MARCH 2017 GLOBAL PERSPECTIVE FOR INVESTORS

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GLOBAL CURRENCY OUTLOOK

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Six years into the U.S. dollar bull market, prospects for the greenback still look relatively bright. Many long term factors are still supportive, while the other major currencies remain hampered by weaker growth profiles, less attractive interest rates and/or political uncertainty. Our forecast of single-digit gains for the U.S. dollar are tempered by what is likely the late stage of the bull market. Proposed Republican policies in the U.S. could represent a shot in the arm for the greenback and further extend this period of dollar strength.

The U.S. dollar bull market remains in full swing. Since the greenback bottomed in mid-2011, many factors have contributed to its upward path, several of which are still in place today even as the long-term cycle matures. Moreover, other currencies remain hampered by domestic factors: weaker growth profiles, political uncertainty and easier monetary policy. Our forecasts for the greenback call for modest, single-digit gains versus other developed-market currencies.

The two previous bull markets lasted six and seven years, and the increases were 67% and 43% from bottom to top, respectively (Exhibit 1). Bull markets are traditionally supported by stronger levels of economic growth and higher interest rates in the U.S. than abroad – two elements that are still supportive today. Compared with past cycles, the experience since the dollar bottomed in 2011 looks remarkably familiar (Exhibit 2). A long bottoming process started in May 2011, followed by phases of a steady appreciation, a furious rally and more recently, the establishment of a comfortable range. The current stage seems to be nearing its end with the trade-weighted dollar rising above the consolidation range.

Cycles help dictate our strategic bias on the U.S. dollar over longer time periods, while tactical risks to the U.S. dollar may come in and out of focus. At the moment, we are wary of several short-term risks to further greenback strength: the failure of economic data to continue surpassing expectations, an

Exhibit 1. U.S. trade-weighted dollar index

Source: U.S. Federal Reserve

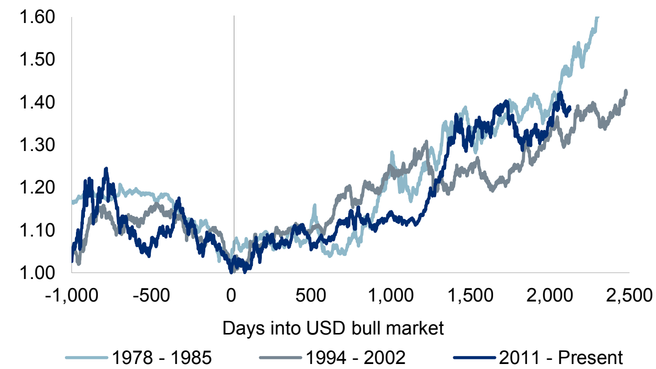
improvement in economic growth abroad and the possibility that vacant seats on the U.S. Federal Reserve's (Fed) monetary policy board will be filled by dovish members. However, it is longer-term fundamentals that drive our forecasts for the direction of exchange rates over the coming year. And it is these fundamental factors – valuations, relative monetary policies and demand for U.S. dollars – that we believe will remain supportive for the greenback this year.

While our valuation models suggest the U.S. dollar is about 10% overvalued, we should note that the greenback is correcting from an extremely undervalued position. Valuations can be estimated in a variety of ways. Our favoured measure is the simple purchasing power parity model, which evaluates whether a basket of goods is attractively priced in one country relative to another. The model assumes that both consumers and corporations setting up production facilities will seek to acquire goods and services as cheaply as they can. Theoretically, a country with a cheaper overall basket of goods should experience higher demand for its currency and thus a strengthening of the exchange rate until price parity exists between goods in both countries. In reality, factors such as tariffs and transportation costs mean that significant deviations from the "parity" exchange rate are required for broad shifts in purchasing to occur. A 20% deviation from fair value has historically marked that level (Exhibit 3). Based on purchasing power parity, most currencies tend to travel from one extreme to another over the course of several years, passing through fair value along the way. Given the U.S. dollar's current valuation, it will be necessary for the greenback to continue strengthening for the global procurement and purchasing patterns to shift.

