AMERICAS

The USD will maintain an appreciating bias in 2016. Strengthening economic fundamentals, monetary policy shifts and commodity price adjustments will support broad-based USD appreciation. Both the CAD and MXN will retain a defensive tone in the early months of the New Year. A deep crisis in Brazil limits BRL recovery prospects.

EUROPE

The EUR will continue to weaken in 2016. Growth and interest rate differentials will continue to weigh on the single European currency, as the ECB intensifies its accommodating stance. The GBP may face adverse headwinds in connection with the referendum on EU membership. The prolonged weakening phase affecting the RUB will likely end in the first half of the year.

ASIA-PACIFIC

The CNY will retain a depreciating bias in 2016. Commodity price shifts and Chinese growth prospects will impact AUD trends in the near term. The JPY may reverse its strengthening trend once China-centered financial market volatility subsides. The developing Asia FX market will be strongly affected by developments in both China and Japan.
Core Exchange Rates

Global Foreign Exchange Outlook

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<th>January 5, 2016</th>
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Graphs showing the exchange rates for EURUSD, USDJPY, GBPUSD, USDCAD, AUDUSD, and USDMXN from January 2011 to January 2016.
Uneven global growth, sustained USD strength, bearish commodity price dynamics, persistent stress in high yielding corporate
debt markets, disruptive financial market developments in China, and escalating military upheaval in the Middle East
(particularly in the energy-rich nations) are key factors shaping investor sentiment in global foreign exchange markets at the
beginning of the year.

We remain constructive on the outlook for the USD through 2016. The USD ended 2015 with a 9% rise versus the major
currencies, its third consecutive annual gain. We think the USD will strengthen further in the coming months but the “easy”
money being long USD has already been made. As the rally enters the mature stage of the cycle late in 2016, the trending
nature of the USD rally may turn into a choppier and more volatile phase of movement that is more typical of market trend
transitions. The United States remains the G7 growth leader and the economy has seen a marked structural improvement in
recent years (stronger labour market, lower deficits). Stress in the high yield corporate debt market underscores the fact that
problems remain, however.

The Fed has successfully initiated policy “lift off”. However, there is still a clear split between the Fed’s rhetoric “gradual pace” of
tightening (four increases of 25 bps this year) and what the market expects the Fed to do (just two increases). We feel there is
more mileage in the policy divergence story for the USD in the year ahead as the market will have to adjust to the Fed’s
schedule.

The outlook is subject to risks. If the US economy stumbles in the first quarter, as has been the case regularly since 2010,
current market pricing for Fed tightening will look vindicated prompting the USD to slide somewhat. Disappointing growth in the
US may strengthen the case for easing elsewhere, however, so it is not obvious that the USD would weaken significantly or for
an extended period. The US economy has typically recovered well from Q1 growth worries.

The Canadian dollar (CAD) is liable to weaken further in 2016, although a lot of bad news is already factored into the exchange
rate. The CAD dropped more than 16% against the USD in 2015 and has fallen more than 30% over the past three years. Low
oil prices and sluggish domestic growth will count against the CAD in the coming year but we think longer-term investors may
start to see the CAD as offering better value if spot reaches the 1.42/1.45 range in the next few months. Seasonally, the weak
points of the year for the CAD are January and October/November. The highs we see in USDCAD in Q1 may represent the high
-tide mark until year-end.

The Latin American exchange rate universe retains a weak tone. The Mexican peso (MXN) may be subject to intensified
volatility as non-resident investors in local-currency securities assess their views on the US interest rate outlook. The Brazilian
real (BRL) will continue to weaken on the grounds of intensifying political risk, accelerating inflation and deep recessionary
conditions, yet the bulk of the depreciation has already occurred. Commodity-linked economies are subject to escalating
currency market stress and low investment dynamics. Indeed, depressed copper and oil prices will weigh on the Colombian,
Chilean and Peruvian currencies for longer than previously anticipated.

The euro (EUR) will continue to weaken in 2016. EURUSD’s strength through December reflected late-year profit-taking and
position adjustment after the ECB policy meeting rather than any significant change of view on the EUR outlook. Rising US
interest rates have widened Eurozone-US interest rate differentials to 140 bps at the short end of the curve (2-year government
bonds), the biggest yield advantage for the USD since 2006. This represents a source of significant support for the currency.
Our fair value estimate for EURUSD, based on spot regressions with spreads and relative equity market returns, suggests
EURUSD should be trading around par now. We target 0.95 over the course of 2016.

We expect the British Pound (GBP) to continue to weaken against the USD but hold up relatively better against the EUR.
Slightly weaker than expected UK growth and persistently low inflation implies the Bank of England is under no immediate
pressure to tighten monetary policy, however. The “Brexit” issue remains a significant downside risk for the pound in 2016.

The Asian FX market will be strongly affected by developments in China. The risk of disruptive financial market volatility as a
result of erratic policy shifts (as experienced last August). We are of the view that the Chinese renminbi (CNY) will maintain a
defensive stance in 2016. The Japanese yen (JPY) may also be affected by Chinese market/policy developments. USDJPY
ended 2015 very close to where it started the year — around 120 — suggesting that the significant sell-off in the JPY seen over
the previous three years has stalled to some extent. We still think risks for USDJPY lie to the topside over the coming year,
given our outlook for higher interest rates in the US and low and stable rates in Japan while regional currency weakness may
add to JPY headwinds in 2016.
Canada
Currency Outlook

The CAD was the worst performer among the G-10 currencies through Q4 2015, weighed down by firmer US interest rates (and wider interest rate differentials relative to Canadian bonds), weaker oil prices and sluggish domestic data. The CAD sell-off extended further than we expected late last year, leaving USDCAD starting off 2016 about where we thought it would end this year.

