



May 2012

Hawkish Bank of Canada inflates loonie

- **The Canadian dollar's decoupling from commodities is currently being sustained by heightened expectations of interest rate hikes, following the Bank of Canada's more hawkish stance. But with the domestic economy showing surprising signs of fatigue, and Europe remaining a clear and present danger for global growth, a BoC rate hike this year is far from guaranteed. If, as we expect, the BoC delays rate action to next year, that should take some steam out of the C\$.**
- **While European economic data has unfolded as we had expected, the euro has remained resilient in a sea of bad news. In our view, the forces that are currently supporting the euro will eventually succumb to gravity allowing the common currency to drift towards our end-of-Q2 target of 1.27 US\$/€.**
- **The US dollar has underperformed in a period when it typically does well. But with the euro likely to return to losing ways, a positive VIX/USD correlation should be restored sooner rather than later. The apparent moderation in global growth should prompt further bouts of risk aversion and give a boost to the greenback in the process.**

NBF Currency Outlook*								
	Current 2-May-12	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
USD/CAD	0.99	1.02	1.03	1.02	1.00	0.99	0.98	1.00
<i>US cents per CAD</i>	<i>1.01</i>	<i>0.98</i>	<i>0.97</i>	<i>0.98</i>	<i>1.00</i>	<i>1.01</i>	<i>1.02</i>	<i>1.00</i>
EUR/USD	1.32	1.27	1.23	1.20	1.18	1.20	1.22	1.23
USD/JPY	80	79	80	81	82	83	84	85
AUD/USD	1.03	1.00	1.02	1.04	1.05	1.07	1.08	1.06
GBP/USD	1.62	1.58	1.54	1.53	1.51	1.53	1.54	1.55
USD/CNY	6.31	6.30	6.27	6.25	6.20	6.17	6.15	6.10
AUD/CAD	1.02	1.02	1.05	1.06	1.05	1.06	1.06	1.06

* forecasts for end of quarter
Source: NBF Economic Research

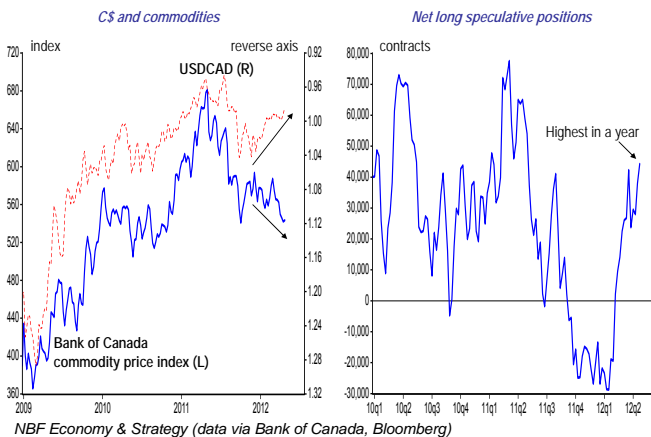
ECONOMIC AND STRATEGY GROUP – 514.879.2529
Stéfane Marion, Chief Economist and Strategist

General: National Bank Financial (NBF) is an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on Canadian stock exchanges. ♦ The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete. The opinions expressed are based upon our analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein. ♦ Canadian Residents: In respect of the distribution of this report in Canada, NBF accepts responsibility for its contents. To make further inquiry related to this report or effect any transaction, Canadian residents should contact their NBF Investment advisor. ♦ U.S. Residents: NBF Securities (USA) Corp., an affiliate of NBF, accepts responsibility for the contents of this report, subject to any terms set out above. Any U.S. person wishing to effect transactions in any security discussed herein should do so only through NBF Securities (USA) Corp. ♦ UK Residents: In respect of the distribution of this report to UK residents, NBF has approved this financial promotion for the purposes of Section 21(1) of the Financial Services and Markets Act 2000. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant securities or related financial instruments discussed in this report, or may act or have acted as investment and/or commercial banker with respect thereto. The value of investments can go down as well as up. Past performance will not necessarily be repeated in the future. The investments contained in this report are not available to private customers. This report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever. This information is only for distribution to non-private customers in the United Kingdom within the meaning of the rules of the Regulated by the Financial Services Authority. ♦ Copyright: This report may not be reproduced in whole or in part, or further distributed or published or referred to in any manner whatsoever, nor may the information, opinions or conclusions contained in it be referred to without in each case the prior express written consent of National Bank Financial.