While economic growth in the developed world has improved, the U.S. economy continues to outshine its peers. As a result, we believe that monetary-policy divergence will continue, with the Fed gradually raising rates at the same time that almost every other developed-market central bank holds interest rates near crisis lows. This is reflected in widening interest-rate differentials (Exhibit 4) in the face of the continued quantitative easing being conducted by the European Central Bank (ECB), Bank of Japan (BOJ) and Bank of England (BOE).

Finally, demand for U.S. dollars is rising, while supply is being constrained by several changes in the structure of the market. Being the world's primary reserve currency, the U.S. dollar is used extensively by foreigners as a unit of account, a means of exchange and a store of value. In the

Exhibit 2: U.S. dollar bull markets

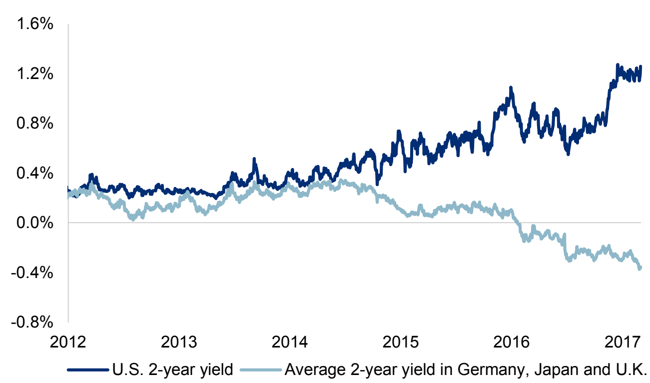


Source: Bloomberg, RBC GAM

Exhibit 3: U.S. dollar purchasing power parity

Source: RBC GAM

Exhibit 4: Wider interest-rate differentials
U.S. versus other developed countries

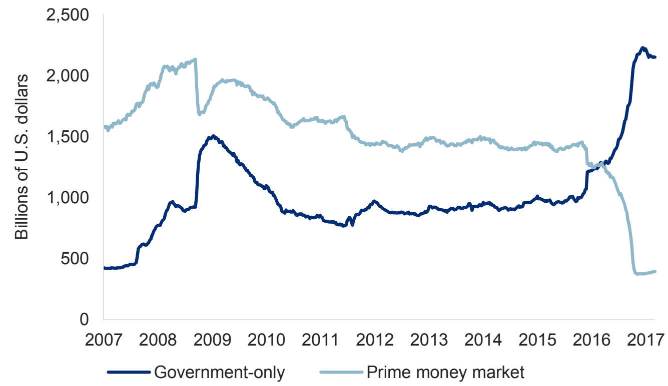


Source: Bloomberg, RBC GAM

Eurodollar market, an immense amount of borrowing and lending occurs in U.S. dollars outside American borders, and this market relies on a sufficient supply of U.S. currency to function properly. Plentiful liquidity helps keep interest rates low and grease the wheels of commerce and lending. Conversely, a lower global supply of dollars can cause a tightening of financial conditions and raise the cost of borrowing. Money-market fund reforms last fall resulted in a US$1 trillion reduction in the amount of widely-available dollar funding (Exhibit 5) that has historically supplied the Eurodollar market, and tighter U.S. financial regulation has made it more expensive for U.S. banks to make loans abroad. Supply could be further dented by a proposed corporate U.S. tax holiday, which would encourage multinational firms to bring home a growing pile of profits earned abroad. In sum, there is a growing disparity between the global supply and demand for dollars, the result of which should be a higher cost of funding and further yield support for the greenback.

