RBC Global Asset Management

Global currency outlook

The beginning of the end of U.S. exceptionalism

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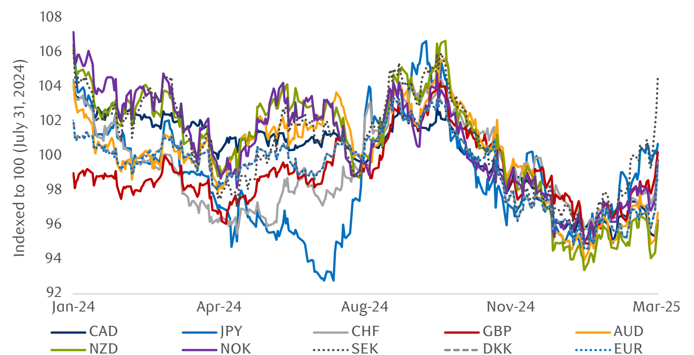
The U.S. dollar is overvalued by the most it has been in almost four decades versus the currencies of its main trade partners and the *most ever* against the Canadian dollar. The overvaluation follows the greenback's near-9% rally during the last quarter of 2024, a move that unfolded as investors assigned higher odds to President Trump's policy proposals on trade and deregulation. The U.S. dollar's strength stalled at about the same time as Trump started his 2nd term at the White House, and the currency's failure to surpass cycle highs from 2022 (Exhibit 1) suggests that the fears (and hopes) associated with the president's agenda were already built into exchange rates at that time. The U.S. dollar's direction has been one of the primary drivers in FX market as investors toggled their focus between U.S. interest rates and U.S. elections. This was evident in the way that developed-market exchange rates have become increasingly synchronized since the fall of 2024 (Exhibit 2).

Exhibit 1: USD rally falls short of 2022 cycle high

Note: As at March 5, 2025. Source: Bloomberg, RBC GAM

Exhibit 2: Developed market currencies have been synchronized since the fall of 2024



Note: As at March 5, 2025. Source: Bloomberg, RBC GAM

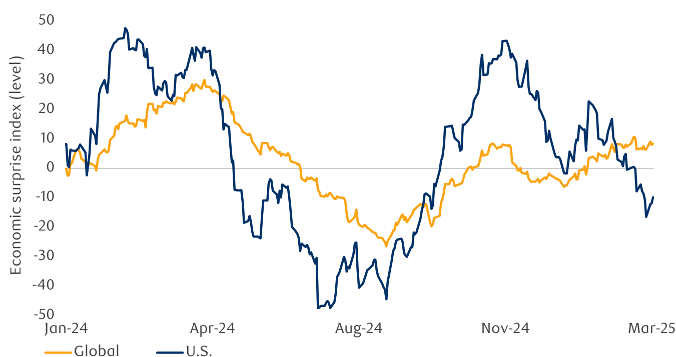
We expect that the greenback will weaken in the longer-term, but we put our bearish outlook on pause last quarter following the U.S. November elections owing to trade measures that would be tough on U.S. trade partners. At the time, Trump's victory also suggested a revival of inflation that would keep the Federal Reserve (Fed) from cutting rates as quickly as we had previously assumed. A more immediate decline of larger magnitude largely depends on signs that investors are becoming more enthusiastic about allocating money outside of the U.S. Such evidence that capital is being drawn away from the United States has indeed begun to materialize, albeit only tentatively:

- The recent agreement between the German chancellor-in waiting and coalition partners to fund defense and infrastructure boosts eurozone growth expectations and makes the region a more attractive investment destination.
- Outperformance of Chinese and European stocks in early 2025 could be an early sign that investors are beginning to appreciate those long-avoided regions. The more that these equities appreciate, the greater the chance that global investors take notice.
- An inability for the U.S. to meet increasingly elevated expectations of economic growth, as seen in the gap between Citibank's U.S. and Global economic surprise indices (Exhibit 3).

