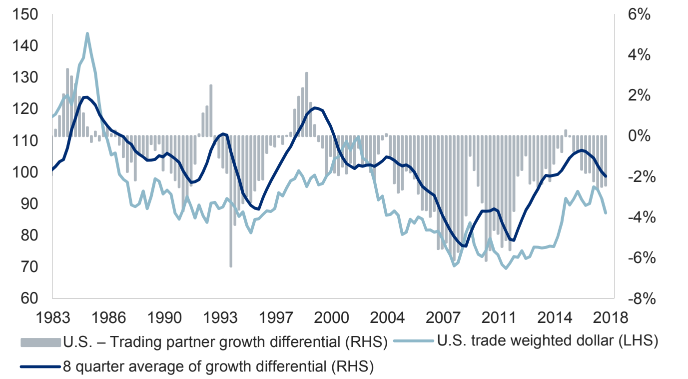
Economic growth in the Eurozone rebounded sharply last year, thanks to the stimulative effect of very cheap money, lower energy prices and a weak euro. A similar backdrop has also supported Japanese growth, and emerging-market economies have been pulled along by improving exports to the developed world. This global improvement eroded the American growth advantage, lowering capital inflows and spelling a trend of U.S. dollar weakness (Exhibit 2).

One additional consequence of the broadening global economic expansion is that central banks outside the U.S. are increasingly expected to tighten monetary policies over the next few years. The fact that this tightening will occur at a slower pace than the U.S. Federal Reserve (Fed) does not matter because financial markets have been reacting to marginal changes in policy expectations, not the level of interest rates. More recently, however, the link between interest rates and exchange rates has broken down. Exhibit 3 shows the yen overlaid on 10-year interest-rate differentials, a relationship that seemed ironclad until a few weeks ago. A similar break can be seen for other major currencies and is also evident in correlations, which have collapsed for most currency pairs. The breakdown of this link tells us that U.S. fiscal and trade concerns have been commanding investors' attention. The substantial tax cuts signed into law late last year will have a positive impact on economic growth this year and next, but present a concern for longer-term investors as the extra issuance required to fund deficits adds to the country's debt burden. Similarly, current-account deficits are not narrowing as much as hoped because reduced imports of crude oil have been offset by higher imports in other areas. Together, U.S. fiscal and current-account deficits form the "twin-sin" index, which tends to align fairly well with the U.S. dollar over longer time frames (Exhibit 4).

This is not to say that interest rates won't reassert themselves in the next few months. For one thing, we believe that the European Central Bank (ECB) is likely to tighten monetary policy more slowly than investors expect. In contrast, the Fed debate over how fast to hike rates is starting to point to a quicker pace than many had anticipated.

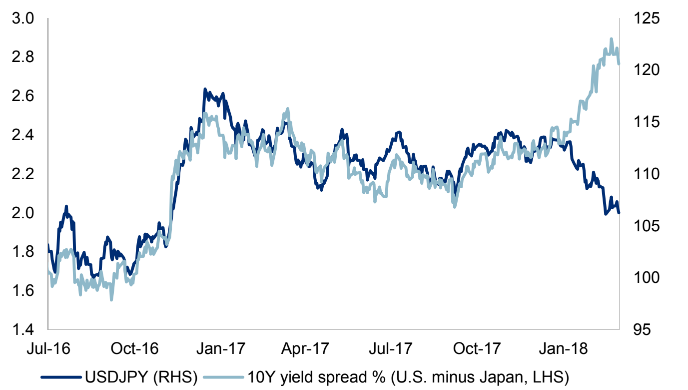
Another element that may help the U.S. dollar's fortunes, at least temporarily, is risk aversion – a topic of great discussion after the early February selloff in U.S. and global