Beyond these three slow-burning supports for the U.S. dollar is a fourth: policies proposed by Congressional Republicans could be a very powerful force in currency markets. Deregulation, fiscal spending, tax policy and profit repatriation all have the potential to boost economic growth or increase the attractiveness of the U.S. as an investment destination. Of particular relevance are plans to introduce border-adjustable taxation (BAT), a policy that could dramatically alter the way U.S. corporate tax is paid. Under these plans, American companies would be taxed on the value of goods imported, providing incentives for U.S. firms to move manufacturing back home. This matters for currency markets because the introduction of BAT would immediately make foreign goods far more expensive than domestic alternatives, and currencies would weaken against the U.S. dollar to restore competitiveness. There is, of course, disagreement as to whether BAT can be enacted. President Trump is wary of its complexity while others in the White House are more supportive of the plan. Our forecasts reflect this uncertainty and conservatively assume that the U.S. dollar is set to gain 5% to 10% versus other developed-market currencies over the next 12 months, as traditional drivers put upward pressure on the greenback and bold policy choices by the new U.S. administration serve to extend the cycle. Some estimates suggest that BAT could cause the greenback to strengthen by 10%-15% over a short period, an upside risk to our forecasts.

Exhibit 5: Changing composition of money markets



Source: I.C.I

The euro

We expect the euro to weaken over the next 12 months, eventually reaching parity with the U.S. dollar. Policy divergences between the Fed and the ECB will continue to tilt the outcome in favour of euro weakness. In addition, heightened political risks in 2017 will weigh on the value of the currency.

Underpinning our weaker-euro stance is the assumption that the ECB will continue to provide substantial monetary stimulus. The ECB's bond-purchase program should continue through the end of 2017. ECB President Mario Draghi has said he remains particularly attuned to downside economic risks in contrast to a more optimistic Fed, which we expect to raise interest rates gradually over the next year.

An important consideration for the ECB is the lacklustre outlook for inflation in the Eurozone. While headline inflation approached the ECB's target of 2% in January, this mostly reflects the end of year-on-year declines in energy prices. Meanwhile, core inflation is low and stable, indicating modest upward pressure on prices. In addition, while inflation expectations have risen, they have done so only modestly and remain well below the ECB's 2% target and expectations from a few years ago (Exhibit 6).

If the price of oil remains near current levels, the impact of higher energy prices should retreat quite quickly, leaving the ECB facing a tepid inflation outlook once again. The ECB has stated that it will not worry about the temporary impact of higher headline inflation due to energy prices as long as underlying measures of core inflation remain contained.

Another reason for the ECB to keep policy accommodative is the uneven performance of European economies. While Germany's economy exhibits almost no slack, major economies such as France, Italy and Spain have substantial idle capacity (Exhibit 7). We expect that the ECB will err on the side of easier monetary policy to aid the fortunes of these economically weaker members of the Eurozone.

The benefits of ECB easing and accelerating global growth could be lost on Europe if political uncertainty does not abate (Exhibit 8). Europe is saddled with a busy 2017 political calendar, with general elections scheduled in the Netherlands, France and Germany. The possibility of early elections in Italy also exists. The impact of political risk will be threefold. First, reform efforts could founder as politicians defer hard policy choices to improve their election odds. Second, consumer confidence and business investment will take a hit, impairing growth. Finally, the value of the euro will be weighed down by a higher political-risk premium.

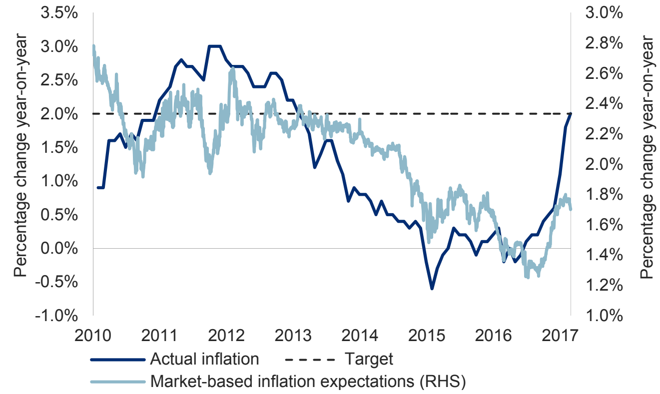
These political risks and subdued inflation suggest that the ECB will maintain its accommodative policy stance. The continued monetary easing will stand in stark contrast to the gradually increasing rates that we expect from the Fed, and this should result in a weaker euro.

