Highlights
By Stéfane Marion / Krishen Rangasamy

- When will the period of USD strength come to an end? The answer to that question will depend on the timeline for the resumption of trade talks between the U.S. and China. The global investor community will be hoping the two superpowers can come to an agreement at the G-20 meeting on June 28–29. If a deal is not possible, the greenback will remain strong for longer, more so if the Federal Reserve does not deliver the rate cuts that markets are currently expecting.

- The extension of loose monetary policy by the European Central Bank and threat of U.S. tariffs on goods from the European Union do not bode well for the euro. We have trimmed our EURUSD targets accordingly.

- The Canadian economy is on the mend as evidenced by the strong handoff from March which signals an acceleration of growth in Q2. That, coupled with the removal of tariffs by the U.S. on steel and aluminum imports from Canada, should have given a lift to the Canadian dollar which instead continues to struggle amid investor concerns about global growth. While we’ve left unchanged our end-of-year target of 1.30 for USDCAD, expecting a U.S.–China trade deal to breathe new life into oil prices and hence the Canadian currency, we may have to revise that forecast if June’s G-20 meeting fails to alter the current toxic tone in trade negotiations between the U.S. and its trade partners.

### NBF Currency Outlook*

<table>
<thead>
<tr>
<th>Currency</th>
<th>Current 31-May-19</th>
<th>2019Q3</th>
<th>2019Q4</th>
<th>2020Q1</th>
<th>2020Q2</th>
<th>2020Q3</th>
</tr>
</thead>
<tbody>
<tr>
<td>USDCAD</td>
<td>1.35</td>
<td>1.33</td>
<td>1.30</td>
<td>1.31</td>
<td>1.32</td>
<td>1.34</td>
</tr>
<tr>
<td>US cents per CAD</td>
<td>0.74</td>
<td>0.76</td>
<td>0.77</td>
<td>0.77</td>
<td>0.76</td>
<td>0.75</td>
</tr>
<tr>
<td>EURUSD</td>
<td>1.11</td>
<td>1.12</td>
<td>1.15</td>
<td>1.14</td>
<td>1.13</td>
<td>1.12</td>
</tr>
<tr>
<td>USDJPY</td>
<td>109</td>
<td>111</td>
<td>114</td>
<td>113</td>
<td>112</td>
<td>111</td>
</tr>
<tr>
<td>AUDUSD</td>
<td>0.69</td>
<td>0.70</td>
<td>0.72</td>
<td>0.70</td>
<td>0.69</td>
<td>0.68</td>
</tr>
<tr>
<td>GBPUSD</td>
<td>1.26</td>
<td>1.27</td>
<td>1.26</td>
<td>1.24</td>
<td>1.23</td>
<td>1.21</td>
</tr>
<tr>
<td>USDCNY</td>
<td>6.91</td>
<td>6.90</td>
<td>6.75</td>
<td>6.70</td>
<td>6.65</td>
<td>6.55</td>
</tr>
<tr>
<td>USDMXN</td>
<td>19.62</td>
<td>19.10</td>
<td>18.40</td>
<td>18.50</td>
<td>18.60</td>
<td>18.80</td>
</tr>
</tbody>
</table>

*Forecasts for end of period
NBF Economics and Strategy
Trade war lifts USD

The escalating trade war, U.S. vs China and U.S. vs Mexico, not surprisingly hammered world stock markets in May, with the return of “risk off” sentiment giving a lift to so-called safe-haven currencies such as the Japanese yen, the Swiss Franc and the U.S. dollar. The latter’s appreciation against currencies of emerging markets was even more significant than that of its broader index. That should not be surprising because foreign investment in emerging markets tends to be most sensitive when doubts arise about the global growth outlook.

World: Surging U.S. dollar not far from all-time high
Broad Dollar Index, Advanced Foreign Economies Dollar Index, and Emerging Market Economies Dollar Index

And there are doubts aplenty. Investors understand that global GDP growth, which is highly positively correlated with trade volumes, is set to be curtailed by rising trade barriers. Latest data from the CPB won’t be reassuring in that regard. For the first time since the 2008-09 recession, there was a back-to-back quarterly decline in global trade volumes, no doubt in response to the imposition of tariffs by the U.S. on China last September. Declining trade is wreaking havoc in export-centric economies such as emerging markets where exports fell for a second consecutive quarter in Q1. So much so that the ratio of industrial production to export volumes, a proxy for inventories, jumped in the first quarter of 2019 to the highest since 2002Q1. Such inventory build does not bode well for production and hence world GDP growth over the rest of the year.

World: Strong USD correlated with global trade weakness
Broad Dollar Index versus World trade volumes

USD appreciation makes it harder for dollar borrowers around the world to service and repay debt and could, by extension, worsen global economic growth. The USD surge also has potential to curtail trade volumes, with negative repercussions on the global economy. According to the Bank of International Settlements, roughly 65% of global trade is financed by firms themselves and 35% is financed by the banking system. Around 80% of the financing from banks is denominated in US dollars. Simply put, a significant chunk of global trade is financed by the banking system in US dollars. So, if the cost of financing (e.g. USD exchange rate) rises, that will slow lending and borrowing in US dollars hurting trade volumes and hence world GDP growth.

What to expect from the ECB?

EURUSD was down for a fourth month in a row in May, hammered by the USD ascent. And that despite economic data showing higher-than-expected GDP growth and inflation in the eurozone. So much so that the European Central Bank (ECB) may raise its forecasts when it presents new projections in June – recall that the ECB said last March that 2019 GDP growth and inflation will be only 1.1% and 1.2% respectively.