From dove to hawk...

One of the results of the less-austere-than-expected federal budget was more flexibility for monetary policy. Something had to be done to address what it views as “*the biggest domestic risk*”, i.e. household debt accumulation, and the Bank of Canada seized that opportunity with both hands, announcing in its very first meeting after the budget was presented, that “*some modest withdrawal of the present considerable monetary policy stimulus may become appropriate*”. That marked a shift in its stance and language which had been quite dovish earlier. And to back its hawkish stance, the BoC presented, in its latest Monetary Policy Report, strong enough 2012 growth forecasts as to allow the output gap to close earlier than what it anticipated back in January. The BoC’s more hawkish stance immediately inflated the Canadian dollar, with markets raising bets of rate hikes this year, and speculators increasing their net long CAD positions to the highest in a year. Those forces helped reinforce the loonie’s decoupling from commodity prices.

Canada: Loonie temporarily decouples from commodities



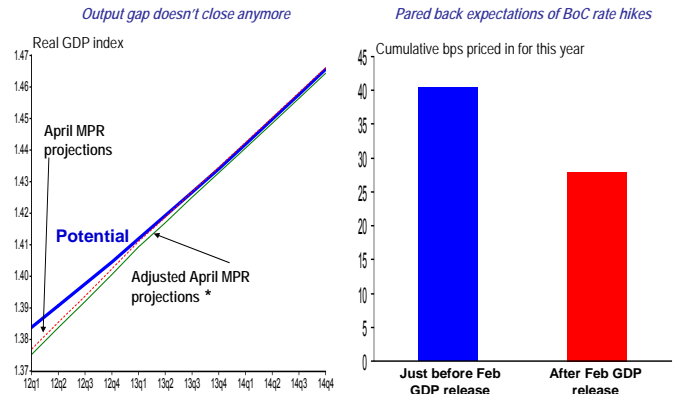
But less than two weeks after the brand new MPR was released, a disappointing February GDP report threw a wrench in the Bank of Canada’s forecast for the first quarter.

... to dove again?

February’s results were so bad that, barring a miracle in March, Q1 growth will fall well short of the BoC’s 2.5% call for the quarter. Even assuming an overly optimistic 0.5% increase in March output, Q1 GDP growth is likely to print around 2%. So, just how significant is a 0.5% miss in the BoC’s Q1 forecast? Assuming no change to the MPR projections after Q1 of 2012, the output gap doesn’t close through the

projection horizon. While that in itself doesn’t rule out rate hikes, it certainly reduces the probability this year — which explains why markets pared back their expectations right after the GDP data was released.

Canada: Rate hikes this year? Not so fast



*Assuming 2012Q1 growth ends up at 2% rather than the 2.5% the BoC estimated, and no change to post-Q1 MPR projections
NBF Economy & Strategy (data via Bloomberg, Bank of Canada and NBF calculations)

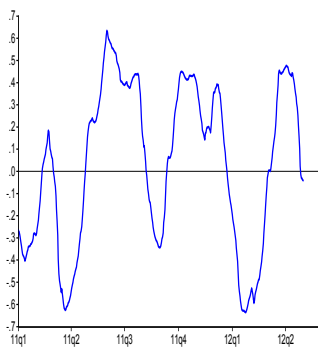
And there’s more than just domestic woes to contend with. The BoC made clear that “*the timing and degree of any such withdrawal (of stimulus) will be weighed carefully against domestic and global economic developments*”. So, the evolution of the European recession will also be crucial in determining monetary policy at home. Given our slightly more bearish view on Europe than the BoC and the apparent Q2 softening in the US, we continue to expect rate hikes to be delayed until next year. Given what’s still priced in by markets, that would work as take some steam out of the C\$, putting it closer to 1.02 C\$/US\$ by the end of Q2, a level more consistent with commodity prices.