The pound

The British pound has fallen 15% versus the U.S. dollar since the Brexit vote in June, and we believe sterling has further to fall. While the more dire growth predictions have not come to fruition, inflation has accelerated to a three-year high due to higher energy prices and substantial pass-through from the pound's depreciation (Exhibit 9). The BOE has indicated that it will accept a prolonged period of above-target inflation in order to offset an expected weakening of economic activity. The robust consumer spending that followed the referendum was likely driven by individuals completing major purchases before expected price increases. Going forward, we expect higher inflation to reduce the purchasing power of households and uncertainty surrounding EU exit negotiations to undermine business investment. The combination of slower growth and faster inflation bodes ill for the pound's fortunes.

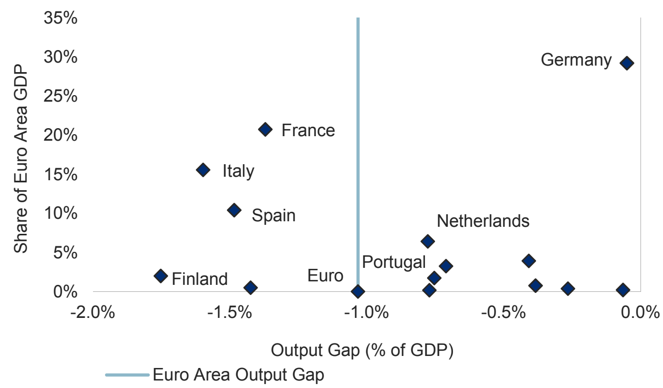
Uncertainty regarding what the U.K.'s relationship with the EU will look like after exiting will also weigh on the

Exhibit 6: Eurozone inflation and expectations



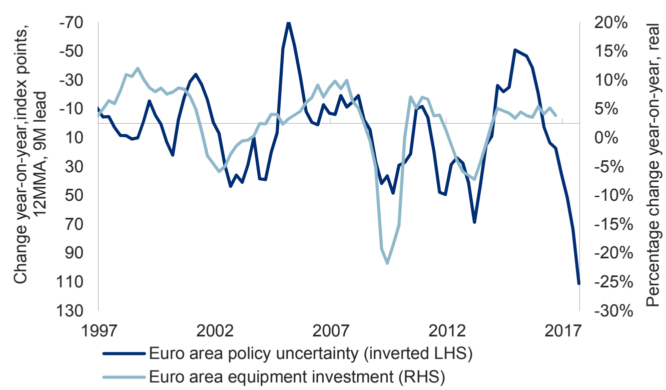
Source: Bloomberg, RBC GAM

Exhibit 7: Output gaps are still large in key Eurozone countries



Source: European Commission

Exhibit 8: Eurozone political uncertainty and business investment



Source: Eurostat, Economic Planning Unit, RBC GAM pound. The U.K. government has prioritized control over its borders, a position that may come at the cost of losing preferential access to the EU as an export market. The disruption is already being seen in the financial-services industry, a major contributor to the U.K. economy, as several large employers consider relocating personnel to Frankfurt or Paris.

Faced with the loss of access to the EU's single market, the U.K.'s attractiveness as an investment destination has almost certainly been impaired. Moreover, domestic businesses are more likely to hold off on major investments as long as the exact nature of the U.K.-EU relationship is up in the air.

With the backdrop of the unappealing prospects of lower economic growth and rising inflation, the U.K. must contend with a current-account deficit that ranks among the largest in the world. Prior to the Brexit referendum, the U.K. had managed to easily finance its current-account deficit due to its relative attractiveness vis-à-vis Europe. However, much of the deficit is relatively insensitive to currency movements and the arguments for investing in the U.K. have weakened, so a further decline in the pound may be needed to restore greater balance. We expect the pound to extend its decline to 1.15 against the U.S. dollar over the next year.

