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CURRENCY STRATEGY HIGHLIGHTS

- **Treading Water:** a tug of war between still-firm commodity prices and Bank of Canada rate cuts will leave the C\$ treading water for the next quarter or so. Rising oil prices in the latter half of the year should support a modest appreciation of the loonie.
- **Euro Nearing Peak:** the euro will see its best days as the Fed eases aggressively in Q1. A US second-half recovery, coupled with an ease by the ECB in Q4, will take the steam out of the euro thereafter.

EVENTS TO WATCH IN COMING MONTH

- **US Payrolls (Feb 1):** recession or not? Payrolls is the best judge, and we need to see sustained declines to confirm dollar bears' worst fears.
- **Cdn Employment (Feb 8):** the prior month's job declines came after huge gains. A second soft month would be more meaningful, and would be in line with our call for a 50-bp rate cut by the Bank of Canada in March.
- **Reserve Bank of Australia (Feb 4):** RBA bucks the trend elsewhere by hiking rates.
- **The Monoline Saga:** ratings downgrades or rescue package for bond insurers? The US equity market, and dollar-yen, will closely track this story. The yen is a beneficiary of capital market jitters.

CURRENCY OUTLOOK

End of period:	2008 I	2008 II	2008 III	2008 IV
US\$ Rates:				
C\$/US\$	0.990	0.985	0.955	0.952
US\$/Euro	1.49	1.45	1.43	1.40
Yen/US\$	106	109	110	107
US\$/Sterling	1.92	1.91	1.91	1.89
SFr/US\$	1.11	1.14	1.15	1.18
US cents/A\$	91.0	93.0	88.0	86.0
Mex Peso/US\$	11.0	11.2	11.0	10.9
Euro crosses:				
Yen/Euro	158	158	157	150
Sterling/Euro	0.775	0.760	0.750	0.740
SFr/Euro	1.660	1.656	1.650	1.650

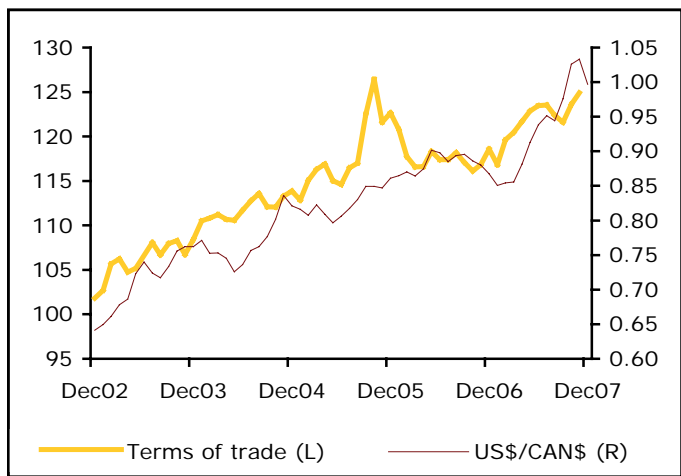
Dollar's Worst Days

For now, the Fed is taking the lead in battling economic slowdown risks, largely because its banking system has been the most exposed to the credit market shock emerging from housing. The dollar will stay on the weak side against most majors in Q1. Global growth remains much less at risk, as is clear in commodity prices that remain firm by historical standards. Commodities currencies will, as a result, hold up well, particularly the A\$ where at least one more rate hike is in the cards. Other majors are likely to peak in Q1, during the worst of the US capital market storms, then give way if, as we expect, the US manages to escape a huge credit crunch recession. US dollar depreciation beyond 2008 is likely to be centred in moves against Asian and oil-exporter currencies.

C\$ Tracking Our Forecast

Our call for the C\$ to hover near parity through the first half of the year remains on track, despite the likelihood of a more extended period of Bank of Canada rate cuts. The Bank's slim quarter-point cut belies the downside risks to financial market stability and economic growth, and given low core inflation, we could see up to another 100 bps in easing over the next two quarters. The Bank sees a near-parity exchange rate as "not inconsistent" with commodity price fundamentals, with the loonie having matched an equivalent rise in the terms of trade—the ratio of export prices to import prices (Chart 1).

