June 2018

No “Dolce vita” for Italy

- How long can USD strength last? As we saw in May, there will be bouts of USD strength with events tied to the Fed’s tightening of monetary policy or risk-off sentiment that precipitate safe haven flows. But the trend is likely to be lower because of diverging monetary policy. The Fed’s abilities to tighten policy is indeed restricted by the flattest yield curve in a decade and the belief within the FOMC that the fed funds rate could soon be at or above neutral.

- Soft data and uncertainties brought by mounting trade protectionism and Italy’s new coalition government make it harder for the European Central Bank to hit its 2% inflation target. In other words, the ECB’s monetary policy is likely to remain loose over the near term. While we have lowered our near-term targets for the euro to reflect ongoing headwinds, our longer-term view for the common currency remains unchanged. A EURUSD cross near 1.25 is possible by next year if, as we expect, the zone’s economic fortunes improve and markets start to price in some policy tightening by the ECB.

- We are keeping unchanged our targets for USDCAD, expecting the loonie to benefit from improving yield spreads with the U.S. A positive global economic backdrop should also be supportive of commodity prices and hence the C$. Any appreciation could be amplified by speculators who are likely to unwind their C$ short positions if their bets turn sour. That outlook, of course, assumes downside risks including European politics and U.S. protectionism, are contained.

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NBF Currency Outlook*

	Current 1-Jun-18	2018Q3	2018Q4	2019Q1	2019Q2	2019Q3
USDCAD	1.30	1.23	1.21	1.20	1.22	1.21
US cents per CAD	0.77	0.82	0.83	0.83	0.82	0.83
EURUSD	1.17	1.18	1.21	1.25	1.23	1.25
USDJPY	110	112	114	114	112	113
AUDUSD	0.75	0.78	0.81	0.83	0.81	0.82
GBPUSD	1.33	1.35	1.37	1.38	1.34	1.35
USDCNY	6.42	6.39	6.35	6.30	6.31	6.25
USDMXN	19.84	19.10	18.80	18.60	18.70	18.40

*Forecasts for end of period
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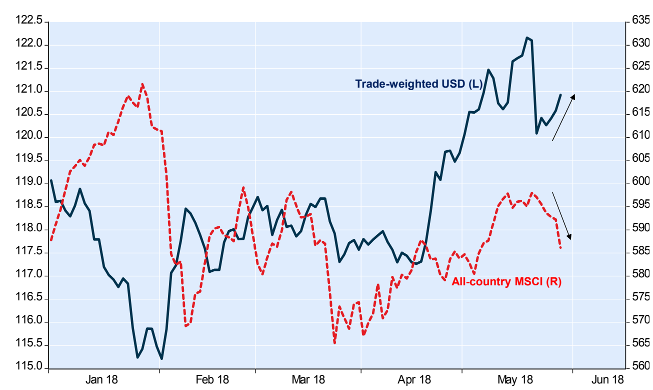
Market uncertainty boosts USD

The U.S. dollar had a rather eventful May. The month started well for the currency as solid U.S. economic data, which hinted at a sharp acceleration of U.S. GDP growth in Q2, propelled the trade-weighted USD to its highest point since July. But then came dovish Fed minutes which made clear the FOMC would accept “a temporary period of inflation modestly above 2%”, taking some steam out of the currency. The return of risk aversion in the last week of the month, courtesy of Italy’s political crisis, then reenergized the greenback via safe haven flows, allowing it to register an overall appreciation over the month.

USD benefited from safe haven flows in May
Trade-weighted USD versus All-country MSCI index



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May’s market gyrations are a reminder that currency volatility should be expected in the current environment of enhanced uncertainties about the economy, policy and politics.

