Thanks to the ramp up in the Fed’s printing press, it’s possible the USD has peaked already. That, however, doesn’t mean the greenback will now fall like a rock. It’s unlikely dollar shortage, which is providing support to the greenback, will evaporate overnight especially with the significant amount of USD-denominated debt that needs to be serviced in both advanced and developing economies. The return of foreign capital flows to normal in emerging markets could also take longer than expected, keeping respective currencies weaker against the USD (and for longer) than would otherwise be the case.

The European Central Bank’s timid approach relative to the Fed has allowed EURUSD to hang on despite relatively weaker eurozone economic data. Considering the extent of the downturn, we suspect the ECB will be forced to increase its balance sheet at a faster pace than is currently the case. The central bank signalled just that in April, saying it is prepared “to increase the size of the pandemic emergency purchase programme and adjust its composition, by as much as necessary and for as long as needed”. When it does, count on the euro to lose some steam.

The Canadian dollar showed surprising resilience in April, managing to appreciate against the U.S. dollar despite slumping oil prices. The Fed’s open-ended QE program implies a bias towards further Canadian dollar appreciation. We have accordingly adjusted our near term USDCAD forecasts, expecting the cross to reach 1.36 by year end. But we’re not ruling out occasional bouts of C$ weakness especially if ugly Canadian economic data (still to come for March-May) get investors to price a more aggressive QE response from the Bank of Canada than is currently the case.
The U.S. dollar made history again in April. After hitting an all-time high in late March, the trade-weighted dollar remained at elevated levels through April leading to its highest monthly average in history.

**Trade-weighted U.S. dollar at an all-time high …**

Nominal Broad U.S. dollar, monthly averages

Bad world economic data for Q2 (which are yet to be published), increased protectionism (if Trump follows through on threats to hit China with additional tariffs in retaliation for the coronavirus pandemic) or the possibility of a second wave of coronavirus infections worldwide (which would jeopardise government plans to reopen the economy), either of which could have investors re-evaluate corporate earnings and global stock market valuations.

Emerging market woes could also keep the USD strong for longer. The double whammy of slumping world trade and government-mandated lockdowns (to limit the spread of coronavirus), means emerging economies as a group are set for a contraction of real GDP in 2020, and that for the first time in more than 40 years. With such gloomy prospects, foreign capital is not surprisingly fleeing the region, prompting the IMF to raise the alarm about financing needs for the region, estimated at $2.5 trillion at the very least. According to the international agency, this surpasses reserves and domestic resources of emerging economies. Capital flight has hammered emerging markets not just through their currencies — Argentina, Brazil, India, Mexico, South Africa and Turkey have seen their respective currencies sink to all-time lows against the U.S. dollar — but also eaten into their reserves, particularly in countries where central banks have been trying to support the value of their currency. Turkey, for instance, has seen its foreign currency reserves plunge more than 20% in the first three months of 2020.

While the announcement of the Federal Reserve’s "open-ended" Quantitative Easing program in late March took some steam out of the greenback, the latter nonetheless found support from dollar shortage on world financial markets. Recall there are now ten major central banks who are using the Fed’s swap lines to borrow dollars to meet demand in their respective domestic markets. The amount of dollars borrowed from the Fed climbed from less than $60 million in the first half of March to more than $400 billion by late April.

**… as dollar shortage is offsetting drag from open-ended QE**

Nominal Broad U.S. dollar versus Fed’s dollar swap line with other central banks

Thanks to the ramp up in the Fed’s printing press, it’s possible the USD has peaked already. That, however, doesn’t mean the greenback will now fall like a rock. It’s unlikely dollar shortage will evaporate overnight, especially with the significant amount of USD-denominated debt that needs to be serviced in both advanced and developing economies.

Market panic could also resurface and prop up the world’s reserve currency via safe haven flows. And here we’re thinking of a string of bad world economic data for Q2 (which are yet to be published), increased protectionism (if Trump follows through on threats to hit China with additional tariffs in retaliation for the coronavirus pandemic) or the possibility of a second wave of coronavirus infections worldwide (which would jeopardise government plans to reopen the economy), either of which could have investors re-evaluate corporate earnings and global stock market valuations.

While currency depreciation should help improve current account balances in some of those emerging markets when global trade bounces back, it creates other problems including higher imported inflation (although the overall effect will be masked somewhat over the near to medium term by the oil price slump), higher debt servicing costs for issuers of U.S. dollar denominated debt, and lower investment (as we explained in last February’s edition of Forex). So, even when world trade resumes, emerging markets may be left with legacy issues from the ongoing recession. In other words, the rebound in emerging market economic growth and return of foreign capital flows to normal could take longer than expected, keeping respective currencies weaker against the USD (and for longer) than would otherwise be the case.
Euro hangs on thanks to timid ECB

The euro was little changed against the USD in April despite disastrous economic data, including Q1 GDP. The latter slumped 14.4% annualized, the worst ever performance for the common currency area, as government-mandated lockdowns sent the economy into recession. The Q1 economic collapse was three times more brutal than in the U.S. (the latter printing -4.8% annualized) where lockdowns occurred a bit later in the quarter. So much so that the European Central Bank now expects the eurozone’s 2020 real GDP to contract between 5% and 12%, depending on the duration of virus containment measures.