At this point, we are reluctant to chase the market and alter our forecasts for the year overall. The risk is clearly geared towards more CAD weakness in the next few weeks, however, as the negative factors noted above remain intact, supporting the USD and undermining the CAD. For example, interest rate differentials for US/Canada 2-year government bonds have widened to around 60bps, the biggest yield advantage for the USD since 2007. While spreads remain wide, or widen further, the USD is unlikely to backtrack.

Historically, in fact, there is a clear tendency for USDCAD to strengthen significantly in the early stages of the calendar year before moderating. We think this is perhaps going to be the case this year. Gains towards the 1.42/1.45 range would not surprise before the end of Q1 but the “average” pattern of trade for USDCAD over the past 25 or so years would then see the USD move sideways and consolidate through Q2/Q3 at least.

We continue to favour USDCAD long positions from a short-to-medium term perspective but we also think the CAD is starting to look relatively attractive against some of its major currency peers where relative monetary policy (EUR) or value (AUD) considerations suggest the CAD looks a little more attractive now.

The Bank of Canada is expected to remain on hold at the late January policy meeting. But weak growth momentum and last year’s rate cut surprise likely mean the market will approach the decision cautiously and the CAD may still find itself slipping if the central bank sounds dovish in its outlook for the economy.
United States and Canada

Fundamental Commentary

UNITED STATES — The US economy is showing healthy momentum heading into 2016. While recent reports have been somewhat mixed, consumer spending and housing activity remain well supported by pent-up demand, a robust job market, rising income gains, solid household balance sheets, cheap gasoline prices, and low borrowing costs. Ongoing hiring gains, led by construction and services, have pushed the unemployment rate to a seven-year low of 5.0%, and alternative measures of labour market underutilization continue to improve. Consumer confidence softened a bit toward year-end, but remains relatively firm, and buying intentions are still solid. Motor vehicle sales are running at record levels, and retailers are reporting solid holiday sales. A gradual easing in lending conditions, low mortgage rates and strengthening household formation are underpinning home sales and residential construction, though affordability pressures are beginning to emerge. Non-residential construction is showing broad strength across industrial and commercial sectors. The overall momentum in industrial activity remains soft amid the retrenchment in oil & gas drilling, inventory readjustments and sluggish export sales. US dollar strength and moderate global growth are weighing on export activity, though solid domestic sales should maintain expanding manufacturing production, led by motor vehicles, home furnishings and consumer electronics. Capital goods orders continue to point to restrained business investment plans, held back by the retrenchment in the energy and mining sectors. Services activity is reporting broad-based expansion across a range of industries, including real estate, finance, utilities, and wholesale and retail trade. The US economy also is getting a lift from a pickup in local and state government spending, and a reduced pace of federal fiscal restraint. Core inflation has edged up to a still muted 2.0% y/y, with firmer services price trends tempered by lower import costs. Headline US inflation is likely bottoming, and is expected to drift back toward core inflation in 2016.

CANADA — The Canadian economy has sputtered following the contraction in the first half of 2015. Output rebounded in the third quarter, driven by exports and residential investment, but trade flows have softened once again and commodity prices continue to weigh on the mining and oil and gas industries. Full-year growth likely averaged around 1¼% in 2015, alongside weak global demand and business investment. Despite slow growth last year, the labour market added jobs at a moderate pace, with positive momentum in services and construction more than offsetting weakness in resources and manufacturing. However, recent business confidence surveys have indicated a broad downturn in hiring intentions moving into 2016, which may temper job gains going forward. Vehicle sales are at record highs, and auto production has picked up after an extended period of retooling in the first half of 2015. Consumer spending has been supportive of growth, but Canadians are expected to be relatively cautious spenders in the year ahead in the face of weak wage growth, soft consumer confidence and elevated household debt. Manufacturing will likely improve with an increasingly competitive Canadian dollar and rising auto sales and residential construction south of the border. Business investment remains muted with energy sector cutbacks and moderate sales growth weighing on capital spending plans, though infrastructure investment will increasingly provide support. Despite the sharp decline in energy prices, headline inflation remains around 1%, well above most other advanced nations. Core inflation is running just over 2%, reflecting the pass-through of a weaker Canadian dollar on imported goods.

Monetary Policy Commentary

UNITED STATES — We forecast that the Federal Reserve will increase the federal funds rate four times in 2016, leaving the federal funds rate sitting in a range of 1.25-1.50% at the end of the year. We expect that the Federal Reserve will continue reinvesting maturing principal from Treasuries, MBS, and federal agency securities throughout 2016. The main risk to our forecast seems to be skewed to the downside, i.e. that the Federal Reserve might raise rates fewer than four times in 2016 should the economy underperform its forecasts. That said, even if the Federal Reserve pauses its interest rate increases at some point as a result of weakness in economic data, as Fed Chair Yellen has said, “gradual does not mean mechanical”; even were economic data to deteriorate leading to uncertainty about the economic outlook, the Fed could well choose to pause and then catch up later as uncertainty decreased, for instance.

