Scotiabank

GLOBAL ECONOMICS & FX STRATEGY

FOREIGN EXCHANGE OUTLOOK

September 12, 2024

Contributors

Shaun Osborne
Chief FX Strategist
416.945.4538
shaun.osborne@scotiabank.com

Anibal Alarcón, Senior Economist
Scotiabank Chile
+56.2.2619.5465
anibal.alarcon@scotiabank.cl

Ricardo Avila, Senior Analyst
Scotiabank Peru
+51.1.211.6000 Ext. 16558 (Peru)
ricardo.avila@scotiabank.com.pe

Derek Holt
VP & Head of Capital Markets Economics
Scotiabank Economics
416.863.7707
derek.holt@scotiabank.com

Brian Pérez, Quant Analyst
Scotiabank Mexico
+52.55.5123.1221 (Mexico)
bperezgu@scotiabank.com.mx

Jackeline Piraján, Senior Economist
Scotiabank Colombia
+57.601.745.6300 Ext. 9400
jackeline.pirajan@scotiabankcolpatria.com

Luisa Valle, FX & FI Strategist
Scotiabank Mexico
+52.55.5123.1725
lvallef@scotiabank.com.mx

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Market Tone

The US dollar (USD) has underperformed in the third quarter, reflecting a constellation of factors that have shaken up currency trading and injected renewed volatility into markets. We had expected the USD to ease somewhat in H2 as cyclical factors turn less supportive and while USD losses have moderated somewhat in recent trading, the net impact is still a somewhat weaker USD than we had anticipated at this stage.

USD weakness can be largely explained by the following. Firstly, US yields eased in July and fell sharply in August following the release of a weaker-than-expected US July employment report. The data boosted slowdown concerns, prompting markets to ponder whether the Federal Reserve (Fed) was "behind the curve" and would need to kick off its easing cycle with a more aggressive rate cut in September. Secondly, a Bloomberg/Businessweek interview with presidential candidate Trump revealed his concern that the strength of the USD was a "problem", particularly against the Japanese yen (JPY) and Chinese yuan (CNY), adding to corrective pressure on the JPY but weighing on the USD tone broadly. A third, and related factor, was the extended surge in the JPY following an unexpected increase in the Bank of Japan's (BoJ) policy rate at the end of July, with JPY gains compounded by short-covering demand as JPY-funded carry trades were unwound aggressively. A fourth factor was Vice President Harris' elevation

Continued on next page …

FX Forecasts

Major Currencies		2023	2024f	2025f	2024f Q1a	Q2a	Q3	Q4	2025f Q1	Q2	Q3	Q4
Japan	USDJPY	141	150	140	151	161	150	150	145	145	140	140
Euro zone	EURUSD	1.10	1.09	1.15	1.08	1.07	1.07	1.09	1.11	1.11	1.15	1.15
	EURJPY	156	164	161	163	172	161	164	161	161	161	161
UK	GBPUSD	1.27	1.27	1.31	1.26	1.26	1.25	1.27	1.29	1.29	1.31	1.31
	EURGBP	0.87	0.86	0.88	0.85	0.85	0.86	0.86	0.86	0.86	0.88	0.88
Switzerland	USDCHF	0.84	0.90	0.89	0.90	0.90	0.92	0.90	0.91	0.91	0.89	0.89
	EURCHF	0.93	0.98	1.02	0.97	0.96	0.98	0.98	1.01	1.01	1.02	1.02
Americas												
Canada	USDCAD	1.32	1.36	1.30	1.35	1.37	1.38	1.36	1.34	1.32	1.32	1.30
	CADUSD	0.76	0.74	0.77	0.74	0.73	0.72	0.74	0.75	0.76	0.76	0.77
Mexico	USDMXN	16.97	20.50	21.30	16.56	18.32	19.80	20.50	20.70	20.80	21.00	21.30
	CADMXN	12.80	15.07	16.38	12.23	13.38	14.35	15.07	15.45	15.76	15.91	16.38
Brazil	USDBRL	4.86	5.33	5.26	5.01	5.59	5.42	5.33	5.30	5.26	5.25	5.26
Chile	USDCLP	879	890	870	979	940	900	890	870	870	870	870
Colombia	USDCOP	3,855	4,116	4,150	3,852	4,153	4,102	4,116	4,120	4,125	4,140	4,150
Peru	USDPEN	3.70	3.75	3.78	3.72	3.84	3.80	3.75	3.75	3.75	3.80	3.78
Asia-Pacific												
Australia	AUDUSD	0.68	0.68	0.72	0.65	0.67	0.68	0.68	0.70	0.70	0.72	0.72
New Zealand	NZDUSD	0.63	0.61	0.65	0.60	0.61	0.60	0.61	0.63	0.63	0.65	0.65

