March 2018

Budget deficits and the U.S. dollar

- The February announcement by Congress that it would increase government spending this year and next will prompt a temporary growth spurt in the U.S. but have a more permanent impact on America's budget deficit which is slated to surge past 5% of GDP in the next couple of years. By pushing up Treasury yields near 3%, markets are firing a warning shot about their limited tolerance for fiscal indiscipline. The U.S. dollar is unlikely to flourish in such an environment, even with Fed rate hikes in the cards. As such, we have adjusted our FX targets to show USD weakness persisting for a while longer.

- The euro stands to benefit from USD weakness and we have accordingly raised our EURUSD targets. But the path of the common currency over the coming months won't be linear, with events such as Italy's March elections expected to periodically fuel volatility.

- Concerns about NAFTA, the Canadian housing sector, corporate tax cuts/deregulation in the U.S. are combining to foster a climate of uncertainty on loonie. However, the Canadian dollar has room to appreciate amidst USD weakness which is likely to be reinforced by a sharply deteriorating U.S. budget deficit. The positive economic backdrop for the global economy is also favourable to commodity prices and hence the C$. As such, we have adjusted our targets to show a more resilient loonie over the forecast horizon, albeit with USDCAD remaining in the 1.20-1.30 range for the next 12 months. Those projections, however, assume a favourable outcome to NAFTA negotiations.

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NBF Currency Outlook*

	Current *1-Mar-18*	2018Q2	2018Q3	2018Q4	2019Q1	2019Q2
USDCAD	1.29	1.25	1.23	1.21	1.20	1.22
US cents per CAD	*0.78*	0.80	0.82	0.83	0.83	0.82
EURUSD	1.22	1.23	1.25	1.26	1.28	1.25
USDJPY	107	108	110	111	112	110
AUDUSD	0.77	0.80	0.82	0.83	0.84	0.83
GBPUSD	1.37	1.41	1.43	1.43	1.44	1.42
USDCNY	6.35	6.25	6.15	6.10	6.05	6.10
USDMXN	18.90	18.50	18.25	18.20	18.10	18.50

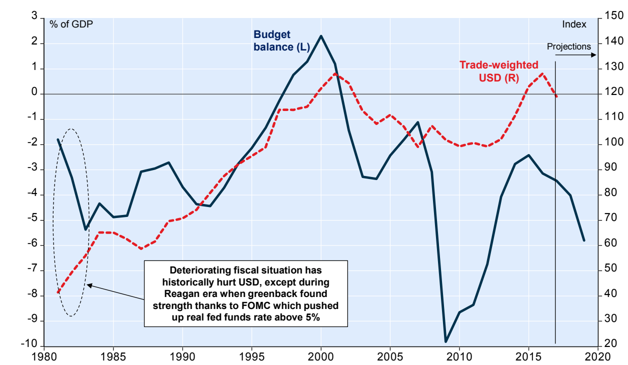
** forecasts for end of period*
Source: NBF Economics and Strategy

Forex

USD doesn't tend to do well when fiscal situation deteriorates

As if tax cuts were not enough, the U.S. Congress opted last month to dispatch another dose of fiscal stimulus, this time by increasing spending caps. As such, America's budget deficit is now projected to soar past US$1 trillion or more than 5% of GDP in 2019. And if history is any guide, the U.S. dollar, which has already lost 9% in trade-weighted terms since Trump became President, could continue to struggle. Indeed, the USD tends to be positively correlated to the budget balance.

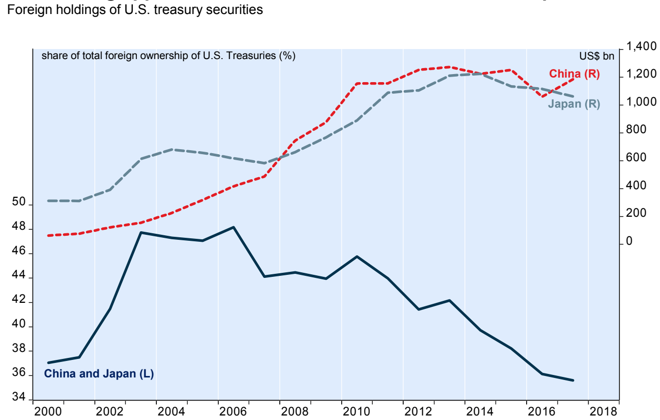
Will the big dollar cave under the weight of deteriorating budget deficits?
Budget balance versus Trade-weighted USD at year-end



