Highlights
By Stéfane Marion/Krishen Rangasamy

- While the Fed’s open-ended QE program isn’t exactly positive for the U.S. dollar, that doesn’t necessarily mean the world’s reserve currency has already peaked. Major central banks including the European Central Bank and the Bank of Japan are more likely than not to loosen monetary policy via further unconventional measures amid the likelihood of deep recessions. That would in theory weigh on their currencies and lift the USD in the process. More importantly perhaps is the situation of dollar shortage which acts as a natural booster for the world’s reserve currency. As such the USD, which reached an 18-year high in trade-weighted terms in March, could remain elevated for a while longer.

- Already battered by prospects of a deep eurozone recession, the euro has room to fall further. The European Central Bank will pull all the stops to cushion the blow by delving deeper in unconventional policies. Political backlash from the European Union’s apparent mishandling of the coronavirus crisis in places like Italy, – which is fomenting talk of a potential break-up of the union – won’t help the common currency either. We continue to expect EURUSD to drop to 1.03 this year.

- The downgrade to our 2020 forecasts for world GDP growth and OPEC/Russia price war prompted us to lower our projections for oil prices. WTI oil is now expected to average around $28/barrel this year (versus roughly $47 in our previous forecast). That translates to a lower path for the Canadian dollar than anticipated earlier. We now see USDCAD heading past 1.45 by mid-year due to a combination of disastrous economic data and weak oil prices, before moving back down (i.e. C$ appreciation) later in the year as WTI recovers.

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<th>NBF Currency Outlook*</th>
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<td>USDCAD</td>
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<td>US cents per CAD</td>
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<td>EURUSD</td>
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<td>USDJPY</td>
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*Forecasts for end of period

NBF Economics and Strategy
Does the Fed’s open-ended QE mean USD has peaked?

The trade-weighted U.S. dollar hit an 18-year high in March (on a monthly average basis), fueled by safe haven flows stemming from the risk-off environment generated by coronavirus-related disruptions. And that, despite losing steam late in the month as the Federal Reserve said that its previously announced Quantitative Easing program would be "open-ended" (i.e. no limit to amount of asset purchases).

### World: Dollar hits 18-year high

The decision by the Fed and Congress – which approved a historic $2 trillion stimulus in March – to take unprecedented action was in response to an unprecedented recession. Not only did America start to go downhill in March, courtesy of coronavirus-related operational shutdowns, but the speed of deterioration is one for the record books. The U.S. labour market turned, in the space of a month, from shutdowns, but the speed of deterioration is one for the record books.

So, does the Fed’s open-ended QE mean the USD has peaked? Probably not, considering still-significant levels of uncertainty with regards to economic prospects and action by other central banks around the world. The European Central Bank, the Bank of Japan and others are more likely than not to loosen monetary policy via further unconventional measures amid the likelihood of deep recessions in their respective economies. That would in theory weigh on their currencies and lift the USD in the process.

More importantly perhaps is the situation of dollar shortage which acts as a natural booster for the world’s reserve currency. While the supply of dollars looks plentiful on the surface – e.g. Fed’s printing press and a U.S. budget deficit that’s set to hit double digits as % of GDP – demand for dollars can be even stronger. Note that global trade is still largely settled in dollars and borrowers worldwide, particularly in emerging economies, tend to issue dollar-denominated debt to entice foreign investors wary of domestic currency risk. Dollar shortage globally is evidenced by a sharp ramp up of demand by world central banks via the Fed’s swap lines.

The Fed’s swap lines, designed to diminish stress in global U.S. dollar funding markets, had already been in place since 2013 with the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank. But in March, the Fed agreed to swap lines with the Reserve Bank of Australia, the Banco Central do Brasil, the Danmarks Nationalbank, the Bank of Korea, the Banco de Mexico, the Norges Bank, the Reserve Bank of New Zealand, the Monetary Authority of Singapore, and the Sveriges Riksbank. Most of them did not wait long before tapping that facility. The amount of dollars borrowed from the Fed climbed from less than $60 million in the first half of March to almost $400 billion in early April as ten major central banks used the facility. The shortage of dollar suggest the USD could remain elevated for a while longer, if not reach a new all-time high in trade-weighted terms.