It is the 3rd of these items that most warrants monitoring. The U.S. dollar's gains in recent years are largely a result of stronger economic growth from the U.S. and the higher interest rates that are generally associated with a stronger economy. The theme of 'US exceptionalism" – larger fiscal spending than other developed-market economies over the past few years is part of the story, and, while U.S. government deficits will continue, we doubt that the fiscal boost can remain as positive as it has been over the past two years. Moreover, the considerable uncertainty surrounding Trump policies of tariffs, tax-cuts, government cutbacks and deregulation has acted to sideline business investment – the exact opposite of what the president had intended when he campaigned on bringing manufacturing capacity back to the U.S. A scenario where the European economy recovers at the same time as U.S. growth slows could trigger accelerated selling of the dollar by investors who are already overweight the currency (Exhibit 4).

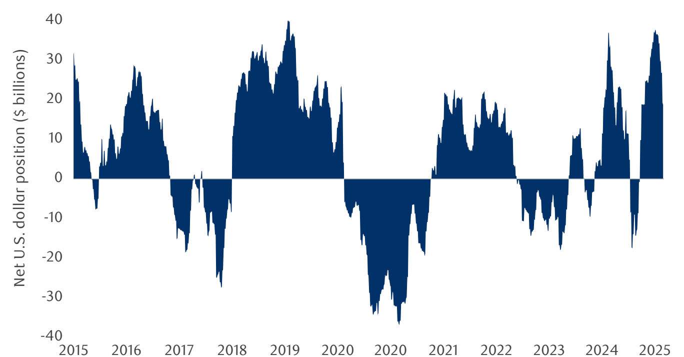
One obvious risk to this lower-dollar view would be a more heavy-handed approach from the White House on tariffs. Prior to his inauguration, Trump had promised the immediate imposition of a 10% blanket tariff worldwide and an even larger 60% levy on imports from China. Not only were these actions conspicuously absent from executive orders signed on his first day in the Oval office, but Trump's subsequent promises to tariff Canada and Mexico on Feb 4th

Exhibit 3: U.S. growth coming in below expectations



Note: As at March 5, 2025. Source: Bloomberg, Citigroup, RBC GAM

Exhibit 4: Stretched long U.S. dollar positioning

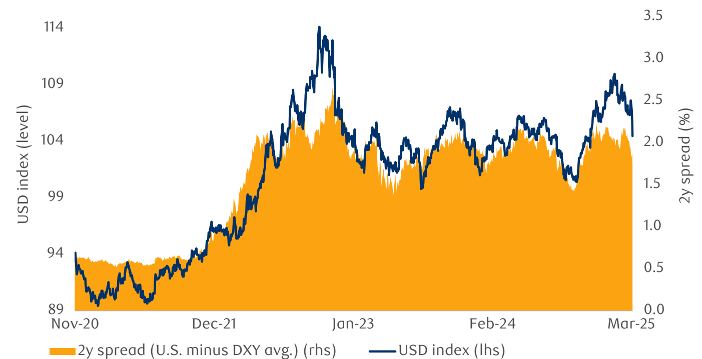


Note: As at February 28, 2025. Source: Bloomberg, CFTC, RBC GAM

were delayed. His weekend-long spat with Colombia in late January, where tariffs were imposed one day and rolled back the next after Colombia ceded to U.S. demands on accepting illegal immigrants, also suggests that tariffs are being used as a negotiating tool. At this stage, our indicators show that investors have become desensitized to the impact of tariff announcements. One way to evaluate this is by looking at the dollar's performance relative to its main driving variable: the dollar's interest rate advantage (Exhibit 5). The greenback rallied more than could be explained by interest rates in early-November as markets shifted focus from Fed policy to tariffs following the U.S. presidential elections. This gap can be seen as a proxy for the impact and the likelihood of tariffs – a kind of discount applied to other currencies and a premium associated with the dollar. This gap has narrowed rather than expanded in recent weeks, indicating that a smaller probability is being assigned to the imposition of lasting tariffs. In addition to interest rates, we could also consult option markets to gauge the likelihood of large currency market fluctuations, since those instruments are often used to protect against adverse market volatility. The cost of such protection has actually fallen, suggesting that the insurance isn't in heavy demand.