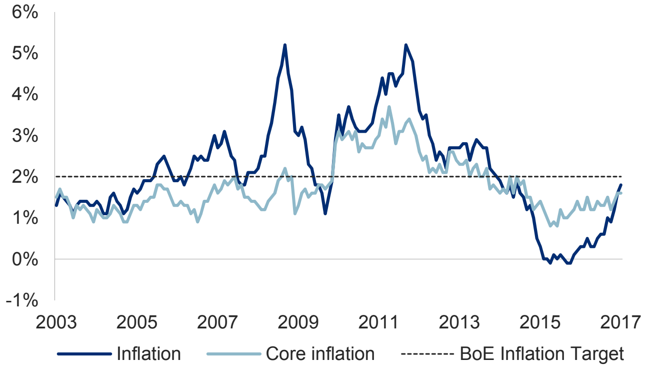
The yen

We expect the BOJ, similarly to the ECB, to continue supplying substantial monetary stimulus for some time. That's because better-than-expected Japanese economic activity has been due to improved exports rather than a domestic demand-led cyclical upturn. Meanwhile, the inflation picture for Japan remains decidedly dour. We do not expect the BOJ to change its policy stance as long as inflation remains below target – and the evolution of the yen suggests that this could be some time coming (Exhibit 10).

The BOJ last year shifted policy to focus on targeting the yield on the 10-year Japanese government bond, a policy known as "yield-curve control" (YCC). Under YCC, the 10-year yield is targeted at 0%, plus or minus 10 basis points. While the BOJ has so far kept earlier commitments to expand its asset holdings by 80 trillion yen (US$700 billion) per year, the credibility of the new program has become the overriding concern for market participants. As we highlighted in the last Global Investment Outlook, the net effect of the BOJ's framework has been to lower the volatility of JGBs and increase the relevance of monetary-policy divergence for yields and currency values. With the Japanese yield curve relatively constrained, movements in the yen have become a function of U.S. interest-rate changes. Indeed the yen has strengthened almost to pre-election levels as longer-term U.S. interest rates have fallen. This appreciation creates difficulties for the BOJ, which will now find it harder to stimulate inflation at all, let alone reach the 2% target. We believe the BOJ will need to maintain accommodative policy for some time in order to achieve its target.

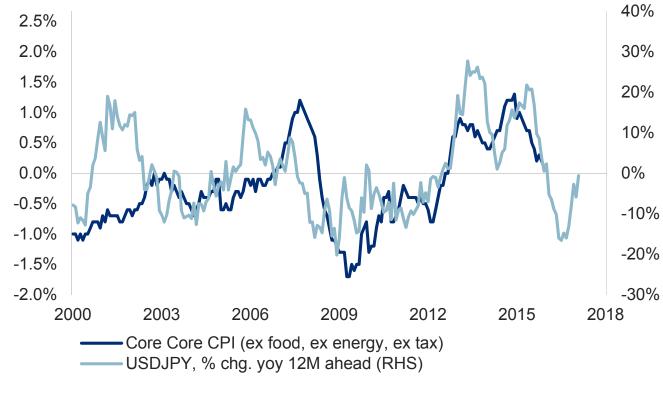
Meanwhile, we expect capital outflows from Japan to continue apace. This is important, as these outflows need to offset a sizeable current-account surplus (Exhibit 11). These flows will represent M&A activity by Japanese firms

Exhibit 9: U.K. measures of inflation



Source: Office for National Statistics

Exhibit 10: Japan inflation impulse from currency movements



Source: BOJ, Bloomberg, RBC GAM

looking for growth abroad and domestic investors seeking higher returns in foreign assets as the BOJ continues to buy substantial amounts of JGBs. In addition, rising political risks in Europe may lead Japanese investors to reroute their funds to U.S. bonds. As long as these outflows continue, we expect small depreciation of the yen, limited by the fact that the currency is already cheap.

