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MONTHLY FX OUTLOOK

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WHAT'S INSIDE:

CURRENCY STRATEGY HIGHLIGHTS

- **Some Peace and Quiet**: A Bank of Canada rate cut in January should keep the C$ treading water through the first half of the year, with the A$ more attractive for yield seekers. A somewhat stronger US economy in the second half of the year will see the C$ do better than other majors, owing to the positive implications for commodity prices.
- **Who's Next?**: The US dollar looks to have essentially completed its depreciation against Europe. Given the remaining large trade imbalances, it's the Chinese yuan and the OPEC currencies (many now pegged to the dollar) where we could see further appreciation vs. the greenback.

EVENTS TO WATCH IN COMING MONTH

- **Bank of Canada (Jan. 22nd)**: The market still doubts that Dodge will cut rates at the next meeting, but banking sector tightness points to another 25-bp move. Negative for the C$.
- **US Payrolls (Jan. 4th)**: Ongoing job growth has been key to staying out of recession, so markets will key on January payrolls for first clues on Q1. Look for a softer reading to take a bit of wind out of the US$.
- **Bank of England (Jan 10th)**: A unanimous vote to cut at the last meeting raised odds of a quick follow-up move. Negative for sterling if it comes that quickly.
- **US Credit Markets**: Dollar-yen trading still affected by risk perceptions—yen could gain again as credit troubles remain in the headlines for another month.

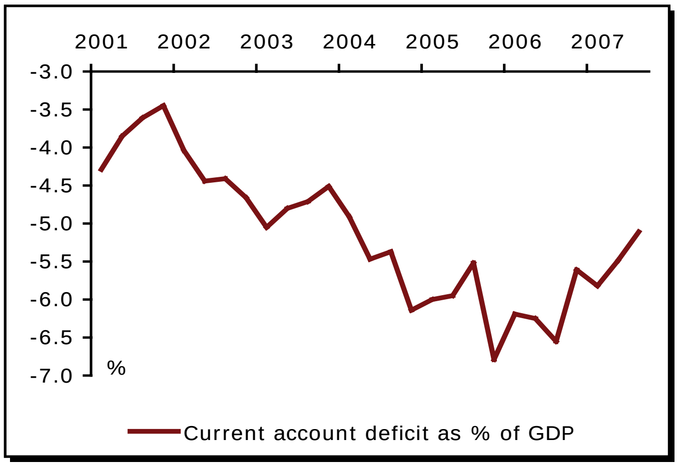
CURRENCY OUTLOOK

End of period:	2008 I	2008 II	2008 III	2008 IV
US$ Rates:				
C$/US$	1.000	0.990	0.970	0.952
US$/Euro	1.45	1.42	1.40	1.40
Yen/US$	110	113	112	107
US$/Sterling	1.97	1.89	1.94	1.94
SFr/US$	1.15	1.17	1.18	1.18
US cents/A$	87.0	93.0	88.0	86.0
Mex Peso/US$	11.2	11.1	11.0	10.9
Euro crosses:				
Yen/Euro	160	160	157	150
Sterling/Euro	0.736	0.750	0.720	0.720
SFr/Euro	1.670	1.656	1.650	1.650

Dollar Story Partly Done

While still wide, the third quarter US current account deficit was at its smallest share of GDP since early 2004 (Chart 1). Although the real trade balance should improve, sharply higher import prices could see a weaker nominal balance in Q4, with a somewhat wider current account deficit. But the trend towards improved real net export performance suggests that the US dollar has reached a more competitive exchange rate relative to Europe, Canada, and other major developed economies. Pressure for further dollar depreciation will be centred on China (which we expect to allow a faster pace of yuan appreciation in 2008 as part of its efforts to fend off inflation), and the major oil-exporting countries, which are at risk of dropping their pegs to the US$.

