Highlights
By Stéfane Marion/Kyle Dahms

- The trade-weighted U.S. dollar reached a new cyclical high in July against a basket of 26 currencies. The Bank for International Settlements estimates that the real effective exchange rate of the U.S. dollar is the highest in two decades. This erosion of competitiveness is not going unnoticed on the profitability of US companies. In our view, this sets the stage for a very tangible reduction in the pace of business hiring after the exceptional gain of 528,000 payroll jobs in August.

- July was a roller coaster ride for the Canadian dollar. The loonie started the month at 1.29 before losing several feathers, with USD/CAD even reaching our Q3 target of 1.32 on July 14, faster than we had envisioned in our previous Forex piece and despite an unexpected jumbo rate hike from the Bank of Canada. After rallying 4 cents through August 1, the loonie has returned to 1.29 against the greenback on disappointing jobs data. Unforced retirements, not layoffs, seem to be the main cause of recent job losses. We still see USD/CAD converging to 1.22 in the coming quarters.

- The current situation in Europe is precarious and will require material improvements on both the geopolitical and inflation fronts. Growth is likely to moderate in the second half of the year. We continue to see some lingering euro weakness in the short term with the potential for a little appreciation of the common-area currency further out on the forecast horizon as the USD weakens. The Pound for its part was little changed on the announcement of a larger-than-usual rate hike by the BoE as economic projections were significantly downgraded.

NBF Currency Outlook

<table>
<thead>
<tr>
<th>Currency</th>
<th>Current August 2, 2022</th>
<th>Q3 2022</th>
<th>Q4 2022</th>
<th>Q1 2023</th>
<th>Q2 2023</th>
<th>ppp (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Canadian Dollar</strong></td>
<td>(USD / CAD)</td>
<td>1.29</td>
<td>1.30</td>
<td>1.27</td>
<td>1.25</td>
<td>1.22</td>
</tr>
<tr>
<td><strong>United States Dollar</strong></td>
<td>(CAD / USD)</td>
<td>0.78</td>
<td>0.77</td>
<td>0.79</td>
<td>0.80</td>
<td>0.82</td>
</tr>
<tr>
<td><strong>Euro</strong></td>
<td>(EUR / USD)</td>
<td>1.02</td>
<td>1.00</td>
<td>1.02</td>
<td>1.04</td>
<td>1.05</td>
</tr>
<tr>
<td><strong>Japanese Yen</strong></td>
<td>(USD / JPY)</td>
<td>132</td>
<td>136</td>
<td>134</td>
<td>132</td>
<td>128</td>
</tr>
<tr>
<td><strong>Australian Dollar</strong></td>
<td>(AUD / USD)</td>
<td>0.70</td>
<td>0.69</td>
<td>0.71</td>
<td>0.72</td>
<td>0.72</td>
</tr>
<tr>
<td><strong>Pound Sterling</strong></td>
<td>(GBP / USD)</td>
<td>1.22</td>
<td>1.20</td>
<td>1.21</td>
<td>1.22</td>
<td>1.22</td>
</tr>
<tr>
<td><strong>Chinese Yuan</strong></td>
<td>(USD / CNY)</td>
<td>6.76</td>
<td>6.78</td>
<td>6.70</td>
<td>6.60</td>
<td>6.55</td>
</tr>
<tr>
<td><strong>Mexican Peso</strong></td>
<td>(USD / MXN)</td>
<td>20.5</td>
<td>21.0</td>
<td>20.5</td>
<td>20.0</td>
<td>20.5</td>
</tr>
<tr>
<td><strong>Broad United States Dollar</strong></td>
<td>(3)</td>
<td>122.0</td>
<td>124.0</td>
<td>121.7</td>
<td>119.6</td>
<td>118.9</td>
</tr>
</tbody>
</table>

1) PPP data from OECD, based in Local Currency per USD
2) Current Account Balance data from IMF, as a % of GDP (2020 & 2021 IMF estimates)
3) Federal Reserve Broad Index (26 currencies)

Canadian Dollar Cross Currencies

<table>
<thead>
<tr>
<th>Currency</th>
<th>Current August 2, 2022</th>
<th>Q3 2022</th>
<th>Q4 2022</th>
<th>Q1 2023</th>
<th>Q2 2023</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Euro</strong></td>
<td>(EUR / CAD)</td>
<td>1.31</td>
<td>1.30</td>
<td>1.30</td>
<td>1.30</td>
</tr>
<tr>
<td><strong>Japanese Yen</strong></td>
<td>(CAD / JPY)</td>
<td>102</td>
<td>105</td>
<td>106</td>
<td>106</td>
</tr>
<tr>
<td><strong>Australian Dollar</strong></td>
<td>(AUD / CAD)</td>
<td>0.89</td>
<td>0.90</td>
<td>0.90</td>
<td>0.90</td>
</tr>
<tr>
<td><strong>Pound Sterling</strong></td>
<td>(GBP / CAD)</td>
<td>1.57</td>
<td>1.56</td>
<td>1.54</td>
<td>1.53</td>
</tr>
<tr>
<td><strong>Chinese Yuan</strong></td>
<td>(CAD / CNY)</td>
<td>5.25</td>
<td>5.22</td>
<td>5.28</td>
<td>5.28</td>
</tr>
<tr>
<td><strong>Mexican Peso</strong></td>
<td>(CAD / MXN)</td>
<td>15.9</td>
<td>16.2</td>
<td>16.1</td>
<td>16.0</td>
</tr>
</tbody>
</table>
USD: Recession fears abate for now