Exhibit 2: U.S. dollar tends to track growth differentials



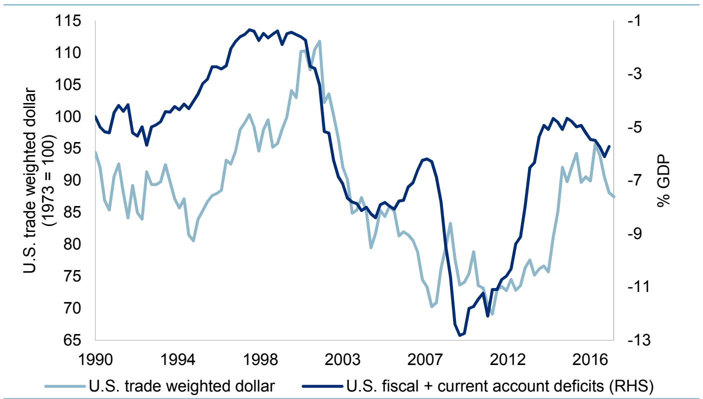
Source: Westpac, Bloomberg, RBC GAM

Exhibit 3: Breakdown in yield / FX relationship



Source: Bloomberg, RBC GAM

Exhibit 4: U.S. dollar and twin deficits



Source: Bloomberg, RBC GAM

equity markets. To quantify the safe-haven status of the U.S. dollar, we ranked 15 years of weekly data into 10 deciles, with the first decile representing weeks of poorest S&P 500 performance. Exhibit 5 illustrates that the U.S. dollar and Japanese yen showed the strongest tendencies to outperform during times of market stress while the Canadian, Australian and New Zealand dollars suffered.

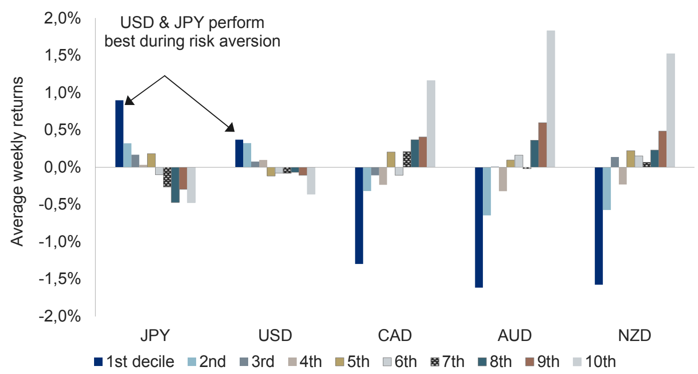
Past turning points in broad dollar trends have unfolded through a process whereby the greenback makes highs versus different currencies in sequence rather than all at once. This pattern is repeating, and we see an environment that is shifting in favour of the euro and yen, while we retain a less rosy outlook on the British pound and Canadian dollar.

Emerging-market currencies

The goldilocks economic environment that we have described, one involving synchronous growth and predictable monetary-policy shifts, has been kind to emerging-market currencies (Exhibit 6). Certainly, rising commodity prices and the year-long decline in the U.S. dollar have also helped, and the resulting gravitational pull of capital into emerging-market equities and bonds has been powerful (Exhibit 7). In truth, a bearish outlook on the U.S. dollar is not a precondition for stronger emerging-market currencies because these countries have improving fundamentals in the form of higher economic growth, falling inflation and strengthening institutional frameworks. Emerging markets also offer more attractive returns in terms of cheaper valuations, higher yields and faster earnings growth than their developed-market peers.

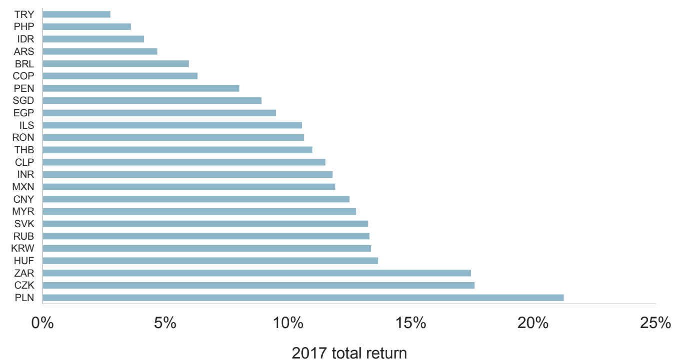
While the threat of spikes in market volatility continues to loom, emerging-market assets have been surprisingly resilient as investors are underweight and have been quick to bump up allocations on any sign of weakness, as was the case during the market rout in early February. Perhaps the more significant risks to these currencies are from domestic politics and the geopolitical sphere. The vocally protectionist stance of President Trump could have meaningful economic implications for large trading partners such as China and Mexico amid threatened tariffs on imports of Chinese aluminum and steel and heated negotiations surrounding the fate of the North American Free Trade Agreement (NAFTA). Important national elections will take place in Mexico, Brazil, Colombia and Russia in the year ahead and that uncertainty has been holding back investors' enthusiasm. In South Africa, on the other hand, a leadership