The Canadian dollar

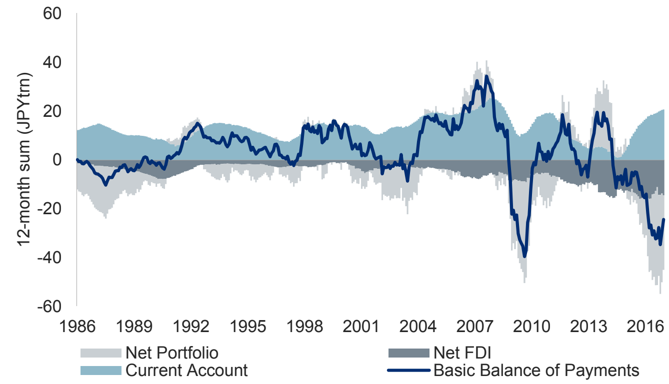
We expect that the loonie will also lose ground over the next year versus the dollar. For one thing, the Bank of Canada (BOC) is likely to keep interest rates unchanged due to a lacklustre economic outlook, while the Fed extends its round of gradual rate increases. Oil prices, while higher than a year ago, are not high enough to encourage fresh investment in the oil-dependent parts of the economy, and the Canadian housing market is reaching lofty levels, with the pace of activity unlikely to be sustained. What is more, the currency is not weak enough to boost Canadian non-energy exports. Overall, we believe the Canadian economy is set up for an extended period of relatively poor performance versus the U.S., and this will result in a weaker loonie.

While inflation has recently risen in large part due to higher energy prices, weak core inflation (Exhibit 12) suggests that there remains substantial slack in the economy. Moreover, overall gains in the labour market have been impressive, but the details behind them are decidedly less so. Since 2015, the bulk of the jobs added by the Canadian economy have been part-time positions. Wage growth has also left much to be desired. In stark contrast to the U.S., where we are seeing increased signs of a tight labour market, there is little evidence that the same dynamics are forming in Canada.

The underlying weakness in Canadian employment numbers can be explained by the situation in both oil and non-energy manufacturing. The rise in global oil prices over the past year has not been enough for high-cost Canadian oil-sands producers, which have had to reduce their reserve estimates because projects are not economically viable at current prices. While prices are high enough to cover marginal costs and keep existing production online, there will be fewer new projects that require capital and labour.

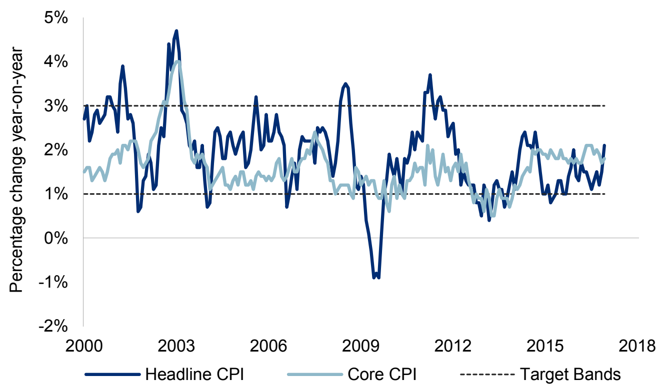
The state of affairs in non-energy manufacturing is not much better, with the decline in the value of the loonie failing so far to spur a significant surge in manufacturing activity (Exhibit 13). After several years of remarkable