f: forecast a: actual

CAD FX Forecasts

Canadian Dollar Cross-Currency Trends

FX Rate	Spot 12-Sep	24Q1a	24Q2a	24Q3f	24Q4f	25Q1f	25Q2f	25Q3f	25Q4f
AUDCAD	0.91	0.88	0.91	0.94	0.92	0.94	0.92	0.95	0.94
CADJPY	104.7	111.8	117.6	108.7	110.3	108.2	109.8	106.1	107.7
EURCAD	1.50	1.46	1.47	1.48	1.48	1.49	1.47	1.52	1.50
USDCAD	1.36	1.35	1.37	1.38	1.36	1.34	1.32	1.32	1.30

Market Tone

as the Democrats' candidate for the presidential election. This has undermined former President Trump's lead in opinion polls and forced markets to reconsider USD-positive "Trump reflation" trades. The outcome of the US presidential election will have a significant impact on financial markets broadly in the latter part of the year and may complicate the outlook for the USD in the medium term.

A final consideration might be weak USD seasonality in Q2 and Q3. Seasonal trends have not been especially prominent in the past couple of years, but the 2024 evolution of trading closely resembles the typical pattern of trade in the dollar index (DXY) over the past 25 years. If the pattern extends, more weakness is likely in the next month or so—possibly reflecting some further weakening in cyclical supports for the USD as the Fed starts to cut interest rates and US growth momentum slows. A moderate, late-year rebound in the USD would be a typical reflection of its average performance since the late 1990s, all else equal.

The Canadian dollar (CAD) has recovered from weakness seen through late July and early August that saw the USD retest the 1.39 area (close to the 2022 and 2023 USD highs). Slowing inflation and rising unemployment prompted the Bank of Canada (BoC) to cut interest rates three times since June, stealing a lead over its many of its central bank peers. Weak cyclical drivers intensified bearish sentiment in the CAD through mid-year but negative sentiment appears to have peaked just as the CAD troughed. The broader slide in the USD through August squeezed out a significant proportion of CAD short positions, with lower US yields (and narrower US/Canada spreads) helping pin back the USD.

Pressure on the Mexican peso (MXN) has intensified in the past few months. Political concerns remain a drag on the MXN amid speculation that President Lopez Obrador will push ahead with judicial reforms before he steps down. MXN losses have extended to the 20 zone, with weakness amplified by the unwind of JPY-funded carry trades in the MXN following the BoJ rate hike. Heightened volatility across markets generally will likely preclude any significant revival in carry trade demand for the MXN for now. Other Pacific Alliance currencies have outperformed the MXN so far in Q3 but are trading off their best levels. Softer copper prices and lower rates have undercut the Chilean peso (CLP) while weak crude oil prices have weighed on the Colombian peso (COP). The Peruvian sol (PEN) is the top regional performer so far over the quarter.

Most core G10 currencies have benefitted from lower US yields and somewhat narrower short-term interest rate differentials to post gains against the USD over Q3. The Japanese yen JPY is the top-performing major currency, reflecting some of the factors noted above (BoJ tightening and the washout in carry trades prompting significant JPY short covering). In addition, the central bank intervened again in support of the currency in July and BoJ officials appear confident that monetary policy is on the right course, leaving the door open to additional, if modest, rate increases in the coming months. A firm ceiling on USDJPY has been established around the 160 point now but the JPY remains weak in real effective terms, implying that the sharp appreciation seen in the currency in Q3 has room to extend in the medium term as US/Japan interest rate differentials continue to narrow.

Both the euro (EUR) and pound (GBP) have appreciated a little more rapidly than we had expected against the soft USD since the middle of the year. While both the European Central Bank (ECB) and Bank of England (BoE) are poised to cut interest rates in the coming months, economic conditions (sticky service inflation in the Eurozone and still-elevated wages in the UK) suggest rates may fall relatively more slowly in the Eurozone and UK than in North America. But term yield spreads appear fairly priced to reflect these developments, suggesting that the USD may remain soft but might not weaken that much more unless rate expectations adjust significantly from current levels.