Perhaps one reason why markets aren't overly concerned about tariffs is that they are less likely to stick given that their dollar-positive impact runs counter to the administration's preference for a weaker currency. President Trump and his vice-president, JD Vance, have been vocal about a weaker dollar being a key part of their agenda to promote export-competitiveness and to encourage greater manufacturing within U.S. borders. In their note "How to Devalue The Dollar," Gavekal Research theorized that the only feasible way to depress the dollar was for the US Treasury to actively intervene in foreign exchange markets by buying up other currencies. The problems with this plan are well-known in currency circles: efforts to push the greenback lower aren't likely to be successful unless intervention is coordinated with other major economic powers. It's also clear that the US$300 billion Exchange Stabilization Fund - the only approved facility with which intervention can be conducted – is way too small to leave a lasting mark on the massive US$7.5 trillion-per-day foreign-exchange market. This could be why Trump and team may be resorting to the possibility of a "Mar-a-Lago accord" to weaken the greenback, in a strategy much like the 1985 Plaza accord that was conceived at New York's Plaza Hotel

Exhibit 5: Tariffs adding a premium to the U.S. dollar

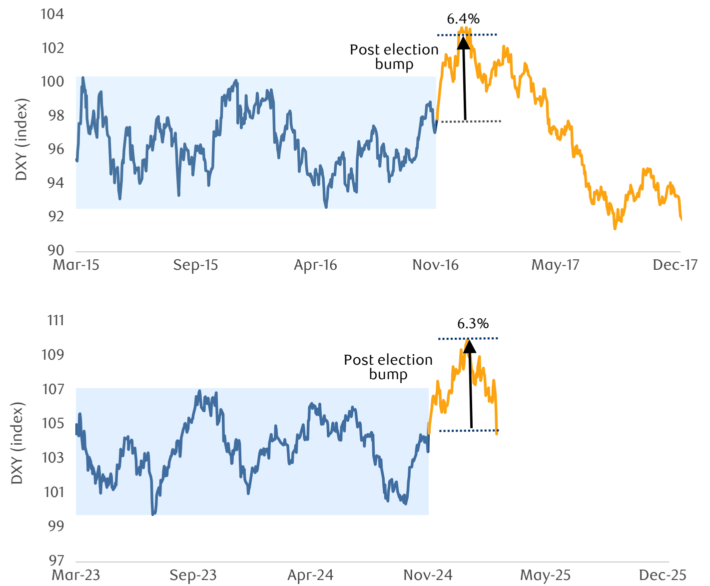


Note: As at March 5, 2025. Source: Bloomberg, RBC GAM

in the mid-1980s. Most recently, Treasury Secretary Scott Bessent floated the idea of encouraging foreign reserve managers into swapping their debt into non-tradeable 100-year zero-coupon bonds to avoid tariffs. Bessent's hope is that by removing that chunk of debt from active markets he will reduce the annual interest costs in the budget and increase the country's competitiveness via a weaker U.S. dollar.

Comparing the US dollar's performance this year with Trump's last inauguration in 2017, we see remarkable similarities (Exhibit 6). In both episodes, the dollar had been trading within a relatively tight 5% trading range that was broken following Trump's early-November election victories. Those initial rallies – 6% in both cases – topped out at around the time of inauguration as Trump's day-one executive orders failed to live up to what investors had feared. What followed was a 12% decline in the greenback over the first three quarters of 2017 – perhaps a prescient roadmap for the current environment as dollar weakness at the time was driven partly by faster-than expected economic growth abroad that saw investors reallocating capital away from the U.S.