Exhibit 5: JPY & USD are clearly safe-haven currencies



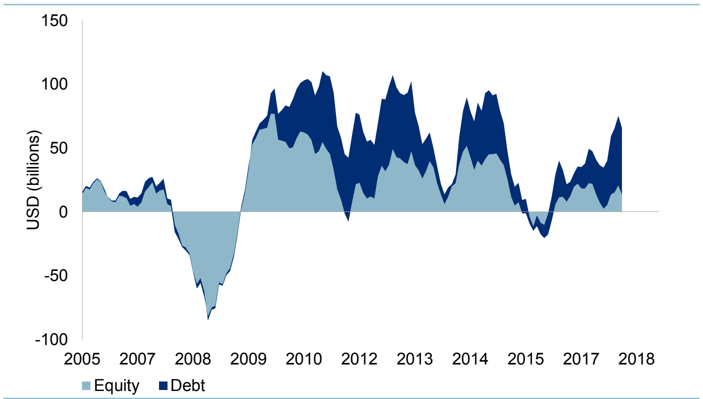
Source: Bloomberg, RBC GAM

Exhibit 6: Emerging-market currencies performed well in 2017



Source: RBC GAM

Exhibit 7: Emerging-market portfolio inflows (12-month sum)



Note: Estimated using portfolio flows for 10 E.M. countries.
Source: Bloomberg, RBC GAM

change has led to heightened uncertainty surrounding the implementation of electoral promises, which could reverse economic optimism currently priced in. A careful look at opportunities in these countries is required, and decisions must be made on a case-by-case basis.

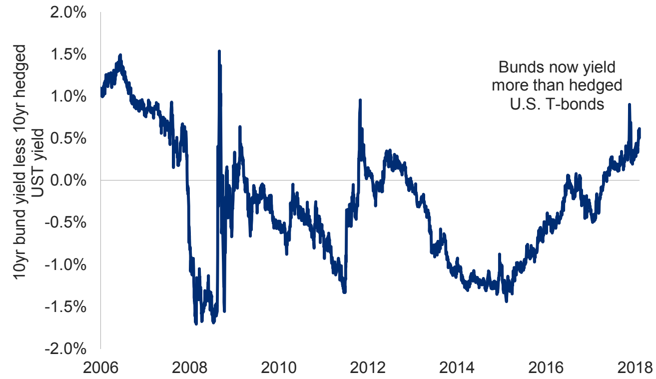
With these considerations in mind, we are rather optimistic about long-term returns from emerging-market currencies. We find them to be especially attractive for Canadian investors owing to Canada's vulnerable fundamentals. Since the Canadian dollar is sensitive to many of the same headlines as emerging markets, Canadian investors experience less volatility when owning those currencies.

Euro

In recent editions of the *Global Investment Outlook*, we pointed to European economic and political trends that had improved the outlook for the euro. These developments – stronger-than-expected economic growth and the calming of political risks after the election last year of French President Macron – are slow-moving and continue to unfold, but they have created a little too much confidence that the ECB will bring forward interest-rate hikes. As a result, domestic fixed-income investors who had been looking abroad for positively yielding bonds are now starting to find more value in European assets than those in other regions (Exhibit 8). This sentiment may also be true for non-European managers of international reserves, whose euro portfolio holdings have begun to rise, according to IMF data (Exhibit 9).

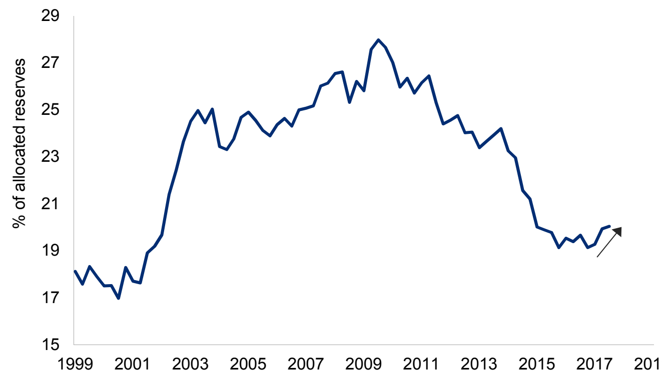
This is not to say that economic and political risks in the euro area are exhausted. Pockets of uncertainty still surround Brexit negotiations and the formation of a new government in Italy. In fact, we believe financial markets have become too smitten with a region that still has a fair share of challenges ahead. Recent economic optimism has caused a significant tightening of financial conditions, for example, as German bund yields have risen by 50 basis points from early 2017 levels and the currency has rallied 8% on a trade-weighted basis (Exhibit 10). These headwinds, alongside a rally in crude-oil prices, will act to curb economic activity in the year ahead and put pressure on the ECB to delay or slow the pace at which it is expected to hike rates in 2019. A euro trading near US$1.25 assumes too much optimism about economic and policy realities. We expect some euro depreciation as the U.S. dollar finds its