Shaun Osborne, Canada 416.945.4538

September 12, 2024

Federal Reserve and Bank of Canada Monetary Policy Outlook

FEDERAL RESERVE—GRADUAL REMAINS THE PLAYBOOK

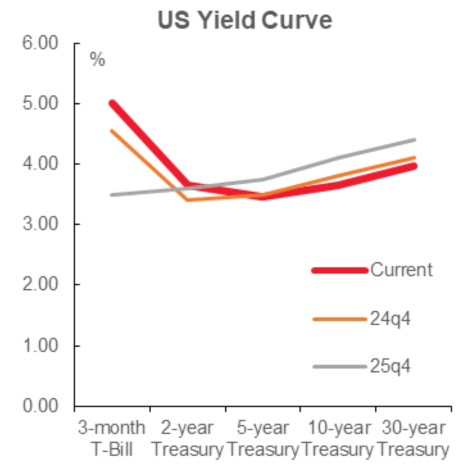
Scotiabank Economics expects the FOMC to cut in three consecutive quarter point moves over the remaining meetings of 2024 followed by another 125bps of cuts next year. That should put the upper limit of the fed funds target range at 3.5% by the end of 2025 and hence still restrictive. We also expect QT (quantitative tightening) to end by late Winter or early Spring next year.

The US economy remains in excess aggregate demand with a labour market that is still tight. It's too soon to declare inflation risk as having gone away especially in light of potential ongoing challenges with seasonal adjustments to inflation and jobs data.

And yet we have more confidence now compared to earlier that the US economy is rebalancing the forces of supply and demand in order to enable an easing cycle. Trend gains in productivity and population including undocumented workers have expanded the potential supply of the US economy. Demand is expected to cool with further lagging effects of credit tightening and prior policy tightening. Fiscal policy has been dragging against US GDP growth for some time. The broad dollar has recently softened but there could still be lagging negative effects on net trade stemming from appreciation over prior years. Housing affordability remains pressured.

As excess demand wanes so should pressures on the Fed's dual mandate and aided by an expected lessening of housing's influences on inflation into 2025.

A key risk, however, remains the US election and the likelihood that whoever wins there may be further upward pressure on term premia shown in our yield curve forecasts. Trade policy and fiscal policy are difficult to assess until we get past the US election.



Sources: Scotiabank Economics, Bloomberg.

BANK OF CANADA—THE LEVERAGE ADVANTAGE RETURNS TO CANADA

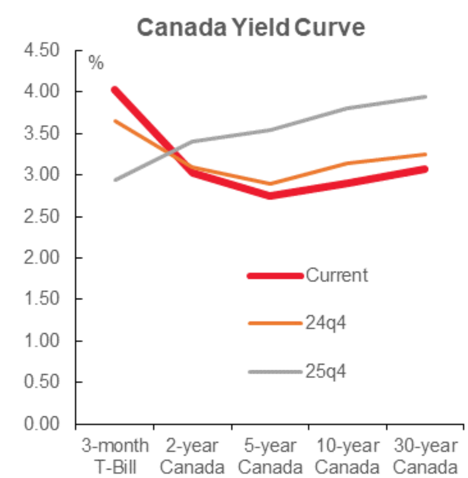
Scotiabank Economics expects two more quarter point rate cuts this year in October and December followed by a cumulative 75bps reduction spread over early next year. That should put the overnight rate at 3% by the second quarter of next year which would remain substantially higher than pre-pandemic levels. This forecast is little changed from previous expectations.

There are many uncertainties overhanging this forecast. One is geopolitical developments including the US election and its potential impact upon fiscal and trade policies. Other risks are domestic in nature. Mild excess capacity is expected to persist even as the supply side is expected to grow more slowly due to ongoing productivity challenges and curtailed population growth, but demand pressures could face greater strength than we forecast and close spare capacity faster and thus limit rate cuts.

One such channel is fiscal policy being more stimulative than we have incorporated. A federal election year beckons, and governments of any stripe that are down in the polls like the current one tend to engage in fiscal pump priming. Greater than expected fiscal easing could complicate monetary easing.

More important could be views on the consumer and housing markets. To say there is upside is a tough sell at present due to the recency bias; many households have been pressured by developments to date. But as forecasters looking to the future, upside risk could come from a combination of pent-up demand, excess saving in narrow and broad forms, and the lagging effects of a population surge. The catalyst to this happening is that whereas high debt was a disadvantage in a rising rate environment, high debt confers more rewards to the Canadian economy relative to others as rates normalize.