Exhibit 11: Japan's basic balance of payments



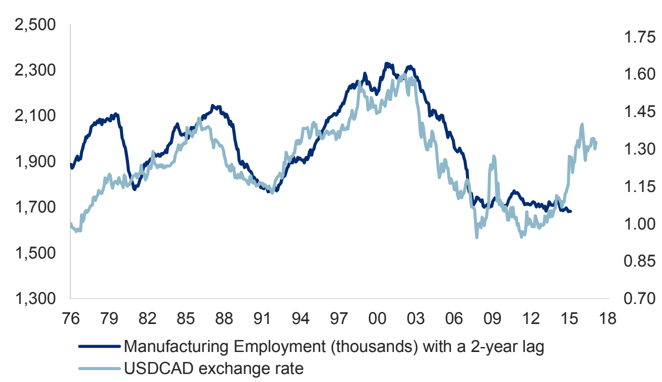
Source: BOJ, Bloomberg, RBC GAM

Exhibit 12: Canada headline and core inflation



Source: Bank of Canada

Exhibit 13: Canada manufacturing employment and the exchange rate



Source: Bank of Canada, StatsCan, RBC GAM

Canadian-dollar strength, coupled with the global financial crisis, much of Canada's manufacturing capacity has disappeared. A weaker loonie cannot provide opportunities for businesses to capitalize on new-found export competitiveness when those businesses no longer exist. Much of the production has either closed or moved to more competitive countries such as Mexico. It is important to note that as much as the Canadian dollar has weakened from its 2007 highs against the greenback, the Mexican peso has weakened much more (Exhibit 14). It will take several years of pronounced weakness in the loonie for businesses to commit to producing in Canada.

In addition to these pre-existing conditions, there are now new factors potentially eroding Canada's attractiveness as an investment destination for manufacturing. They include the increase of U.S. protectionism under President Trump and reductions in U.S. tax rates, which would eliminate the tax advantage that Canadian companies now enjoy. What is more, Canada has relative high electricity costs and stricter environmental regulations, which also figure in where businesses decide to locate. There is some hope that Canada will avoid some of the more destructive impact of U.S. trade protections if they come to fruition. However, it seems premature to bank on a renaissance for Canadian manufacturing, even with a much lower loonie, as long as President Trump is promising to renegotiate NAFTA and to aggressively promote U.S. industry.

The final consideration for our outlook is housing. While concern over the continued surge in prices for residential real estate and in household debt may keep the BOC from cutting its policy rate further, it is also true that any slowdown in the housing market would represent another headwind for the economy. The current torrid pace of housing price gains will inevitably cool either of its own volition or via the impact of increased macroprudential measures. This is not a trivial issue for the economy, as housing-related activity accounts for around 15% of GDP. In addition, as mortgage rates begin to rise, following higher bond yields, demand for housing will slow and force consumers to spend more on debt servicing and less on other goods and services.

In sum, we expect the gap between the U.S. and Canadian economies to continue to grow. Cognizant of the challenges and differences described here, the BOC will likely remain on hold as the Fed continues to hike interest rates. Widening interest rate differentials will contribute to the attractiveness of the dollar. Our forecasts call for further weakening of the loonie.

Exhibit 14: Canadian dollar and Mexican peso versus the U.S. dollar

Source: Bloomberg, RBC GAM

Conclusion

With almost six years of U.S. dollar appreciation behind us, it's only natural that we continuously question the rationale for further strength in the greenback. We note that, until recently, the bulk of the strength was fueled by external rather than domestic drivers, including at various times: fiscal tightening in Europe; the European sovereign-debt crisis; a reduction in Chinese stimulus; Abenomics and a switch to negative rates by the ECB and the BOJ. Currencies are a relative game, and the U.S. dollar had been winning mostly due to the failures of others. Within the last couple of years, domestic factors have come to the fore, such as improvement in the U.S. labour market and the related normalization of Fed policy. The already dollar-bullish setup was given a potential shot in the arm by the U.S. presidential election, with many of the Republican proposals expected to boost the economy's growth potential, competitiveness and therefore, demand for the U.S. dollar. As a result, our forecasts may turn out not to be bullish enough. They are, however, tempered by our recognition of the later stage of the cycle and by uncertainty concerning proposed U.S. economic and foreign policies.

A note on forward-looking statements

Global Asset Management

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