NBF Economics and Strategy (data via Committee for a Responsible Federal Budget, Congressional Budget Office, Datastream)

One exception, however, was during the Reagan deficits of the 1980s which did not seem to put off foreign investors who continued to find U.S. assets attractive as Paul Volcker, the Fed Chairman at the time, pushed up the real fed funds rate past 5%. But this time is different because mild inflation and a significantly reduced natural rate of interest limit Jerome Powell's scope in tightening monetary policy. As such, foreign investors may not be as keen to finance mounting U.S. deficits. Major holders of Treasuries, such as Japan and China are now showing signs of fatigue.

Diminishing appetite for U.S. Treasuries from China and Japan
Foreign holdings of U.S. treasury securities



NBF Economics and Strategy (data via Bloomberg)

If not the Fed, what could boost the USD? An improving U.S. trade balance could eventually help support the greenback, but this has to be sustainable. The likelihood of such an outcome has diminished significantly courtesy of the enhanced fiscal stimulus which is poised to boost domestic demand in tradable sectors and hence raise U.S. imports. While the Trump administration could restrict imports via say tariffs and quotas and force consumers to buy American goods, any subsequent improvement in the trade balance may not be sustainable because retaliation from trade partners would in turn hurt U.S. exports.

All told, the outlook for the U.S. dollar has suddenly worsened with this extra dose of fiscal stimulus and we have accordingly adjusted our currency targets to show USD weakness persisting for a while longer. That's not to say the greenback will not have periodic bouts of strength on its way down. Temporary spikes could indeed coincide with events tied to the Fed's tightening of monetary policy, e.g. speeches by FOMC members and surprises with regards to inflation, employment and growth.

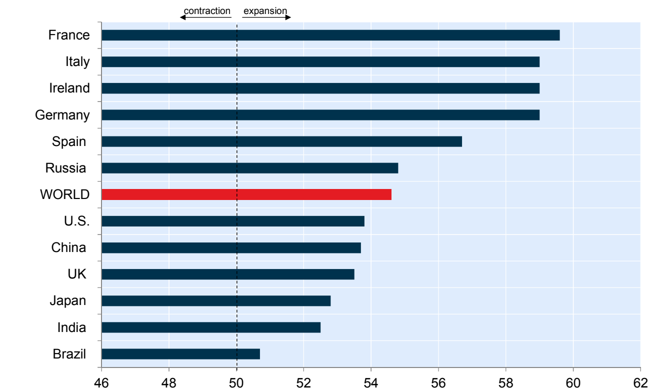
Euro capitalizes on USD weakness

Other major currencies, including the euro, stand to benefit from the deteriorating U.S. fiscal situation in at least two ways. For one, the ensuing USD weakness will give a lift to most major currencies. But currencies of economies trading with the U.S. may also benefit from an improved economic outlook courtesy of positive spillovers from America's stimulus. IMF research shows that the exporting economy's output would rise about 0.1% on average in response to a 1% GDP overall fiscal shock in the U.S.

Such positive spillovers will be stronger for the exporting economy if it has slack, as is the case for the eurozone. That's because economic slack helps keep inflation under wraps and prevents significant interest rate hikes that would crowd out private investment in the exporting economy.

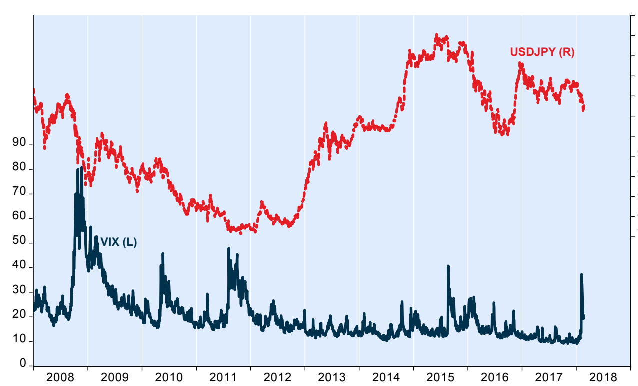
This extra boost may well help the eurozone economy achieve another year of above-potential growth. Recall that last year, the common currency area saw a decade-best performance when real GDP growth hit 2.5%. The domestic eurozone economy benefited from better credit growth for households and non-financial corporations and it's not surprising that economic sentiment surged to a 17-year high. And if Markit's purchasing managers indices for January are any guide, momentum extended to early 2018. Powerhouses such as Germany, France, Italy and Spain are top of the charts with composite PMI's well above 50 and above the global average.

