CIBC

Economics

Monthly FX Outlook

July 17, 2015

Currency Strategy Highlights

- While the **USD** broadly appreciated on the back of recent safe-haven flows, there's still another leg-up on the horizon. Impending rate hikes from the Fed will drive interest rates across the US curve higher and lift the dollar against most other currencies.
- The **Canadian dollar** has been battered by a series of unexpectedly weak data points and a resultant rate cut from the central bank. The punishment is not over though. A wide current account deficit coupled with divergent monetary policies between the US and Canada will weigh on the loonie well into 2016.

Events to Watch in Coming Month

- The **FOMC** will meet again on July 29th and the accompanying statement could firm up talk of a September rate hike.
- In **Canada**, upcoming data releases will be looked to for confirmation that the economy is stabilizing. However, any better export data could be countered by another giveback in private sector jobs.
- Stress resulting from the ongoing **Greek** saga and the **Chinese** equity market crash seem to have subsided. But, many hurdles remain on both fronts and renewed volatility would drive bouts of demand for safe-haven currencies.

Currency Outlook

End of period:	17-Jul-15	2015 III	2015 IV	2016 I	2016 II	2016 III	2016 IV
US$ Rates:							
USDCAD	1.29	1.30	1.33	1.32	1.31	1.30	1.28
EURUSD	1.09	1.05	1.08	1.11	1.14	1.17	1.20
USDJPY	124	125	125	126	125	124	121
GBPUSD	1.56	1.53	1.59	1.61	1.62	1.61	1.60
USDCHF	0.96	0.99	0.96	0.95	0.93	0.91	0.90
AUDUSD	0.74	0.73	0.72	0.73	0.75	0.77	0.80
USDBRL	3.13	3.05	3.13	3.18	3.22	3.21	3.21
USDMXN	15.79	15.22	15.65	15.30	15.28	15.28	15.42
USDKRW	1149	1130	1120	1110	1100	1085	1070
USDCNY	6.21	6.20	6.20	6.18	6.16	6.14	6.12
USDSGD	1.37	1.36	1.36	1.35	1.34	1.32	1.30
USDTWD	31.1	31.0	31.5	31.0	30.0	29.9	29.8
USDMYR	3.81	3.80	3.75	3.65	3.55	3.45	3.40
USDINR	63.5	64.0	64.0	63.5	63.0	62.5	61.5
Other Crosses:							
CADJPY	96	96	94	95	95	95	95
AUDCAD	0.96	0.95	0.96	0.96	0.98	1.00	1.02
GBPCAD	2.02	1.99	2.11	2.12	2.12	2.10	2.05
EURCAD	1.40	1.37	1.44	1.47	1.49	1.52	1.54
EURJPY	135	131	135	140	143	145	145
EURGBP	0.70	0.69	0.68	0.69	0.71	0.73	0.75
EURCHF	1.04	1.04	1.04	1.06	1.06	1.07	1.08
EURSEK	9.28	9.30	9.25	9.20	9.10	9.00	8.95
EURNOK	8.85	8.70	8.50	8.35	8.22	8.20	8.15

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A 'Safe' Time to be a USD Investor

Safe-haven flows into the USD have been the dominant force in foreign exchange markets since mid-June. The escalation of tensions between Greece and its creditors, coupled with the recent dive in Chinese equity prices drove investors into USD-denominated assets. The greenback's gains were widespread, with most major currencies depreciating on the crosses.

True, with the Greek situation nearing a resolution, if not a lasting one, and some tentative signs of China's economy stabilizing, some of the motivating factors behind recent flows are waning. But the US side of the story suggests that the bull market for the greenback still has some steam left. American economic activity continues to ramp up at a healthy pace (Chart 1) and the US looks well on its way to seeing higher interest rates later this year. Most of the questions raised by the poor performance registered in the first quarter have now been put to bed by an acceleration in the spring.

More of the same lies ahead. Driven by an average of almost 210K jobs per month during the first half of this year, the unemployment rate of only 5.3% has the labour market much closer to full employment. Although the Fed will be looking for more indications of continued momentum, they won't wait until—in the words of Larry Summers—they can see the 'whites of inflation's eyes'. By September, the FOMC will have enough confidence that the economy is on track to hit its inflation and labour market targets to raise rates.