But don’t count on a hawkish statement from the ECB. There are still significant uncertainties with regards to the U.S.-China trade war, the possibility of more trade barriers (e.g. U.S. threat to impose tariffs on European autos), social unrest in places such as France and Italy, and of course the seemingly never-ending Brexit saga, which all
threaten to derail growth in the eurozone. Instead, the central bank is likely to make the case that monetary policy needs to remain accommodative in light of below-target inflation. Investors will be seeking more details on the already-announced Targeted Longer-Term Refinancing Operations (TLTROs) which are slated to start in September and last through March 2021. The combination of loose monetary policy and trade-related uncertainties does not bode well for the euro. We have trimmed our EURUSD targets accordingly.

Canadian economy turning the corner

Like the euro, the Canadian dollar suffered a fourth consecutive monthly decline versus the USD in May. While interest rate differentials with the U.S. improved in favour of the loonie during the month, courtesy of largely positive economic data, that was offset by declining oil prices, the latter hammered by concerns about the global economy.

And given the pervasive fear factor in markets during May, we would not be surprised that waning capital inflows or outright outflows also played a role in the loonie’s woes. Recall that Canada and its currency are largely dependent on capital inflows to finance a chronic current account deficit which reached 3.1% of GDP in the first quarter. While long-term and stable capital flows such as foreign direct investment (FDI) would have been desirable, those are unfortunately not the type of flows we’re receiving — FDI flows were actually negative in Q1 and that for the third time in the last four quarters, i.e. more Canadian direct investment abroad than foreign direct investment in Canada. Instead, the external deficit was again entirely financed in Q1 by portfolio inflows which can be unstable because they have potential to quickly reverse.

Canada: Continued reliance on short-term capital flows

Sources of financing for external deficit

Even the Bank of Canada’s measured statement failed to prop up investor sentiment about Canada. The central bank indeed acknowledged the improving data in its May statement but opted to leave interest rates unchanged. Uncertainties about global trade represent a risk that is significant enough to keep the central bank in pause mode and as such we continue to call for rates to remain unchanged through 2019.

A further deterioration of the global economy, and corresponding oil price slump, represent the biggest downside risk for the loonie. But if, as we expect, policymakers in the U.S. and China realize the cost of their dangerous policies and step back from the brink, investor sentiment about global growth will improve. Investors may then be able to focus on positive developments in Canada.

The removal of tariffs by the U.S. on steel and aluminum imports from Canada makes the ratification of USMCA more likely — although it remains to be seen how Mexico will react to Trump’s threats of levying new tariffs on that country. The economy is also on the mend. Indeed, the slowdown of 2018Q4-2019Q1 seems to have been temporary. While Q1 GDP results were not spectacular — real GDP growth was only 0.4% annualized — a solid handoff (+0.5% unannualized increase in March) bodes well for second quarter growth. Moreover, oil production, whose mandated cuts hammered growth last quarter, is reportedly returning to normal. Canadian exporters also stand to benefit from stronger U.S. imports in the second quarter after the Q1 purge stateside. If, as we expect, Q2 growth ends up being better than the 1.3% print the Bank of Canada is currently estimating, that would likely get markets to reduce any remaining expectations of rate cuts this year, boosting the Canadian dollar in the process.

All told, we’ve left unchanged our end-of-year target of 1.30 for USDCAD. But we may have to revise that forecast if June’s G-20 meeting fails to alter the current toxic tone in trade negotiations between the U.S. and its trade partners.
Annex

<table>
<thead>
<tr>
<th>Currency</th>
<th>Current</th>
<th>2019Q3</th>
<th>2019Q4</th>
<th>2020Q1</th>
<th>2020Q2</th>
<th>2020Q3</th>
</tr>
</thead>
<tbody>
<tr>
<td>USDCAD</td>
<td>1.35</td>
<td>1.33</td>
<td>1.30</td>
<td>1.31</td>
<td>1.32</td>
<td>1.34</td>
</tr>
<tr>
<td>EURCAD</td>
<td>1.50</td>
<td>1.49</td>
<td>1.49</td>
<td>1.49</td>
<td>1.49</td>
<td>1.50</td>
</tr>
<tr>
<td>CADJPY</td>
<td>81</td>
<td>83</td>
<td>88</td>
<td>86</td>
<td>85</td>
<td>83</td>
</tr>
<tr>
<td>AUDCAD</td>
<td>0.93</td>
<td>0.93</td>
<td>0.94</td>
<td>0.92</td>
<td>0.91</td>
<td>0.91</td>
</tr>
<tr>
<td>GBPCAD</td>
<td>1.70</td>
<td>1.69</td>
<td>1.64</td>
<td>1.62</td>
<td>1.62</td>
<td>1.62</td>
</tr>
<tr>
<td>CADCNY</td>
<td>5.11</td>
<td>5.19</td>
<td>5.20</td>
<td>5.13</td>
<td>5.05</td>
<td>4.88</td>
</tr>
</tbody>
</table>

*Forecasts for end of period

NBF Economics and Strategy
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

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

Paul-André Pinsonnault
Senior Fixed Income Economist
paulandre.pinsonnault@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
MD & Head of Public Sector Strategy
warren.lovely@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.

NBF or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. Consequently, 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 historical performance. Past performance is not a guide to future performance.

Past performance is not a guide to future performance.

Neither the author nor NBF assumes any obligation to update the information contained herein or to notify any recipient of any changes, amendments, or revisions thereto.

The trading interests of NBF and its affiliates may also be contrary to any opinions expressed in this Report.

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.

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 past performance.

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 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 office at 71 Fenchurch Street, London, EC3M 4HD.

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.