### World: Dollar shortage apparent as central banks tap Fed’s swap line

The strong USD a problem? In theory, USD appreciation is a positive development for non-U.S. economies because their exports are suddenly more competitive. But that impact tends to be more than offset by headwinds generated through the financial channel. According to the Bank for International Settlements roughly 35% of...
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Forex

Global trade is financed by the banking system, with around 80% of that denominated in U.S. dollars. So, if the cost of financing (e.g. USD exchange rate) rises, this will slow lending and borrowing in U.S. dollars, hurting trade volumes. That explains the observed negative correlation between growth in global trade volumes and that of the Broad Dollar index.

Another element of the financial channel which can turn an appreciating greenback into a major problem is the record amount of USD-denominated debt. A stronger USD can indeed make it harder for firms to service their dollar credit. Note that USD-denominated debt held by non-bank borrowers outside of the U.S. stood at around US$12 trillion at the end of last year, or nearly 19% of World GDP excluding the U.S. That’s roughly double the exposure of 20 years ago.

World: Dollar surge threatens global financial stability
USD-denominated debt held by non-bank borrowers outside of U.S.

In other words, the USD’s surge, if not controlled, would raise default risks and turn the current global recession into something far worse. That could then feed back into USD strength.

Loonie crushed by oil

The Canadian dollar lost 6% against the USD in March, its worst monthly performance in five years. Granted, the economy is now in recession and GDP growth this year is set to be the worst ever recorded. But the U.S. is in a similar position. With the Bank of Canada following the Fed with historic interest rate cuts and unconventional policies such as QE in March, Canada–U.S. yield differentials are not what’s moving the Canadian dollar. Instead it’s the oil price collapse, courtesy of the global recession and the Saudi–Russia price war, which is hammering the currency, taking it to depths last seen in 2015. Indeed, a barrel of Western Canada Select oil can now be bought for as little as US$4. Just so our readers do not think this is a typo, note that even an average-size rhubarb pie at your local grocery store costs more than a barrel of WCS.

Canada: Coronavirus brings energy sector to its knees
Western Canada Select oil price

Could the loonie lose more ground against the USD? That’s contingent on (you guessed it) the price of oil whose path in coming weeks will depend on whether or not producers can agree to curtail supply amid shrinking global demand. Seeing the devastation in America’s oil fields, even U.S. President Trump – who famously chided OPEC for not pumping enough oil – is now seeking production cuts from the cartel. Tariffs are reportedly being considered by the White House to strong arm OPEC and Russia into coming to an agreement soon. Tariffs or not, we still think oil price will remain grounded by this unprecedented global recession which, in the IMF’s estimation, will be “as bad if not worse” than the 2008/09 downturn. The downgrade to our 2020 forecasts for world GDP growth and OPEC/Russia price war prompted us to lower our projections for oil prices. WTI oil is now expected to average around $28/barrel this year (versus roughly $47 in our previous forecast).

That translates to lower path for the Canadian dollar than anticipated earlier. We now see USDCAD heading past 1.45 by mid-year due to a combination of disastrous economic data and weak oil prices, before moving back down (i.e. C$ appreciation) later in the year as WTI recovers.
Annex

**Currency Exchange Rates**

<table>
<thead>
<tr>
<th>Currency Pair</th>
<th>Current</th>
<th>2020Q2</th>
<th>2020Q3</th>
<th>2020Q4</th>
<th>2021Q1</th>
<th>2021Q2</th>
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<td>EURCAD</td>
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<td>17.57</td>
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*Forecasts for end of period
NBF Economics and Strategy
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