In contrast, developed and emerging markets including, the Eurozone, Japan, China, India, Australia, Switzerland and, of course, Canada have all eased policy this year. As a result, higher interest rates in the US in 2015 will be a stark reminder of just how advanced the recovery is south of the border. Look for the dollar to strengthen against all G7 currencies in the run-up to the first rate hike. Similarly, a pause in the hiking cycle next year will see the USD give back some of these gains.

No Timeouts for CAD's Continuing Weakness

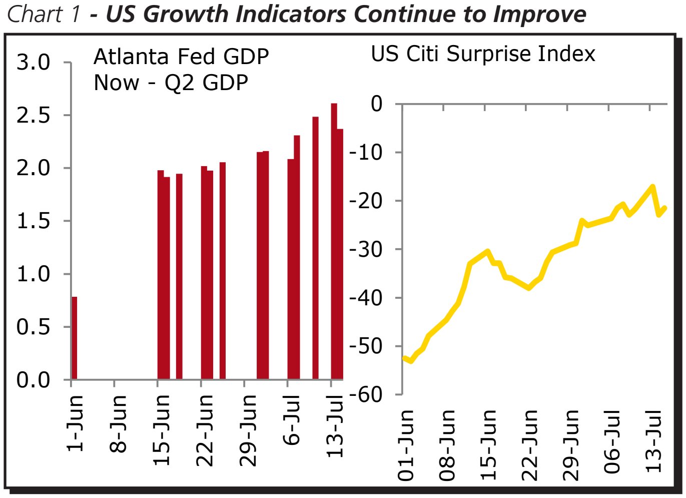
The Canadian dollar's losses during the past month were the fallout from unexpectedly weak data releases. April's surprise negative GDP print caused us to lower our Q2 forecast and at the same time call for a July rate cut by the Bank of Canada. May hasn't looked any better in trade and factory volumes, and a retreat in oil added to the market's concern.

The delivery of the July quarter-point cut by the BoC, one not fully priced in until later in the year, drove a further devaluation in the loonie. As a result, the CAD is about 5% weaker against the greenback than it was at this time in June.

Markets are now pricing in a significant chance of a third rate cut by the central bank, but we expect the BoC to remain on hold unless the data were to seriously deteriorate from here on out. So does that mean the Canadian dollar will quickly reverse its losses as these positions are pared back? Unlikely.

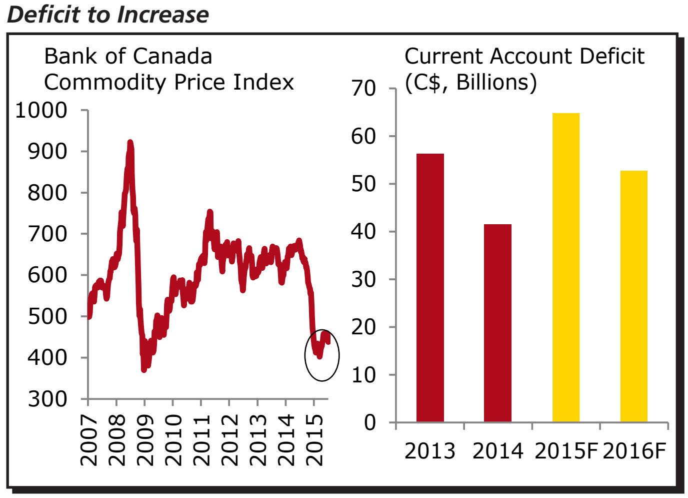
The Bank of Canada's commodity price index shows just how far the prices of many Canadian exports have fallen over the past year (Chart 2) and, despite the

Chart 1 ***- US Growth Indicators Continue to Improve***



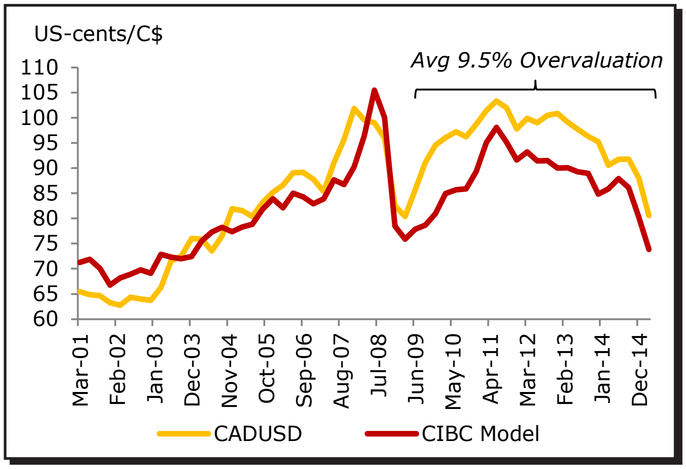
Source: FRB Atlanta, Bloomberg, CIBC

Chart 2 ***- Terms of Trade Shock Has Caused Current Account Deficit to Increase***



