Monthly FX Outlook

June 19, 2018

Currency Strategy Highlights

- Over the course of the past month, the Fed surprised us by sounding more hawkish, while the ECB did the opposite by communicating a more dovish than expected stance on rates. Together, that has us looking for a slightly more resilient **US dollar** in the near-term.
- The **Canadian dollar** has been depreciating in line with our expectations. But, a fourth Fed rate hike this year combined with some harsh American rhetoric on trade has us weakening our forecast for the currency a touch further. We now expect USDCAD to reach 1.34.

Events to Watch in Coming Month

- The **OPEC** meeting later this week will provide direction for a number of commodity currencies. We continue to believe the cartel will raise oil production over the remainder of this year.
- Incoming data flow will be key to a **Bank of Canada** rate hike on July 11th. We're sticking with our forecast for central bankers to take action, but it's become a closer call than previously anticipated.
- The **EU Leaders Summit** on June 28-29th is unlikely to bring about material progress in terms of Brexit negotiations keeping international investors wary of sterling.

Currency Outlook

End of period:	19-Jun	2018 III	2018 IV	2019 I	2019 II	2019 III	2019 IV
US$ Rates:							
USDCAD	1.33	1.33	1.34	1.31	1.28	1.31	1.30
EURUSD	1.16	1.17	1.19	1.21	1.23	1.25	1.28
USDJPY	110	112	110	108	106	104	104
GBPUSD	1.32	1.31	1.33	1.36	1.39	1.42	1.47
USDCHF	0.99	0.98	0.97	0.96	0.95	0.94	0.94
AUDUSD	0.74	0.76	0.79	0.81	0.82	0.84	0.85
NZDUSD	0.69	0.70	0.71	0.73	0.75	0.77	0.78
USDBRL	3.76	3.70	3.55	3.50	3.45	3.50	3.55
USDMXN	20.59	19.40	18.90	18.50	18.10	18.40	18.00
USDKRW	1109	1055	1045	1035	1030	1025	1020
USDCNY	6.48	6.20	6.10	6.05	5.95	5.85	5.80
USDSGD	1.36	1.33	1.32	1.32	1.31	1.31	1.30
USDTWD	30.2	29.7	29.6	29.5	29.4	29.3	29.2
USDMYR	4.00	3.80	3.75	3.70	3.65	3.55	3.50
USDINR	68.4	67.3	67.1	66.9	66.6	66.3	66.0
USDIDR	13932	13900	13800	13700	13600	13500	13400
Other Crosses:							
CADJPY	83	84	82	82	83	79	80
AUDCAD	0.98	1.01	1.06	1.06	1.05	1.10	1.11
GBPCAD	1.75	1.74	1.78	1.78	1.78	1.86	1.91
EURCAD	1.53	1.56	1.59	1.59	1.57	1.64	1.66
EURJPY	127	131	131	131	130	130	133
EURGBP	0.88	0.89	0.90	0.89	0.89	0.88	0.87
EURCHF	1.15	1.15	1.15	1.16	1.17	1.18	1.20
EURSEK	10.31	10.00	9.90	9.80	9.70	9.60	9.50
EURNOK	9.48	9.30	9.25	9.10	8.95	8.85	8.80

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USD Gains to Gradually Fade

Just as the weather outside is heating up, the US economy looks to be doing the same. Following a blockbuster retail sales report, we're now calling for a roughly 4% pace to growth in the second quarter, leaving the year now tracking an advance of just under 3%.

Those upgrades, combined with a more hawkish sounding Fed, have us now forecasting a fourth rate hike in 2018. That, however, is simply a pulling forward of one of the three 2019 moves we had previously penciled in.

The surprise outperformance of the US economy so far in Q2 and a more dovish than expected ECB have seen investors bid up the USD. As a result, we've pushed back our forecasted depreciation of the greenback. That said, we still see structural factors as suggesting that a weaker USD is in store.

Indeed, the effects of fiscal stimulus should taper off into the end of 2019 and markets will need to come to terms with an economy that has reached full employment and is grappling with a wide current account deficit.

