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We remain bullish in our 12-month forecast for the U.S. dollar, which is benefiting from strong relative economic growth, currency-supportive monetary and fiscal policies, as well as risk-aversion caused by emerging-market challenges. For these reasons, though, the U.S. dollar has become extremely overbought in the near term and could experience a temporary pullback. That said, we continue to expect long-term U.S. dollar strength in light of Brexit, an economic slowdown in Europe and competitiveness issues in Canada. We look for a weakening in the British pound, Canadian dollar and euro, but expect strength from the Japanese yen over the next year.

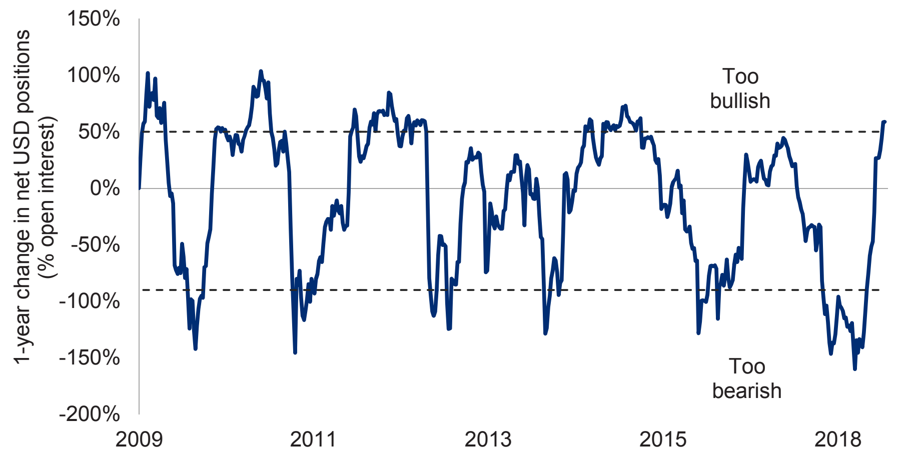
Global Currency Outlook

Too much love for the dollar?

To say that things change quickly in the currency markets is an understatement. In just the past year, the U.S. dollar has declined by 6% and then rallied by 8% – impressive swings for the trade-weighted currency basket. Even more staggering were the dollar's moves relative to individual currencies: the Turkish lira and the Argentine peso lost at least half their value while the Mexican peso lost as much as 14% before recovering. This dizzying round-about has split traders on which themes are likely to dominate the foreign-exchange discussion. Is the dollar headed up or down? What happens to the renminbi if trade wars heat up? What does contagion from emerging markets mean for developed-market currencies? And what about Europe, where uncertainty lurks because of Brexit and political disaffection in Italy? We will offer our take on these questions and explain how our team is managing currency risk through this period of elevated volatility.

We remain bullish in our 12-month forecast for the greenback, but believe the U.S. dollar could face challenges in the short term. For instance, whereas investors were overly bearish on the U.S. dollar six months ago, indicators now tell us that they are nearing the opposite extreme (Exhibit 1) – a signal that the dollar is overbought. We are struck by the intensity with which these sentiment shifts occur, but consider

Exhibit 1. USD positioning



Source: CFTC, Bloomberg, RBC GAM

them opportunities to add value in our portfolios. It is not just the overly positive sentiment toward the U.S. dollar that leads us to conclude that the dollar may fall in the short term. Trends in relative economic growth and interest rates have been among the most reliable determinants of currency movements and both are giving us reason to expect a pause in the dollar's ascent. One metric we follow suggests that improvement in economic data in Canada, the U.K. and Japan are helping to close the gap with the U.S. (Exhibit 2). While these economies may expand more slowly than the U.S., growth will be fast enough to encourage their central banks to continue tightening monetary policy. Sure enough, interest rates are beginning to reflect this reality. The gap between 2-year yields in the U.S. and the basket of its major trading partners is set to shrink. This spread will continue to attract attention in 2019 as the market anticipates interest-rate hikes from the European Central Bank (ECB) at the same time as the U.S. Federal Reserve (Fed) is seen to be nearing the end of its hiking cycle.