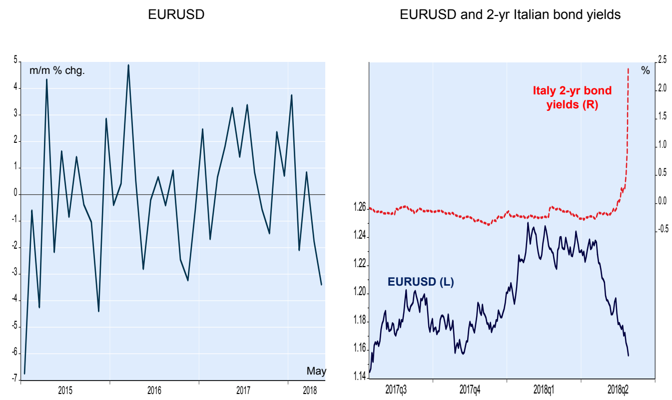
Does the USD rally have legs? As we saw in May, there will be bouts of USD strength with events tied to the Fed’s tightening of monetary policy or risk-off sentiment that precipitate safe haven flows. But we continue to expect the greenback to trend lower over the forecast horizon in part because of diverging monetary policies. The Fed’s abilities to tighten policy is indeed restricted by the flattest yield curve in a decade — the yield spread between 10-year and 2-year Treasuries is now less than 50 basis points — and the belief within the FOMC that the fed funds rate could soon be at or above neutral.

No “Dolce vita” for Italy

The euro just saw its biggest monthly slump since 2015. Weakness towards the end of April spilled over into May courtesy of soft economic data (including Q1 GDP) and dovish signals from the European Central Bank.

But the euro’s slide turned into a rout in the second half of May as Italy’s political crisis worsened, prompting investors to question the viability of Italy within the Eurozone.

Euro hammered by soft data and political crisis



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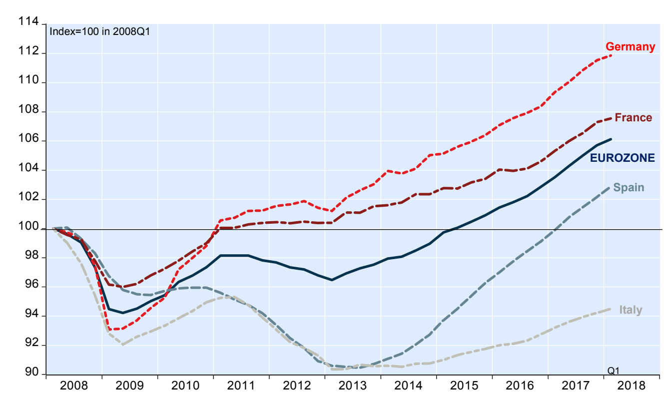
To be sure, membership in the Eurozone has not come with the advertised benefits for Italy. The latter’s economic growth continues to lag that of its peers. Real GDP, for example, is still about 6% below the 2008 peak. That contrasts with the Eurozone as a whole whose output is roughly 6% *above* 2008 levels. Italy’s unemployment rate remains well above the eurozone’s average, with the contrast even larger among the youth whose jobless rate of more than 30% contrasts with a 17% average for the Eurozone.

Eurozone: Diverging fortunes over the last decade
Real GDP



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With such underwhelming performance relative to its peers, little wonder that populism is gaining traction. Italy’s new coalition government, with its Euroscepticism and anti-establishment rhetoric, will cause headaches in Brussels. The uncertainty that creates does not help a Eurozone already reeling from a

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difficult start to the year. The sharp increase in Italian bond yields in recent weeks should not be surprising amidst investor concerns.

Soft data and uncertainties brought by mounting trade protectionism and Italy's new coalition government make it harder for the European Central Bank to hit its 2% inflation target. In other words, the ECB's monetary policy is likely to remain loose for the next little while.

But that's not to say the euro is doomed. As we've seen before, politicians can change their tune as reality sets in — remember Alexis Tsipras and his Syriza party in Greece. Comes a point Italian populists will have to weigh the benefits of leaving an organized trade bloc (the European Union or the Eurozone or both) to gain greater fiscal and monetary independence, versus the alternative of staying and engaging into painful reforms. Recall that Mr Tsipras, despite all the anti-Europe rhetoric at the time, chose the latter option.

But you never know with politicians and voters. Their unpredictability is the reason why markets are likely to remain on edge for the next few months. While we lowered our near-term targets for the euro to reflect ongoing headwinds, our longer-term view for the common currency remains unchanged. A EURUSD cross near 1.25 is possible by next year if, as we expect, the zone's economic fortunes improve and markets start to price in some monetary policy tightening by the ECB.