Source: Bank of Canada, Haver Analytics, CIBC

Chart 3 - ***CIBC Model of Canadian Dollar's Fair Value***



Source: Bloomberg, CIBC

recent depreciation in the CAD, the current account deficit is expected to swell to record levels. That should weigh on the currency going forward, at least until we see some positive signs on the trade front. However, a longer timeframe to eliminate the steady drumbeat of rising global oil inventories suggests a more gradual and choppy recovery in the price of Canada's most important export than we previously had assumed.

In addition, our own analysis (see June 2015 issue of *Economic Insights*, *"Rich Loonie to Slow Poloz"*) suggests that, at current levels, the Canadian dollar remains overvalued by almost 10% (Chart 3), contributing to tighter overall financial conditions than would be expected if only looking at interest rates. Our research shows that the tighter monetary conditions have been a drag on the economy, especially via the trade balance. Propelled by Fed tightening and the dovish BoC image left after this year's rate cuts, the weaker average exchange rate in 2015-16 will work off some of this overvaluation, with the rest dependent on a rebound in the terms of trade.

All of this has knocked the outlook for the Canadian dollar several cents weaker than our prior targets. Look for dollar-Canada to average near 1.33 around the time Fed rate hikes drive broad strength in the greenback. Moving forward, we expect the loonie to stay above the 1.30 level well into 2016, before rebounding slightly as the Fed takes a pause in its rate hike cycle and oil prices firm up.

ECB Easy Money Policies Return to the Fore

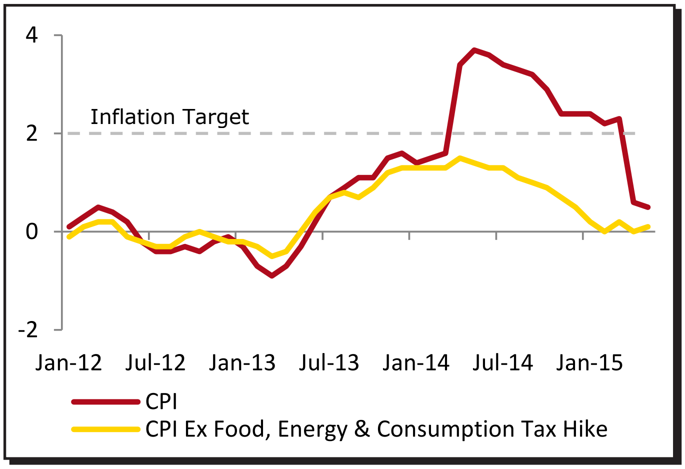
In recent weeks, investors have maintained moderate EUR short positions as the news flow raised questions about the underlying fundamentals and political backdrop for the single currency. After the latest set of marathon EU negotiations, we are well on the road to crossing the t's and dotting the i's on a third Greek bailout package. This, however, assumes that countries like Germany, Austria, the Netherlands, Finland, Slovakia and Estonia clear the internal political processes necessary for approval (with the latter three posing the greatest risks) and that the IMF's objections to the lack of debt relief don't pose a last minute hitch.

Once we've moved past these immediate political concerns, expect markets to refocus on the continuation of ECB monetary easing policies. Moreover, look for a continued convergence in the size of the ECB and Fed's respective balance sheets.

While easy monetary policy from the ECB was in part motivated by the need to offset the drag from negative sentiment during the height of the Greek standoff, political uncertainties will still linger over Greek implementation, a potential change in government in that country, and the likelihood that fiscal targets will be unachievable due to economic underperformance. Further out, elections in Spain will draw attention to that country's ability to persist with its own austerity program. And even if political developments go smoothly, the scale of the existing output gap in Europe is reason enough for the ECB to remain steadfast in its QE program.

As a result, EUR shorts will extend on the back of monetary policy divergence with the US, while any signs of austerity implementation slippage in Greece would also see investors extend EUR shorts. Both factors lean towards near-term weakness in the EUR against the dollar, particularly as we get closer to a Fed hike in September. Come 2016, however, an early pause in Fed hikes will have markets looking at other fundamentals, with the still-sizable US current account deficit, and reasonable Eurozone growth, powering a recovery in the euro.