With markets now overly pessimistic in terms of ECB policy and expected Fed hikes largely priced in, the medium-term course still seems to be set for depreciation against most other majors.

CAD Backed Into a Corner

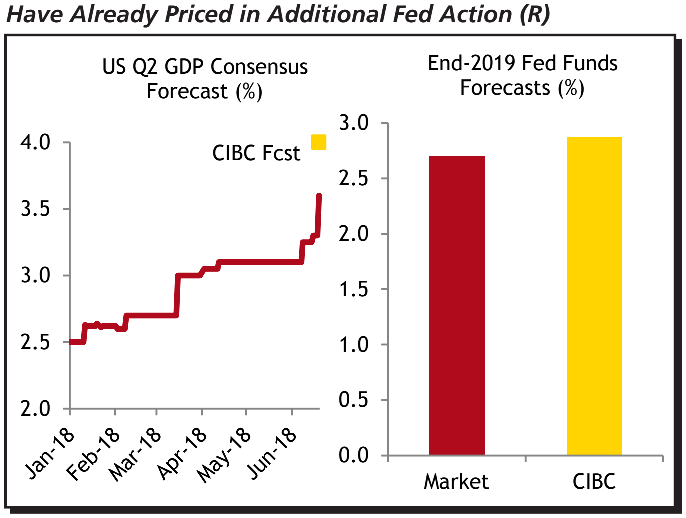
The loonie has come under attack in recent weeks from both Trump administration officials and falling oil prices. It hasn't helped that the economic data flow has also looked patchier of late.

Adding to the loonie's woes will be Federal Reserve officials who look set to raise rates this year more aggressively than previously envisaged. As a result, while CAD has depreciated in line with our forecasts, the slightly stiffer headwinds now have us calling for it to hit 1.34 versus the greenback later this year, slightly weaker than our last projection.

Steel and aluminum tariffs proved to investors that the Trump administration wasn't going to let Canada off the hook for perceived unfair trade practices. The recent increase in verbal jabs across the 49th parallel show that Canada is now a focus of the administration's ire regarding trade rather than just a bystander.

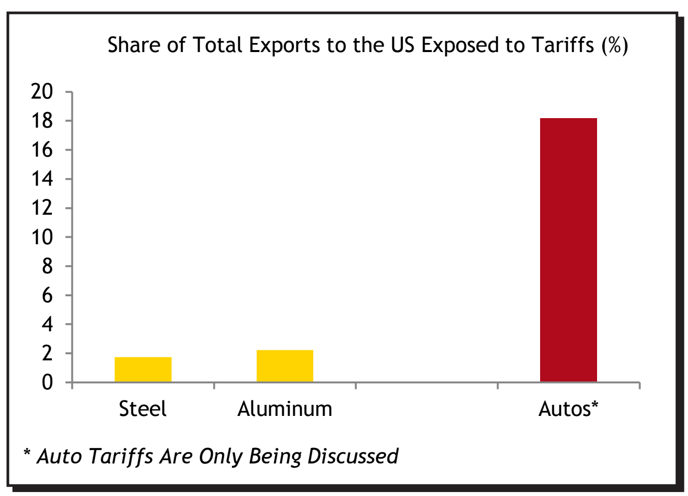
The potential for US auto tariffs present a risk to the Canadian dollar, and would see an even weaker profile for the loonie if they became a reality. However, even under the base case scenario that those tariffs aren't imposed, uncertainty surrounding the trade environment will still likely shows up as a drag on business investment. Canada has already lost a competitive advantage from US tax cuts and a broad-based regulatory rollback, meanings it's more likely that the Canadian dollar will need to stay weak to aid investment and export performance.

Chart 1 ***- US Growth Forecasts Upgraded (L) But Markets Have Already Priced in Additional Fed Action (R)***



Source: Bloomberg, CIBC

Chart 2 ***- Auto Tariffs Present a Material Risk***



Source: Statistics Canada, CIBC

Overall, we continue to expect that the currency will weaken somewhat in the months ahead, and then average roughly 1.30 over the next two years to keep the economy competitive on the global stage.

