NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Forex

Economics and Strategy

August 2018

Optimistic Fed supportive of USD

- The U.S. dollar's near term prospects remain good amidst a hot economy that is prompting the Fed to tighten monetary policy. The return of risk aversion in the run up to mid-term U.S. elections could also prop up the world's reserve currency. But with the fed funds fast approaching the estimated neutral rate, the impact of rate differentials on the USD will fade and eventually reverse as other major central banks tighten policy. As such, we continue to expect the trade-weighted USD to weaken next year.

- The euro continues to struggle courtesy of a dovish European Central Bank. For now, speculators seem to be losing faith in the common currency based on their dwindling long positions. Comes a point, however, when investors will expect and hence price the end of Fed normalization, allowing yield differentials to push up EURUSD.

- The Chinese yuan has lost more than 8% against the USD since April, the worst four-month slump since 1994 when the currency was devalued as part of broader reforms. Should the U.S. deliver on its threat to impose steeper tariffs on more imports from China, one can expect the yuan to sink further either via market forces or by "currency management" from Beijing. More generally, emerging market currency woes could persist amidst trade-related uncertainty, boosting the trade-weighted USD at least over the near term.

- Until the U.S.-Canada trade dispute is resolved, it's difficult for us to see the Canadian dollar flourish in a sustainable way. Our forecast for the loonie to appreciate after Q3 is based on a trade deal being reached by Washington and Ottawa, something that admittedly may not happen this year. For now, we are keeping unchanged our target range of 1.25-1.35 for USDCAD for the next 12 months.

Stéfane Marion / Krishen Rangasamy
514-879-3781 514-879-3140

NBF Currency Outlook*

	Current 6-Aug-18	2018Q3	2018Q4	2019Q1	2019Q2	2019Q3
USDCAD	1.30	1.32	1.28	1.28	1.27	1.25
US cents per CAD	0.77	0.76	0.78	0.78	0.79	0.80
EURUSD	1.16	1.15	1.18	1.20	1.21	1.23
USDJPY	111	107	109	110	112	113
AUDUSD	0.74	0.73	0.76	0.77	0.78	0.80
GBPUSD	1.29	1.28	1.31	1.33	1.34	1.35
USDCNY	6.85	6.87	6.90	6.88	6.85	6.80
USDMXN	18.50	19.00	18.70	18.60	18.20	17.90

*Forecasts for end of period
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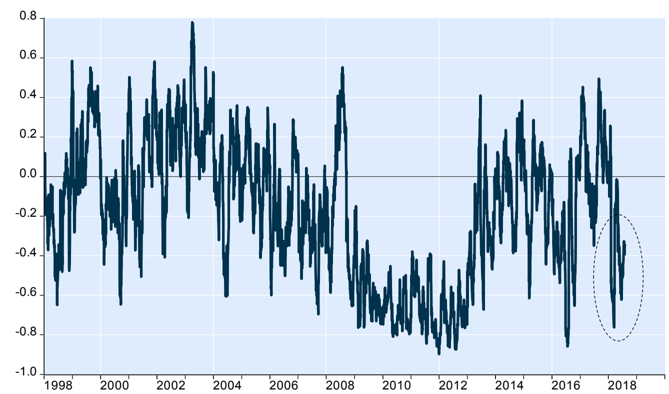
A more optimistic Fed

After three consecutive monthly increases, the trade-weighted U.S. dollar took a breather in July, shedding more than 1%. The greenback declined against the euro, Canadian dollar, Australian dollar and Mexican peso, which altogether account for about half of the weight in the trade-weighted USD. The return of risk taking and strong performance of global stock markets — the All-Country MSCI World index jumped more than 2% during July —, helped by hopeful signs with regards to U.S.-European Union trade relations, seem to have boosted the above-mentioned currencies and hurt the trade-weighted greenback in the process.