Chart 1 - ***US Current Account Gap Improves***

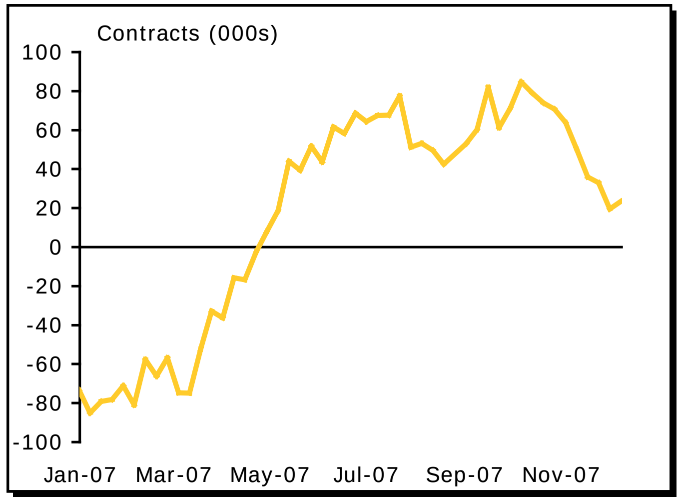


C$ Quiets Down

The C$ has forces tugging in opposite directions, a result that could leave it hugging near parity for the next couple of quarters. We weakened our C$ targets a bit for the earlier part of the year, now that financial market conditions have forced the Bank of Canada to play along with Fed cuts.

That said, there's no reason to expect further downward pressure on the loonie's value. Speculators have a fairly clean sheet on the C$, having now completed the process of reducing their previously heavy long-C$ positions (Chart 2). Canadian money market rates are no longer below those on US$ assets, and commodity prices are high enough to keep the current account in the black. In that regard, we retained our year-end 2008 target for a five-cent C$ appreciation, consistent with our call for a record crude oil price and a more supportive market for natural gas.

Chart 2 - ***Speculators Net Long C$ Positions, Options & Futures***



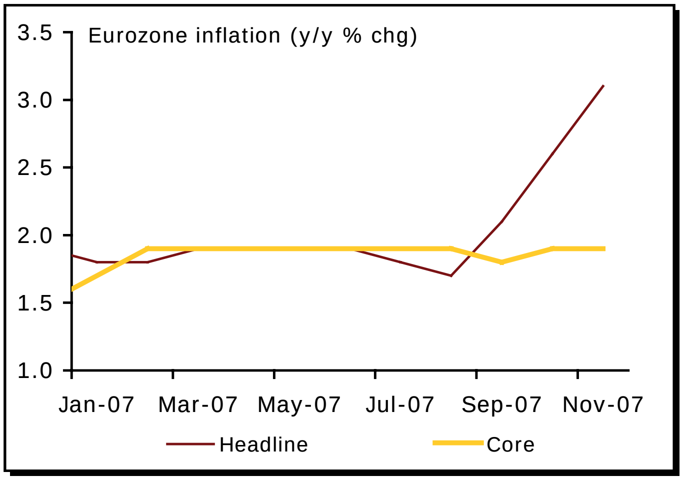
Longer term, whether the C$ can remain at a premium valuation to the US$ will depend on just how much damage loonie strength inflicts on non-energy exporters, and on the country's ability to offset that with gains in other sectors. Given how little time has past since the C$ surged towards parity (the C$ was 15% cheaper a year ago), it's too soon to get much of a reading on that issue, particularly since manufacturing is also seeing the impacts of a US slowdown. But ongoing oil price appreciation might not continue to press the C$ stronger beyond 2008 if the energy surplus is offset by a larger non-energy trade deficit. The current account has also started to feel the impacts of earlier foreign buying of Canadian materials companies, which results in larger net outflows of the corporate interest and dividend income.

Euro Holds Until US Improves

The euro should hold ground as long as US recession risks linger, and even a US recovery won't prove that negative. We've retained our call for a stable to slightly stronger euro in Q1, and for only a modest retreat from its 2007 gains over the balance of next year.