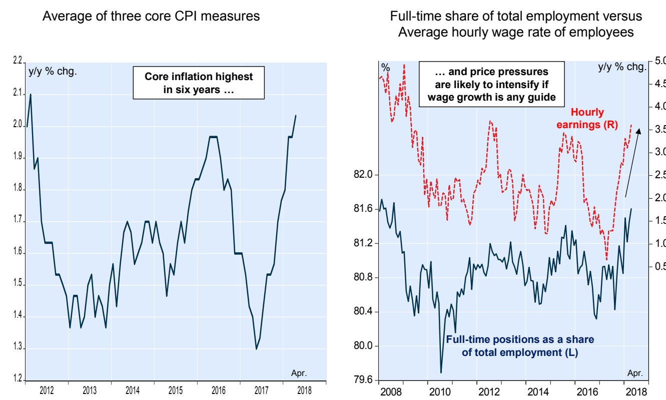
Bank of Canada hints at July hike

The Canadian dollar lost some ground against the USD in May. At some point USDCAD even crossed 1.30, amidst USD strength and as investors started to question whether the Bank of Canada would be able to raise interest rates in July.

But then came the Bank of Canada statement in the last week of May. The central bank left the overnight rate unchanged at 1.25%, but hinted at a July hike. While acknowledging uncertainties about trade policy and housing (amidst the ongoing adjustment to new mortgage guidelines), the BoC said that "developments since April further reinforce Governing Council's view that higher interest rates will be warranted to keep inflation near target". The central bank sounded more upbeat about the labour market by emphasizing its expectations that solid labour income growth will support housing activity and consumption going forward. The loonie gained a cent after the announcement.

Rising price pressures likely got the attention of the BoC. The average of the three core CPI measures now show an annual inflation rate above 2%, the highest in six years. Wages are also growing at the fastest pace since 2012, suggesting further price pressures down the line.

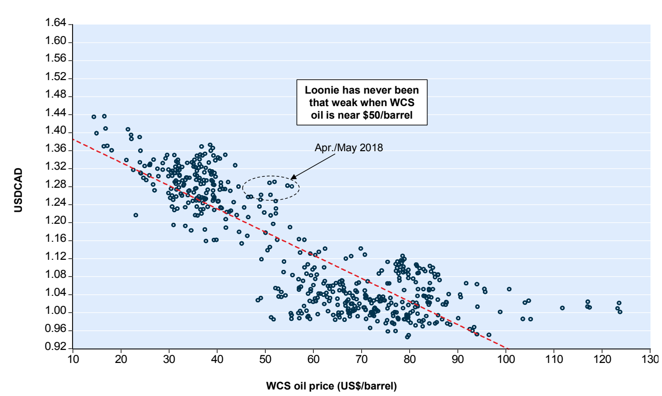
Canada: Inflation heats up



NBF Economics and Strategy (data via Statistics Canada)

The impact of unfavourable yields relative to the U.S. has been more than offsetting the lift provided by rising oil prices, leaving the loonie grounded at much weaker levels than would typically be associated with current oil prices. So, look for the Canadian dollar to appreciate against the USD as Canada-U.S. yield spreads improve further in the coming months.

Loonie should be stronger than current levels given current oil price
WCS oil versus USDCAD, weekly data since May 2008



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That outlook, of course, assumes the Canadian economy is not subject to negative shocks over the forecast horizon. And here we're thinking of the housing market or U.S.-Canada trade relations which have potential to deteriorate and prompt an exodus of foreign capital. The recent implementation of tariffs by the U.S. on steel and aluminium imports from Canada will not break the latter's economy but is nonetheless concerning.

In the 12 months to March 2018, Canadian exports of steel products to the U.S. amounted to C$7.4 bn and those of aluminium products totalled C$11 bn. Taken together, those represent less than 5% of Canadian goods exports to the U.S. and less than 1% of Canadian GDP.

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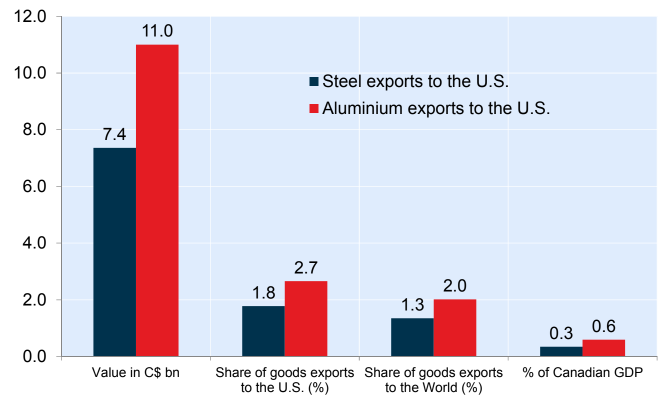
While the impacts are small, those measures open the door for a broadening of tariffs to include more goods, something that cannot be entirely ruled out as U.S. politicians seek to boost their approval ratings in rust belt states ahead of mid-term elections.