The accompanying chart shows how this is expected to unfold as the rates curve normalizes into 2025 with potentially higher inflation and issuance risk as term premia rise.



Sources: Scotiabank Economics, Bloomberg.

Derek Holt, Canada 416.863.7707

North America

USD

Lower US Yields Undercut USD **Current spot 1,232.85**

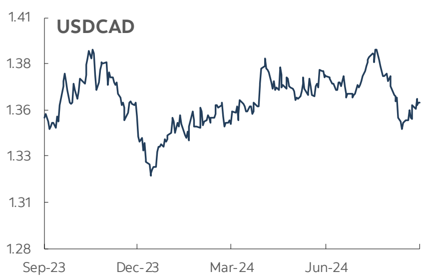
Source: Bloomberg.

USD—Lower US yields and narrower (though still positive) yield spreads have weakened the USD since the middle of the year. The US economy is slowing but the Fed may have engineered a soft landing that will allow it to ease monetary policy gradually in the months ahead, supporting expectations that are already baked into swaps and term yields. Markets are positioning for more USD weakness in the near term but a lot of bad news (in terms of rate expectations) are already priced in to the USD at this stage, suggesting that while the USD may remain soft, scope for additional losses is limited for now. The outcome of the US presidential election will have a major bearing on the USD's medium-term course.

Shaun Osborne, Canada 416.945.4538

USDCAD

Short Covering, Spreads Lift CAD **Current spot 1.3593**



Source: Bloomberg.

USDCAD—The CAD has recovered from its mid-year weakness, with losses holding around the 1.3850/1.39 (USc72) area, as we expected. The reversal in over-extended CAD sentiment (CFTC data through July reflected record net short CAD positioning) provided some of the impetus for the CAD rebound while narrower US/Canada short-term yield spreads also supported CAD gains. Domestic economic developments and the relative pace of BoC/Fed easing will drive the broader direction of USDCAD in the medium term. In the short run, there still appears to be an overhang of stranded CAD shorts that will use minor CAD declines as an opportunity to square up positions, curbing USDCAD gains.

Scotia Forecasts	Q3-24	1.38	Q4-24	1.36	Q1-25	1.34	Q2-25	1.32

Shaun Osborne, Canada 416.945.4538

USDMXN

MXN Losses Steady Near 20 **Current spot 19.5465**

Source: Bloomberg.

USDMXN—The MXN has depreciated sharply following the presidential elections, constitutional reforms, and international events. It seems that the market in general is still analyzing the implications of these structural changes, so there could be more volatility as the changes are implemented and the elections in the United States take place. The MXN has reached levels not seen since 2022 around 20.15 but has managed to stabilize just below 20.0. We expect it to depreciate a little more as Banxico eases monetary policy and carry trade interest diminishes. For now, everything points to the Banxico target rate closing the year at 10.25% and dropping close to 8.0% in 2025.

Scotia Forecasts	Q3-24	19.80	Q4-24	20.50	Q1-25	20.70	Q2-25	20.80

Brian Pérez, Mexico +52.55.5123.1221

Major Currencies

EURUSD

Cautious ECB Helps Steadies EUR **Current spot 1.1045**

Source: Bloomberg.

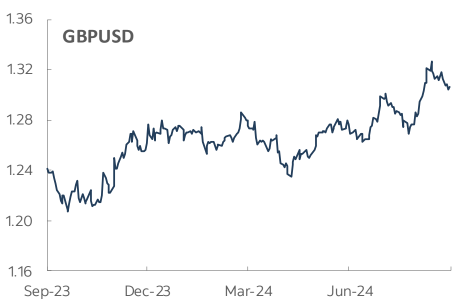
EURUSD—The outcome of the snap parliamentary election in France injected some uncertainty into the EUR outlook but French government bonds took most of the strain resulting from a hung parliament and a tilt to the political right. The appointment of Michel Barnier as PM may ease tensions for now. A budget bill early next year will be the primary hurdle for the government's stability. The Eurozone economy is struggling to gain momentum amid weak industrial activity across the core economies. Markets remain relatively optimistic on the EUR outlook as the ECB seems likely to ease rates only cautiously for now. The EUR faces stiff technical resistance around 1.12 now but should find support on dips to the 1.08/1.09 area.