USD negatively correlated with stock market performance
Trade-weighted USD versus MSCI All-Country index, 30-day moving correlation of daily changes



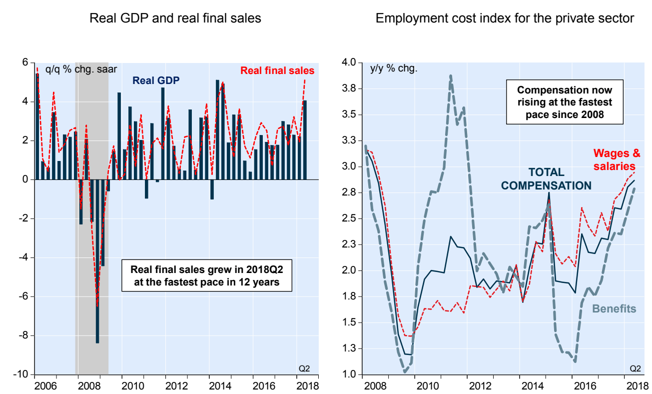
NBF Economics and Strategy (data via Datastream)

But one month does not make a trend. With trade tensions running high — and here we're thinking about U.S. relations with China and Canada — the return of risk aversion and hence an immediate USD rebound cannot be ruled out over the near term. Moreover, the greenback could capitalize on more favourable interest rate spreads amidst tightening of U.S. monetary policy in response to an improving economy.

Recall that real final sales in the U.S., i.e. GDP excluding inventories, grew a stunning 5.1% annualized during the second quarter, the best performance in 12 years. The only reason Q2 real GDP growth ended up at 4.1% (and not 5.1%) was the drag from inventories. The latter's drop, however, is good news for restocking activity and hence Q3 production. All in all, GDP growth this year (Q4/Q4) is on track to top 3%, the upper range of the Fed's forecasts. The labour market is also running hot as evidenced by the creation of 215K jobs/month on average in the first seven months of 2018 (according to the establishment survey) and a jobless rate of just 3.9%. The tight labour market is creating cost pressures for firms — the employment cost index for the private sector was up 2.9% year-on-year in Q2, the fastest pace in a decade — and the Federal Reserve will do what it can to nip inflation in the bud.

While it left the fed funds rate unchanged at 1.75-2.00% in early August, the Fed signalled an imminent rate hike by expressing even more optimism about the economy. It now sees economic activity rising at a "strong" rate, saying that household spending (which accounts for 70% of the economy) has "grown strongly". A September rate hike is now almost fully priced by markets, but the USD may yet get a boost next month should the Fed accompany the expected rate hike with bullish signals. And here we're thinking about the Summary of Economic Projections which could show an upgraded outlook. Those developments may be enough to encourage a majority of FOMC members to call for an additional hike in December (after the one in September), something that is not fully priced by markets.

U.S.: Strong growth and mounting cost pressures



NBF Economics and Strategy (data via Bureau of Economic Analysis, Bureau of Labor Statistics)

But with the fed funds fast approaching the neutral rate, the impact of rate differentials on the USD will fade and eventually reverse as other major central banks tighten policy. Also keep in mind the bloating U.S. budget deficit and fading impact of fiscal stimulus on GDP growth. As such, we continue to expect the trade-weighted USD to weaken next year.

ECB and BoJ keep money taps open

For now, however, both the European Central Bank and Bank of Japan are in no rush to tighten policy. The ECB, which left monetary policy unchanged at its July meeting, said it expected interest rates to remain unchanged at least through the summer of 2019. The ECB will continue to purchase assets at a pace of €30 bn/month until end-September after which the pace will drop to €15 bn/month until the end of the year when Quantitative Easing will end. The central bank will then reinvest principal payments from maturing securities "for an extended period of time after the end of the net asset purchases". The ECB made clear that "significant monetary policy stimulus is still needed to support the further build-up of domestic price pressures and headline inflation developments over the medium term". As such looser monetary policy compared to the U.S. and the UK — recall that the Bank of England raised interest rates to 0.75% in August — will continue to weigh on the euro over the near term. For now speculators seem to be losing faith in the common currency based on their dwindling long positions. Comes a point, however, when investors will expect and hence price the end of Fed normalization, allowing yield differentials to push up EURUSD.

