Foreign Exchange

US DOLLAR TO TRADE MORE DEFENSIVELY IN 2018

We are more convinced that the longer-term bull trend in the US dollar (USD) is poised to moderate or reverse following its poor overall performance over the course of 2017. While USD losses moderated into the end of last year, it closed out the year with a 10% loss versus its DXY (market-weighted) index, its weakest performance since 2003. Weak price action in the USD over the course of 2017 echoes market movement at previous, major secular USD peaks and supports our contention that medium- to longer-term risks are tilting lower for the USD overall.

The global economy continues to enjoy a broad upswing and central bank policy is becoming more active again; we think this situation will deliver a two-pronged assault on the USD. Firstly, faster growth elsewhere should draw investment flows away from the US economy, especially if US growth in the early part of the year disappoints again. Secondly, more active central bank policy elsewhere will tend to support their own currencies via higher interest rates—or market expectations thereof. We think additional pressure on the USD will stem from the perception of less political risk in the Eurozone whereas political risks may increase in the US. We also feel that the recent tax cut legislation in the US will do little to drive growth higher in 2018/19 but investors may start to focus on US structural imbalances—the USD’s “Achilles Heel”—once again. Combined fiscal and external deficits are widening and weighing on the USD’s performance which is usually bad news for the currency.

The Canadian dollar (CAD) rallied strongly in late 2017, reflecting a rebound in domestic inflation data (and markets pricing in the strong probability of a January rate increase by the Bank of Canada—BoC). CAD strength leaves us in something of a predicament as we are already at our year-end 2018 forecast point. We expect the CAD to retreat somewhat in the next few weeks on profit-taking if the BoC confirms our expectation of a rate hike (it will fall a bit further and quite a lot faster if tightening speculation is disappointed).

But we think scope for sustained CAD losses should be limited. Strengthening global growth momentum is helping bolster commodity prices and stronger commodities have helped propel the CAD higher in the last month or so. The rise in commodity prices and the resulting improvement in Canada’s terms of trade are perhaps not yet fully reflected in the CAD, we feel. Higher commodity prices may give the CAD some protection from clear risks around the outlook (NAFTA, housing, etc.) which remain obvious, if hard to quantify at this point. In other words, the CAD may not be able to rally much more for now but we don’t think it will fall too far either at the moment and expect it to remain well supported on dips overall this year.

The Euro (EUR) is trading near its highest in three years as the Eurozone economy continues to gain momentum. Recent PMI survey data suggests economic momentum has picked up to its strongest level since 2011. Inflation continues to lag, and the most recent data highlights the fact that price growth remains well below the European Central Bank’s (ECB) 2% target. However, robust economic growth suggests that the European Central Bank will wind down...
its asset purchase programme later this year regardless, even if rate hikes remain a 2019 story at this point. The past year was characterized by heightened political risk that focussed on a number of key, national elections in the Eurozone. All of these votes have passed, leaving the political centre—and pro-European consensus—largely intact. The looming Italian election, due on March 4th, had been seen as a potential constraint on the EUR but, with the major parties all backing the EUR, the risk of a significant shock has perhaps diminished. The EUR should benefit from capital being redeployed to Europe and global investors rebuilding exposure to the single currency again as political risks subside.

The pound (GBP) remains generally soft but has sustained a steady rise versus most major currencies, excluding the EUR, over the past year as the Brexit fall-out has been less severe than imagined in the immediate aftermath of the 2016 vote. Still, the economy is hardly robust; consumer demand and housing are two key sectors of the economy that look somewhat fragile amid weak real wage gains. UK inflation has been rising, partly due to the weak exchange rate, forcing the Bank of England (BoE) to tighten monetary policy modestly. We think further, modest rate increases are likely in 2018 to keep inflation in check but Brexit risks are likely to restrain the pound and uncertainty may still force the exchange rate back from current levels versus the USD. We maintain, however, that a pronounced drop in the GBP would leave the currency looking somewhat stretched in terms of its longer-run valuation.

We are bearish on the yen (JPY) and expect it to remain a relative under-performer in the major currency space this year. The JPY will remain vulnerable to firmer nominal yields elsewhere as we do not expect the Bank of Japan (BoJ) to alter its aggressively accommodative policy stance through 2018, given that domestic inflation at 0.6% remains very distant from the central bank’s objective. Stronger global growth, rising global equity markets and a pervading sense of risk-seeking investment strategies suggest that “safe haven” demand for the JPY will remain muted for the moment as well.

Strengthening global growth trends are supportive of Asian Emerging Market FX broadly but regional central banks will be conscious of the need to remain regionally competitive with each other as exports recover. Strong current account surpluses are supportive of the Korean won, Thai baht and Taiwan dollar while rising export growth is supportive of the Malaysian ringgit, which we feel remains undervalued in nominal and real effective terms. We expect the Chinese yuan to rise modestly this year on rising foreign interest in yuan-denominated assets while high yields leave the Indonesian rupiah looking attractive. Markets appear to have discounted India’s weaker fiscal position as recovering growth momentum supports the rupee. With the USD expected to remain on the defensive, Asian regional central banks may have to become a little more active in managing domestic currency appreciation in 2018. FX reserve accumulation may add more support to the EUR in the coming year as FX purchases are diversified into other currency holdings. We expect the Chinese yuan to trade narrowly around current levels in the early part of this year and appreciate modestly over the balance of 2018 towards 6.45 versus the USD.

The Mexican peso (MXN) ended 2017 on a soft note, falling back to near the 20 level amid continued uncertainty over trade relations with the US and the impact of US tax reform on domestic growth. Upward pressure on inflation should abate somewhat in early 2018 but markets continue to price in the risk of tighter monetary policy. However, in Mexico—and other regional economies—political developments are poised to influence exchange rate developments significantly in the coming year. Polling suggests the main candidates for Mexico’s July presidential election are in a three-way tie at the moment. We expect the MXN to remain largely stable through 2018, however. We anticipate modest appreciation for the Peruvian sol (PEN) though domestic politics does inject some downside risks to the growth outlook which is somewhat contingent on public investment; we see USD/PEN ending this year at 3.18. We expect the Chilean peso (CLP) to remain firm this year amid strengthening domestic growth and firm copper prices. Markets may also be influenced by the shape of incoming President Pinera’s government. Pension reform and October’s presidential election may keep the Brazilian real trading more defensively this year, however.
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 in 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.

™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.