Scotia Forecasts	Q3-24	1.07	Q4-24	1.09	Q1-25	1.11	Q2-25	1.11

Shaun Osborne, Canada 416.945.4538

GBPUSD

GBP Sentiment Improves on BoE Outlook **Current spot 1.3093**



Source: Bloomberg.

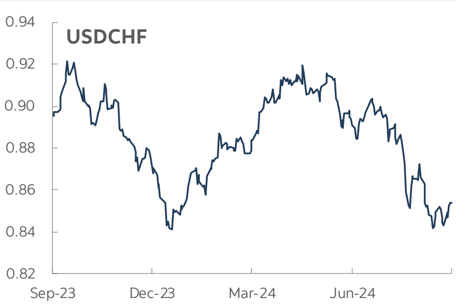
GBPUSD—The GBP has strengthened broadly so far in Q3, only losing ground to the CHF and JPY in the G10 space. Improved GBP sentiment is supported by UK economic momentum picking up a little in H1 and sticky wages and services inflation prompting a cautious approach to easing from the BoE. Policy settings are likely to remain on hold until later this year. A landslide win for Labour in the July general election has not had a significant impact on the GBP. If anything, the new government's desire for a constructive reset of the UK's relations with the EU should be a GBP-positive in the medium term.

Scotia Forecasts	Q3-24	1.25	Q4-24	1.27	Q1-25	1.29	Q2-25	1.29

Shaun Osborne, Canada 416.945.4538

USDCHF

CHF Gains Start to Hurt Local Industry **Current spot 0.8532**



Source: Bloomberg.

USDCHF—The CHF has outperformed in recent weeks as heightened volatility in global markets drove haven demand. CHF strength, revisiting the extremes against the EUR of the past decade or so, has prompted calls from Swiss industry for the Swiss National Bank to take action to ease upward pressure on the exchange rate. Economic data are supporting the case for another cut in the 1.25% target rate at the end of September. Slower-than-expected CPI (1.1% Y/Y in August) and signs of weak domestic demand in the Q2 GDP report give a clear rationale for the SNB to ease.

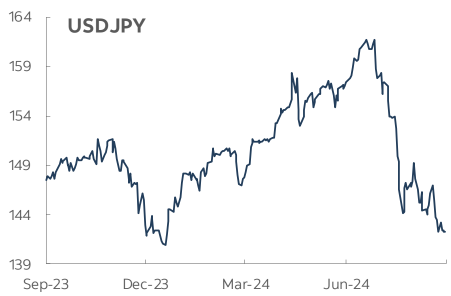
Scotia Forecasts	Q3-24	0.92	Q4-24	0.90	Q1-25	0.91	Q2-25	0.91

Shaun Osborne, Canada 416.945.4538

Major Currencies *(continued…)*

USDJPY

BoJ, Carry Trade Unwind Lift JPY **Current spot 142.53**



Source: Bloomberg.

USDJPY—A confluence of factors combined to drive the JPY significantly higher in the past few months and may set the stage for a further rebalancing in the still-weak exchange rate (in broad terms). Aggressive intervention by the BoJ earlier this year set a clear cap on USDJPY around the 160 level. An unexpected rate hike by the BoJ at the end of July triggered more gains in the currency and prompted a major unwind of JPY-funded carry trades. Developments have moved the needle on JPY sentiment significantly and a major, technical top/reversal in USDJPY formed through the July–September period. A sustained push below the 140 area could prompt medium term JPY gains towards 125/130.

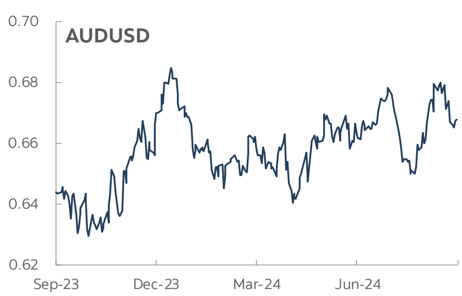
Scotia Forecasts	Q3-24	150	Q4-24	150	Q1-25	145	Q2-25	145

Shaun Osborne, Canada 416.945.4538

Australia

AUDUSD

AUD Underperforms, Holds Broad Range **Current spot 0.6707**



Source: Bloomberg.