CANADA — We continue to forecast that the Bank of Canada will maintain its overnight rate at 0.5% throughout 2016 – even as the Federal Reserve raises the federal funds rate. The main logical premise of our forecast is that economic growth will likely remain subdued in Canada, and the BoC will thus be reticent to tighten financial conditions and potentially risk increasing the output gap by dampening growth. The main risk to our forecast seems to be to the downside, i.e. that the BoC may elect to decrease the policy rate further if the economy materially underperforms its forecasts for growth and inflation. Still, we’re wear about forecasting an interest rate cut because the BoC may choose to keep some powder dry given housing/consumer risks as well as international risks.
G10 Currency Outlook

EURO ZONE — EUR appears most vulnerable to sentiment and positioning in an environment of elevated uncertainty as we consider the sizeable CFTC net short ($22.1bn as of Dec 22, 2015) and EUR’s role as a funding currency. Conflicting fundamentals and sentiment have left EUR trading well above levels implied by interest rate differentials, and thus vulnerable to weakness in the event of an improvement in the broader market tone. We maintain expectations of EUR weakness and hold a Q4 2016 forecast of 0.95.

UNITED KINGDOM — GBP has entered 2016 with a weakening bias, trading at fresh multi-month lows while maintaining the downtrend that prevailed through the latter half of 2015. Trend and momentum indicators are decisively bearish, and we note the absence of significant support ahead of the April 2015 lows around 1.4550. CFTC data detail a net short $2.5bn position as of December 22nd, with ample space for a build toward the wider levels observed in 2015. We hold a year-end 2016 GBP forecast of 1.44.

JAPAN — JPY has rallied into 2016, trading at multi-month highs with gains driven by risk aversion and safe haven flows in an environment of elevated uncertainty. Sentiment remains the primary driver for JPY, providing for periodic knee-jerk rallies in stark contrast to weakness implied by interest rate differentials. Measures of JPY sentiment are closer to the narrow end of their one year range, leaving JPY vulnerable to weakness in the event of a rebuild in bearish positioning. Technically, USDJPY appears well supported above 118 with resistance seen above 123.50. We hold a year end 2016 USDJPY forecast of 131.

NORWAY — NOK is under renewed pressure, entering 2016 at fresh lows not seen since early 2002. Oil prices continue to provide for weakness, with added risk from sentiment as market participants consider a shift toward intervention among Norway’s Scandinavian peers. USDNOK is rapidly approaching 9.0000, with no significant technical resistance levels ahead of the October 2000 high around 9.6000. Momentum indicators remain an ongoing concern, as we consider their failure to confirm much of the 2015 rally in USDNOK. We hold a year end 2016 USDNOK forecast of 9.00.

Eric Theoret
416.863.7030
eric.theoret@scotiabank.com
EURO ZONE — The euro zone economic recovery is expected to continue to gain momentum in 2016, with real GDP growth rising to 1.7% from 1.5% in 2015. The contribution to growth could ease from consumer spending as tailwinds from low energy prices fade and from net exports amid slower emerging market growth and stronger domestic demand boosting imports. However, this is forecast to be counterbalanced by a pick-up in business investment, which remains roughly 15% below its pre-crisis level, underpinned by improving corporate sentiment, profitability, credit conditions, and rising capacity utilization. Further support should come from the cautious recovery in residential and public investment at a time when economic output is expected to be buoyed by the influx of refugees and a modest pick-up in government spending. Nevertheless, high public and private sector debt, elevated unemployment, and structural rigidities will continue to weigh on the outlook. Despite the generally positive growth picture, euro zone inflation remains stubbornly low at 0.2% y/y and well below the European Central Bank’s (ECB) target of close to, but below, 2%. Given the recent strengthening of the euro and the weak oil price outlook, inflation expectations have edged lower, with the headline HICP print forecast to rise only gradually to a year-end rate of 1% y/y in 2016 and 1.6% in 2017. In this context, the ECB will likely maintain record low interest rates until early 2018 at a minimum and will run its asset purchase program of €60 billion per month until at least March 2017. The ECB could be forced to do more if inflation dynamics continue to disappoint.

UNITED KINGDOM — The UK economy should continue to maintain decent growth of just over 2% this year, down from an estimated 2.2% in 2015 and 2.9% in 2014. Growth in consumer spending is expected to remain supportive, but will likely ease in the second half of the year as real income gains slow on the back of gradually rising inflation. Meanwhile, despite the smoother path of deficit reduction in the Autumn Statement, fiscal tightening will also remain a drag on growth, which will be exacerbated by prospects of higher interest rates and the EU referendum. The timing of the first Bank of England (BoE) rate hike has been pushed back persistently in recent years. The proximity of headline inflation to zero has been the biggest obstruction, but so too has the lack of wage inflation. Both should become more favourable over the coming year, helping to pave the way towards the first BoE rate hike and a gradual pace of monetary tightening thereafter. We believe that the first hike will arrive in the second quarter of 2016 — sooner than the markets’ current assumption of end-2016/early 2017. The UK’s in-out referendum on its EU membership will likely generate significant uncertainty and weigh on business sentiment and investment in the run-up to the likely summer vote. Prime Minister David Cameron has voiced optimism that a deal could be secured by the end of February, which could lead to a vote as early as June. The main sticking point remains Cameron’s determination to prevent citizens of other EU countries from accessing social benefits for four years.