Exhibit 8: For European investors bunds now yield more than U.S. Treasuries



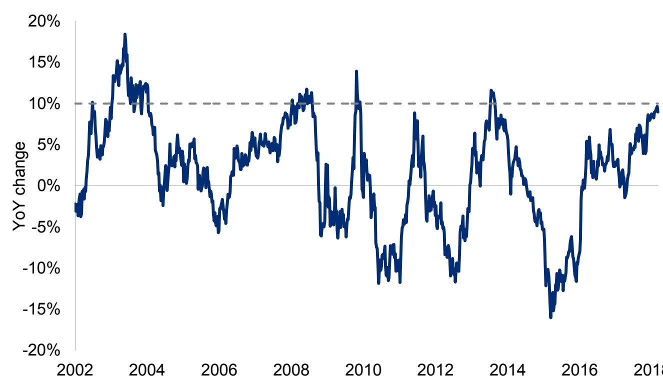
Source: Bloomberg, RBC GAM

Exhibit 9: Euro's share of global reserves



Source: COFER, RBC GAM

Exhibit 10: Year-over-year change in trade-weighted euro



Source: Bloomberg, RBC GAM

footing and expect the exchange rate to gravitate toward our forecast of US$1.17.

Japanese yen

Japan's backdrop has improved similarly to Europe's. The Japanese economy, having posted eight straight quarters of growth, may forge further gains from infrastructure investment ahead of the 2020 Olympics and from rising exports to trade partners whose economies are also growing, like the U.S. and Europe.

While signs of inflation are emerging as the Japanese economy operates faster than potential, we don't subscribe to recent speculation that the Bank of Japan (BOJ) could soon end quantitative easing. Any reduction in asset purchases has more to do with the fact that the central bank needs to buy fewer bonds to enforce its aim of keeping the 10-year government-bond yield between -0.10% and +0.10%. If anything, the re-appointment of Haruhiko Kuroda as BOJ governor to a second five-year term and selection of two new dovish members of the monetary policy committee suggest to us that the central bank will maintain its very accommodative policy stance.

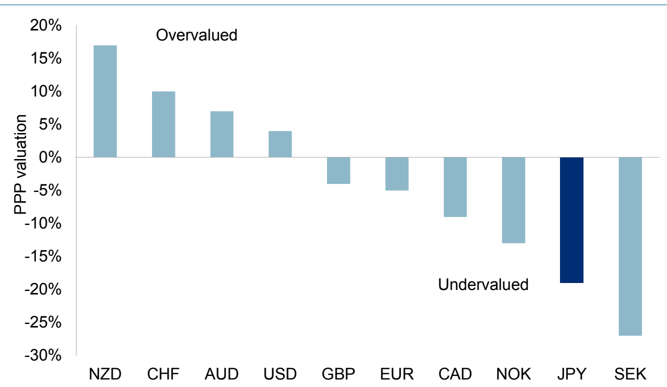
While Japanese yields are lower than in other regions, we expect the Japanese yen to appreciate slightly for two reasons. A cheaper valuation is the first. The yen is among the most undervalued of the world's major currencies, according to all longer-term models that we follow (Exhibit 11). The second is a more yen-supportive balance of capital flows. The country's substantial current-account surplus is no longer being reinvested abroad, which creates steady demand for the currency domestically as foreign trade and income proceeds are repatriated. Recognizing that the Japanese currency also benefits from risk aversion, we expect less short-term U.S.-dollar strength versus the yen than against other currencies. Our expectation is that the yen will trade within the range of 100-110 per U.S. dollar this year, and feel comfortable revising our forecast for a slightly stronger yen at 105 per dollar.