World: Momentum extends to early 2018
Markit composite purchasing managers indices for January 2018



NBF Economics and Strategy (data via Markit)

... propped up by mounting risk aversion
Japanese yen and VIX



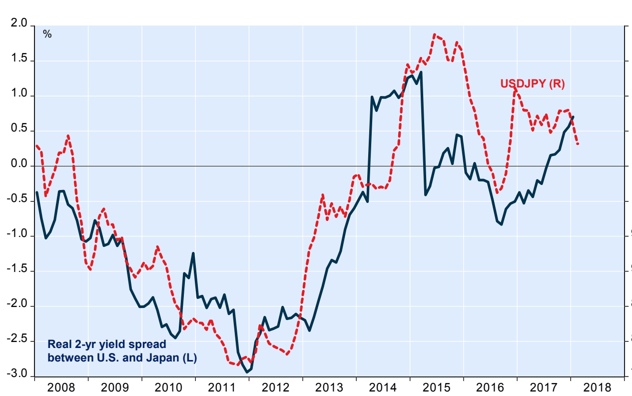
NBF Economics and Strategy (data via Statistics Canada)

The European Central Bank will continue to assist growth by keeping monetary policy highly stimulative amidst below-target inflation. But that's not to say markets will not push up the euro in anticipation of tighter monetary policy in late 2018 or next year. In light of the USD's woes, we have raised our EURUSD targets expecting the cross to add to its 2% increase so far this year. But the path of the common currency over the coming months won't be linear, with events such as Italy's March elections expected to fuel volatility.

Yen rallies beyond fundamentals

In the first two months this year, the Japanese yen has already appreciated more than it did in the whole of 2017. So much so that the currency has overshot levels that would be consistent with U.S.-Japan real yield spreads.

Yen departed from yield spreads in early 2018 ...
Real 2-year yield spread between the U.S. and Japan versus the yen



NBF Economics and Strategy (data via Datastream)

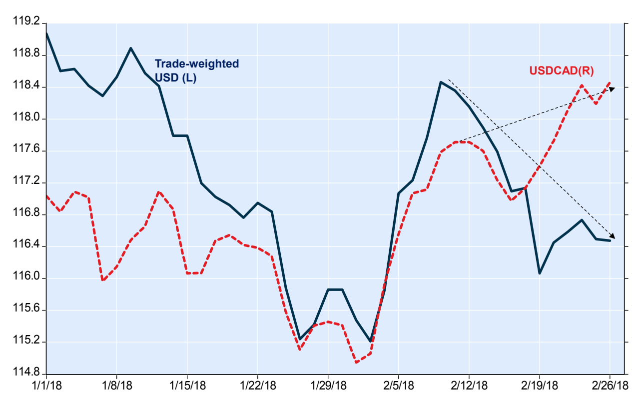
The yen surge was partly due to the return of risk aversion in world financial markets which seems to have choked carry trades.

If as we expect, financial markets regain their mojo amidst an improving global economy, the return of risk-taking could take steam out of the yen. That's not to say the yen will not retest current levels over the longer term as investors start to price the removal of monetary accommodation by the Bank of Japan. While inflation remains tame for now, it is likely to heat up as the output gap moves further into positive territory.

Uncertainties weigh on loonie

The Canadian dollar is the only reserve currency losing ground against the USD this year. This is an unusual situation for the C$ since it is normally highly correlated with the trend in the broad dollar index.

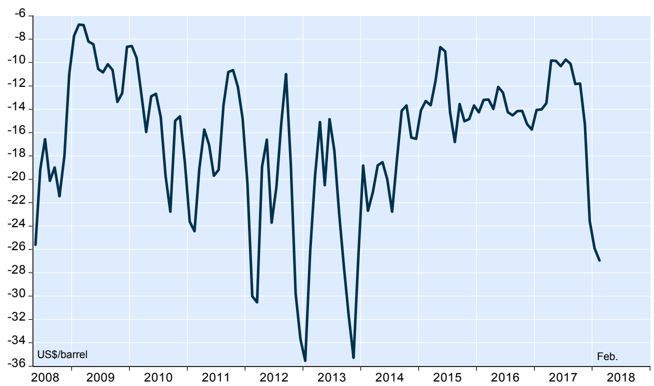
Loonie weakens despite USD woes
Trade-weighted USD versus USDCAD



NBF Economics and Strategy (data via Bloomberg)

Concerns about NAFTA, the Canadian housing sector, corporate tax cuts/deregulation in the U.S. are combining to foster a climate of uncertainty on loonie. The largest price difference in more than four years between WTI oil and Western Canada Select, courtesy of diminished flows through an impaired Keystone pipeline, hasn't helped the Canadian currency either.