Speculators losing faith in euro
Non-commercial net long positions on the euro

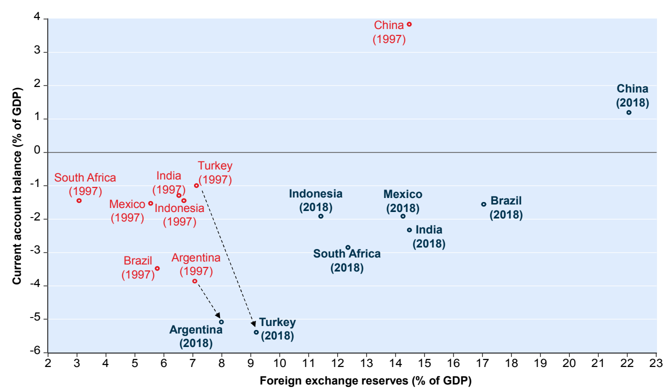
NBF Economics and Strategy (data via Bloomberg)

Like the euro, the yen is struggling with unfavourable yields against the U.S. The Bank of Japan, which was expected by markets to move towards normalization instead went for forward guidance, announcing its intention "to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time". The BoJ will continue with its asset purchase program with the amount outstanding of Japanese government bonds on its balance sheet increasing at an annual pace of ¥80 trillion. While the central bank says the economy is growing above its estimated potential, it bemoaned persistently weak inflation: "due mainly to the experience of prolonged low growth and deflation… firms' cautious wage- and price-setting stance as well as households' cautiousness toward price rises have not yet clearly changed". As such, the BoJ sees risks to prices as skewed to the downside. So, barring a sudden return of risk aversion, the yen is likely to remain under pressure over the forecast horizon.

Emerging market currencies under pressure

It's been a rough year so far for currencies of emerging economies. Investor sentiment has seemingly been impacted by mounting U.S. protectionism which threatens to disrupt global trade flows and hence hurt growth prospects of emerging economies. Some emerging economies are better positioned than others to weather the current onslaught. Unlike Turkey and Argentina (whose currencies are among the worst performing this year), several major emerging economies including Brazil, India and China are in a much better economic situation than say 1997, when the Asian financial crisis started, thanks to sharp increases in foreign exchange reserves and manageable external deficits. But with foreign investors having a tendency of painting all emerging markets with the same brush, there's no guarantee even those economies with good fundamentals will remain unscathed.

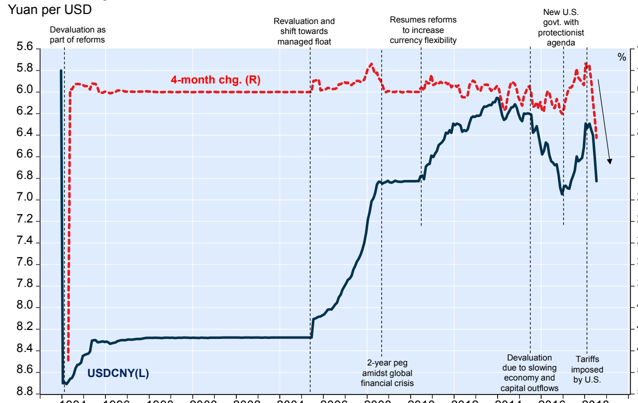
World: Can emerging economies weather the current onslaught?
Current account balance versus FX reserves in 1997 and 2018



NBF Economics and Strategy (data via IMF, Bloomberg)

The Chinese yuan for example has lost more than 8% against the USD since April. That's the worst four-month slump since 1994 when the currency was devalued as part of broader reforms. Should the U.S. deliver on its threat to impose steeper tariffs on more imports from China, one can expect the yuan to sink further either via market forces or by "currency management" from Beijing. All told, emerging market currency woes could persist amidst trade-related uncertainties, boosting the trade-weighted USD at least over the near term.

Yuan slump is worst since 1994
Yuan per USD

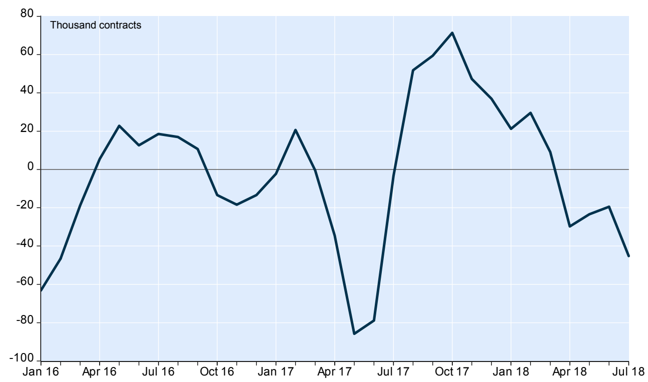


NBF Economics and Strategy (data via Datastream)

July surprise for loonie

The Canadian dollar shrugged off slumping oil prices and increased speculative short positions to gain 1% against the USD during July. And that despite largely unchanged interest rate spreads with the U.S. So, what exactly propelled the loonie last month? Capital inflows, which have been weak in the first half of the year, may have bounced back especially if investor sentiment about Canada's prospects improved. But because timely data is not available on capital flows, we'll have to wait a few months before confirming or rejecting that possibility.