While the ECB has responded aggressively to the need for end-of-year liquidity in the banking system, it's much less inclined to talk about an outright easing in its target rate. Economic conditions only show a taste of the downside risks that are visible stateside. Germany's IFO index softened a bit more than we anticipated in December, but the damage to the financial-market-sentiment ZEW index was less of a surprise.

Chart 3- ***Eurozone CPI: Worrisome Headline***



As in the US, third-quarter growth was healthy (0.7% not annualized), and some labour market data, including falling German unemployment, make the case that the economy is still close to its non-inflationary limits. Indeed, inflation is testing a hawkish central bank's toleration, with headline eurozone CPI at a six-year high of 3.1% (Chart 3). Double-digit M3 money supply growth is still treated as a harbinger of potential inflation issues ahead. That doesn't point to an outright rate hike, but watch for hawkish talk from the ECB ahead of key wage negotiations, a supportive backdrop for the euro. An earlier-than-expected end to Fed rate cuts in 2008 will narrow that advantage, positioning the euro for a retreat back to $1.40 by year end.

Sterling Sheds its High-Yield Benefits

In contrast with the eurozone, across the channel the Bank of England had plenty of reasons to join in the rate-cutting bandwagon, with three more quarter-point cuts likely for 2008. The fact that the recent cut was a unanimous vote on the MPC hints that the next move won't be long in coming, and we weakened our Q1 sterling target as a result. Further easing through 2008 will see a retreat for the pound, heretofore one of the beneficiaries of yield-seeking capital flows.

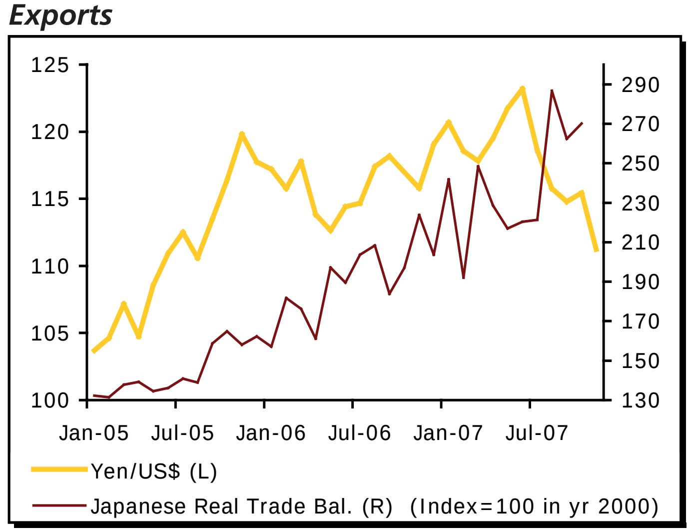
Despite coming off a period of healthy growth and still-low unemployment, inflation now seems decidedly less of a threat. Wage earnings eased to a 4% annual gain in October, the softest since April 1975. CPI is still a hair above target at 2.1%, but the core rate is only 1.4%, giving the green light for further rate cuts. Manufacturing was decidedly firm in October, but the real concern lies in the critical consumer sector, with retail sales in a clear deceleration to October. If that persists through the holiday season, Q4 GDP will be miles weaker than the healthy 0.7% (not annualized) pace for Q3.

Yen Participates in Asian Gains

Recent yen strength had little to do with Japan's domestic scene. While Q3 GDP was, by Japanese growth standards, not bad, recent signposts have been less supportive. The leading economic index fell to its lowest possible score in September, before rebounding this past month. Industrial production held steady in October, but of concern were sharp drops in consumer confidence in October and November and a soft trend in retail data. Manufacturers also look less optimistic as per last week's Tankan survey, which does not bode well for business investment. It could be some time into 2008 before deflation risks are low enough to allow the Bank of Japan to resume yen-supportive rate hikes.