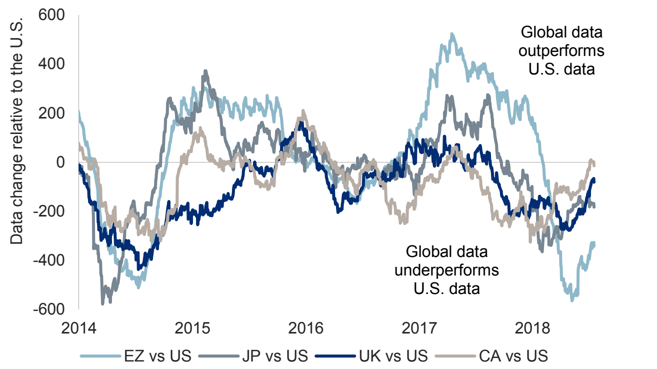
A variety of other elements factor into our forecasts, and we are left to weigh the significance of both positive and negative drivers. On the one hand, the prevailing environment of a flattening U.S. yield curve (where the difference between yields on short- and long-term bonds narrows) tends to be quite positive for the dollar, while fiscal and current-account deficits will weigh on the greenback. Another risk that could add to volatility in the short term is the U.S. mid-term elections.

In the longer term, however, we maintain our thesis that the dollar remains in its multi-year uptrend, and that the topping process that concludes this cycle will be longer and choppier than past episodes. Currency adjustments may be either sharp or protracted – and absent the extreme levels of overvaluation seen in 1985 and 2002 (Exhibit 3), we are likely to see a longer-than-average process whereby the greenback makes its highs versus different currencies at different times. This is especially true as policymakers in the U.S. are sensitive to the value of the dollar and may limit the extent to which it can strengthen.

Chinese renminbi

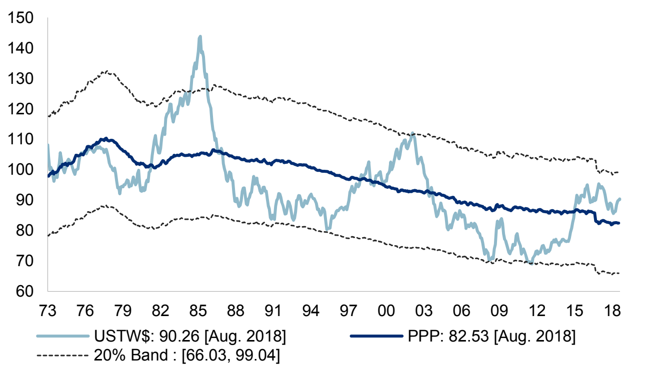
Investors have been more focused on China over the past year amid concerns over softening growth and the economic impact of trade tariffs imposed by the Trump administration. It's no secret that the U.S. wields more power in this trade battle because it imports more from China than China does

Exhibit 2: Citibank data change indices



Source: Citibank, Bloomberg, RBC GAM

Exhibit 3: USD purchasing power parity valuation



Source: RBC GAM

Exhibit 4: CNY trade weighed index

Source: Bloomberg, RBC GAM

from the U.S. China's tools for retaliating include non-tariff measures such as restricting rare-earth exports or placing obstacles on U.S. firms operating in China. But the easiest tool could be for the Chinese to gradually weaken the currency as a way to recapture the advantage lost to U.S. trade tariffs. Since late June, we've seen a 6% decline in the trade-weighted renminbi, a pace that is highly unusual for a currency that typically moves at glacial speed (Exhibit 4). A simple analysis suggests that the currency may need to fall another 3% to fully offset trade tariffs proposed so far (Exhibit 5), and we note that, while the Chinese tend to not telegraph action concerning the currency, they exercise more control over the exchange rate than other major countries. They are wary, however, of letting the currency depreciate too much for fear of causing a return of the destabilizing renminbi outflows that occurred in 2015. As a result, China may choose fiscal rather than monetary stimulus to help recover growth lost to trade with the U.S.

We do not expect another period of sustained capital outflows similar to 2015. For one thing, the Chinese central bank has done a more thorough job of restricting outflows and has been quicker to stem speculation by imposing reserve requirements on short-sellers and reintroducing measures that slow the momentum of declines. Close monitoring of the People's Bank of China will be crucial as policymakers' words and actions are important clues to whether the currency is a bargaining chip in trade negotiations.

Euro

The single currency has traded in a tight range between US$1.15 and US$1.18 for most of the summer. It's for this reason that so much attention was given to the mid-August decline to US$1.13, a move that looks to have been the final push in the build-up of dollar bullish bets. We were not among those who were selling the euro in late summer, partly because of shorter-term concerns about the U.S. dollar and partly because we see the beginnings of a more positive outlook for the European currency. We have written previously about the region's current-account surplus, a long-term flow that helps support the currency. A second positive element that may compel the ECB to abandon its dovish tack is that wages by several measures are rising at the fastest pace since 2013 and may prompt the ECB to accelerate interest-rate hikes late next year. We think that 2019 will be a year where relative monetary policy will re-assert itself as a major determinant of the direction of developed-market currencies.