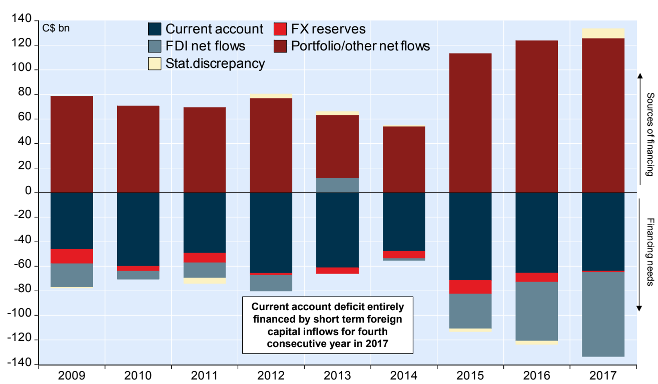
Canada not yet reaping benefit of rising oil prices
Western Canada Select minus WTI oil price



NBF Economics and Strategy (data via Bloomberg)

The chronic current account deficit (roughly 3% of GDP last year), is also not helping the Canadian currency. Continued dependence on short-term foreign capital to finance the deficit makes the Canadian dollar more vulnerable because such flows have potential to quickly reverse — 2017 was the fourth consecutive year when the external deficit was entirely financed by short-term foreign capital inflows.

Canada: Over-reliance on short-term capital inflows
Sources of financing for current account deficit, by year



NBF Economics and Strategy (data via Statistics Canada)

While foreign inflows into Canada are welcome, efforts should be made by policymakers to encourage longer-term investment such as FDI which is more stable and less prone to reversal. To be sure, it will be challenging to attract FDI amidst recent changes to U.S. tax policy which have made Canada relatively less competitive. But a revival of FDI is still possible, particularly if NAFTA-related uncertainties dissipate and the Canadian economic outlook improves further.

The Canadian economy is performing well as evidenced by the evaporation of economic slack and mounting inflation pressures. Recall that the annual core inflation rate (common) climbed to a six-year high of 1.8% in January.

Canada: Core inflation jumps to six-year high
Core CPI, common component

NBF Economics and Strategy (data via Statistics Canada)

In addition to acknowledging stronger-than-expected price pressures, the Bank of Canada may also have to upgrade its 2018 Canadian GDP growth forecast again in April's Monetary Policy Report to account for new information provided by federal and provincial budgets which are set to confirm additional fiscal stimulus. As such, the central bank may not be able to keep its dovish tone for much longer.

All told, the Canadian dollar has room to bounce back. The positive economic backdrop for the global economy is also favourable to commodity prices and hence the C$ — the impact of rising commodity prices on the loonie could be amplified as WCS-WTI spreads return to normal. As such, we have adjusted our targets to show a more resilient loonie over the forecast horizon, albeit with USDCAD remaining in the 1.20-1.30 range for the next 12 months. Those projections, however, assume a favourable outcome to NAFTA negotiations.

Forex

Euro

Canadian dollar

Japanese yen

Australian dollar

British pound

Chinese yuan

NBF Economics and Strategy (data via Datastream)

Canadian dollar*

	Current 1-Mar-18	2018Q2	2018Q3	2018Q4	2019Q1	2019Q2
USDCAD	1.29	1.25	1.23	1.21	1.20	1.22
EURCAD	1.57	1.54	1.53	1.53	1.54	1.52
CADJPY	83	86	90	92	93	90
AUDCAD	0.99	1.00	1.01	1.01	1.01	1.01
GBPCAD	1.77	1.76	1.75	1.73	1.73	1.73
CADCNY	4.92	5.00	5.01	5.03	5.02	5.00
CADMXN	14.65	14.80	14.87	15.02	15.02	15.17

** forecasts for end of period*
Source: NBF Economics and Strategy

Forex

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