British pound

In the U.K., we are finally seeing the economic outcome that we had predicted last year. Faced with rising import prices and falling real incomes due to a weaker pound after the Brexit vote, households borrowed to maintain their spending. While such loans have been a helpful cushion to the economic impact of the vote, they represent unsustainable consumption that has essentially borrowed from future economic growth. Indeed, more than a year later, we are beginning to see a reversal of the U.K.'s fortunes as retail activity grinds to a halt (Exhibit 12). So far, financial markets have paid little attention to the evolution of this trend given that their focus sits squarely on negotiations that are to decide the future relationship between Britain and the EU. From our vantage point, these negotiations do not seem to be progressing smoothly and the scope for the U.K. to extract concessions from the EU appears limited given Prime Minister May's weak leadership position. Against this backdrop, we admit to being surprised by the resilience of the pound and to the extent to which options markets continue to ignore downside risks (Exhibit 13).

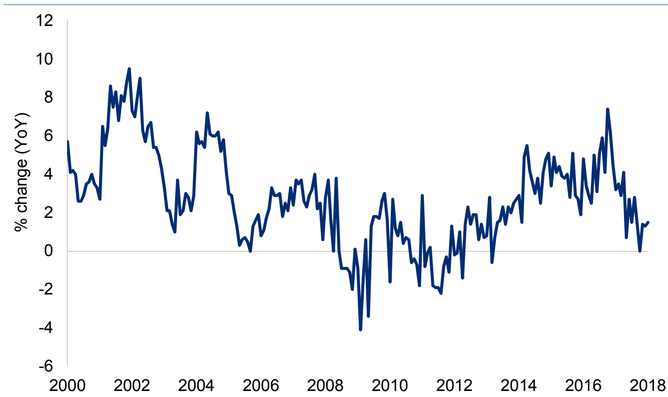
We expect the pound to underperform other currencies, whether developed or emerging, with a one-year forecast of US$1.20.

Exhibit 11: Purchasing power parity valuation



Source: RBC GAM

Exhibit 12: U.K. retail sales



Source: Macrobond, RBC GAM

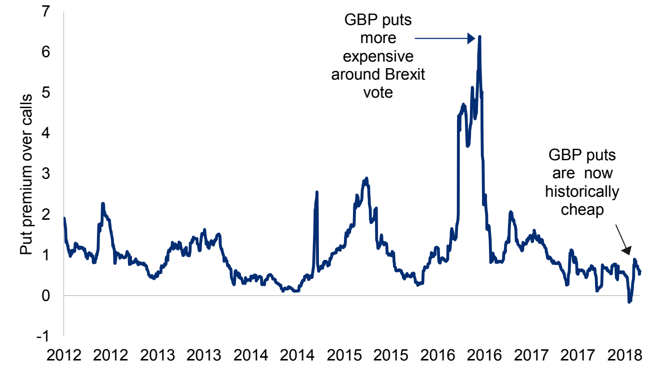
Canadian dollar

Canada has been among the fastest-growing economies in the developed world, with consumption, government spending and business investment running at a solid pace throughout 2017. That economic strength seems centred in the labour market, with an impressive 427,000 new jobs created during the year. The loonie's strength has, in part, reflected this economic strength as the Bank of Canada (BOC) raised interest rates three times from 0.50% last year to the current policy setting of 1.25%. Investors expect at least two more hikes through the end of 2018, but perhaps more important for the currency are expectations of where the policy rate will settle in the longer term. This so-called terminal rate can be estimated by overnight index swaps that estimate the 1-month yield, three years into the future. Exhibit 14 illustrates that the terminal rate for Canada is indicated to exceed that of the U.S., an argument that fails to find purchase even among Canadian dollar bulls.

We are skeptical that the short- and long-term outlooks for the Canadian economy will be strong enough to justify such a view on Canadian yields. This is especially the case in the short term in light of the uncertainty surrounding NAFTA negotiations, which are holding back businesses from reinvesting in plants and equipment. Statistics Canada reported recently that foreign direct investment dropped last year to the lowest since 2010, and another StatsCan report projects that private capital expenditures will decline 1.1% in 2018, led by the oil and gas industry. The dispute between Alberta and British Columbia over whether a proposed Kinder Morgan pipeline gets built shines a spotlight on the long-standing discount that Canada has been receiving for crude oil and will do little to restore such investment activity.

