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MONTHLY FX OUTLOOK

January 28, 2010

Avery Shenfeld (416) 594-7356 | Benjamin Tal (416) 956-3698 | Peter Buchanan (416) 594-7354 | Warren Lovely (416) 594-8041 | Meny Grauman (416) 956-6527 | Krishen Rangasamy (416) 956-3219

Krishen Rangasamy • Avery Shenfeld

WHAT'S INSIDE:

CURRENCY STRATEGY HIGHLIGHTS

- **US$ Has More Room to Run**: The trade-weighted US$ continues to gather steam on positive US data and eurozone weakness. We suspect that run will continue right through Q1 helped by a string of positive economic data, following on the significant ramp up in output in the final quarter of 2009.

- **Updated Forecasts**: We have raised Canada's growth forecasts for the first half of the year and have accordingly pared back the C$'s depreciation over the period. We were already near-term bearish on the Brazilian real, but added room for a further leg of weakness in the currency after it depreciated through our target.

EVENTS TO WATCH IN COMING MONTH

- **US Nonfarm Payrolls for January**: While weather may have distorted US payrolls for December, there will be no such excuses in January's report. We see positive job growth by the end of Q1, but January claims figures suggest further net layoffs that month. Look for the greenback to rally on any upside surprises.

- **Equity Market Sentiment:** Markets overreacted to China's monetary policy tightening, showing an extreme sensitivity to anything that might stand in the way of growth. Keep an eye on how stocks interpret subsequent measures (bank reforms, fiscal austerity in parts of Europe, etc) for a guide to the C$'s performance, as strength in the commodities-linked loonie also depends on optimism over global growth.

CURRENCY OUTLOOK

End of period:	2010 I	2010 II	2010 III	2010 IV	2011 I	2011 II	2011 III	2011 IV
US$ Rates:								
USDCAD	1.07	1.03	0.98	1.03	1.04	1.00	1.01	0.98
EURUSD	1.37	1.38	1.44	1.47	1.48	1.50	1.51	1.52
USDJPY	94	93	90	87	86	86	85	85
GBPUSD	1.59	1.61	1.67	1.71	1.72	1.73	1.73	1.75
USDCHF	1.06	1.04	1.01	0.99	1.00	1.01	1.02	1.01
AUDUSD	0.92	0.94	0.96	1.00	0.99	1.00	1.00	1.02
USDBRL	1.87	1.82	1.77	1.72	1.70	1.69	1.67	1.65
USDMXN	13.5	13.0	12.7	12.5	12.3	12.3	12.0	12.0
Other Crosses:								
CADJPY	88	90	92	84	83	86	84	86
AUDCAD	0.98	0.97	0.94	1.03	1.03	1.00	1.01	1.00
GBPCAD	1.70	1.66	1.64	1.76	1.79	1.73	1.75	1.71
EURCAD	1.47	1.42	1.41	1.51	1.54	1.50	1.52	1.49
EURJPY	129	128	130	128	127	128	128	128
EURGBP	0.860	0.855	0.860	0.860	0.860	0.865	0.870	0.870
EURCHF	1.450	1.440	1.450	1.460	1.480	1.510	1.530	1.540

US$ Has It's Day in the Sun

The US$ continues to recoup some of its lost ground on generally positive economic data at home (Chart 1). Industrial production rose almost 2% (not annualized) in the final quarter of 2009 and, together with a pick up in consumer spending, underpinned a strong Q4 GDP print. The resurgence in demand is being helped by restocking, and the economy is set to continue to benefit from inventory refills over the first half of 2010. That, together with a turn to positive payrolls data (likely before the end of Q1), should lend further support to the dollar against other majors, but less so against the C$ given the benefits to commodities and Canadian exports of stronger US growth.

Look for the US economy to lose momentum in the second half, as inventory restocking levels off and fiscal stimulus fades. A huge output gap and a double dip in housing should delay Fed rate hikes until next year, which should put a damper on the dollar in the second half of 2010. That will take the US$ back on its long-term depreciating trend and help America better deal with its growing debt load and correct for trade imbalances.

Loonie Nears Cheap End of Its Range

After holding steady in the face of the US$'s ascent in the preceding month, the Canadian dollar could not repeat the feat in January, succumbing to a string of less-than-stellar economic reports, including trade and retail sales for November and soft employment data for December. Recent days saw the loonie near the weak end of our forecast range for 2010, which we adjusted in our recent issue of "Forecast" to allow the Canadian dollar to average a few cents stronger than our prior view.