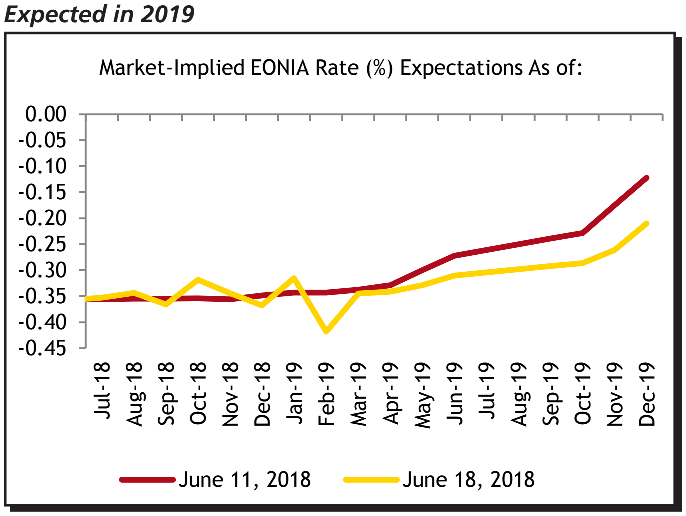
EUR Appreciation Delayed

The ECB surprised markets by announcing the timeline to end bond buying at their June meeting rather than waiting for more data and making the announcement in July. But officials also announced that they wouldn't be raising rates before the end of next summer, something that was seen as a dovish commitment by the central bank.

While the ECB have tied themselves to calendar-based guidance, and Draghi having reeled off a litany of risks to the economic backdrop, downward revisions to 2018 growth still leave the economy running above trend into the end of next year. Rising domestic price pressures as spare capacity is eroded could lead HICP to overshoot even the upwardly revised 1.7% forecast (up 0.3%-pts from the March projections) of the ECB for 2018 and 2019.

While the re-pricing of rate expectations will see a weaker EUR profile than we previously anticipated, evidence of building inflationary pressures and commentary from ECB hawks still suggests a modest appreciation over the medium run. Indeed, markets should not lose sight of the fact that calendar-based central bank guidance does not always run according to plan.

Chart 3 - ***ECB Guidance More Dovish Than Market Had Expected in 2019***



Source: Bloomberg, CIBC

JPY: Low for Longer

To little surprise, the BoJ left its policies unchanged at their June meeting. However, the downward revisions to their CPI estimates came as a surprise, with policymakers now seeing core CPI in a range of 0-5-1.0% this year, compared to 1.0% in April. That indicates significant policy adjustment has likely been pushed further into the future.

Although the Q1 GDP disappointment was likely transitory, until there are more material signs of an increase in wages, it remains evident that the BoJ is on a different trajectory than other G7 central banks. As a result, we have pushed out our timeline for action from the BoJ, and now see the yen ending the year on a weaker note than previously expected.

Disappointing Growth Holding GBP Back

The Bank of England assumes that the weakness in Q1 GDP was largely temporary and a function of external factors, including poor weather. A strong rebound in Q2 therefore likely leaves the possibility of an August rate hike intact depending on how the data evolves.

And although retail spending has rebounded sharply into Q2, there remains doubt as to the sustainability of those gains. Outside of the bounce in retail sales, the underlying data remains mixed at best. Indeed, both manufacturing output and net trade started Q2 under a cloud, with exports declining 5.9% m/m in April, which should trim the odds of an August rate hike. As such, we are leaning towards a November rate hike.

Ongoing Brexit related political risk is also likely to impact Sterling valuations beyond those determined by monetary policy expectations. Our base case scenario for the upcoming EU Leaders summit (June 28-29) is that Brexit negotiations do not see material progress as the UK continues to debate internally what trading arrangements it is likely to pursue. Indeed, with the political fortunes of the UK PM remaining challenged, we expect international investors to remain wary of holding Sterling until there more certainty prevails.