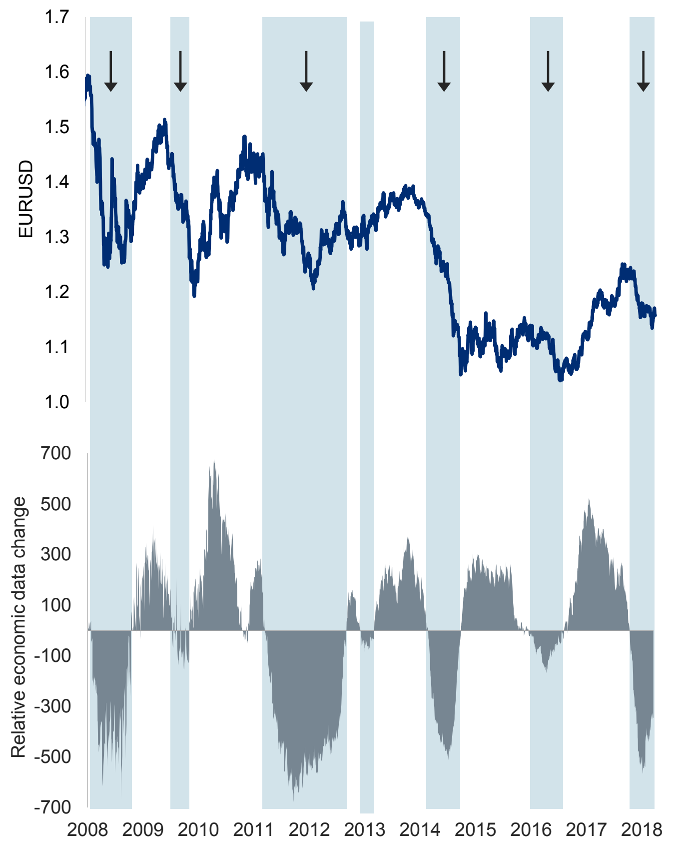
Exhibit 5: RMB weakness and tariffs

		Benefit (US$ bln)	
	Announced tariff	**U.S.**	**CHINA**
June 15	US announces 25% on 50bln (34+16bln)	12.5	
June 16	China counters with 25% on 50bln		12.5
July 10	US threatens 25% tariffs on 200bln	50	
Aug 3	China counters with 25% on 60bln		15
June-Aug	6% RMB decline affects net trade of 390bln		23.4
	Total	**62.5**	**50.9**

3% more RMB weakness would even the scales

Source: RBC GAM

Exhibit 6: Econimic data drives the euro



Source: Citibank, Bloomberg, RBC GAM

Not all is positive in the Eurozone, though. Financial markets are again grappling with heightened policy uncertainty amid tensions between Italy and the EU over fiscal spending. Yields on Italian debt spiked in May and remain elevated, reflecting the fact that pressure on the nation's banks could have damaging repercussions for the economy. More broadly, economic momentum in the Eurozone, an indicator that has reliably foretold the euro's movements (Exhibit 6), is clearly weaker than in other developed-market countries. We forecast a 0% total return from the euro over the next year, with small price gains toward US$1.17 mostly offset by the drag from negative interest rates.

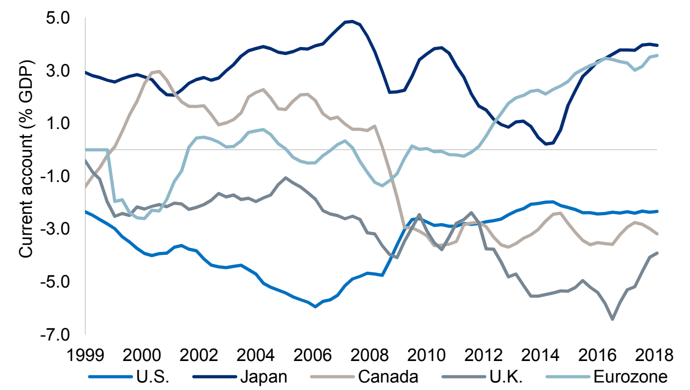
Japanese yen

We expect the yen to outperform major currencies including the U.S. dollar over the next 12 months. Not only does the currency have excellent fundamentals, but it tends to perform well during challenging market environments like the one we are in now. Part of this resilience is due to Japan's healthy current-account balance (Exhibit 7). At 4% of GDP, the surplus tops those of other major developed nations and stands in stark contrast to large deficits in Canada, the U.S. and the U.K. The fact that Japan enjoys persistently greater exports than imports suggests that the currency is undervalued, a thesis supported by valuation metrics ranking the yen among the cheapest currencies in the world (Exhibit 8).