We did so despite recognizing that, even with the recent improvements in commodity prices, the loonie remains fundamentally overvalued. A significant current account deficit is just a reflection of that situation. But over the near-term, hot money flows usually trump trade fundamentals. Central banks and other international pools of capital see the Canadian dollar as an alternative when diversifying away from a US dollar that still has its longer term doubters, with some eyeing huge US deficits and debt as a risk that America will try to inflate its way out of its debt service burden.

Our upgraded outlook for the loonie reflects a somewhat more bullish take on global growth, and an upward revision to our outlook for Canadian economic growth over the first half of the year (Chart 2). Recent data suggests that there will be more of a one-time lift to Canadian exports from US growth and inventory restocking on both sides of the border.

While we are more bearish than the central bank in our two-year outlook, first half gains will be close enough to the Bank's call that we are at risk of a premature round of rate hikes in the third quarter. That will be months ahead of any move by the Fed, and it could trigger expectations for a further widening in overnight rate differentials. That should propel the C$ through parity against the greenback, only to retreat when, in the face of disappointing economic reports later this year, the Bank goes on hold again for several

Chart 1 ***- Major Currencies Losing Ground vs US$***

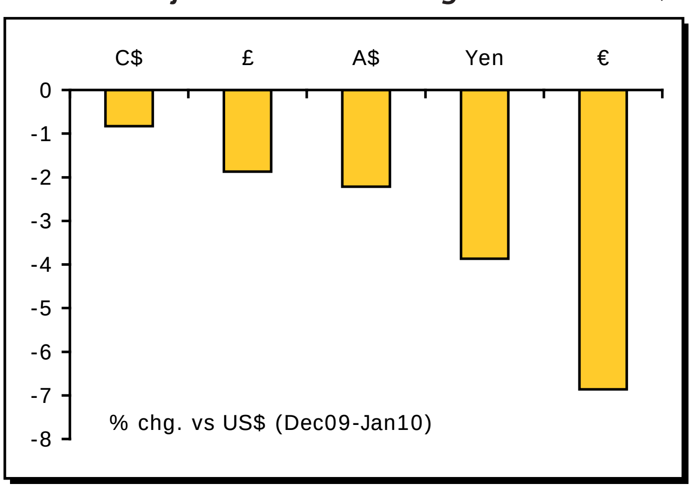
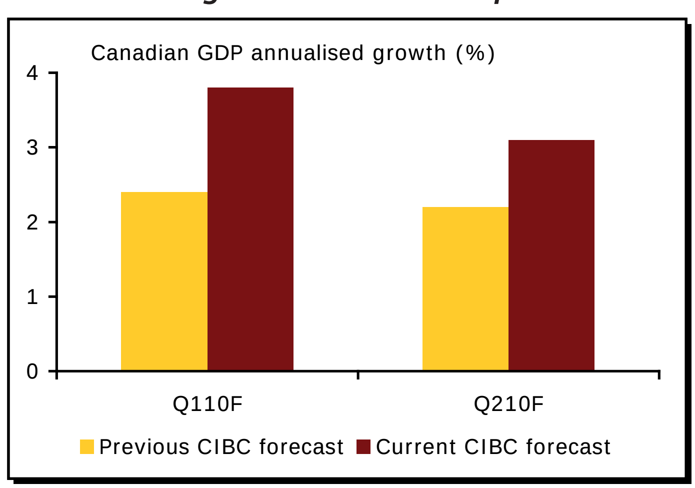


Chart 2 ***- Stronger First Half Now Expected for Cda***



months. Still, disenchantment with the US dollar and the resulting capital inflows will have C$ ending 2010 near 1.03 C$/US$, a stronger level than it started the year at.

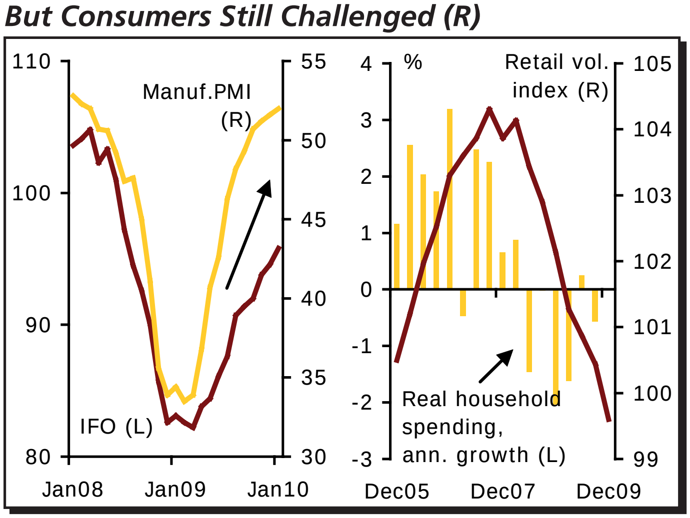
Eurozone Recovers on Inventory Cycle Not Domestic Demand