Chart 4 - ***Year/Year Japanese Inflation Has Weakened Again***



Source: Bloomberg, CIBC

Yen Strength to Fade

Amidst a rising tide of risk aversion, Japanese investors aggressively unwound their holdings of foreign currency-denominated bonds in June. That caused the yen to gain ground against a variety of other currencies. However, with the worst of the recent volatility likely behind us, the yen has now begun to slowly depreciate again. Moving forward, expect Japan's Ministry of Finance to remain vigilant with regards to further safe haven-related JPY appreciation, using verbal intervention to contain the currency if needed.

Japan's economy is showing signs that it is finally moving in the right direction, with the Tankan index reaching a five-quarter high in Q2. But consumption hasn't regained vigour after being hammered by last year's sales tax hike, and medium-term issues tied to mounting debt and a declining workforce haven't gone away.

Inflation and inflation expectations remain the key variables for the BoJ's monetary policies. In theory, the BoJ shouldn't be dismayed to see both ease if the underlying cause is a softening in energy prices, which is a net benefit to Japan as an oil importer. But despite the role of both energy and the dropping off of a consumption tax hike from the numbers in affecting CPI figures (Chart 4), the BoJ appears to be treating the disinflationary shift with concern, and as a reason to extend the QE program well into the future.

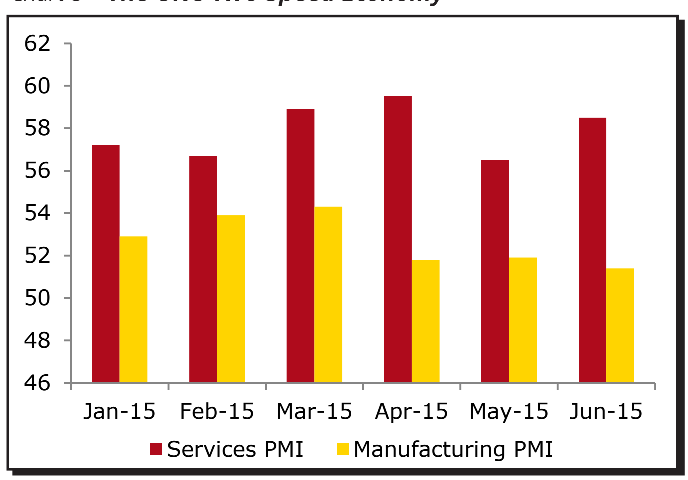
Look for the yen to therefore trend to the weaker side against the dollar, albeit in a choppy pattern that allows for bouts of strength on the back of temporary safe-haven flows.

UK Hawks Ready to Flex Their Wings

The UK economy is once again demonstrating a tendency to move at two speeds. While the services sector continues to generate significant momentum from higher real earnings and a sliding misery index, manufacturing is still facing near-term headwinds from the Eurozone, its primary market. The PMI indices clearly reveal the increasing degree of divergence in these two sectors (Chart 5).

However, with activity levels in the UK for both 2014 and Q1 2015 being revised higher, spare capacity is likely less than previously assumed. Amidst record levels of employment and the aforementioned rising real earnings, it seems that, aside from near-term disinflationary influences due to renewed oil price fragility, MPC hawks are likely to soon be flexing their wings. Look for ongoing sterling resilience against other major currencies apart from the USD, which will get a boost from tighter Fed policy later this year.

Chart 5 - ***The UK's Two Speed Economy***



Source: Bloomberg, CIBC

Australia Looking to the Currency Rather than Rates for Help

Despite a re-widening in the yield advantage of 10-year aussie bonds over Treasuries, the AUD continues to be one of the worst performing currencies against the USD in 2015. While the RBA has held rates at a record low 2.0% since its last cut on May 5th, the central bank continues to be seen as dovish. That's unsurprising given that growth projections remain below trend and the hoped for rebound in non-mining sector investment remains largely illusory.

With the central bank mindful of both high consumer leverage and the strength in the Sydney housing market, we expect an ongoing determination to ease financial conditions via the currency. The post-decision RBA statement continues to underline that a further currency depreciation seems both likely and necessary, particularly given the significant declines in key commodity prices. That's only jawboning rather than RBA action, but we're maintaining a negative AUD bias for now, expecting the cyclical trough to be above the 0.65 level.