JAPAN — Japan’s economic performance remains subdued despite Prime Minister Shinzo Abe’s enduring efforts to revive the economy. Nevertheless, revised data show that the economy has avoided another technical recession; real GDP grew by 0.3% q/q (+1.7% y/y) in the third quarter, following a 0.1% q/q contraction (+0.7% y/y) in the April-June period. The government’s supplementary budget will provide short-term support to the economy; in mid-December, the Cabinet approved a ¥3.5 trillion additional spending package for the ongoing fiscal year (April-March). New debt will not be issued for financing the extra budget as it will be funded by tax revenues. An ultra-accommodative monetary policy stance will remain in place for the foreseeable future; however, further stimulus in the form of quantitative easing is unlikely. Monetary authorities remain confident that the Bank of Japan’s price stability target of 2% y/y will be achieved with the help of the current asset purchase program, which is set to increase the monetary base by ¥80 trillion annually. According to policymakers’ estimates, inflation will reach the target between October 2016 and March 2017. However, in our view price pressures will remain more muted until April 2017 when the second hike in the consumption tax rate (from 3.5% y/y in November, though core inflation — excluding food and energy — has picked up to 0.9% y/y. We expect the headline rate to accelerate gradually to 1.0% by the end of 2016.

NORWAY — Norway entered into the crude glut with solid fundamentals and has weathered the oil price collapse relatively well. Seasonally adjusted real GDP growth accelerated to 1.8% q/q (3.1% y/y) in the third quarter of 2015 from a virtual standstill in the first half of the year. The economy received a boost from surprisingly strong performance in petroleum activities and ocean transport, which expanded by 9.7% y/y in Q3. Household consumption held up well (up 2.2% y/y) while gross fixed capital formation remains a drag (down 3.4% y/y) in the back of project deferrals. Norway’s unemployment rate ticked up slightly in October to 4.6%; while enviable relative to most European peers, unemployment has been trending higher since a recent low of 3.2% in April 2014, before the oil price began to fall. In an attempt to aid the ailing economy, the Norges Bank lowered its benchmark interest rate by 25 basis points in September to a record-low 0.75% and central bank Governor Olsen has indicated that further cuts may be justified as the country’s growth outlook darkens. Inflation rose to 2.8% y/y in November from 3.5% y/y in October. Norway’s current account surplus slipped slightly in the third quarter, to 8.9% of GDP from 9.1% in Q2. Norway has long discussed the need to diversify its economy away from a dependence on oil-related revenue, but little progress was made before global oil prices began tumbling. Crude oil production has fallen to roughly 2 mbpd (down 45% relative to its mid-2001 peak), but recent discoveries should allow the country to maintain output around current levels.
BRIC Currency Outlook

BRAZIL — December news-flow was bad for Brazil: we saw the country lose its investment grade rating by a second agency (Fitch downgraded the country to junk, following the earlier action by S&P), while FinMin Levy quit his position after failing to avert a credit rating downgrade as the country’s fiscal stance continues to deteriorate due to large spending rigidities – which protect as much as 90% of spending items. Worryingly, we don’t yet see a credible plan to regain market confidence. The BRL was the second worst performing major FX in 2015 (-32.9%), only outperforming the ARS (-35.5%).

RUSSIA — The Russian ruble (RUB) has faced significant weakening pressure against the US dollar (USD) on the back of oil price weakness, ongoing economic challenges and rising political tensions. USDRUB is forecast to end 2016 at 69.0.

INDIA — The INR edged up against the USD in December and outperformed regional peers. We expect this trend to continue in the month ahead and would buy the INR funded by the low-yielding TWD or SGD. The nation’s FX reserves may decline slightly further on account of the RBI’s intervention to curb market volatility. Meanwhile, the central bank will continue to inject INR liquidity into the system through its open market operations. USDINR will likely reach 67.0 in January.

CHINA — The CNY and CNH depreciated the most in December compared to other EM Asian currencies post the IMF’s decision on the yuan’s SDR inclusion. On December 30th, the PBoC halted cross-border yuan services for at least three foreign banks until the end of March to curb the profitable arbitrage flows. Now the PBoC has lessened intervening in the offshore market but will step in certainly to contain extreme movements. In the near term, we stay vigilant on the wide onshore-offshore spread. We expect around 3% orderly depreciation of the CNY and CNH vs. the USD in 2016, particularly in the first half. If the nation’s economy starts to stabilize from mid-2016 following stimulus efforts, the CNY and CNH may pare some losses then.
BRAZIL — The Brazilian real (BRL) will retain a defensive tone through the first quarter of the year. However, the extreme devaluation registered over the past 12 months will likely not be repeated in 2016. The escalating political crisis and ensuing social tensions may heighten sudden bouts of currency market volatility, yet the main drivers of exchange rate direction will be the following: the direction of the US dollar (USD), the potential for China-centered emerging market stress, the Brazilian central bank intervention policy in foreign exchange markets, multiple credit rating downgrade activity, and the success in rebalancing the still large twin (current account and fiscal) deficits. A deep and prolonged recession, coupled with widening fiscal and current account deficits, and a high inflationary environment have all been factors impairing the Brazilian credit outlook. International credit agencies are readjusting further rating downgrades in alignment to current pricing dynamics in asset markets. The Brazilian economy remains in an emergency situation. Real GDP contracted by 4.5% y/y in the third quarter of 2015, accumulating six consecutive quarters of negative performance. The fight against inflation is a macroeconomic priority. The market-watched IPCA headline inflation rate is already in double-digit territory, placing the central bank on high alert. At the heart of such increase in price pressures lies the sharp depreciation of the BRL as well as the distorting wage-indexation mechanisms currently in place.