The euro slid further against the greenback in January on mounting concerns about stagnant growth and Greece's shaky fiscal situation. But the inventory cycle is providing some offset to weakness in domestic demand and likely helped the Eurozone post some growth in Q4 despite its other challenges.

The slowdown in the rate of destocking seen in Q3's GDP report likely continued in the final quarter of 2009, and the 1% increase in industrial production in November could be a reflection of that. The manufacturing Purchasing Managers' Index suggests that factory momentum grew further in December and January, and the increase in the German business IFO index in January is also consistent with output expansion (Chart 3, left). But once the inventory refills are over, it is difficult to see the Eurozone growing above trend further into 2010.

That's largely because aside from exports and inventories, demand remains decidedly frail. The contraction of domestic demand in Q3 could indeed be followed by further declines. Consumption likely remained soft in Q4, based on retail sales data (Chart 3, right). A 1.2% drop in November wiped out the small gain in the prior month, taking retail volumes to a four and a half year low. The expiry of fiscal incentives for auto purchases, the ongoing credit crunch and the still-weak labour market (with unemployment rate exceeding 10% in November) are restraining spending, and should continue to impose a speed limit on Eurozone growth in 2010.

Chart 3 - ***Eurozone Business Confidence Rise (L), But Consumers Still Challenged (R)***



Growth in some countries will be cushioned by fiscal stimulus, but austerity programs will hurt growth prospects in others facing more troublesome debt burdens. As for trade, while it contributed to GDP in Q3, it's unclear if that will be repeated in Q4 and into 2010, as the lagged effects of past currency appreciation hits Europe's market share abroad.

All told, the euro will continue to feel the weight of a slow recovery and ongoing banking and fiscal problems in the near to medium term. Nonetheless, the common currency should be able to make a comeback in the second half of the year as the US$ rally loses steam and as a more hawkish-tempered ECB moves ahead of the Fed in raising interest rates, allowing the euro to close out the year at 1.47 US$/€.

QE Wind-down Could Help Sterling

The UK came out of recession in the final quarter of 2009, but just barely, growing at a tepid annualized pace of 0.4%. The preliminary GDP report provides scant details, but it's likely that inventory restocking and consumer demand played major roles in getting Britain back to growth. With the expected stabilization in business inventories not materializing in Q309, restocking may have been delayed to Q4 and early 2010.

Consumer spending likely held firm in the quarter, based on retail sales data and in line with an improving labour market. The unemployment rate edged down to 7.8% in November and should remain stable if Bank of England surveys showing greater business optimism and net hiring intentions are to be believed.

Despite lingering growth headwinds, inflation has also caught the market's attention. Even excluding energy and other volatile items, UK inflation ramped up in December as the dampening effects of the Dec08 VAT cut dropped out of the calculation (Chart 4). The upward trend is set to extend through 2010, helped by the January VAT increase and higher import prices from