**Eurozone: Q1 economic collapse more brutal than U.S.**

Real GDP in Eurozone and U.S.

Despite such dire forecasts, the ECB opted in April for a more timid approach compared to the Fed, leaving unchanged its asset purchase program (APP) at €20 billion/month. The pandemic emergency purchase programme (PEPP) will also remain in place until at least the end of the year and its overall envelope is unchanged at €750 billion. The central bank is, however, improving access to loans. It lowered rates on targeted longer-term refinancing operations (TLTRO III) and started a new non-targeted pandemic emergency longer-term refinancing operations (PELTROs) which will start in May and mature by the Fall of next year.

Considering the extent of the downturn, we suspect the ECB will be forced to increase its balance sheet at a faster pace via asset purchases. The central bank signalled just that in April, saying it is prepared “to increase the size of the PEPP and adjust its composition, by as much as necessary and for as long as needed”.

When it does, count on EURUSD to lose some steam.

**Is the loonie really heading to all-time lows versus USD?**

With the fiscal picture deteriorating fast due to the ongoing recession, the possibility of Canada losing its AAA credit rating cannot be ruled out. Indeed, Canada does not compare favourably with other AAA-rated nations with regards to the budget deficit and gross debt.

Does it matter if Canada is downgraded? Not as much as you think. Sure, we lose bragging rights of belonging to an exclusive club. But the real cost of any credit downgrade, namely an expected ramp up in borrowing costs, is likely to be limited thanks in part to the Bank of Canada’s asset purchase program. The Canadian dollar could also be under pressure, with some even calling for a return to all-time lows against USD after a hypothetical credit downgrade. The last time Canada lost its AAA rating, back in April 1993, the Canadian dollar depreciated about 13% against the USD in the following two years as foreign investors ran for the hills. A similar depreciation from current levels would push USDCAD near the all-time record of 1.61. The loonie is indeed vulnerable to capital flight given the large foreign ownership of domestic securities – the impact on the currency, however, should not be as negative because unlike in the 1990’s most government debt is now denominated in C$.

**Foreigner share of Canadian securities highest since 1999**

Book value of Canadian securities held by foreign investors

That’s not to say doomsayers are right about the loonie’s collapse in response to a hypothetical ratings downgrade. The USDCAD exchange rate is, by definition, a relative price and hence its trajectory depends on developments in both the U.S. and Canada. Everything else equal, the fiscal situation on its own is unlikely to hammer the loonie the way some are expecting. That’s because
things are much worse stateside. The Congressional Budget Office estimated in April that the U.S. budgetary shortfall this fiscal year will be US$3.7 trillion or nearly 18% of GDP. Even milder estimates from the IMF put Canada in good light relative to the U.S. on both major fiscal measures, namely the budget deficit and gross debt. This is a much different situation from the one prevailing in 1993 when the ratings downgrade sent the loonie tumbling.

The Canadian dollar could, however, tumble for other reasons, e.g. if there’s an asymmetric macro shock that hits Canada and leaves the U.S. largely unscathed. The recent oil price collapse could fit the bill if it proves permanent. Oil producers, including OPEC, agreed to cut output by about 10% over the near term. But because demand reportedly fell at double that pace in Q2, the problem of excess oil supply is worsening. Estimates put the decline in oil demand this year at more than 9%, the biggest annual slump ever recorded. So, unless the coronavirus goes away, or an effective vaccine becomes available, the outlook for the world economy (and hence the demand/supply balance in the oil market) will remain gloomy.

With oil prices saddled by excess supply, it’s not easy to be bullish on the Canadian dollar. The latter, however, showed surprising resilience in April, managing to appreciate against the U.S. dollar despite slumping oil. So much so that, for the first time since September 2017, USDCAD now seems a bit overvalued relative to what would be expected from current oil prices.

The loonie’s unexpected resilience could be related to monetary policy. And here we’re not talking about U.S.–Canada yield differentials, which haven’t changed much over the last month, but rather asset purchase programs of the Federal Reserve and the Bank of Canada. While the BoC’s QE program is capped, the Fed’s is “open-ended” (i.e. no limit to how much can be purchased). Simply put, the Fed’s printing press is busier than the Bank of Canada’s. And that’s evidenced by accumulated assets on the Fed’s balance sheet which now amount to 30% of GDP, compared to roughly 15% of GDP for the Bank of Canada.

So where does the loonie go from here? As mentioned earlier, the U.S. dollar may have peaked already amid the Fed’s open-ended QE program. That implies a bias towards Canadian dollar appreciation. We have accordingly adjusted our near term USDCAD forecasts, expecting the cross to reach 1.36 by year end. But we’re not ruling out occasional bouts of C$ weakness especially if ugly Canadian economic data (still to come for March–May) get investors to price a more aggressive QE response from the Bank of Canada than is currently the case.
Annex

**Euro**

**Canadian dollar**

**Japanese yen**

**Australian dollar**

**British pound**

**Chinese yuan**

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**Canadian Dollar***

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<th>Currency</th>
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*Forecasts for end of period

NBF Economics and Strategy
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