Exhibit 6: 2017 U.S.dollar analog

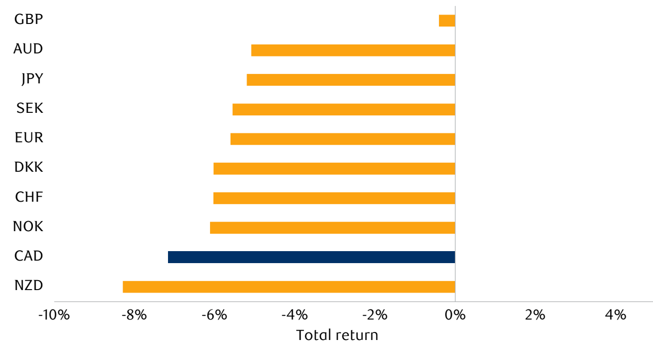


Note: As at March 5, 2025. Source: Bloomberg, RBC GAM

Canadian dollar

The Canadian dollar has been among the worst performing developed market currencies over the past 12 months (Exhibit 7). Contributing to that poor performance are the country's slower growth, lower interest rates, dovish central bank and lack of productivity. But the more pressing issue, of course, is that Canada has become a target of tariffs as one of the U.S.'s main trading partners. President Trump has made his stance clear on using tariffs to punish illegal border immigration and drugs, even though it's far from certain that Canada contributes meaningfully to either problem. In any case, Trump's tariff threats as well as his statements that Canada could be a 51st US state act as a warning to investors. Not only do economic growth expectations need to be revisited under a more contentious bilateral relationship, but so do many of the other long-term considerations that had previously been taken for granted: an implicit U.S. security guarantee under NATO; a strategic partnership protecting the Northwest Passage; and a collaboration toward food and energy security. In a

Exhibit 7: Canadian dollar among worst performing G10 currences over the past year



Note: As at March 5, 2025. Source: Bloomberg, RBC GAM

world where the U.S. would seek to expropriate foreign assets like Ukrainian minerals and the Panama Canal, do Canadians need to worry that Trump would attempt to take over Canada's valuable potash, metals and water resources?

A related concern is the ability of the Canadian government to respond decisively to this quickly shifting landscape given the country's political situation. Prime Minister-designate Mark Carney will have his work cut out for him as his minority government must soon seek support from other parties or call an early election. This means the loonie could get hit by tariffs more than we would otherwise expect simply because the country lacks the ability to negotiate credibly with the White House.

How far the currency could weaken is a difficult question to answer, as it's certainly not the case that a 10% tariff warrants a 10% currency decline. A number of elements complicate the dynamic, including the amount of time that tariffs are left in place and the fact that Canada will almost certainly impose counter-tariffs on its imports from the U.S. It's also likely that at least a portion of proposed tariffs will not require Canadian-dollar weakness in order for Canadian businesses to remain competitive. The relatively inelastic demand for heavy Canadian crude oil, for example, means that U.S. consumers would be the ones to bear the cost of tariffs via higher energy prices.

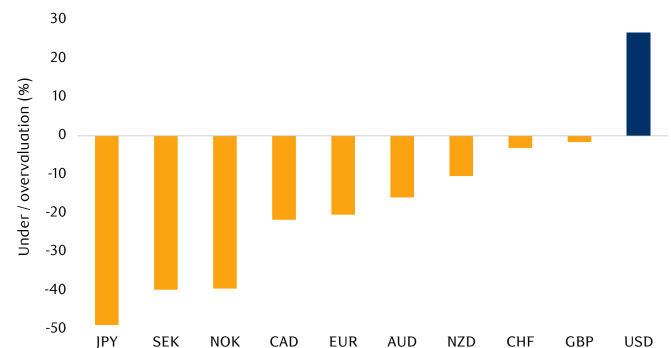
It is doubtful that all of these economic relationships could be accurately modelled to estimate the tariff impact on the Canadian dollar. Instead, we reviewed a variety of models and currency market responses to past tariffs to arrive at a range of possible scenarios (Exhibit 8). These are just a few examples: the variety of scenarios that could play out over the coming months is everchanging and highly uncertain. One condition that makes it harder for the Canadian dollar to fall much further is that the U.S. currency is 26% overvalued (Exhibit 9), and unlike in 2016-2018, Trump's election and imposition of tariffs have not come as a complete surprise. We had also already seen the Canadian dollar weaken in late 2024 to price in some of the potential tariff threats.