Swiss Policymakers Hoping for Eurozone Stability

According to OECD estimates, the CHF remains the most overvalued major currency. The estimates suggest that the Swiss franc currently trades around 30% above its long-term fair value. The impact of CHF overvaluation has been reflected in sliding business confidence with KoF business sentiment retreating back to levels not seen since the end of 2011.

Against this backdrop of weakening growth prospects, the SNB once again felt compelled to intervene in the FX market to lean against a further CHF appreciation during the recent Greek stand-off. While the action is likely to have been little more than a smoothing operation, we would not be surprised to see foreign exchange reserves rise to fresh highs when the July data is released on August 7th. We expect the central bank would continue this intervention if risks in the euro area rise again. As a result, the SNB may be hoping for Eurozone stability almost as much as the area's actual members.

Expect the central bank to maintain the view that negative deposit rates will eventually sap CHF strength, as will more positive CPI expectations, which should come soon since positive CPI base effects will appear as early as the July print.

Unconventional Times in Sweden

Amidst ongoing euro-related political uncertainty, we have seen those European central banks who had previously resorted to negative deposit rates responding to renewed euro uncertainty via additional unconventional policy responses. In the wake of EURSEK persistently testing through the 9.20 threshold, the Riksbank unexpectedly lowered the deposit rate by another 10 bps to -0.35% and increased its QE program by SEK45 bn.

It's clear that the Riksbank remains committed to arresting any near-term currency appreciation in an effort to both maintain competitiveness and reduce disinflationary risks. Ahead of the next scheduled central bank decision (September 3rd), the Riksbank has reminded the market that they can and will take such action at any time. Therefore, against the backdrop of expected broad EUR weakness, we could see more aggressive policy should EURSEK drift toward 9.20 again.

A Subdued Outlook for Norway

The Norges bank didn't surprise markets on June 18th when it cut its main policy rate by 25 bps to 1.0%. In light of the central bank's downgraded growth forecasts (1.25% for this year and 1.5% next year—both below consensus), we are wary of another 25-bp cut on September 24th. Although underlying CPI unexpectedly rebounded in June, the central bank remains mindful that any upward pressure on prices could dissipate. The Norges bank's fears that 'the economic outlook has deteriorated somewhat' are likely to have been further fanned by the fact that the June manufacturing PMI plunged to 44.0, marking the lowest reading since October 2009. With oil prices again under pressure, oil sector investment can be expected to continue to decline.

The combination of weaker oil revenues and investment expectations, coupled with the prospect of still easier monetary policy, has seen the NOK be the worst performer versus the EUR over the last month. Nevertheless, unless oil prices trend aggressively lower in H2 (not our forecast), we expect a modest correction in EURNOK into the end of the quarter, even amidst the prospect of easier Norges bank policy. Look for a reversal back towards the 200-day MAV, which currently stands around 8.70.

Brazil's Government Under Scrutiny

After depreciating on risks related to Greece and China, USDBRL has reversed some of that move in the wake of more constructive news in the those regions.

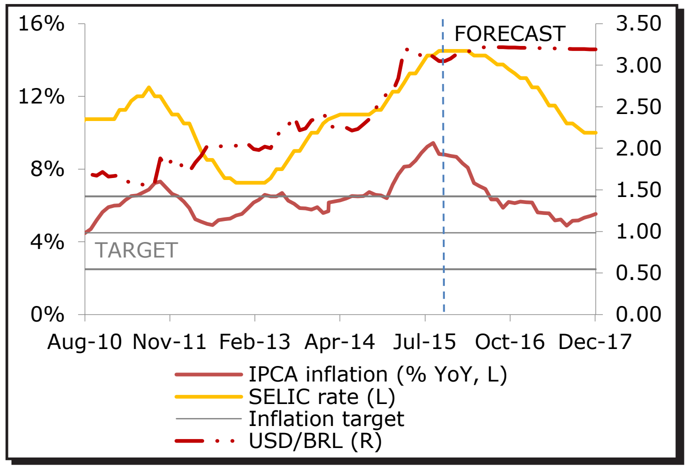
President Rousseff, however, remains on pins and needles as she faces allegations of tampering with the 2014 national accounts, accepting improper campaign donations and having direct connections to the ongoing issues facing Petrobras. Each of these accusations, on their own, could lead to Rousseff leaving office.