Chart 4 - ***UK Inflation Takes Off Again***

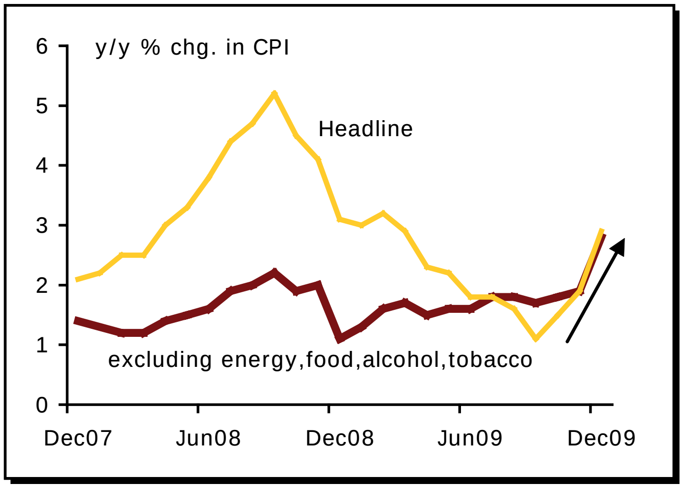
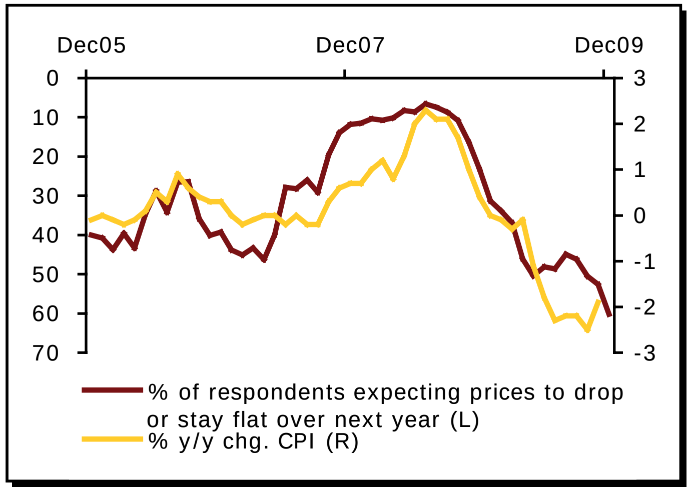


Chart 5 - ***Deflationary Expectations Pick Up Speed in Japan***



past sterling weakness. While the Bank of England, in its last inflation report, expected a temporary burst of inflation, it admitted that there were upside risks to the outlook. The latest BoE meeting minutes confirm that at least one of those risks is materializing, with the Bank acknowledging that the pass-through of the VAT increase in January by businesses to final consumers has been "somewhat greater than had been previously assumed".

While that does not translate into higher interest rates right away, given the still-weak economic conditions in Britain, it raises the odds that the central bank will start winding down its QE program. Coupled with ongoing problems across the channel, that should allow sterling to continue outperforming the euro in the near term, and the US$ over the longer term. Accordingly we have marginally lifted our end of year target for cable to 1.71.

Deflation Puts Japanese Recovery in Jeopardy

As much as Japan's new government wants to diversify the economy away from exports and towards domestic demand, the near term reality is that, given the sluggishness in the domestic economy, trade will determine if Japan's recovery has legs.

The downbeat Tankan survey responses on business investment plans suggest that, as in Q3, investment was a drag in the final quarter. With wages cut more steeply than the decline in inflation, the resulting drop in purchasing power does not bode well for consumption either. Although it's only a modest component of all consumption spending, it's noteworthy that nationwide department store sales were 5% below year-earlier levels in December.

Recent Cabinet Office survey results appear to confirm the lack of shopping vigour, showing declining consumer confidence and deflation. Over 60% of respondents, the highest since records started in 2004, expected prices to either fall or stay unchanged over the next twelve months, in line with recent trends in the CPI (Chart 5).

Stepping in to fill some of the gap in private sector demand, the recently passed US$79 bn fiscal stimulus package addresses job protection, corporate loan guarantees, and provides incentives to boost demand for durable goods. That should help Japan stay afloat before stronger global growth allows the export-centred economy to take off again.

With the US$ rally extending to Q1, we suspect that the yen could give back some of the gains it made in January. But longer term, Japan's trade surpluses with the US, and the prospects for appreciation for the currencies of other key trading partners, including the Chinese yuan, could allow a return to a stronger yen. Our end-of-2010 target for the currency remains unchanged at 87 yen/US$.

A$ To Hold Firm in the Face of US$ Onslaught

The A$ recovered some ground on the US$ in January despite the latter's recent bout of strength. Supporting the Aussie was a string of positive Australian economic data for November, including better than expected retail results, an improvement in the trade balance, and