RUSSIA — The worst of Russia’s economic woes appears to be in the past, with moderating declines seen in real GDP growth, industrial production and investment at a time when policy initiatives have helped restore credit flows to firms and the ban on Western food imports has buoyed agricultural output. Inflationary pressures have also eased, with the headline print falling to a one-year low of 12.9% y/y in December, down from 15% in November, which is forecast to continue through 2016 as base effects from the ruble’s devaluation start to fade. Nevertheless, Russia’s economic outlook remains very weak. Real GDP growth is forecast to contract by 0.5% this year following a 3.8% decline in 2015 as household purchasing power continues to be stripped away by nominal wage stagnation and high inflation, while weakness in business investment will likely persist given the low oil price outlook. Geopolitical tension also continues to rise. After Russia imposed sanctions on Turkey for shooting down a Russian warplane that entered Turkish airspace from bordering Syria, Russia has suspended free trade with Ukraine in an attempt to protect its economy from the implementation of the Ukraine-EU Deep and Comprehensive Free-Trade Agreement (DCFTA). This came as the EU was assessing whether to renew sanctions on Russia for its involvement in the Ukraine crisis, which ultimately resulted in a 6 month extension until July 31st, 2016 due to the fact that key elements of the Minsk agreement remained unfulfilled. Nevertheless, with consumer price inflation still well above the Russian Central Bank’s (RCB) target of 4% y/y and monetary normalization underway at the US Fed, the RCB likely maintain a cautious monetary policy stance over the short term.

INDIA — The widening divergence in economic performance between Asia’s two giants is becoming increasingly evident in 2016 with India continuing to outpace China’s real GDP growth; we expect India’s output to expand by 7.6% this year (compared with China’s 6.4% gain), supported by favourable demographics. While India’s inflation environment remains generally positive, consumer price gains have accelerated somewhat in recent months reaching 5.4% y/y in November, driven by higher food prices. We expect a further modest pick-up over the course of 2016 before inflation stabilizes around 6% y/y at the end of the year. Monetary conditions will remain accommodative for the foreseeable future; at the end of September, the Reserve Bank of India cut the benchmark interest rate by 50 basis points to 6.75%. Pressure by the government may prompt the central bank to lower the policy rate further to 6.50% over the coming months. Due to lack of majority in the upper house, the administration of Prime Minister Narendra Modi will continue to make only slow progress on structural reforms, which are aimed to improve the business environment in the country. In this respect, the Goods and Services Tax bill — an important tax reform proposal — was not passed in the winter session of parliament that concluded on December 23rd. The government’s attention to the national reform agenda may be swayed away by several important state elections that will be held in 2016.

CHINA — The New Year in China has started in a volatile fashion with local equity markets in sell-off mode, driven by persisting concerns regarding the health of the Chinese economy. Indeed, the economy continues to face strong decelerating forces due to the structural changes that are taking place — i.e. the nation is moving from early stages of economic development to a more advanced phase driven by services and consumers. Therefore, reforming the centrally-planned economic model continues to be a pressing issue and a policy priority over the course of 2016. In this context, heavy government intervention will remain the norm this year in order to manage the implementation risks surrounding the ambitious structural reform agenda. Further opening of China’s capital account will likely continue in 2016, yet very incrementally to minimize any bouts of market volatility. The Chinese government will also emphasize supply side reforms over the coming quarters. Policymakers have indicated that instead of only stimulating demand, they will also focus on lowering overcapacity in the economy. Accordingly, significant monetary stimulus over the course of 2016 is unlikely; we expect only one more cut in the benchmark interest rates in the near term. Meanwhile, targeted fiscal stimulus will likely continue, focusing on infrastructure. We expect China’s real GDP to grow by 6.4% this year following an estimated advance of 6.9% in 2015.
Pacific Alliance
Currency Outlook

MEXICO — Although growth data surprised to the upside and Banxico signaled willingness to use monetary policy to stabilize MXN (it hiked 25 bps in December), MXN was a 5-worst performing major FX during December (-4.0%). We think the poor performance results from foreign investors’ hedging their high holdings of domestic debt, as well as MXN’s use as a hedge for LATAM due to its liquidity. We look for an MXN rally once market jitters diminish. Looking at 2015 as a whole, MXN is a mid-pack performer, down -14.3%, with GBP -5.5%, EUR -10.3%, CAD -16.1%, MYR -18.5%, and COP -25.2%.

COLOMBIA — Although COP had a strong performance in the latter half of December due to hawkish talk coming out of BanRep, the country’s still wide current account gap suggests the peso needs to weaken further to help facilitate the necessary external account adjustment, given we doubt oil-heavy exports will provide relief. COP was the fourth worst performing expanded major in 2015 (-25.2%), and we think we need to see a larger drop before external accounts balance.

CHILE — Although data and news-flow coming out of Chile have not been particularly positive, the rate hike that the BCCh delivered in December drove 4 strong performance days for CLP, helping make the peso the top performing LATAM FX during the month (-1.3%). The other factor supporting CLP was the relatively low foreign participation in the country’s markets. However, we are not particularly constructive on CLP, given the country’s heavy reliance on copper / China, and a “reform” program that is not particularly market friendly.