Twisted USD/VIX correlation

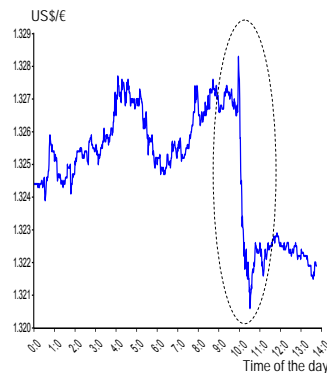
Another tailwind allowing the loonie to fly high and fast in April was the underperforming US dollar. The big dollar which so often in the past capitalized on negative global economic news failed to do so in April. In fact, the US dollar’s correlation with the VIX index, an indicator of risk aversion, even turned negative. So, the bad news emanating particularly from Europe isn’t helping the greenback as much. The negative VIX/dollar correlation seems to have carried over into May with the weak US employment reports, i.e. April’s non farm payrolls and household surveys actually giving a lift to the euro, while a rare piece of consensus-topping data, i.e. the ISM manufacturing caused the greenback to rally against the common currency.

Correlation between VIX and the US dollar now negative

100-day correlation VIX and trade-weighted USD



Reaction of the euro to strong US ISM on May 1st



NBF Economy & Strategy (data via Bloomberg)

What's feeding this negative correlation? One known factor helping the euro weather the sea of negative news is central bank intervention — the Swiss National Bank has indeed pledged to prevent franc appreciation beyond 1.20. Harder to prove is euro buying by central banks of emerging nations to hold down their own currencies, although that wouldn't surprise us given the worsening picture regarding their exports to the eurozone.

Another possible explanation for the euro's surprising resilience is the repatriation of funds by European financial institutions attempting to repair their recession-weakened balance sheets. Foreign acquisition of European sovereign bonds may also be playing a part in supporting the euro.

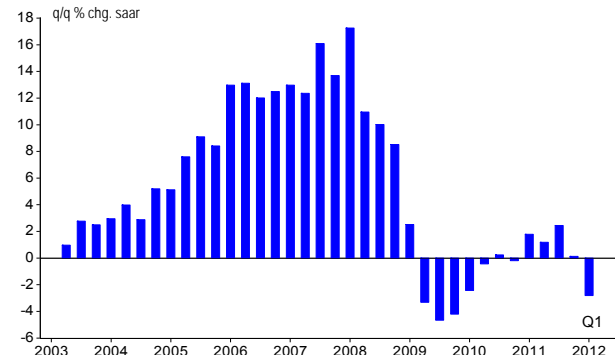
Euro slump in the cards

But for how long can those temporary forces last? The recession is getting worse, not better. Case in point is the zone's manufacturing PMI which fell to 45.9 in April, lower than the level recorded last November when credit stress was acute. A reading below 50 indicates contraction, not a slowdown in growth, meaning that the factory sector is relapsing.

That may be a surprise to some European politicians who, just a few weeks ago, declared that the worst was now behind. But the deterioration is hardly a surprise to us. Eurozone demand is being hammered by a labour market in freefall (ex-Germany) and limited credit access. Despite the ECB's liquidity injections, credit isn't flowing freely to the economy, as evidenced by the contraction of loans to non-financial corporations in the first quarter of the year. This is what tends to happen when banks are forced to recapitalize in a recessionary environment.

World: European credit access limited by banking troubles

MFI loans to non-financial corporations contracted in Q1



NBF Economy & Strategy (data via European Central Bank)

Moreover, bank solvency problems will continue to be an albatross around Europe's neck. True, the 5-yr CDS on European financials have come down a bit since the ECB's long-term refinancing operations provided liquidity to cash-strapped banks. But they remain well above the peaks of 2009 and 2010, highlighting the still-frail state of banks in the common currency area.

World: European banks' solvency problems remain acute

iTraxx Europe senior financials 5-yr CDS remain elevated



NBF Economy & Strategy (data via Bloomberg)

Further bank bailouts by European governments cannot be ruled out, and if those materialize, expect missed deficit targets and further sovereign ratings downgrade. Adding to the fire is political uncertainty with upcoming elections in France, Greece, and the Netherlands. There will be some challenges to German-thinking about how to tackle the current European downturn. Policymakers are indeed slowly waking up to the fact that large scale austerity programs can actually worsen public finances by turning a mild recession into a severe one, and causing revenues to plummet. What's needed is structural reforms to address the long-term path of

spending and economic growth, rather than subject the economy to short-term cuts that can be particularly damaging during a recession.