The other part of the yen's resilience comes from its positive international investment position – the extent to which the Japanese own far more foreign assets than foreigners own in Japan. During times of market stress, Japanese investors reduce risk in their portfolios by liquidating foreign assets and repatriating funds into what they perceive as safer domestic markets. Exhibit 9 illustrates the yen's movements during periods of the best and worst S&P 500 performance, and shows that the yen tends to rally most when stocks decline.

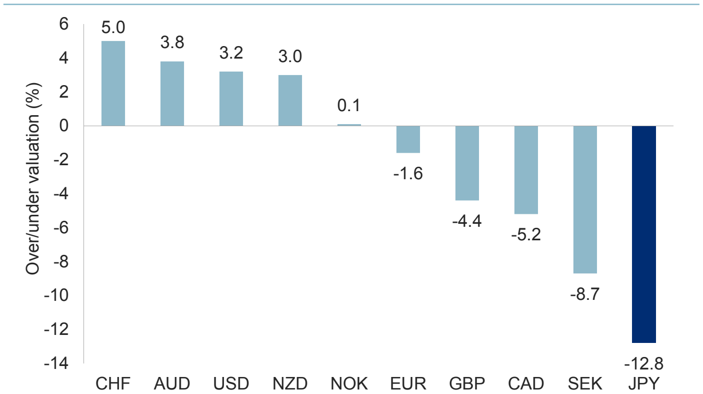
The safe-haven qualities of the yen are especially valuable now because of uncertainty on how events surrounding Italy, Brexit and global trade will unfold. What's more, the meaningful currency depreciations in Argentina, Venezuela and Turkey threaten risky assets across the globe. Signs of contagion to global banks with exposure to Turkish loans have yet to materialize, but the situation in Turkey could worsen. The deterioration in Turkey's legal and political frameworks has been extensive, and Turkey's central bank has been compromised during President Erdogan's

Exhibit 7: Current account balances



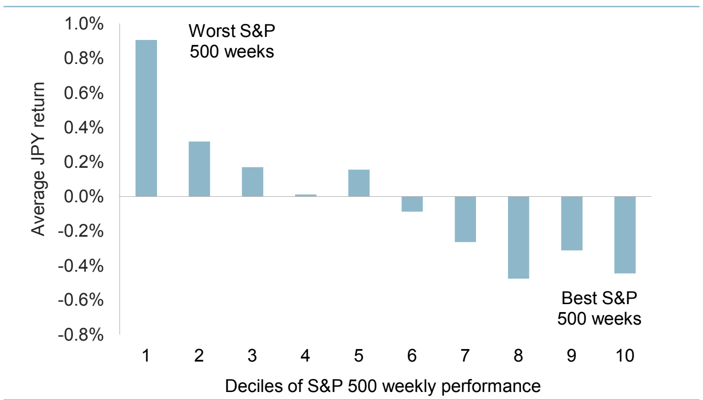
Source: Bloomberg, RBC GAM

Exhibit 8: Valuations



Note: Average of 3 Deutsche Bank models. Source: Deutsche Bank, RBC GAM

Exhibit 9: JPY performs best when stocks sink



Source : Bloomberg, RBC GAM

consolidation of power. Given that Erdogan is unlikely to buckle under U.S. pressure to return a detained American pastor, additional sanctions will likely add to the country's economic woes. We expect the yen to benefit more than the currencies of other developed markets from any emerging-market contagion. Our 12-month forecast is 102 per dollar.