Speculative loonie shorts worst in a year
Non-commercial net long positions on the Canadian dollar, monthly average

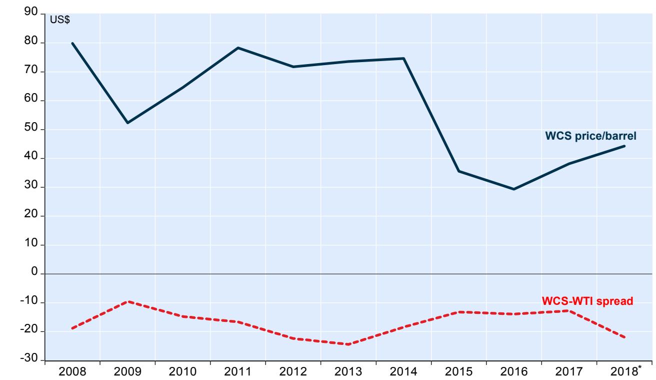


NBF Economics and Strategy (data via Bloomberg)

If capital flows were the reason for the C$'s surprise gains in July, then one can hardly be optimistic about the loonie's near term prospects given the increased likelihood of a reversal of those flows. As we've seen in recent months, it only takes a wayward tweet to shift investor sentiment. And here we're thinking about the possibility of more heated rhetoric in the ongoing U.S.-Canada trade dispute. So, until the latter is resolved, it's difficult for us to see the Canadian dollar flourish in a sustainable way. Our forecast for the loonie to appreciate after Q3 is based on a trade deal being reached by Washington and Ottawa, something that admittedly may not happen this year.

Could firmer oil prices save the loonie, even amidst persistent trade tensions? We're somewhat skeptical given the diverging trajectories of oil prices and the C$ this year. While WCS prices have risen this year — the payoff could have been even better were it not for worsening spreads with WTI —, the loonie has depreciated against the USD.

Better oil prices in 2018 despite worst WCS-WTI spread in years
Western Canada Select oil price versus Spread with WTI, annual averages



* *Jan-Jul. average for 2018*
NBF Economics and Strategy (data via Bloomberg)

So much so that the loonie's divergence with oil prices has worsened this year. As it turns out, the impact of unfavourable Canada-U.S. interest rate spreads has supplanted positives associated with higher oil prices.

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

NBF Economics and Strategy (data via Bloomberg)

So, should a trade deal materialize, the Canadian dollar's appreciation could be significant. The evaporation of trade-related uncertainties would brighten the economic outlook, increasing odds of policy tightening by the Bank of Canada and hence improve Canada-U.S. interest rate spreads. That would in turn allow the loonie to move closer to levels consistent with current oil prices. For now, we are keeping unchanged our target range of 1.25-1.35 for USDCAD for the next 12 months.

Forex

Annex

Euro

Canadian dollar

Japanese yen

Australian dollar

British pound

Chinese yuan

NBF Economics and Strategy (data via Datastream)

Canadian Dollar*	Current 6-Aug-18	2018Q3	2018Q4	2019Q1	2019Q2	2019Q3
USDCAD	1.30	1.32	1.28	1.28	1.27	1.25
EURCAD	1.51	1.51	1.51	1.54	1.53	1.54
CADJPY	85	81	85	86	88	90
AUDCAD	0.96	0.96	0.97	0.99	0.99	1.00
GBPCAD	1.68	1.68	1.68	1.71	1.70	1.69
CADCNY	5.27	5.22	5.38	5.37	5.41	5.44
CADMXN	14.25	14.44	14.59	14.51	14.38	14.32

*Forecasts for end of period
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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

Marc Pinsonneault
Senior Economist
marc.pinsonneault@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

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