As such, we have pushed back our expectations for GBP appreciation with GBPUSD reaching only 1.33 by the end of the year.

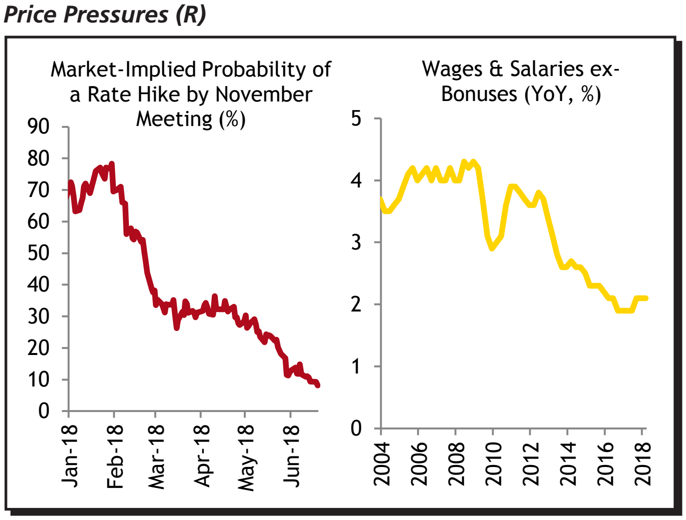
AUD Remains Resilient

Australia's economy outperformed in Q1, with GDP registering an annual growth rate above 3% for the first time in seven quarters. And although RBA Governor Lowe had previously indicated that, "it is likely that the next move in rates will be up, not down" following strong growth progress, the market currently implies less than a 10% probability of a rate hike by the November meeting.

In order for rate hike expectations to move higher in 2018, we will need to see evidence of either rising wages or an uptick in CPI. Although inflation and wage expectations have risen in June, while the unemployment rate eased back to the cyclical low of 5.4% in May, broad based evidence of sustainable, strong growth will likely be required to inject further hawkish sentiment into RBA expectations. Indeed, the decline in the unemployment rate owed largely to a fall in participation, and nominal pay growth has subsided in contrast to the expectations indicator. The Australian economy also tends to be adversely impacted by trade tensions and that could materially impact AUD sentiment given heightened protectionist rhetoric.

However, with the market already discounting significant bad news (net positioning remains negative) it wouldn't take much of an uptick in the data backdrop, or commodity influences, to encourage a positioning reversal and modest gains in AUD valuations. Overall, we still see AUD gaining against the greenback in the months ahead, rising to 0.79 by the end of the year.

Chart 4 ***- Subdued Rate Expectations (L) Owed to Sluggish Price Pressures (R)***



Source: Bloomberg, CIBC

NZD on A Path toward Gradual Appreciation

Although the release of Q2 CPI (16 Jul) will likely see annual inflation ticking back towards the mid-point of the RBNZ's 1-3% target range, due in large part to base effects, a moderating growth trajectory and a deceleration in house prices suggests we can expect RBNZ Governor to remain patient regarding any changes to monetary policy. While Governor Orr may have attempted to keep his options open, we anticipate that the next move will be a hike albeit not until 2019. Moreover, due to high levels of household indebtedness expect the bank, in line with most other central banks, to act with caution.