PERU — Heavy handed intervention by the BCRP has helped the sol hold its ground relatively well, making it the second best performing LATAM FX during the month of December (down -1.2%). However, it is worth noting that on recent client meetings we did not perceive much interest in Peru exposure to be particularly strong, and some investors even raised questions about how long intervention can be kept on for, as some question how much of the BCRP’s reserves are “usable”.

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The international trade and investment fronts have become increasingly hostile. The acute erosion of the terms of trade as a result of declining copper prices, coupled with increasing costs of international finance as the US Federal Reserve normalizes monetary policy, has so far placed the central bank reference rate at 5.75%. Despite a challenging external trade and domestic inflation context, the government firmly believes that domestic demand drivers will lead the economy to grow by 3% this year. The inflation front has sharply deteriorated; consumer prices increased by 6.4% y/y in November, prompting the monetary authorities to activate a tightening cycle, which has so far placed the central bank reference rate at 5.75%. Despite a challenging external trade and domestic inflation context, the government firmly believes that domestic demand drivers will lead the economy to grow by 3% this year.

Moreover, the escalation of political tensions between Iran and Saudi Arabia has added fuel to an already volatile energy market environment. Other key factors affecting the value of the COP include: the sell-off momentum affecting emerging markets in general (particularly in the corporate high yield sector), the speed of US monetary policy normalization in the coming months following the first symbolic adjustment of the Fed funds rate, and the evolution of trade dynamics with other core countries in Latin America as the Colombian authorities attempt to diversify away from US trade dependence. The inflation front has sharply deteriorated; consumer prices increased by 6.4% y/y in November, prompting the monetary authorities to activate a tightening cycle, which has so far placed the central bank reference rate at 5.75%. Despite a challenging external trade and domestic inflation context, the government firmly believes that domestic demand drivers will lead the economy to grow by 3% this year.

The Mexican peso (MXN) will maintain a volatile trading pattern during the first months of the year. The key factors affecting the valuation of the MXN include: the direction of the US dollar (USD) versus its peer currencies, the relative strength of the US economy, the pace of interest rate adjustments to be implemented by the US Federal Reserve, the evolution of crude oil prices, further currency intervention by the Mexican central bank, and the overall investor sentiment embedded in systemically relevant emerging market economies (particularly, China and Brazil). The MXN depreciated by 14% against the USD over the past 12 months (a relatively positive performance when compared against the 33% depreciation of the Brazilian real). The central bank has intensified its intervention in the FX market in order to moderate the disruptive effects of volatility spikes. In fact, FX reserves declined by US$20 billion last year. The Mexican economy is well positioned to gain some traction in the coming years; we estimate that real GDP will expand by 2.8% and 3.5% in 2016 and 2017, respectively, up from an estimated growth of 2.5% in 2015. On the monetary front, Banco de Mexico executed its first adjustment to its policy setting rate (increasing it by 25 basis points to 3.25%) in strict alignment to the US move. Headline inflation remains contained, for now, as reflected by the latest reading of 2.2% y/y in November.

The Colombian peso (COP) remains primarily affected by the direction of crude oil prices and overall effects of the oil price shock on the rest of the economy. Following a sharp reduction in crude oil prices which traded below US$34 per barrel (WTI) last December, the Colombian currency has lost 25% against the USD over the past 12 months. This move reflects a decoupling from other members of the Pacific Alliance bloc which have been more resilient to energy price movements. Moreover, the escalation of political tensions between Iran and Saudi Arabia has added fuel to an already volatile energy market environment. The inflation front has sharply deteriorated; consumer prices increased by 6.4% y/y in November, prompting the monetary authorities to activate a tightening cycle, which has so far placed the central bank reference rate at 5.75%. Despite a challenging external trade and domestic inflation context, the government firmly believes that domestic demand drivers will lead the economy to grow by 3% this year.

The Peruvian Sol (PEN) has not escaped the bearish market trend affecting the Latin American region, having accumulated a depreciation of 13% against the USD over the past 12 months. The speed of currency adjustment seems to have accelerated in the final months of 2015, as the central bank opted to reduce its intervention in the market place. The primary factors shaping the exchange rate in Peru include: the direction of metal prices, growth dynamics in China, the investment flow in the mining sector, the broad-based move of the USD versus major currencies, Peruvian central bank intervention and overall sentiment affecting emerging markets. In addition to the traditional issues driving currency market sentiment, the Peruvian economy has been adversely affected by the effects of the El Niño Southern Oscillation effect. The evolution of local policy rates does not have a material impact in shaping FX market direction at present. Nevertheless, it is worth highlighting that headline inflation has been trending upwards over the past 12 months reaching 4.4% y/y lately. The central bank has responded in a traditional manner taking into account both domestic and external market conditions by increasing its reference rate by 25 bps to 3.75% in early December. Further monetary tightening is likely, heavily dependent on US rate adjustments and domestic inflation developments. However, we estimate that headline inflation will resume a declining trend and close the year at 3.5%.
Developing Economies

Currency Outlook

SOUTH KOREA — We expect that the BoK will maintain monetary policy stance accommodative as the pace of the domestic economy’s recovery is gradual. Divergent monetary policies could continue to impose depreciating pressure on the KRW. In addition, the nation has a large economic exposure to China that is struggling to boost its economic growth. We think USDKRW will break above 1,200 in the coming months.

THAILAND — We think the THB will decline further against the USD in the year ahead given divergent monetary policies. On December 28th, the central bank governor pointed out that the country’s economy is entering a difficult transition period, and that he stands ready to tailor the bank’s policies to support more growth. Moreover, persistent political uncertainties could weigh on the THB as well. The pair may reach 37.0 level in the coming months.