Exhibit 8: Potential outcomes for the Canadian dollar under different tariff scenarios

Scenario	Impact on USD/CAD exchange rate	USD/CAD rate (CAD per USD)
No tariff, indefinite delay	USD depreciates by 2-3%	1.41-1.42
10% universal tariff*	USD appreciates 5%	1.52
25% universal tariff*	USD appreciates 10%	1.60

Note: *Assumes tarrifs remain in place until the end of 2025. Source: RBC GAM

Exhibit 9: USD remains massively overvalued



Note: As at February 21, 2025. Source: Bloomberg, RBC GAM

It is likely that currency markets exhibit higher levels of volatility during trade negotiations, and holders of U.S. dollars could take advantage of this volatility to buy undervalued currencies. These opportunities don't come along very often and last materialized for Canadians in 2007, when the loonie was expensive and Canadians rushed to buy properties in Florida – a decision that paid off handsomely over the following decade. We believe we are at the opposite extreme now, and while the U.S. dollar sell-off may take time to occur, we are confident that there is money to be made from buying the Canadian dollar while it's extremely cheap. Our 1-year forecast period is considerably shorter than the investment horizon of most investors, however, and over this next 12 months we expect only moderate Canadian dollar strength to C$1.36.

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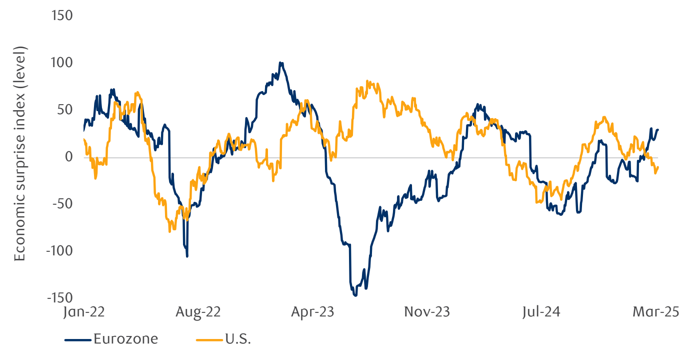
Euro

In many ways, the euro outlook reflects the flipside of the broader U.S. dollar view because together the two currencies represent the lion's share of global foreign-exchange volumes and because the euro exchange rate reflects the performance of one currency relative to the other. While this makes currency investing a comparison of relative merits, that job is made a bit easier when drivers of the two currencies are pointing in opposite directions. This seems to be the case now, as economic growth looks poised for some recovery in Europe while also set to slow from strong levels in the United States (Exhibit 10). To be fair, the U.S. is still likely to post stronger overall economic growth than Europe and will likely offer higher interest rates too, but the fact that investors are so downbeat on all things European (economy, politics, equity markets, currency) means that it doesn't take much to prompt a relief rally in the single currency. As this article was written, a number of elements have come together to buoy sentiment and lift the euro above 1.07 from its early-February lows near 1.02 (Exhibit 11). As mentioned previously, these include the possibility of a peace deal in Ukraine and better prospects for much-needed fiscal spending to support the economy and to add defense capabilities. While Germany's debt-brake has limited federal spending to 0.35% of GDP per year as a way of preventing irresponsible spending, it has also thwarted counter-cyclical fiscal policy needed to cushion