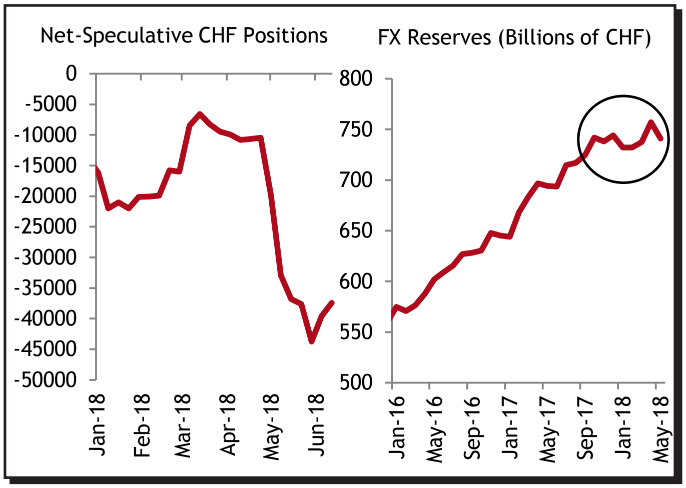
In terms of the NZD, its recent performance correlates well with both positioning and the performance of the economic surprise index. The excessive NZD longs at the end of April, driven in part by an uptick in consumer confidence and spending into the end of Q1, have corrected as data trends have retreated and global macro confidence was undermined by global trade tensions. However, with the dairy price index registering a solid uptrend and long end spreads versus the US rebounding from levels not seen in 25 years, we expect a gradual appreciation in NZD heading into 2019.

SNB to Resist Strengthening CHF

We entered the month with net CHF shorts at levels not seen in more than ten years, something we see as increasingly inconsistent with fundamentals. Indeed, annual GDP in Q1 advanced at the fastest rate since the end of 2014. Despite the SNB anticipating a robust growth outlook, the market remains relaxed about the prospect of SNB tightening.

Amidst ongoing trade tensions we expect a correction in excessive CHF shorts, and in the process an appreciation of CHF. However, the SNB is likely to resist aggressive CHF gains amidst concerns of returning to deflationary pressures. After seeing FX reserves retreat in May, when EURCHF tested 1.20, we wouldn't be surprised if the upcoming months saw renewed reserve accumulation as the currency moves back stronger.

Chart 5 - ***Negative CHF Sentiment (L) Has Allowed SNB to Ease Off Intervention (R)***



Source: Bloomberg, CIBC

Fundamentals Still Point to a Stronger SEK

Although the Swedish economic surprise index retreated from nine month highs into the start of the month, fundamentals remain supportive, suggesting that the broad undervaluation of the SEK should continue to correct. The combination of an upbeat business survey from the Riksbank, and rising inflation expectations in the latest Prospera survey, underline the fact that pressure is building on the Riksbank to row back its ultra-easy monetary policy.

With the Riksbank business survey revealing that 'demand is strong in all sectors' and that the economic upswing is continuing, we expect Riksbank rate hawks to be increasingly in the ascendancy. Indeed, with the latest inflation survey revealing that labour market participants believe that inflation over a 2-5 year time horizon is likely to exceed the Riksbank's 2% CPI target, there now seems to be momentum towards a Q4 hike.

The combination of robust fundamentals allied to the prospect of early action, likely well ahead of the ECB, underlines why we continue to favour SEK gains. Such upbeat sentiments come as the SEK has proved by far the top performing major versus the EUR since the start of last month, advancing by more than 4%. Expect such gains to continue.

NOK to Unwind Serious Undervaluation

Although Norwegian inflation unexpectedly eased in May, we don't expect this to change the underlying message from the Norges Bank. Remember that policy makers have previously flagged that rates will be on the rise 'after the summer'. We expect that the Norges bank will use their policy meeting on June 21 to underline that rates are going higher potentially as soon as the September 20 meeting, in line with the Monetary Policy Report.

Despite the retreat in inflation, we would expect the central bank to pay close attention to the results of their regional business survey. Hence, despite the current inflation shortfall, rising capacity utilization underlines the need for imminent policy action with further tightening to come during 2019.

Solid fundamentals and rising rates, in addition to a burgeoning current account surplus, suggest that NOK gains will continue, unwinding what we consider still to be a seriously undervalued currency.