Canada: Will U.S. tariffs break the economy?
Canadian exports of steel and aluminium products to the U.S. (April 2017-March 2018)



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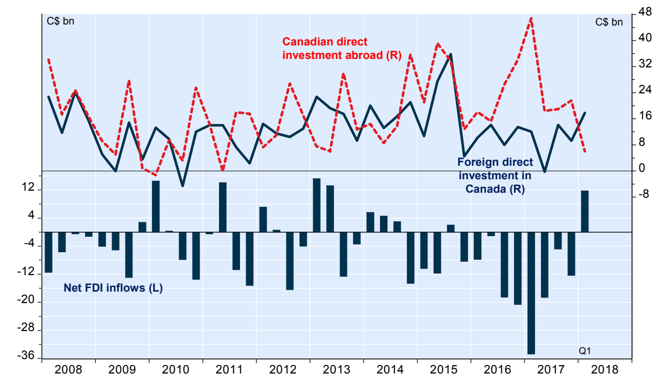
The massive current account deficit, which reached 3.6% of GDP in Q1, means that Canada is dependent on foreign capital. Should there be a negative turn in foreign investor sentiment (e.g. in response to additional U.S. trade action, housing market deterioration, unexpected economic slowdown), the Canadian dollar would be vulnerable.

There is some good news on that front, however, with latest data showing an improvement in the way the external deficit is financed. For the first time in years, the deficit in the first quarter of 2018 was financed not by short-term portfolio flows — which turned negative as foreigners ditched Canadian securities, particularly federal government bonds — but by foreign direct investment (FDI) which are less prone to reversal. Net FDI inflows turned positive for the first time since 2015 thanks to a combination of lower Canadian investment abroad (dragged down by slower M&A activity) and stronger foreign direct investment into Canada.

Canada: FDI inflows turn positive for the first time since 2015
Sources of financing for current account deficit



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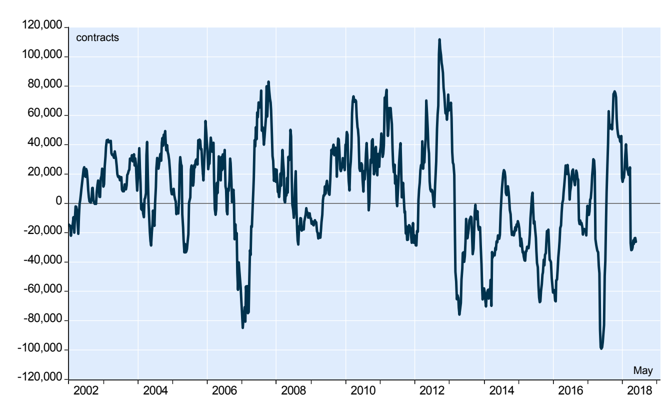
Of course, one quarter does not make a trend and hence one should be careful in declaring victory in the intense global battle to attract foreign investment. But we take heart from the apparent increase in foreign interest in Canadian operations, particularly the manufacturing sector, the latter taking in more than half of FDI in Canada in Q1 and more than 40% in the last four quarters.

All told, we are keeping unchanged our targets for USDCAD, expecting the loonie to benefit from more favourable investor sentiment and improving yield spreads with the U.S. A positive global economic backdrop should also be supportive of commodity prices and hence the C$. Any appreciation could be amplified by speculators who are likely to unwind their C$ short positions if their bets turn sour. That outlook, of course, assumes downside risks including European politics and U.S. protectionism, are contained.