Exhibit 10: Eurozone economic growth is recovering



Note: As at March 5, 2025. Source: Bloomberg, Citigroup, RBC GAM

Exhibit 11: Euro up from February lows

Note: As at March 5, 2025. Source: Bloomberg, RBC GAM

the economy during downturns. News in early March that the German government would try to relax this policy came as a positive surprise for markets that had not expected much from the traditionally conservative stance of the German Bundestag. The shift comes on the heels of U.S. suggestions that it could reduce support or even abandon NATO – a frightening enough prospect for European policy makers, particularly following Trump's Oval Office spat with President Zelensky. And even though some of this spending would be directed toward buying U.S. goods as a token to avoid tariffs, or because of lack of domestically-produced defense equipment, it should nonetheless be supportive for European growth.

Absent any major and lasting tariffs being imposed on Europe by the Trump administration (especially on the auto sector), we suspect that the euro will continue to grind higher toward $1.09. As the economy continues to recover and as the ECB stops reducing interest rates, European assets should start to garner accelerated demand from global investors. We expect this momentum to pick up nearer to the end of our 12-month forecast horizon and for the euro to trade on more solid footing into 2026.

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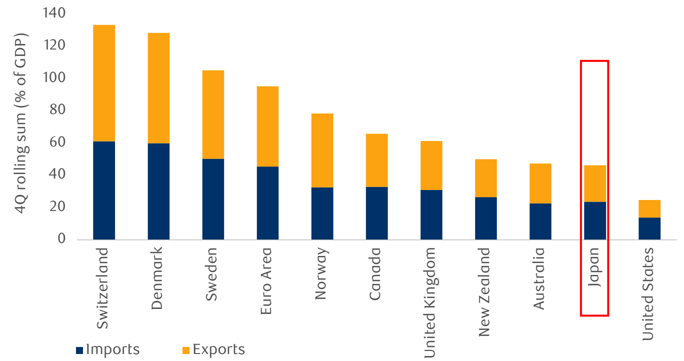
Japanese yen

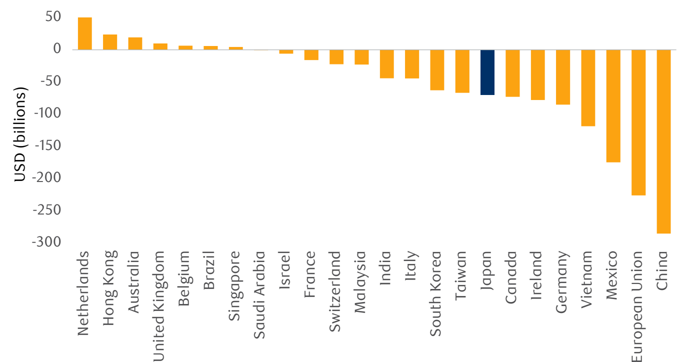
The Japanese yen is well placed to be among the best performing developed market currencies this year. For one thing, the Japanese economy is perhaps the least affected by tariffs given that it is less dependent on trade than its peers (Exhibit 12) and because the U.S. trade deficit with Japan is a fraction of those of Trump's main targets: China, Europe and Mexico (Exhibit 13). Japan-specific factors are also supportive as the yen enjoys large income receipts on assets held abroad and wage-driven inflation is guiding the Bank of Japan to hike interest rates (Exhibit 14). Not only is the currency one of the cheapest in the world, but the Japanese Ministry of Finance has also been trying to prop up its value in recent months – so Japan is one of the few U.S. trade partners whose currency preferences are aligned with the Trump administration. One final reason to love the yen is its status as a safe-haven and the tendency for Japanese investors to repatriate capital invested abroad during times of market turbulence. Given the expensive nature of U.S. stocks, it's timely to have some yen currency exposure in portfolios as insurance against market selloffs. We expect the yen to appreciate to 142 per dollar.