On the fiscal front, the Banco Central reported that Brazil's primary deficit as a percentage of GDP had improved somewhat in May. In addition, state and municipal governments continued to show positive signs. However, the government will have to continue to recognize hidden deficits. Therefore, we don't expect much improvement in the numbers until well into Q3.

With regards to inflation, the IBGE reported that June inflation came in at 0.8% or 8.9% year/year (Chart 6). As a result, inflation remains more than 200 bps above the 6.5% ceiling of the target band. Perhaps inflation has started to peak, but there is still slightly more corrective inflation that is expected to occur as electricity tariffs increased another 17% last week. As a result, we expect inflation to stay above 8% for most of the rest of this year.

We are forecasting that the COPOM will hike interest rates by 50 bps in July to battle inflation, which would bring the SELIC to 14.25%. Subsequently, we expect it to raise rates another 25 bps in September. While that should deliver a short-term boost to the real, thereafter, we see it giving back those gains and more as the COPOM pauses for some time to assess the prevailing inflation dynamics and the effectiveness of its policy moves. We expect tighter monetary and fiscal policies to lead to tamer inflation by the end of 2015 that will obviate the need for follow-up hikes.

Chart 6 ***- USD/BRL Spot, the SELIC Policy Rate, and Inflation***



Source: Banco Central do Brasil, IBGE, CIBC

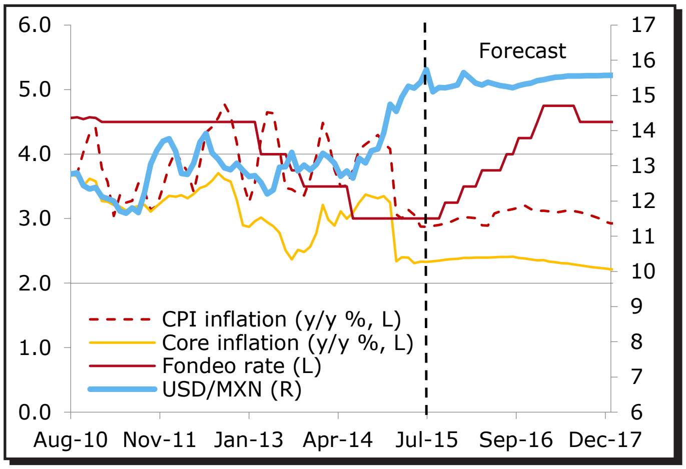
Mexican Central Bank Tying Policy to the Fed

Recently, everything seemed like it was pushing USDMXN higher: US economic indicators, Fed speak, Greece, you name it. That is, until stability in the Chinese equity market and a Greek compromise emerged this week. USDMXN has as a result eased back after peaking at 15.87. For now, disappointing May industrial production and well behaved June inflation dampened any additional peso strength from solid ISM and consumer confidence indicators. A successful conclusion to the Round One auction of shallow-water oil exploration and production blocks on July 15th, though, could be the factor that gives another leg of support for the peso.

June inflation came in at 0.2% month/month or 2.9% year/year (Chart 7). Core came in at 0.2% month/month, while non-core inflation was flat amid a 0.2% month/month drop in fresh vegetables and fruit prices. In addition, although Mexican wage negotiations came in higher than expected at 4.4%, the number likely won't be a harbinger for higher overall inflation.

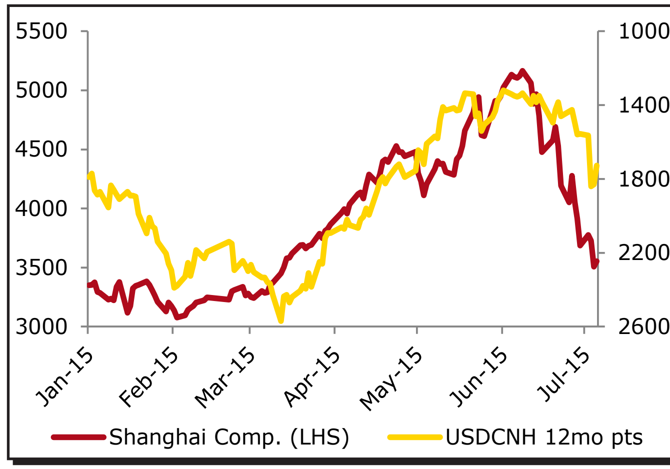
As a result, the central bank has maintained the 3.0% overnight rate that has prevailed for over a year now. Banxico does not anticipate any inflationary pressures from aggregate demand and expects inflation to remain slightly below 3% for the remainder of 2015.