We see the yen stronger in the early part of the year, as ongoing credit jitters reduce the appetite for carry trades, and then again towards year end, as the restart of rate hikes in Japan, and the spillover from currency appreciation elsewhere in Asia (particularly China) lends support. While against the US$ the yen will be on the strong side of its recent range, those levels had seen major gains in Japan's real trade surplus (Chart 4), suggesting that the economy could absorb the negative shock of a somewhat firmer exchange rate vs the dollar.

Chart 4- ***Yen Weakness Boosted Japan's Real Net Exports***

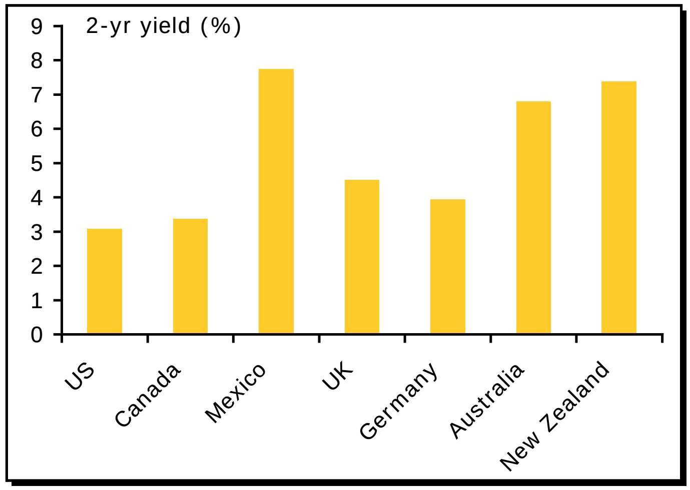


Australian Dollar Volatility Rises

After hitting a 23-year high against the US$ at the end of October, the Aussie dollar fell in November as it did during August's credit squeeze. The currency has also had to cope with the replacement of a pro-business conservative government with a Kyoto-ratifying labour government. But for now, the Aussie economy provides a favourable backdrop for the A$, as demonstrated by the robust Q3 growth of 4.3%, rising wages and tight labour markets. In its December meeting the RBA mentioned that, given inflation pressures, higher interest rates were "likely to be required", but instead, financial markets are doing their work, pushing up market rates even as the RBA target has been on hold. Previous rate action has already been slowing home lending activity and retail sales, while the unemployment rate has moved up a couple of ticks to 4.5% in November, all of which lead us to believe that the RBA will replicate its no-change decision at its next meeting.

In the near term, with competing US dollar alternatives like sterling and the Canadian dollar seeing rate cuts, the still high-yielding A$ (Chart 5) has room to rebound on carry trade action, and we're maintaining our target for a bounce back over the first half of the year. Aussie's commodity mix isn't quite as favourable as Canada's, and it won't get the oil-related bounce we expect for the C$ in the latter part of 2008. Instead, the A$ could retreat if markets begin to anticipate a narrowing of the A$'s interest rate advantage on prospects for rate hikes in the US for 2009 against an easing in Australian policy in the same year.

Chart 5 ***- Aussie Yields Still Attractive***



Peso Lacks Spice

The 150 basis point widening in the Mexico-US interest rate spread this past year seemingly went unnoticed as the peso has stagnated relative to the US dollar while most major currencies posted significant gains versus the greenback. Mexico's economy is set to perform reasonably well in Q4 with industrial production posting a healthy 3% gain in October, retail sales holding steady and the unemployment rate remaining under 4%. One dark spot though is the widening of Mexico's trade deficit in October to $1.6 bn despite oil prices ramping up in the month. Forecasts of slowing US demand over the current and subsequent quarter point to further worsening of the trade deficit, and cast a shadow over the peso in the coming months. In addition, the inflation rate, although close to the Banco's 4% upper range, has been trending lower since November 2006, which might allow an end to the Banco's tightening cycle. As such, the risks for the peso seem to be weighted more to the weak side.