Exhibit 12: Japan is less dependent on trade than peers



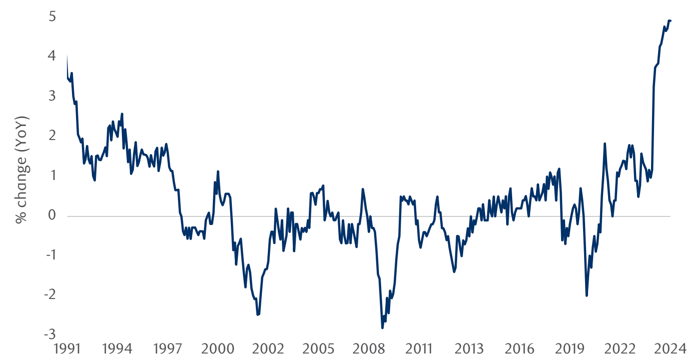
Note: As at: September 30, 2024. Source: IMF, RBC GAM

Exhibit 13: Japan's trade deficit is small compared with the U.S.' other trading partners



Note: As at: September 30, 2024. Source: BEA, RBC GAM

Exhibit 14: Wage pressure supports central bank hikes



Note: As at December 31, 2024. Cash earnings for establishments with over 5 employees. Source: Japanese Ministry of Health, Labour & Welfare, RBC GAM

British pound

We also expect the British pound to rally this year, though there's considerable disagreement among investors on the fate of the UK's currency. January's rise in 30-year UK bond yields to new highs (Exhibit 15) acted as a reminder to investors of the 2022 flash crash in bond markets that led to the ouster of Liz Truss as Prime Minister. To be fair, the UK's persistently large fiscal and current-account deficits have caused investors to question the region's fiscal sustainability for years (Exhibit 16). While there has been an increased amount of scrutiny around fiscal deficits over the past few quarters, it doesn't appear to us as though 2025 will be the year where investors and businesses shun the UK for its excesses. For instance, UK firms have been reducing the proportion of capital expenditures they make abroad, opting to invest in domestic production instead.

It is important to note that the pound is also supported by the UK's relatively higher yields (Exhibit 17), which act as a magnet for capital in a world where most central banks have pivoted to interest rate cuts. While the Bank of England (BoE) has cut three times since mid-2024, we think the UK central bank will be slower cutting rates going forward owing to sticky underlying inflation that looks unlikely to reach the bank's 2% target. Those expecting a stronger pound also point to a more muted impact from trade tensions given that the UK conducts most of its trade with Continental Europe and that the country isn't a target for President Trump's tariffs because the UK actually runs a trade deficit with the U.S. We expect the pound to rise toward $1.33 within 12 months, which would see it strengthen alongside other major developed market currencies as the U.S. dollar begins to falter later this year.

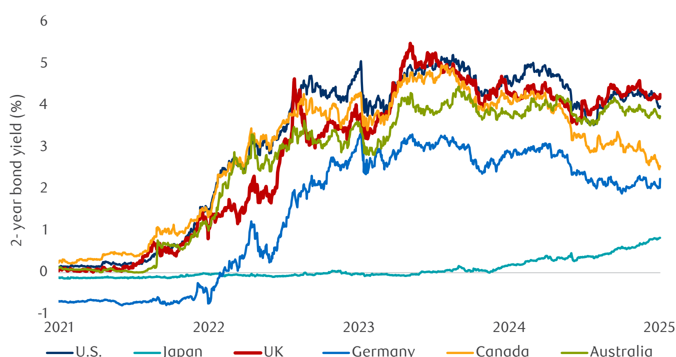
Exhibit 15: UK government bond yields touched new highs in January 2025

Note: As at March 5, 2025. Source: Bloomberg, RBC GAM

Exhibit 16: The UK has run a budget defict for decades

Note: As at December 31, 2024. Source: IMF, RBC GAM

Exhibit 17: Relatively higher yields offer support for the British pound



Note: As at March 5, 2025. Source: Bloomberg, RBC GAM

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