British pound

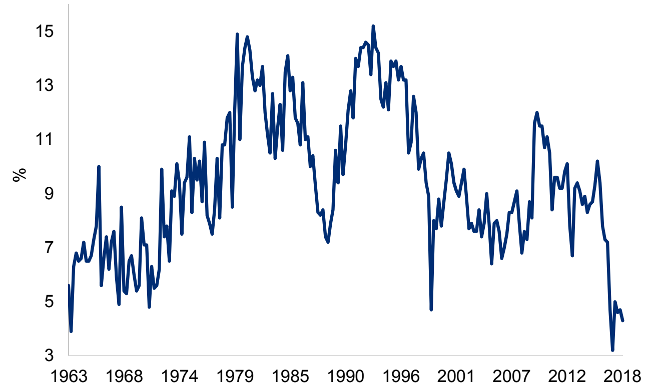
There are two main reasons why we expect the pound to underperform other major developed-market currencies. The first is a theme we've discussed before – the expectation that economic growth will lag its peers. We see good reasons for a slowdown from each of the main factors driving economic growth: fiscal belt-tightening means lower contributions from government spending; companies are delaying investment pending the outcome of Brexit negotiations; and exports have gradually been losing global market share for many decades. Consumers seem to be the ones who have buoyed economic activity, but their contribution has resulted from spending on credit rather than from higher earnings. We note the precipitous decline in the U.K. savings rate toward multi-decade lows (Exhibit 10) and wonder how consumer spending can persist, especially in the absence of the double-digit house-price gains of the past.

The second reason why we expect pound weakness is of more immediate concern. The U.K. faces some very difficult talks with European negotiators about future trade arrangements with continental Europe. While the official deadline to negotiate a Brexit deal doesn't arrive until March 2019, the more immediate timeline requires some agreement this fall so that all 27 European member states will have time for ratification. The foreign-exchange markets tend to be quite myopic about these sorts of risks, focusing on them only when the event takes centre stage. With option markets implying only normal levels of downside risk (Exhibit 11), we think there is plenty of room for the pound to fall when panic eventually sets in, before it recovers toward our 12-month forecast of US$1.25.

Canadian dollar

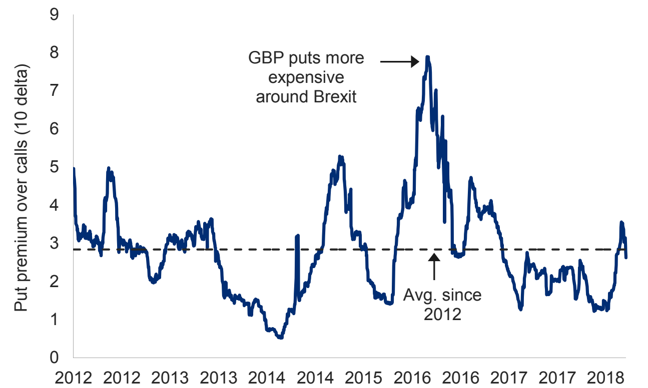
Some signs of economic improvement are starting to emerge in Canada. The country's terms of trade – the difference in prices of exports versus imports – has risen modestly over the past year with the help of higher crude-oil prices. Moreover, expectations for interest-rate hikes have been buoyed by a rebound in economic data, with Citigroup's

Exhibit 10: U.K. savings rate



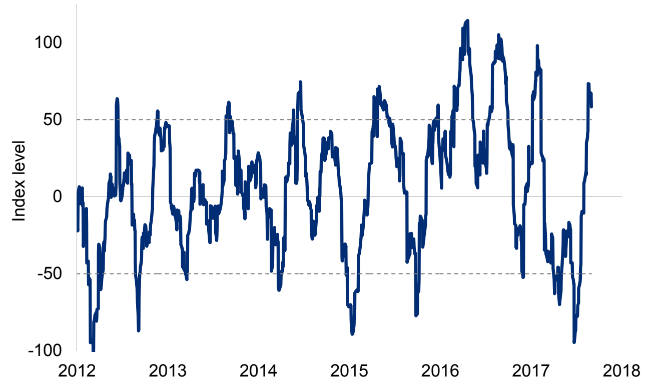
Source: ONS, RBC GAM

Exhibit 11: GBP put premium



Source: Bloomberg, RBC GAM

Exhibit 12: Citi economic surprise index – Canada



Source: Citigroup, RBC GAM

surprise index recovering toward 2017 levels (Exhibit 12). Furthermore, federal policymakers are beginning to show signs of addressing what many businesses and investors say is Canada's lagging competitiveness. Carbon taxes were watered down after being challenged by Ontario's new government, and hints that a corporate-tax cut is in store have quelled complaints from Canadian companies upset that the U.S. recently cut corporate-tax rates below Canada's.