Chart 7 - ***Mexico: USD/MXN, Fondeo Rate, Headline and Core Inflation (year/yr %)***



Source: Banxico, Bloomberg , CIBC

Chart 8 - ***USDCNH Points Responsive to Shanghai Index Moves***



Source: Bloomberg, CIBC

The domestic economy continues to run at a moderate rate of growth with consumption indicators continuing to show signs of recovery. However, weakness in the oil and construction sectors drove industrial production slightly lower in Q1, which appears to have derailed the recovery in investment. As a result, the risks to economic growth remain tilted to the downside.

Although the 2015 GDP forecast was recently revised down, Banxico remains very dependent on the timing and magnitude of Fed rate hikes. Recent comments point to Banxico reacting after the Fed as it saw that "moving before would incur more cost than benefits". Hence, we expect Banxico to start raising the overnight rate late in Q3 (in tandem with any US Fed rate action) and to end the year at 3.5%. Although we expect one-off flows to strengthen the peso in the near term, look for the currency to weaken around the end of the year as the Fed will be well on its way to higher rates by then.

CNY & CNH Ongoing Stability Can Support Confidence

Chinese markets have recently been buffeted by a sharp sell-off in the equity market. Over the past few weeks, the Shanghai index has lost around a third of the 150% it gained over the last year. To date, daily fixings of USDCNY have remained stable and spot levels for both USDCNY and USDCNH have similarly been range-bound. However, there has been some widening in deliverable forward points for USDCNH (Chart 8). USDCNY NDFs have also been firmer, but they are not at levels that should be of concern and are well inside recent ranges. We have viewed the higher points as reflecting some market hedges, rather than signaling a change in either spot trends or the overall expectation of stability.

It has in the past been suggested that China was close to embarking on a depreciation of the currency to boost exports and/or combat deflationary forces. Recently, given that equities have been punished and fears have surfaced that this could affect economic activity, the notion that China might depreciate its currency has again been raised. We, however, don't expect this to happen. Instead, the official policy of maintaining stability in the currency will in fact be reinforced, not rescinded, and that stability in the currency will promote investor confidence.

KRW Weakness Checked by Policy Support

The South Korean economy has faced slower domestic activity as a result of the MERS outbreak at the same time as external demand from China and elsewhere has come in soft. The BoK cut rates to a record low of 1.50% on June 9th and the government also announced a stimulus package to support industry and the economy more generally. These policy moves should eventually promote growth, but near-term challenges still remain. More recently, the BoK left rates on hold at the July meeting which likely signaled the end of its rate-cutting cycle. Although slower activity is expected to prevail in the near term, a recovery should emerge as past simulative policies take hold in 2016.

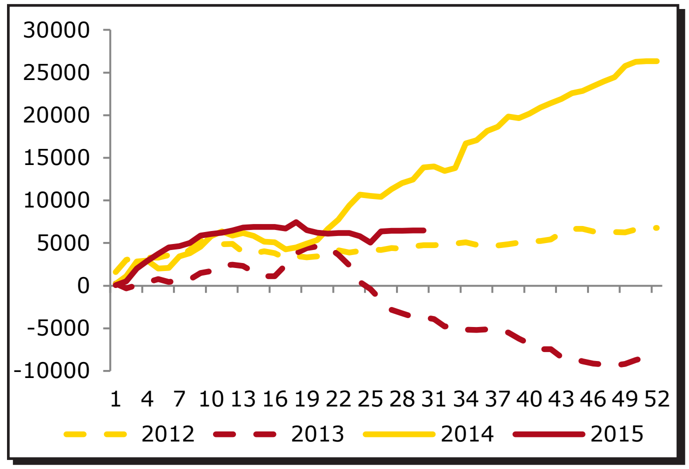
The KRW has been both resilient and stable versus the USD, but retreated versus the JPY during the recent bout of risk aversion in the market. However, that move appears to have reached its limit now that both the market turmoil has subsided and the BoK looks to be done cutting rates. It should be noted that challenges that might have been expected to weaken the KRW have, in part, been neutralized by portfolio inflows. Even though such flows have been slower because of the twin concerns of Greece and Chinese equities, they remain firm on a year/year basis.