TAIWAN — We think the CBC will continue a pro-growth monetary policy stance as central bank governor Perng Fai-nan has highlighted that Taiwan’s real interest rate is still higher than the Fed’s. The TWD is set to face mild depreciating pressure against the USD in 2016. Meanwhile, we think that the CBC will step in to curb extreme volatility in the FX market. In addition, the TWD could be undermined by prospective political uncertainties on account of the general election scheduled for January 16th. Recent dollar-selling flows of local exporters may fade away in the near term, heralding some upside potential for the pair. USDTWD could touch 33.5 in early 2016.

TURKEY — The Turkish lira (TRY) has come under renewed pressure driven by the Turkish Central Bank’s decisions to maintain benchmark interest rates despite the sharper-than-expected acceleration in inflation. The TRY will likely continue to face weakness in the months ahead amid board-based moves in favour of the USD. USDTRY is forecast to end 2016 at 3.05.

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SOUTHERN EURASIA — The end of 2015 brought in a modest acceleration of consumer price inflation in South Korea, with the headline CPI rising by 1.3% y/y in December, up from 0.6% at the end of the third quarter. We will likely see a further modest pick-up in price pressures over the coming months, taking the inflation rate to around 2% by the end of the year. In December, the Bank of Korea announced that its inflation target for 2016-18 is set at 2% y/y, down from 2½-3½% previously. Given the gradually rising inflation trajectory, lower inflation target, and high household debt burden, we do not anticipate that the central bank will ease monetary policy further; the most recent benchmark interest rate cut of 25 basis points to 1.50% took place in June 2015. The South Korean economy is strengthening gradually; domestic demand is relatively solid while net exports continue to be a drag on growth. We estimate that the country’s real GDP expansion will average 3.2% this year and 3.5% in 2017, supported by export sector recovery. We estimate that the country’s output grew by 2.6% in 2015. Parliamentary elections will take place in April 2016 and the presidential ballot in 2017. The approaching elections will likely redirect policymakers’ attention away from long-term structural issues, such as lessening the dominance of the country’s large conglomerates and decreasing the economy’s export dependence.

THAILAND — Deflationary pressures persist in Thailand. Headline consumer price inflation closed 2015 at -0.9% y/y, recording the 12th consecutive month of deflation. We expect prices to continue to decline at least until the second quarter of 2016 after which inflation will likely pick up moderately to around 1.5% y/y by the end of the year. Meanwhile, core inflation remains in positive territory, at 0.7% y/y in December. Thailand’s modest economic growth is underpinned by domestic spending and tourism while merchandise exports continue to record lackluster performance due to weaker demand in China and ASEAN economies. We expect Thailand’s real GDP to expand by slightly over 3% this year following an estimated 2.7% expansion in 2015. Given the challenging economic outlook and muted inflationary developments, we think that the Bank of Thailand may opt to reduce the benchmark interest rate once more in the first half of the year, taking it to 1.25% from the current level of 1.50%. The most recent monetary easing action took place in April 2015 when the policy rate was reduced by 25 basis points. Nevertheless, a high level of household debt (equivalent to around 85% of GDP) will prevent any substantial monetary easing. Investor sentiment toward Thailand is adversely impacted by uncertainty regarding the timing of the next election. We expect that the country will not return to democracy before 2017.

TAIWAN — Monetary conditions continue to ease in Taiwan. In mid-December, the central bank's policymakers decided unanimously to reduce the benchmark interest rate by 12.5 basis points to 1.625%. The previous rate cut of the same magnitude took place in September. The decision reflects the fact that both global and domestic economic growth has fallen short of expectations; the central bank notes that Taiwan’s negative output gap has widened and inflation expectations are mild. Indeed, real GDP contracted by 0.8% y/y in the third quarter, with output expansion estimated to have reached around 1% in 2015 as a whole. We expect that economic growth will pick up modestly over the coming quarters, averaging 2% y/y in 2016. Consumer price inflation remains low at 0.5% y/y in November; nevertheless, price pressures have intensified slightly over the past few months, with inflation returning to positive territory in September after eight months of deflation. While we expect inflation to accelerate further over the coming months, it will likely hover only slightly above 1% y/y for most of 2016. While the New Taiwan dollar is in principle determined by market forces, Taiwanese monetary authorities are prepared to intervene if they believe that the currency market is unduly disrupted by seasonal or irregular factors, such as sizable inflows or outflows of short-term capital.