The problem with this, however, is that bond markets tend to punish those who deviate from deficit targets. To avoid those punishing borrowing rates, a country may opt to tap the ESM/EFSF. But then again, the latter is limited in size and meant to be temporary anyway. So there's a limited amount of time during which a country can remain shut out of financial markets before eventually having to default. Just ask Greece. Jointly issued Eurobonds seem best suited to allow the periphery to borrow at reasonable rates and hence sustainably finance the necessary reforms. For now, that option isn't acceptable to Germany. But expect that issue to return to the table if, as we expect, the threat of sovereign default makes a comeback.

There's no quick fix for the European problems. The temporary forces that have supported the common currency so far are likely to fade over time. The combination of political uncertainty, the ongoing recession, credit squeeze and bank solvency problems, is consistent with deflationary forces, downward revisions for earnings and growth prospects, and further easing of monetary policy by the ECB. That can't be good for the euro.

Moreover, consensus expectations look too optimistic, with GDP contraction estimated at just 0.4% and an unemployment rate averaging 10.9% this year. Note that eurozone unemployment was already at 10.9% in March and with nine months to go consensus is likely to be disappointed. Under those circumstances, we remain comfortable with our call for the euro to fall to around 1.27 against the USD by the end of the quarter.

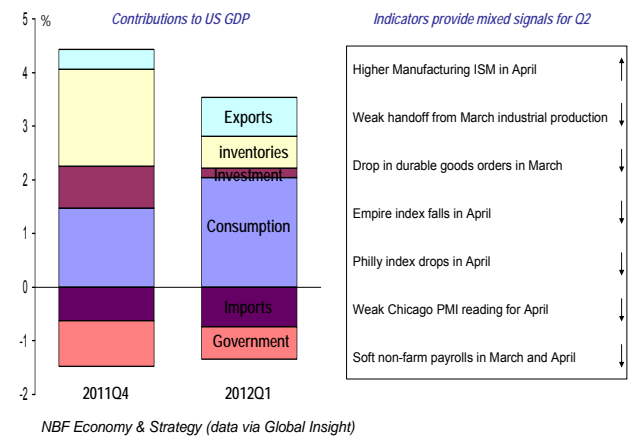
A slowing US economy and the dollar

With the euro likely to return to losing ways, a positive VIX/USD correlation should be restored sooner rather than later. The apparent moderation in global growth should prompt further bouts of risk aversion and give a boost to the greenback in the process.

Given how well the US economy has supported the global economy by offsetting the drag from Europe late last year, investors may get nervous with the apparent moderation this year. While the details of the first quarter GDP report were better than Q4's, with more vigor in consumption spending and exports, overall growth was weaker at just 2.2%

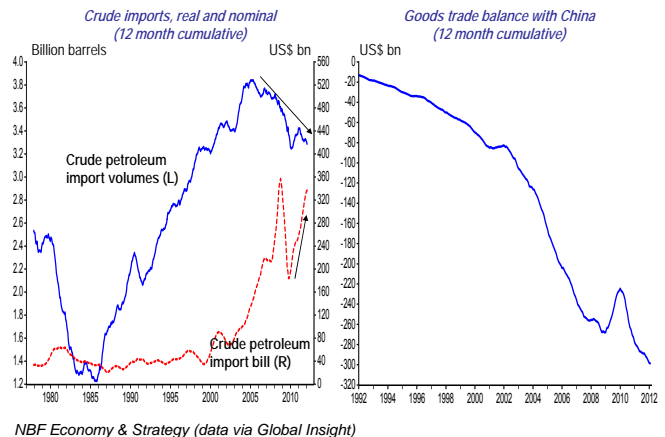
annualized. Preliminary indicators generally suggest a further moderation in the current quarter. But with continuing growth, and employment creation remaining in the triple digits, the Fed has resisted a third round of asset purchases, something that has helped the US dollar somewhat. But if growth deteriorates more acutely, causing the unemployment rate to climb again, further stimulus cannot be ruled out. The prospect of QE3 is *the* downside risk to our forecast for a US dollar rebound.

U.S.: Q1 not as bad as the headline (L); Moderation in Q2? (R)



Longer term, the greenback will remain under pressure to depreciate to address America's trade imbalance problems. Little progress has been made in reducing the oil trade deficit, with the benefits of lower import volumes of crude oil being largely offset by higher prices. Moreover, the deficit with China continues to grow, reaching the highest 12-month total on record in February.

U.S.: Difficult to permanently improve trade balance



Stéfane Marion/Krishen Rangasamy

Annex