INR Pressured on Higher Global Yields

Despite some fears of risk aversion on the back of developments in Greece, USDINR held its ground and did not break above the sideways consolidation range of 61.30–64.30 seen since early January. This is partly because portfolio inflows, which tapered off after beginning the year positively, have now stabilized (Chart 9). Any renewed withdrawal and/or hedging of those flows would pressure the INR; however that's not expected.

The RBI cut rates in early June, and more policy support may be needed for the economy. May trade was weak, as exports were down 20% and imports were down 17% year/year. Uncertainty around the external environment (yields and demand), and how they might be impacted by any Fed rate hikes, risks seeing INR on the defensive, but still potentially offering value in the mid-60's range versus the USD.

Chart 9 - ***Indian Portfolio Inflows are Stable, Not Strong***



Source: Bloomberg, CIBC

MYR Vulnerable to Investor Sentiment

Given that the MYR is off by 8% year-to-date, it's now the worst performing Asian currency versus the USD this year. The currency remains in the penalty box because of negative domestic sentiment and restrained investor risk appetite. Both of these factors have been reflected in weaker portfolio inflows and MYR losses.

Our previous expectation that this underperformance against the USD and regional peers would correct has not come to fruition and is not expected to reverse anytime soon. However, it should be noted that an unexpected recovery in commodity prices and/or global demand would see MYR regaining some lost ground.

Recent economic data has disappointed as May trade data was weak and industrial production for the same month was also soft. Although Malaysian 5-year CDS are off from highs for the year, they remain relatively elevated. As a result, although the BNM should be cutting rates to support the economy, they likely won't because of the risk to the currency.

Foreign ownership hedging and the unwinding of Malaysian bond purchases has contributed to MYR underperformance and remains a key point to watch moving forward.

IDR Weighed on by Uncertainty

Lower oil prices are a relief for Indonesia and should help shore up confidence in the economy. Like other Asian countries, external demand has been soft, with exports falling 15% year/year in May, while the trade balance was only saved by a 21% drop in imports. The IDR had been Asia's weakest currency year-to-date in 2015 (until it was overtaken by the MYR), giving up 6.9% versus the USD, taking it to levels not seen since 1998. As a result, monetary easing by the Bank Indonesia that would support the domestic economy may not be delivered due to worries that the currency might lose even more ground.

Interest Rate and Economic Outlook

End of period:		2015 III	2015 IV	2016 I	2016 II	2016 III
Canada	Overnight target rate	0.50	0.50	0.50	0.50	0.75
	2-Year Gov't Bond	0.45	0.55	0.80	1.00	1.20
	10-Year Gov't Bond	1.65	2.00	1.95	2.05	2.45
US	Federal Funds Rate	0.38	0.63	0.88	0.88	0.88
	2-Year Gov't Note	1.00	1.05	1.30	1.40	1.50
	10-Year Gov't Note	2.60	2.85	2.70	2.75	2.95
Eurozone	Refin.operations rate	0.05	0.05	0.05	0.05	0.05
	2-Year Gov't Bunds	-0.15	-0.10	0.00	0.05	0.05
	10-Year Gov't Bunds	0.50	0.55	0.60	0.70	0.70
UK	Bank rate	0.50	0.50	0.75	1.00	1.25
	2-Year Gilts	0.65	0.85	1.10	1.35	1.70
	10-Year Gilts	2.10	2.20	2.35	2.45	2.60
Japan	Overnight rate	0.10	0.10	0.10	0.10	0.10
	2-Year Gov't Bond	0.05	0.10	0.10	0.10	0.10
	10-Year Gov't Bond	0.40	0.45	0.50	0.50	0.55

		2014	2015	2016
Canada	Real GDP growth (%)	2.4	1.1	2.2
	Unemployment rate (%)	6.9	6.8	6.6
	CPI (%)	1.9	1.2	2.4
US	Real GDP growth (%)	2.4	2.5	2.5
	Unemployment rate (%)	6.2	5.3	5.0
	CPI (%)	1.6	0.6	2.7
Eurozone	Real GDP growth (%)	0.9	1.7	2.2
	Unemployment rate (%)	11.6	11.1	10.5
	CPI (%)	0.4	0.0	1.6
UK	Real GDP growth (%)	2.8	2.0	2.4
	Unemployment rate (%)	6.3	5.4	5.1
	CPI (%)	1.5	0.5	1.9
Japan	Real GDP growth (%)	-0.1	1.0	1.2
	Unemployment rate (%)	3.6	3.5	3.4
	CPI (%)	2.7	0.9	1.3