Chart 1 - C\$ & Canadian Terms of Trade



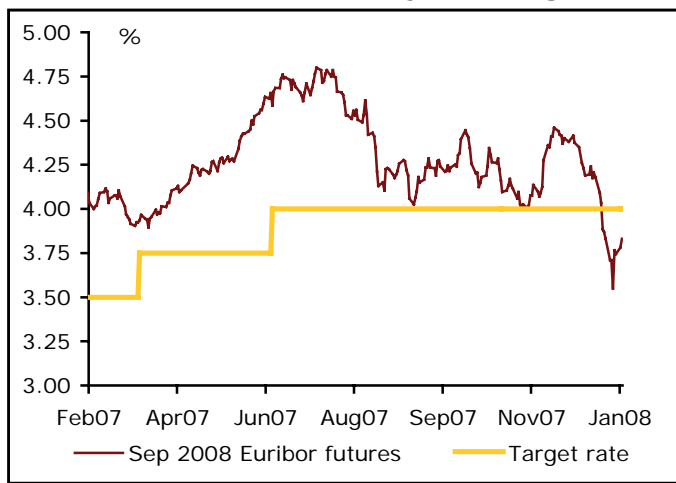
Global growth should see oil prices rise through 2008, and sustain strong prices for metals. But in the near term, the Bank will keep a rein on the C\$ by chopping interest rates, holding overnight spreads to the US at no greater than 50 bps. That makes the A\$ a more attractive near-term play for speculators looking for leverage to commodities, given that RBA rates are still on the rise.

By the second half of the year, the Bank's easing program should be complete, given our expectations that the US economy will then be responding to monetary and fiscal stimulus. With oil prices headed back to US\$100/bbl, we look for the C\$ to appreciate to 0.95 C\$/US\$, still below its recent record levels, but consistent with a healthy trade surplus and the potential for another round of inbound M&A activity—this time in the energy sector.

Market Doubts ECB Hawks

The European Central Bank is, to turn a phrase on its head, talking loudly while carrying a small stick, at least as the market sees it. While the central bankers threaten to tighten, the euribor futures market is already pricing in an ease (Chart 2). For now, such talk is premature, with the euro headed for a modest further climb as Fed rate cuts go unmatched on the continent. Some of the major near-term indicators haven't been that weak, including German unemployment which fell sharply again in December, and the IFO which managed an uptick. Eurozone CPI and money supply are also both well above the ECB's comfort zone. Moreover, the central bankers want to maintain a tough posture ahead of key wage negotiations.

Chart 2 - Euribor Does Not Buy ECB's Arguments



As is the case for other majors, however, any positive noises about the US economy beyond Q1 will take some of the momentum out of the euro. And by late this year, the ECB will likely be shifting to the dovish camp, easing a quarter-point in Q4 on softer growth and dampened inflation risks.

High Street Slump Hits Sterling

The Atlantic may divide them physically, but the US and the UK are not oceans apart when it comes to economic growth risks. It's not a subprime mortgage story, but as in the US, the UK economy is at risk as a combination of falling house prices and heavy mortgage payments threatens the consumer sector. High street spending is already sagging, with retail sales dipping a worse-than-expected 0.4% in December, capping a weak three-month trend. Thus far, unemployment has continued to fall, not surprising given the prior quarter's decent 0.6% (not annualized) advance, but weaker GDP growth ahead spells slack in labour markets. Industrial and manufacturing output are both down on a three-month moving average basis.

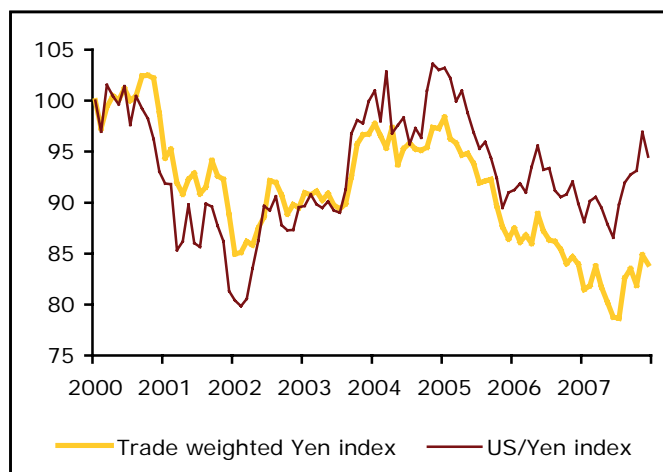
Growth forecasts are being marked down, as we are likely to see in the next BoE estimates. Unlike the Fed, the Bank of England isn't yet willing to turn a blind eye to the inflation numbers, a fact that will limit its repo rate cut to 25 bps in February. But a further 75 bps in repo cuts ahead will keep pressure on sterling, which had earlier been largely a yield play.