The trade-weighted U.S. dollar reached a new cyclical high in July against a basket of 26 currencies (chart). After losing some ground following the release of negative GDP growth in the second quarter, the currency rallied again after the publication of a stellar payroll jobs report eased recession fears. The greenback was also pushed higher due to rising geopolitical tensions between China and the U.S. caused by the visit to Taiwan of the Speaker of the U.S. House of Representatives.

After its latest performance, the Bank for International Settlements (BIS) estimates that the real effective exchange rate of the U.S. dollar is the highest in two decades (chart).

In our view, this sets the stage for a very tangible reduction in the pace of business hiring after the exceptional gain of 528,000 payroll jobs in August. As profit margins continue to be squeezed by an overvalued currency and higher labour costs, companies must now contend with rising inventories (chart).

What does all this mean for the Fed and monetary policy? While the August payroll report certainly makes the case for another rate hike on September 21, the outlook becomes much more uncertain after that. According to our calculations, the current divergence between semi-annual GDP growth and payroll jobs is the largest on record (chart).
Against this backdrop, and given our expectation of a peak in U.S. CPI inflation this summer, we doubt that the Federal Reserve will raise its policy rate much above 3% to guard against a significant deterioration in labour market conditions. Such a development would be conducive to U.S. depreciation later this fall.

**CAD: Job creation disappoints**

July was a roller coaster ride for the Canadian dollar. The loonie started the month at 1.29 before losing several feathers, with USD/CAD even reaching our Q3 target of 1.32 on July 14 (intraday basis), faster than we had envisioned in our previous Forex piece and despite an unexpected jumbo rate hike from the Bank of Canada. After rallying 4 cents through August 1, the loonie has returned to 1.29 against the greenback. Despite the recent decline in commodity prices, our model shows that the Canadian currency is still significantly undervalued (chart).

**CAD: Correlation with oil prices is currently negative**

That said, we do not feel that another move of this magnitude is in the cards. At this juncture, our fixed income strategists see a hike of 75 bps at the September 7 policy meeting. The resulting policy rate, at 3.25%, would then be in mildly restrictive territory before summer is out. Is this moving too fast for the Canadian economy to avoid a recession? After all, home sales are already down sharply and job creation is disappointing: instead of rising 15K as per consensus, Canadian employment fell 30.6K in July, marking a second consecutive decline for this indicator.

This performance should be interpreted with caution, however. Seventy percent of recent job losses have been concentrated among workers aged 55 and over, a category that normally represents 21 percent of the workforce. Unforced retirements, not layoffs, seem to be the main cause of this reduction. In July, Statistics Canada reported that a record 300,000 Canadians had left their job due to retirement in the past year (chart). In our view, this surge likely reflects a resorption of retirements accumulated in 2021 as a result of generous government wage subsidy programs and the ability to work at home that temporarily boosted the labor force participation rate of older workers. By April 2021, the annual retirements had fallen to a multiyear low of only 194,000. Most of the pent-up retirements created during the pandemic have probably now been absorbed. As the participation rate of older workers stabilizes, we don’t expect retirements to continue to weigh on total employment as they have in recent months.
With the unemployment rate remaining historically low and with labour shortages continuing to persist according to the latest figures by the CFIB, we still see enough resilience in the Canadian domestic economy to justify higher interest rates.

Given our expectation that WTI oil prices should stabilize around $90 per barrel, we still see USD/CAD converging to 1.22 in the coming quarters as the oil/loonie correlation turns positive again.

**Canada: Unwinding of pent-up retirements impacts job creation**

Labour force participation for people aged 55+ and # of people leaving their jobs due to retirement

---

**Canada: Shortages of labour remains elevated**

Factors that limit businesses’ ability to grow, share of respondents

---

The ECB is expected to continue normalization at its next meeting, with markets anticipating another 50bps increase. True, hard economic indicators are still flashing green as shown by growth and employment. For the former, GDP in the Eurozone rebounded from 0.5% in Q1 to 0.7% in Q2 on the back of a renewed vigour for tourism activity. The details of the report did however show that Germany experienced no growth in the second quarter as dependence to Russian natural gas is likely curtailing activity.
The unemployment rate for its part remained at 6.6% for the third month in a row in June. This remains the lowest level since recorded data began in 1998. It is difficult to say if this level can perpetuate itself into the second half of the year as the conflict in Ukraine continues and natural gas provisioning remains inconsistent.