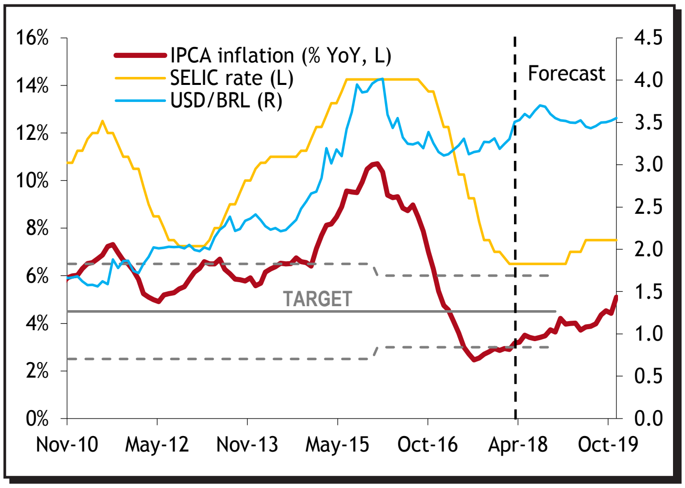
BRL: A Still Uncertain Electoral Outlook

Brazilian markets are making a better evaluation of the risk episodes that the country could face in the next months and possibly years. For the time being, ample uncertainty surrounds the presidential election outcome may lead to USDBRL volatility in the coming months.

While voting intentions polls suggest that Jair Bolsonaro could have a chance to be in the run-off of the election, predicting an adversary for that second round is complicated. PT's under a Lula leadership continues to poll the highest voting intentions of all candidates, but his stay in jail makes it virtually impossible for him to be a candidate. PT's best chances lie in going alone with a member of its party, Fernando Haddad most likely, or endorsing a party outsider. In this last sense, Ciro Gomes comes to mind, but the final decision could lie within Lula and PT's leadership. Uncertainty regarding structural reforms that Brazil will need in order to effectively run a fiscal consolidation exercise is still running high.

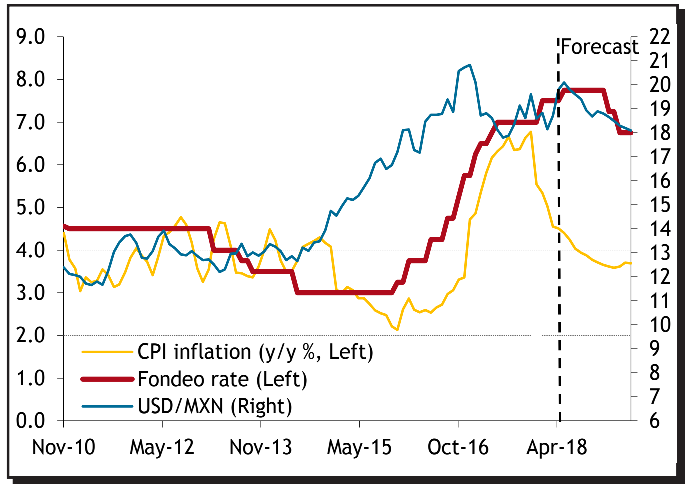
In the short-term, we expect BRL volatility to persist as market participants wrestle the Banco Central

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



Source: Banco Central do Brasil, IBGE, CIBC

Chart 7 ***- USD/MXN, Rondeo Rate, Headline and Core Inflation (y/y %)***



Source: Banxico, Bloomberg, CIBC

(BC) ongoing tactical and unscheduled FX swaps intervention. In this sense, "unpredictability of market timing" is also a strategy. While the BC gives some guidance on how much it wants to do in notional size over a certain time period, the timing is up to the BC and thus maximizes its intervention power. We have seen this behavior back in 2015 and it worked for the central bank in the short-term, but in the middle-term BRL is, of course, a function of fundamentals and the most the BC will be able to do is to try to damp excess liquidity due to flows either way.

MXN: Caught in the Crossfire

The peso continues to find itself in the crossfire of tariff rhetoric, the uncertainty associated with the presidential election and a less optimistic outlook for NAFTA. More clarity surrounding these should relieve some of the weakness in MXN in the coming months, with a weaker USD also supporting a stronger peso.