Even with these changes, Canada is unlikely to regain its competitiveness anytime soon, especially when protecting one's trade interests is a priority for many of our international trading partners. Recent negotiations surrounding the North American Free Trade Agreement (NAFTA) are telling in this regard, as Canadian negotiators found themselves on the sidelines while the U.S. and Mexico negotiated a bilateral deal. Whether Canada joins that agreement depends on what concessions the Trudeau team is willing to grant. Given Canada's poor negotiating position, it now faces a series of unattractive options. Will Canada admit defeat by giving up protection for dairy farmers? Will it face U.S.-imposed auto tariffs, which would have far greater economic consequences? Will Prime Minister Trudeau give up on the dispute-resolution mechanism known as Chapter 19, an item on which Mexico yielded but which Trudeau has said is non-negotiable?

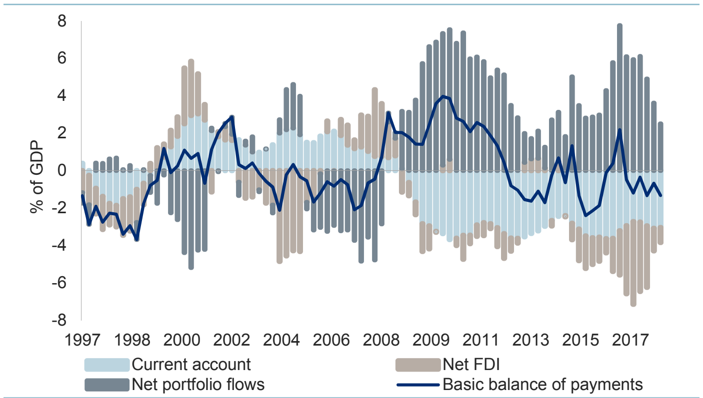
Whatever happens in the trade negotiations, we expect Canada's current account-deficit to persist. The shortfall now amounts to roughly 3% of GDP and represents a quarterly funding requirement of some $15 billion (Exhibit 13). To date, foreigners have been willing to cover this shortfall with loans to Canadian governments and corporations, but further loonie weakness will be needed to encourage an adjustment to a more sustainable balance of flows.

The median Canadian-dollar forecast of 1.24 per U.S. dollar, tracked by Bloomberg (Exhibit 14), doesn't square with the risks associated with NAFTA negotiations, our belief that interest rates will rise less than many investors expect and the continued burden of trade outflows. While our forecast is for the Canadian dollar to trade at 1.35 in 12 months, more market weakness toward 1.40 should not be ruled out.

Conclusion

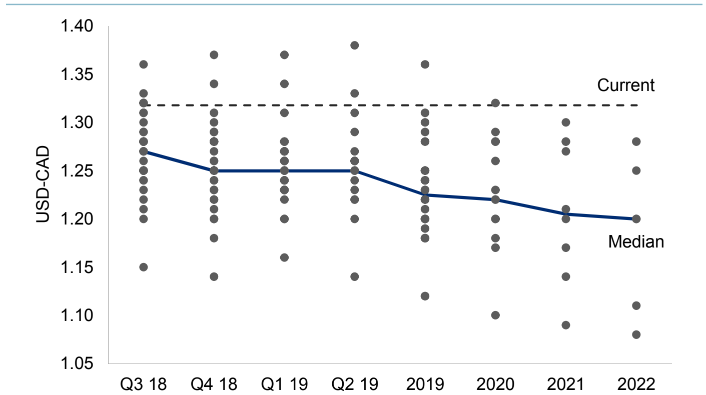
The U.S. dollar has benefited from a confluence of factors: relative economic growth, currency-supportive monetary and fiscal policies, and the heightened risk aversion stemming from emerging markets. Positioning has adjusted to reflect these positives. At the same time, Chinese currency policy appears to have shifted in August, with a pause in both currency depreciation and monetary easing, while fiscal policy is earmarked for future action if needed. As a result, we see a higher probability that the U.S. dollar could weaken in coming months. As for the longer term, we expect an extended topping process to the greenback's seven-year rally to reflect worries about Brexit, an economic slowdown in Europe and continued concerns about Canadian competitiveness. We forecast a weaker British pound, Canadian dollar and euro, but continue to expect strength from a more resilient Japanese yen over the next year.

Exhibit 13: Canada basic balance of payments



Source: Statistics Canada, RBC GAM

Exhibit 14: Investment bank forecasts for USD-CAD



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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