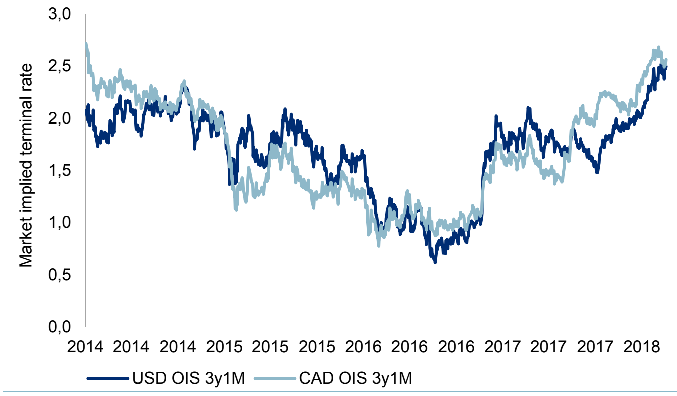
We should also be concerned about indebted Canadian households, who now face an environment of rising interest rates. We don't expect any crisis to result, but do caution that consumption, which comprises about two-thirds of gross domestic product, cannot support economic growth as it has in the past. Exports, too, will remain challenged even beyond the risks posed by NAFTA. Canada's attractiveness as an investment destination declined given higher income taxes, a diminished advantage on corporate taxes, rising minimum wages, tighter regulatory requirements and carbon levies. This development means that Canada's current-account deficit is here to stay (Exhibit 15), and could keep widening absent a decline in the loonie.

Exhibit 13: GBP puts offer cheap downside protection



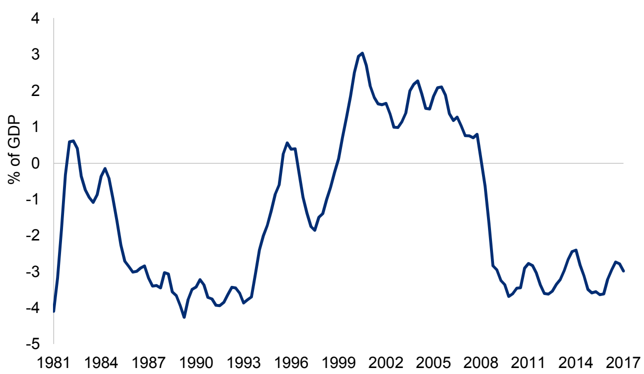
Source: Bloomberg, RBC GAM

Exhibit 14: The market expects the Bank of Canada to finish the cycle with a higher rate than the Fed



Source: Macrobond, RBC GAM

Exhibit 15: Canadian current-account balance



Note: GDP measured as a four quarter rolling sum. Source: Macrobond, RBC GAM

This scenario leaves government spending to pick up the slack, but the federal budget released on February 27 suggests that uncomfortably large deficits are already projected as far out as 2022. A much cheaper currency is part of the solution, and will help provide some relief in the event that economic activity slows. Our 12-month forecast for the loonie sits at 1.35. We expect this to be the result of near-term U.S. dollar strength combined with a more moderate BOC rate-hiking path.

Conclusion

As we said earlier calling cyclical inflection points is a challenge, they don't lend themselves easily to broad dollar up or down generalizations. We have to look more than ever at individual currencies and evaluate their shorter term prospects. Fortunately, the funds we manage allow flexibility when taking active currency positions to adjust our time horizon and size of positions to the market conditions. We take advantage of that. For example, at the stage of the currency cycle when valuations of the dollar are extreme we can have high level of confidence that prospective returns are attractive so our positions can be larger. We can have more tolerance for their volatility.

That's not the stage we are at now, we are at an inflection point in the dollar cycle. Based on our review of the fundamental and technical factors we expect the dollar to trade in a broad range over the next few months. We expect drivers of currency to rotate between deficits, interest rates and other factors. In the short term we favour tactically trading U.S. dollar long versus the Canadian dollar and sterling, while shorting the U.S. dollar versus the Japanese yen and the euro, but our confidence in predicting outcomes is lower and our position sizes are appropriately smaller. We are more tactical in our views, have lower tolerance for volatility, are quicker to take profits and cut the losses. We adjust our style to market conditions to be able to lock value added from tactical trading of currencies.

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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