On the political front, if the polls are correct and Andres Manuel Lopez Obrador wins the presidential bid on July 1st, it could have consequences not only for the political consensus, but also for the way that, and under of, deputies under "proportional representation" are elected. The proportion of national votes that a party gets in the election is used in order to assign the remaining 200 seats on top of the 300 seats elected by direct vote under a set of rules, with the lists for the 200 seats elected by proportional representation being put together by each party. If the MORENA party is able to get enough votes (direct or indirect) to be close to a simple majority, it could make its life much easier in congress.

The next administration also has to put together a transitional team that will work together with the current administration in order to craft a budget for next year, with the new president not being sworn in until December 1st. The creation of the budget for next year should give us important clues to what kind of fiscal policy we will get in the years to come and how the budget balance will impact the direction of MXN.

The lack of agreement in automobile rules of origin and sunset clauses continue to be deal breakers for Mexico and Canada. While our base case for MXN is for an agreement in some shape or form to be reached in either late 2018 or 2019, we think that there could still be some curve balls in this process that could rattle markets. With more certainty regarding the political backdrop in the coming weeks and a weaker USD, look for MXN to strengthen, with USDMSX falling to 19.40 in the months ahead.

CNH & CNY Outlook Unscathed From Tariffs So Far

Global protectionist trade measures still loom large over China, but solid fundamentals will prevail in supporting an appreciation in the renminbi. Since mid-April, USD/China has tracked sideways to modestly higher, with the key driver being a broadly firmer USD against other major currencies. For USD/China itself, this was a correction to a sustained trend move lower from near 7.00 in January 2017.

Our medium- and long-term outlook for the Chinese currency remains for appreciation, both against the USD and on trade-weighted measures. Still, we do not rule out some further sideways trade for USD/China before the trend move lower is resumed.

Global trade protectionism concerns and tariffs imposed on China by the US, set to come into effect on July 6th, remain in the market's consciousness. That said, Chinese trade data for May showed a solid expansion in exports of 13% y/y and an even stronger expansion in imports of 26% y/y. The net result was an overall smaller surplus, though the gap with the US remains wide and will remain a point of friction. Earlier this year, we observed China maintaining a stable level of the yuan, potentially to appease the Trump administration. By and large that has continued, notwithstanding the modest correction. The trade-weighted value of the yuan is also slightly weaker in recent weeks, but we maintain the trend, as against the USD, is toward further medium-term appreciation.

KRW: Eased North Korea Tensions a Long-Term Positive

The just completed summit between Trump and Kim Jong-un in Singapore has been deemed a success. That the meeting appears to, at very least, be a move forward in the relationship and thus serves to damp tensions, we expect investors to be optimistic. Even so, near-term market impact was limited and it is of the medium and longer-term that we see as more important when viewing the outcome. The positive result can lead to long-term positives for North and South Korea and Asia more generally. We expect to see improved investor appetite for positions in the region but these outcomes will take time to develop.

Checking how markets have moved recently and assessing the influence of North Korea, there have clearly been episodes of risk aversion, when portfolio flows to South Korea appeared to either have been slowed or partially reversed. Even so, while equity flows are negative at -$2bln ytd, foreign portfolio flow into the bond market has been strong, currently showing at $22.7bln ytd. The inflow to the bond market is in-line or stronger than in recent years, and the equity flow is weaker, but not out of line with portfolio shifts in many other equities markets this year.

In considering medium- to long-term benefits of eased tensions between North Korea and the US, we remain positive on the outlook of the KRW. Some near-term sideways trade against the USD may continue, in which case near-term gains will be best reflected in trade-weighted measures.

INR: Higher Oil Prices and Negative Sentiment Impact

With higher oil prices and upward pressure on prices and deficits, we forecast INR to be an underperformer against other Asian currencies over coming months. Some ongoing domestic political uncertainty has also damped INR sentiment. The track of USD/INR will be in large part dictated by broad USD direction. Further upside in USD/INR will however likely be capped, and certainly slowed, by potential further RBI rate hikes and intervention.