TURKEY — Turkish real GDP growth in the third quarter proved remarkably resilient, advancing 5.4% y/y, up from 3.8% in the previous quarter. The acceleration was attributable to strong gains in government consumption – pre-election spending and increased security costs amid rising political violence – and a positive contribution to growth from net exports on the back of import weakness, which offset declines in business investment and the slowdown in household spending growth. After months of political uncertainty, the Justice and Development Party unexpectedly captured a landslide victory at the November 1st election and restored its majority government, which it lost in June. Against this backdrop, business and consumer confidence should continue to recover, which bodes well for an improvement in domestic demand over the coming quarters. Nevertheless, Turkish economic growth is forecast to moderate from 3.7% in 2015 to 3.4% in 2016 as US monetary tightening will likely continue to weigh on the lira and constrain capital inflows. This is problematic for Turkey given its high levels of foreign debt and dependence on foreign inflows to finance its large current account deficit, which is forecast to remain above 5% of GDP over our forecast horizon. Sanctions imposed by Russia on Turkey should also bear adverse effects on the country’s tourism, agricultural and construction industries. Meanwhile, inflation is forecast to remain above the Central Bank of the Republic of Turkey’s medium-term target of 5% through 2017 at year-end rate of 7.5% y/y in 2016 and 6.5% in 2017 on the back of continued currency weakness, an increase in the minimum wage, and a modest recovery in commodity prices.
Violence and political machinations in the Middle East have historically had a pronounced effect on the price of oil—as recently as the summer of 2014, the seizing of Mosul by the Islamic State in Iraq pushed the price of Brent crude above $115 per barrel as market participants attempted to account for this latest “political risk premium.” However, since the price of crude began to tumble in the latter half of 2014, oil’s apparent sensitivity to regional crises has declined. This new found insensitivity was tested over the first weekend of 2016 as relations between OPEC powers Saudi Arabia and Iran sharply deteriorated. Notwithstanding a temporary bump as the market first processed this information, oil prices closed lower still, seemingly agnostic to the rising potential for conflict in the oil-rich region.

On Saturday, January 2nd Saudi Arabia executed 47 men for political and terrorism-related offences as part of an ongoing crackdown. Among those executed was Sheikh Nimr al-Nimr, a prominent Shi’ite Muslim cleric and outspoken critic of the Saudi royal family. Iranian authorities condemned the execution and said that Saudi rulers would face the “divine hand of revenge.” Later that evening, protests outside the Saudi embassy in Tehran became violent when protestors stormed the embassy, ransacked offices, and set the building on fire.

In the days since, Saudi Arabia—followed by Sunni-majority allies Bahrain, Sudan, and Kuwait—severed diplomatic relations with Iran while the United Arab Emirates has downgraded its diplomatic status. Saudi Arabia subsequently cut off commercial ties, shut down air routes between the two countries, and banned Saudi citizens from visiting Iran. This remains a developing situation and there is a significant risk of further escalation.

In the past, these rhetorical and diplomatic volleys would have been worth at least $5 a barrel; today, nothing. While commercial crude inventory levels are exceptionally high, spare capacity within OPEC—the traditional safety valve to ease fears of market disruptions—remains low by historical standards. Admittedly, little has changed in the physical oil market—we still have too much oil in the system, Iran is still going to increase production as it re-enters the market, and Saudi Arabia is still unlikely to cut—but the ease by which the market was able to shrug off this latest episode speaks to the entrenchment of current bearish sentiment.

While there has been no physical market impact (yet), there are still concrete repercussions to this latest development. Further deterioration in Saudi-Iran relations has erased the already-slim possibility that OPEC members will cooperate as Iran begins to re-enter the oil market, potentially worsening the oil glut currently plaguing producers. Poorer relations will also exacerbate the financial costs associated with Saudi Arabian posturing in sectarian conflicts (Syria/Yemen) at the very time that it needs to get its government spending under control. Finally, those conflicts will be more difficult to resolve now that the likelihood of getting both Saudi Arabia and Iran negotiating in good faith has all but disappeared.

The New Year is off to a rocky start, and a rhetorical arms race in the Middle East is sure to further cloud an already cloudy outlook.
## Global Currency Forecast (end of period)

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|                  | USDNOK | 8.84 | 9.00 | 7.80 | 8.80 | 8.90 | 9.20 | 9.00 | 8.70 | 8.50 | 8.25 | 7.80 |
|                  | EURPLN | 4.26 | 4.35 | 4.30 | 4.33 | 4.35 | 4.37 | 4.35 | 4.34 | 4.33 | 4.32 | 4.30 |
|                  | USDRUB | 72.5 | 69.0 | 65.0 | 71.0 | 71.5 | 70.5 | 69.0 | 68.5 | 67.0 | 66.0 | 65.0 |
|                  | EURSEK | 9.17 | 9.03 | 8.96 | 9.03 | 9.15 | 9.03 | 9.03 | 9.02 | 9.00 | 8.99 | 8.96 |
|                  | USDTRY | 2.92 | 3.05 | 2.85 | 3.10 | 3.15 | 3.10 | 3.05 | 3.00 | 2.95 | 2.90 | 2.85 |

f: forecast  a: actual
Foreign Exchange Outlook

January 2016

Global Economics & Foreign Exchange Strategy

International Economics Group

Pablo F.G. Bréard
pablo.breard@scotiabank.com

Erika Cain
erika.cain@scotiabank.com

Rory Johnston
rory.johnston@scotiabank.com

Tuuli McCully
tuuli.mccully@scotiabank.com

Estela Molina
estela.molina@scotiabank.com

Canadian & U.S. Economics

Derek Holt
derek.holt@scotiabank.com

Neil Tisdall
neil.tisdall@scotiabank.com

Adrienne Warren
adrienne.warren@scotiabank.com

Dov Zigler
dov.zigler@scotiabank.com

Foreign Exchange Strategy

Shaun Osborne
shaun.osborne@scotiabank.com

Eduardo Suárez
eduardo.suarez@scotiabank.com

Eric Theoret
eric.theoret@scotiabank.com

Qi Gao
qj.gao@scotiabank.com

Foreign Exchange Strategy

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Scotiabank Economics
Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: 416.866.6253 Fax: 416.866.2829
Email: scotia.economics@scotiabank.com

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