Chart 6 - ***Aussie Job Creation Accelerates***

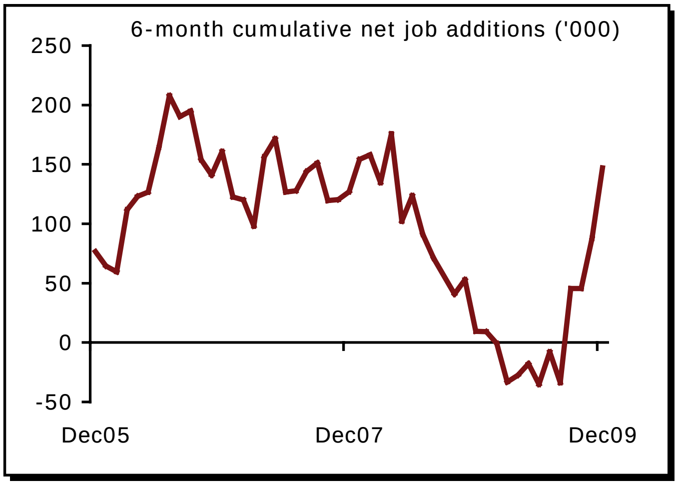
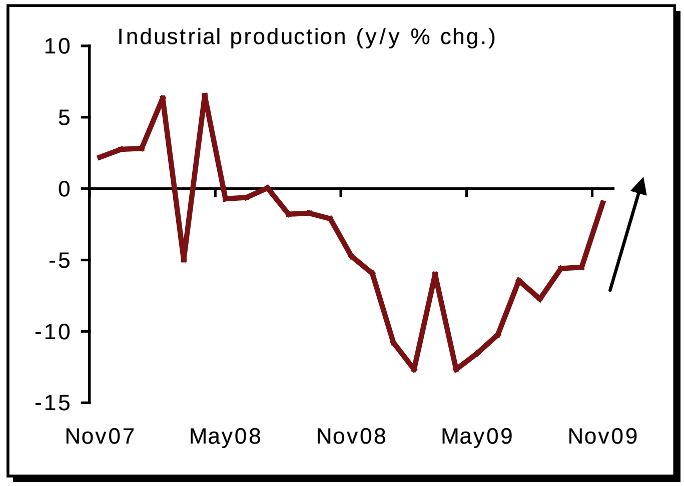


Chart 7 - ***Mexico's Factories on the Rise***



strong building permits. More importantly, the labour market continues to grind out jobs, so much so that the pace of hiring is back to pre-recession levels (Chart 6).

While third quarter GDP growth was soft due to the drag from trade, Q4 is looking much better. The big positive from Q3's report was the strong domestic demand, with significant contributions from households in particular. That trend seems to have extended to Q4 if the monthly retail reports are telling the tale. With strong domestic fundamentals complemented by improving exports, the Australian outlook for 2010 is decidedly positive.

As a result, the A$ could stand alone among major currencies, to stand firm during this first quarter US$ rally. Although inflation looks tame at near-2% over the past 12 months, it's been held down by a single category (financial services), and firm growth should see the RBA tighten at least 100 bps this year. Look for the A$ to drive towards dollar-parity by year end on the resulting yield advantage.

Mexico Hitches a Ride on the US Express

With over 80% of its exports going to the US, Mexico is tied to its main trade partner for the better or for worse. Lately, it's been for the better, with US inventory replenishments allowing for a significant ramp up in Mexico's factory output, so much so that industrial production has improved markedly in recent months (Chart 7). Recent core orders data suggest that American industrial demand will carry into the first half of 2010, drawing in imports from Mexican automotive and other manufacturing facilities.

With the pick-up in economic activity, Mexico is now seeing broad-based job gains, extending beyond manufacturing and construction. The resulting increase in household incomes is lifting domestic demand, as demonstrated by improving retail sales, and is starting to push prices higher. But the new Banco de Mexico Governor, Agustin Carstens, doesn't seem in a rush to raise interest rates just yet, given the still relatively mild core inflation rate.

However, sales tax increases threaten to elevate the overall inflation rate, and the Banco could become more concerned that better labour markets will see wages begin to chase prices if inflation expectations are not kept in check. That could see Mexico moving ahead of the Fed on rate hikes, and together with a more positive economic outlook lift the currency towards our 12.5 peso/US$ year end target. Nonetheless, we expect the peso to see some near-term weakness, not only because of the US$ rally, but also on the Banco's latest plan to purchase US dollars to boost its reserves.