RBI recently hiked rates (+25bps to 6.25% on June 6) in a joint and related effort to damp depreciation of the INR and to respond to higher inflation pressure, the latter driven in large part by higher oil prices. The hike was well-received, but came as USD/INR was already trading below the highs of mid-May. RBI maintained the GDP forecast of 7.4%, but raised the inflation outlook to 4.8-4.9% in 1H 2019 and to 4.7% in 2H, from 4.4% previously.

Ahead of the rate hike, INR, like other deficit currencies in Asia (IDR and PHP) had been under pressure on some withdrawal of portfolio inflows, impacted both by geo-political tensions and uncertainty over the track of global monetary policy. As long as that continues, it will be a hard road back for the INR to regain favour with investors.

IDR: Portfolio and Trade Concerns Linger

IDR, as with other deficit economy currencies in Asia and emerging markets globally, faces challenges of maintaining investor attraction after some years of portfolio inflow and subsequent appreciation of domestic assets (equities and bonds). Until resolution of investor appetite, which will be related to global monetary policy moves, IDR is set to be an underperformer against other Asian currencies and the track of USD/IDR will be dominated by the broad USD bias. BI has raised rates twice in recent weeks (7-day repo now 4.50%) and this has helped to dampen, but not eradicate, pressure on the IDR.

The withdrawal of portfolio monies in specific Asian economies has been most notable in Indonesia. Though the amounts do not read as huge of themselves, it is the reversal of previous positioning and/or the hedging of the currency exposure that has had a significant impact. Indonesian stocks have seen withdrawal of $3.1bln ytd after $3bln was withdrawn in 2017 and after an inflow of around the same amount in 2016. Foreign portfolio flow is into bonds ytd, but just barely, currently +$325mln, coming after inflow of $12bln in 2017 and $7.6bln in 2016.

As investors have been trying to leave by the same small liquidity window, both assets and the currency have been pressured to depreciate. The 5yr bond yield has climbed to 7.02% (high 7.12%) from 5.60% in January. Add a widening trade gap (only March was a surplus since the previous in November) and pressures on the IDR are simply validated.

Interest Rate and Economic Outlook

End of period:		2018 III	2018 IV	2019 I
Canada	Overnight target rate	1.50	1.50	1.75
	2-Year Gov't Bond	2.05	2.05	2.10
	10-Year Gov't Bond	2.50	2.55	2.65
US	Federal Funds Rate	2.13	2.38	2.38
	2-Year Gov't Note	2.60	2.75	2.75
	10-Year Gov't Note	2.95	3.05	3.20
Eurozone	Refin.operations rate	0.00	0.00	0.00
	2-Year Gov't Bunds	-0.50	-0.35	-0.25
	10-Year Gov't Bunds	0.60	0.70	0.80
UK	Bank rate	0.50	0.75	0.75
	2-Year Gilts	0.85	1.10	1.20
	10-Year Gilts	1.50	1.65	1.75
Japan	Overnight rate	-0.10	-0.10	-0.10
	2-Year Gov't Bond	-0.10	-0.05	0.05
	10-Year Gov't Bond	0.05	0.10	0.15

		2017	2018	2019
Canada	Real GDP growth (%)	3.0	2.0	1.6
	Unemployment rate (%)	6.3	5.8	5.7
	CPI (%)	1.6	2.4	2.0
US	Real GDP growth (%)	2.3	2.9	1.9
	Unemployment rate (%)	4.4	3.9	3.7
	CPI (%)	2.1	2.7	2.5
Eurozone	Real GDP growth (%)	2.5	2.1	1.5
	Unemployment rate (%)	9.1	8.4	8.1
	CPI (%)	1.5	1.6	1.9
UK	Real GDP growth (%)	1.8	1.3	1.3
	Unemployment rate (%)	4.4	4.4	4.3
	CPI (%)	2.7	2.5	2.2
Japan	Real GDP growth (%)	1.6	1.2	0.8
	Unemployment rate (%)	2.8	2.5	2.7
	CPI (%)	0.5	0.9	1.1