Speculators still shorting the loonie
Non-commercial net long positions on the Canadian dollar



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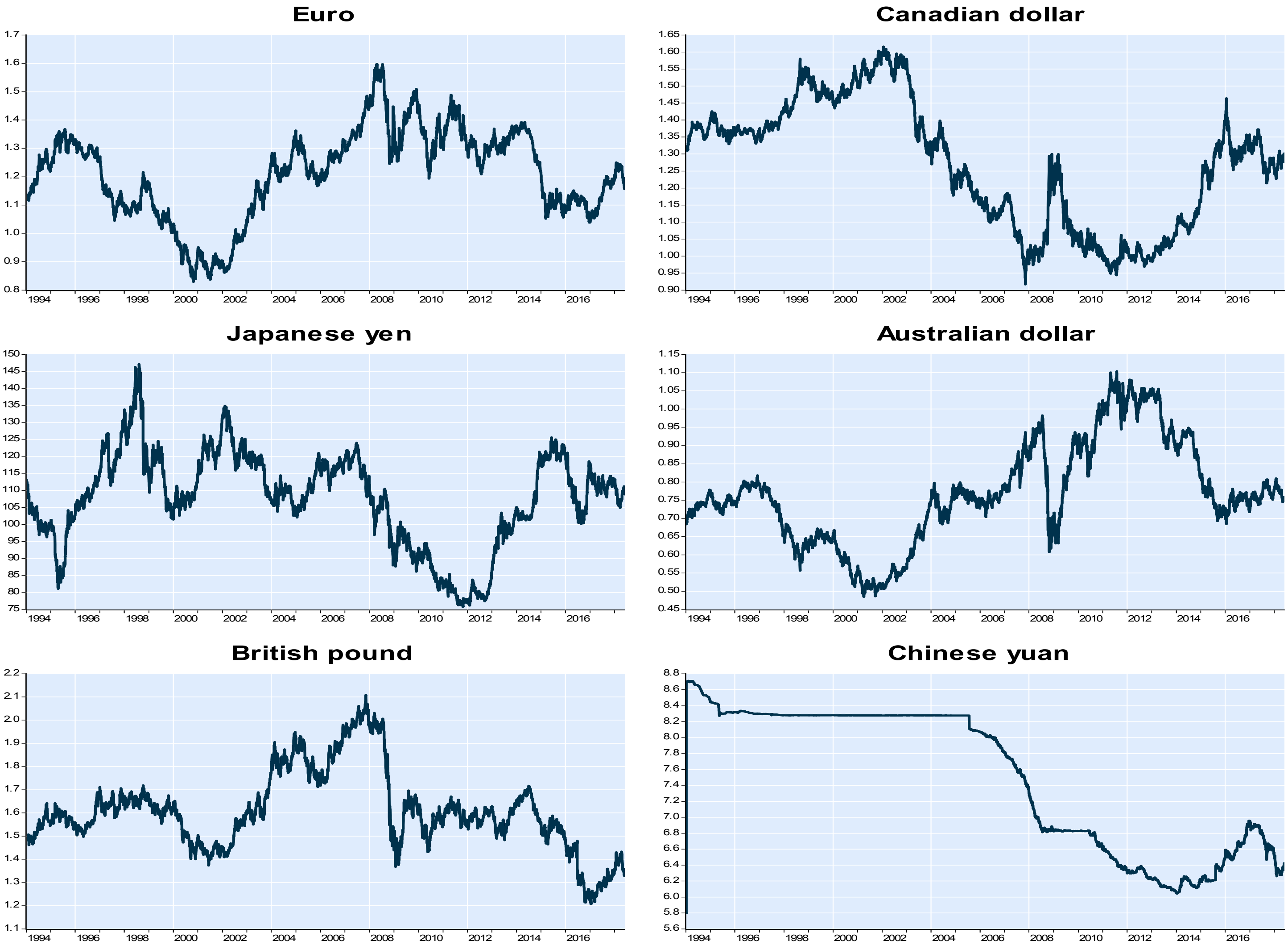

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Canadian Dollar*	Current 1-Jun-18	2018Q3	2018Q4	2019Q1	2019Q2	2019Q3
USDCAD	1.30	1.23	1.21	1.20	1.22	1.21
EURCAD	1.52	1.45	1.47	1.51	1.50	1.52
CADJPY	85	91	94	95	92	93
AUDCAD	0.97	0.96	0.98	1.00	0.99	0.99
GBPCAD	1.73	1.66	1.66	1.66	1.63	1.64
CADCNY	4.94	5.21	5.24	5.23	5.17	5.16
CADMXN	15.28	15.57	15.51	15.44	15.33	15.18

*Forecasts for end of period
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