Other timely indicators argue for some caution. The July flash PMI for the Eurozone fell into contractionary territory and marked the first deterioration in operating conditions in the private sector since February 2021.

Although input cost inflation cooled, business expectations were quite gloomy on the back of inflation, monetary tightening, supply chains and energy. This was also reflected in economic sentiment in the Eurozone which declined in July to its lowest value since 2015 (excluding the pandemic).

All told, the current situation in Europe is precarious and will require material improvements on both the geopolitical and inflation fronts. Growth is likely to moderate in the second half of the year. We continue to see some lingering euro weakness in the short term with the potential for a little appreciation of the common-area currency further out on the forecast horizon.

**GBP: BoE warns of bleak outlook**

The UK is in the throes of an election at a moment where the economy is under pressure from a multitude of threats. The pound sterling has struggled to find a bid in these uncertain times.

The Bank of England for its part elected to conduct its largest rate hike in 27 years, raising its benchmark rate by 50 basis points. The benchmark rate now sits at 1.75% and market anticipations
For another hike at the next meeting in September. Still, the world’s oldest actively traded currency was essentially unmoved by the announcement. Maybe that can be traced back to the extremely pessimistic tone of the central bank, a surprising development. The BoE now expects inflation to reach 13% by year-end and remain at elevated levels for the entirety of 2023 only to fall back to 2% in 2024. Household real after-tax income is also seen dropping approximately 5% from peak to trough, a negative development for consumption and the broader economy. All told, the Bank’s baseline scenario is for the economy sliding into a 15-month recession, during which time GDP should contract more than 2%. Moreover, the unemployment rate is projected to rise in the middle of 2023 and could exceed 6% by the middle of 2025.

That grim view is unlikely to foster a positive outlook of the UK for investors. We expect the Pound has limited upside potential in the short term and will require some to the storm clouds to dissipate in order to make some gains later in our forecast horizon.
Appendix: Spot rates
Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Daren King
Economist
daren.king@nbc.ca

Alexandra Ducharme
Economist
alexandra.ducharme@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
Chief Rates and Public Sector Strategist
warren.lovely@nbc.ca

Taylor Schleich
Rates Strategist
taylor.Schleich@nbc.ca

General
This Report was prepared by National Bank Financial, Inc. (NBF), (a Canadian investment dealer, member of IIROC), an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete and may be subject to change without notice. The information is current as of the date of this document. Neither the author nor NBF assumes any obligation to update the information or advise on further developments relating to the topics or securities discussed. The opinions expressed are based upon the author(s) 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, and nothing in this Report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient’s individual circumstances. In all cases, investors should conduct their own investigation and analysis of such information before taking or omitting to take any action in relation to securities or markets that are analyzed in this Report. The Report alone is not intended to form the basis for an investment decision, or to replace any due diligence or analytical work required by you in making an investment decision.

This Report is for distribution only under such circumstances as may be permitted by applicable law. This Report is not directed at you if NBF or any affiliate distributing this Report is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBF is permitted to provide this Report to you under relevant legislation and regulations.

National Bank of Canada Financial Markets is a trade name used by National Bank Financial and National Bank of Canada Financial Inc.

Canadian Residents
NBF or its affiliates may engage in any trading strategies described herein for their own account or on a discretionary basis on behalf of certain clients and as market conditions change, may amend or change investment strategy including full and complete divestment. The trading interests of NBF and its affiliates may also be contrary to any opinions expressed in this Report.

NBF or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBF and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise. NBF and its affiliates may make a market in securities mentioned in this Report. This Report may not be independent of the proprietary interests of NBF and its affiliates.

This Report is not considered a research product under Canadian law and regulation, and consequently is not governed by Canadian rules applicable to the publication and distribution of research Reports, including relevant restrictions or disclosures required to be included in research Reports.
UK Residents

This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. 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 investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. 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 Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered address at 70 St. Mary Axe, London, EC3A 8BE. NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

U.S. Residents

With respect to the distribution of this report in the United States of America, National Bank of Canada Financial Inc. ("NBCFI") which is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC), an affiliate of NBF, accepts responsibility for its contents, subject to any terms set out above. To make further inquiry related to this report, or to effect any transaction, United States residents should contact their NBCFI registered representative.

This report is not a research report and is intended for Major U.S. Institutional Investors only. This report is not subject to U.S. independence and disclosure standards applicable to research reports.

HK Residents

With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA") which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) and Type 3 (leveraged foreign exchange trading) regulated activities, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates’ businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including National Bank of Canada and National Bank Financial Inc, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.

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 NBF.