AUDUSD—The AUD has underperformed over the quarter and has essentially held a broad, flat range against the USD around the 0.65 point for the past year or so. The AUD has struggled to take advantage of a hawkish Reserve Bank of Australia which has refused to join the global easing cycle and has even dangled the threat of still tighter policy to curb sticky inflation over markets. The AUD's performance has tracked sluggish terms of trade amid weak iron ore and soft demand from client economies, such as China. AUD gains above 0.68 would be technically bullish. Loss of support at 0.6370 would be bearish.

Scotia Forecasts	Q3-24	0.68	Q4-24	0.68	Q1-25	0.70	Q2-25	0.70

Shaun Osborne, Canada 416.945.4538

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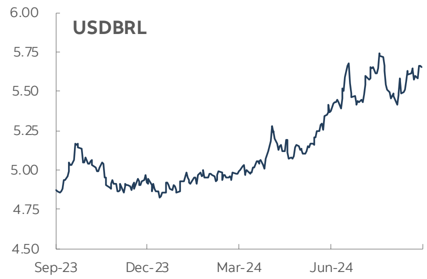
Latin America

USDBRL

Losses May Reverse as Rates Rise **Current spot 5.6392**



Source: Bloomberg.

USDBRL—Fiscal uncertainties remain in Brazil, while President Lula tries to balance the budget. The BRL is following MXN down the depreciation path, falling 7% since the start of the year. However, given recent news in Mexico, the outlook for BRL is less gloomy. Finance Minister Fernando Haddad has claimed that the economy will grow more than 3% this year. Additionally, even though volatility remains above its 1Y average and while the rest of Latam continues their easing cycles, Brazil is expected to start lifting rates again next week. This could make the BRL an interesting for carry trade target. As a result, we see room for BRL to strengthen.

Scotia Forecasts	Q3-24	5.42	Q4-24	5.33	Q1-25	5.30	Q2-25	5.26

Luisa Valle, Mexico +52.55.5123.1725

USDCOP

Lower Rates, Soft Oil Weigh on COP **Current spot 4,223.69**

Source: Bloomberg.

USDCOP—The downside surprise on August's inflation data affirmed expectations for a speed-up in the BanRep's easing cycle, which triggered a significant appreciation in the local bond market and a depreciation in the COP as its carry trade appeal unwinds. Lower oil prices have also impacted COP price action. It is relevant to note that as the domestic demand, especially imports, remains weak, we still favour a scenario of USDCOP easing back to around 4100 pesos. We continue to forecast COP4116 at the end of the year. However, USDCOP volatility will remain elevated and the COP may struggle to establish a trend.

Scotia Forecasts	Q3-24	4102	Q4-24	4116	Q1-25	4120	Q2-25	4125

Jackeline Piraján, Colombia +57.601.745.6300 Ext. 9400

USDCLP

Fed Rate Cuts, Copper Rebound May Lift CLP **Current spot 932.41**

Source: Bloomberg.

USDCLP—The CLP has depreciated by 2% since the previous FX Outlook, due in part to the sharp 7% drop in the copper price, despite the depreciation of the USD. Over this period, the peso's depreciation has been lower than that of most Latin American countries and has been accompanied by a reduction in bets in favour of the peso by non-residents. Looking ahead, the start of cuts in the policy rate by the Fed, smaller cuts by the BCCh and a slight recovery projected for copper prices lead us to anticipate an appreciation of CLP towards 890 by December of this year. Furthermore, the moderation in the political backdrop observed in recent months regarding structural reforms would also support our scenario.

Scotia Forecasts	Q3-24	900	Q4-24	890	Q1-25	870	Q2-25	870

Aníbal Alarcón, Chile +56.2.2619.5435

Latin America *(continued...)*

USDPEN

PEN Weakness May Reverse **Current spot 3.7640**

Source: Bloomberg.

USDPEN—The PEN held in a narrow, sideways range between 3.73 and 3.75 over August before sliding sharply in September. Pension funds had been major sellers of USDPEN in August as they sought PEN liquidity for the seventh withdrawal from pensions. This helped keep the PEN stable but the PEN came under pressure early in September, reaching levels of 3.83. This pressure is likely to continue during the next few weeks as derivatives placed by the BCRP mature and pension funds reduce USD sales. Despite this, the PEN remains the Latam currency with the lowest depreciation (2%) against the USD this year. We forecast USDPEN holding around 3.80 over September and beginning of the Q4 and easing to 3.75 by year-end.

Scotia Forecasts	Q3-24	3.80	Q4-24	3.75	Q1-25	3.75	Q2-25	3.75

Ricardo Avila, Peru +51.1.211.6000 Ext. 16558

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