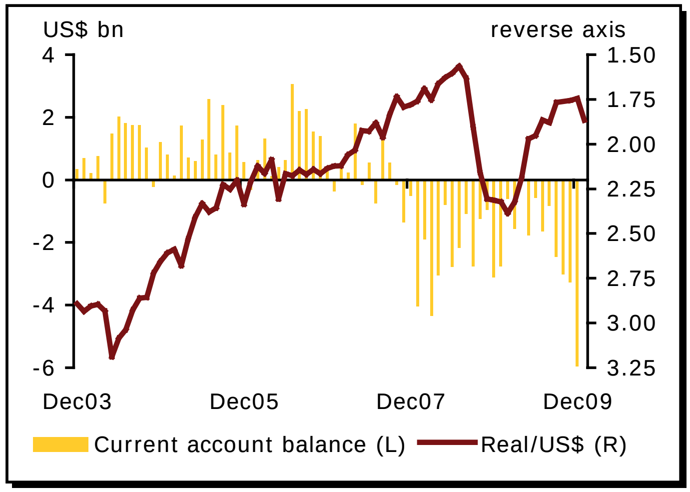
Real From First to Last

After topping currency charts last year, the real started 2010 on the wrong foot, stumbling 6% in January. While part of the real's weakness can be attributed to a rejuvenated US$ and tighter Chinese monetary policy (implying softer future demand from Brazil's biggest customer), markets seem to paying increasing attention to the current account deficit that has been accumulating in recent months. Net outflows of corporate remittances and strong domestic demand relative to external demand are to blame for the deterioration in the current account, but the external imbalance may also be a reflection of an overvalued real (Chart 8). That needn't presage a collapse of the real in 2010. The 12-month cumulative current account deficit of US$24 bn amounts to only 1.6% of GDP, a manageable gap if Brazil's economy continues to look attractive to foreign investors.

In that regard, Brazil still has a lot going for it, with its close ties with China supporting its export sector, but more importantly, a resilient domestic economy supported by a growing middle class. A healthy labour market is lifting household incomes and propping up consumption, as demonstrated by solid gains in retail sales for the seventh consecutive month in November. Despite pent up demand, the Banco Central do Brasil may leave interest rates unchanged through the first quarter of 2010, given still-mild inflation.

While we were already looking for a correction in the real, it has slid faster than we anticipated, and made room for a further leg of near term depreciation against the US$ over the balance of Q1. That could represent a good opportunity to go long the real against the greenback. Our end of 2010 target for the currency is now at 1.72 real/US$, slightly weaker than our earlier call, but still representative of prospects for an economy increasingly tied to booming Asian commodities demand.

Chart 8 - ***Brazilian Current Account and the Real***



Interest Rate and Economic Outlook

End of period:		2010 I	2010 II	2010 III	2010 IV	2011 I	2011 II
Canada	Overnight target rate	0.25	0.25	1.00	1.00	1.00	1.50
	2-Year Gov't Bond	1.45	1.90	2.35	2.00	2.40	2.70
	10-Year Gov't Bond	3.65	3.85	3.95	3.75	4.00	4.05
US	Federal Funds Rate	0.15	0.15	0.15	0.25	0.75	1.50
	2-Year Gov't Note	1.05	1.10	1.20	1.35	2.20	2.45
	10-Year Gov't Note	3.85	4.00	4.15	4.10	4.45	4.45
Eurozone	Refin.operations rate	1.00	1.00	1.25	1.75	2.25	2.75
	2-Year Gov't Bunds	1.30	1.45	1.60	1.85	2.35	2.85
	10-Year Gov't Bunds	3.40	3.60	3.70	3.80	3.90	4.00
UK	Bank rate	0.50	0.50	0.75	1.25	1.75	2.25
	2-Year Gilts	1.40	1.45	1.55	2.00	2.40	2.80
	10-Year Gilts	4.10	4.15	4.25	4.35	4.40	4.50
Japan	Overnight rate	0.10	0.10	0.10	0.10	0.10	0.10
	2-Year Gov't Bond	0.20	0.31	0.33	0.35	0.38	0.40
	10-Year Gov't Bond	1.40	1.42	1.45	1.50	1.55	1.60

		2009	2010	2011
Canada	Real GDP growth (%)	-2.5	2.3	3.0
	Unemployment rate (%)	8.3	8.3	8.1
	CPI (%)	0.3	1.8	2.0
US	Real GDP growth (%)	-2.5	2.8	2.4
	Unemployment rate (%)	9.3	10.2	9.5
	CPI (%)	-0.4	1.7	3.0
Eurozone	Real GDP growth (%)	-3.9	1.5	2.0
	Unemployment rate (%)	9.4	10.6	10.9
	CPI (%)	0.3	1.1	1.5
UK	Real GDP growth (%)	-4.8	1.8	1.4
	Unemployment rate (%)	7.8	8.5	8.7
	CPI (%)	2.1	2.5	2.0
Japan	Real GDP growth (%)	-5.3	1.7	1.5
	Unemployment rate (%)	5.1	5.6	5.1
	CPI (%)	-1.3	-1.2	-0.4