Yen Gets the Benefit of the Doubts

While the yen's ascent has been cut short, expect the Japanese currency to stay on the strong side of its past year's trading range as uncertainties in global financial markets limit outbound capital flows, even in the face of a still-wide gap in interest rates vs. US\$ assets.

The Fed will, of course, be narrowing that gap, but don't expect the Bank of Japan to resume its own tightening course any time soon. Inflation is now positive, but the growth outlook is more clouded. While the jobs picture doesn't justify claims in some quarters that Japan is on the verge of recession, housing investment is softening, and the consumer sector is a puzzle after recent indicators on household spending and retail sales showed diametrically opposing outcomes. Exports shouldn't be too imperiled

Chart 3 - Yen Not Strong vs Trade-Weighted Basket



by the yen's gains against the dollar, as it doesn't look particularly strong against the overall (trade-weighted) basket of major currencies (Chart 3).

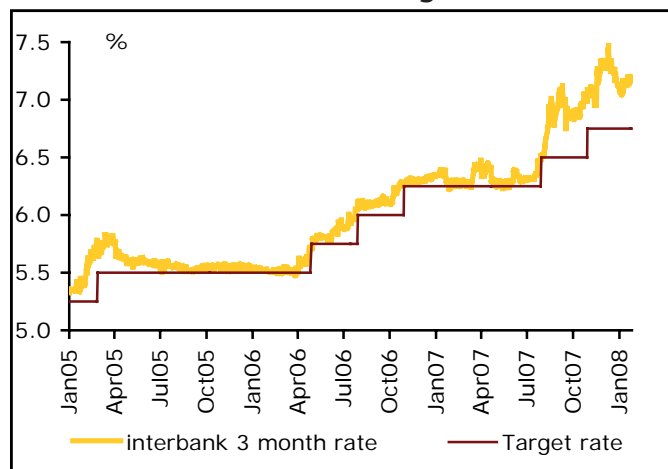
As capital markets settle down, the yen will see renewed portfolio investment outflows that will see it weaken somewhat against the dollar over the final three quarters of the year. Renewed yen appreciation could be in store for 2009 on a return to BoJ rate hikes and a generally favourable tone to Asian currencies.

Aussie Yields Stand Out

Inflation seems to be on everybody's mind in Australia these days. Even the labour government is trying to do its part by announcing spending cuts and a higher target for the budget surplus (1.5% of GDP). RBA's Governor Stevens gave the clearest indication yet of his next move by brushing aside the recent global turmoil as having "little disruption in the broad economy," focusing instead on inflation, which he considered "uncomfortably high in the near term".

A strong Q3 for growth, and subsequent labour market gains, lend support to that hawkish view, and spell a rate hike in February. While money markets are already pricing in this hike (Chart 4), given the rarity of rising rates at this juncture, more generous yields should give further support to the A\$. By year end, however, the RBA's policy might be judged as having been an overkill, and prospects for a narrowing in interest rate spreads vs other majors in 2009 could cool the Aussie's fires.

Chart 4 - Aussie Markets Pricing In a Hike



Ties Across Rio Grande Hit Peso

The widening Mexico-US interest rate spread looks set to continue in 2008 with the Fed cutting aggressively in an attempt to avoid a US recession while Mexico deals with a higher-than-target core inflation rate. But the peso didn't benefit from the 150-bp widening of the spread in 2007. Given its exposure to the US slowdown, Mexico is expected to see some ugly numbers ahead and we are already getting a preview through disappointing November industrial production, and a deceleration in a monthly measure of economic output (the IGAE global economic indicator). Mexico's trade deficit is also a cause for concern, given that it hasn't turned around even in an environment of plus-US\$90 oil. Weaker Q1 trade numbers, and growth risk perceptions, are likely to weigh on the peso in the coming quarter, although it could subsequently rebound as the US economy avoids outright recession and oil prices climb further.

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