**Highlights**

By Stéfane Marion / Krishen Rangasamy

- Risk-off sentiment is back, and so is U.S. dollar appreciation. The White House reminded investors of its protectionist tendencies by imposing tariffs on steel imports from Brazil and Argentina and threatening to hit French champagne and cheese with import tariffs. The irony here is that the White House’s actions are not helping U.S. trade because they are fueling the dollar, the latter now at a 16-year high in real effective terms.

- The euro could remain under pressure over the near term. There is room for speculators to amplify any euro depreciation considering short positions on the common currency are now about a quarter what they were during the slump of 2012 and 2015. For now, we’re keeping our EURUSD end-of-Q1 target of 1.14 unchanged, under the assumption that the U.S. and China can agree to a truce before then.

- While the loonie drifted away from our targets recently, we’re not throwing in the towel just yet. Things can suddenly change for the better for the Canadian dollar and other commodity currencies if, as we expect, the U.S. and China agree to a truce in their ongoing trade war, and the U.S. Congress finally approves USMCA. As such, we are keeping unchanged our forecast for USDCAD to head towards 1.28 by 2020Q1.

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**NBF Currency Outlook**

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<th>Currency</th>
<th>Current 4-dec-19</th>
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*Forecasts for end of period

NBF Economics and Strategy
U.S. dollar strikes back on trade concerns

After being battered by risk-on sentiment, the trade-weighted U.S. dollar bounced back in November amid renewed concerns about the global economy. Doubts that a trade deal between America and China will come to fruition were fueled by passage by the U.S. Congress of a resolution to support human rights in Hong Kong, something that drove yet another wedge between Washington and Beijing. The greenback benefited from further risk aversion in early December as Trump suggested a deal with China might have to wait until after next year’s U.S. Presidential elections. The White House also reminded investors of its protectionist tendencies by imposing tariffs on steel imports from Brazil and Argentina and threatening to hit French champagne and cheese with import tariffs. The irony here is that the White House’s actions are not helping U.S. trade because they are fueling the dollar, the latter now at a 16-year high in real effective terms.

While expressing displeasure at the Congressional resolution (on Hong Kong), China has surprisingly been measured in its response, seemingly intent in not derailing ongoing trade negotiations. That gives some encouragement to those hoping a deal can be achieved as to negate the need for the U.S. to implement scheduled tariff increases on December 15th. But should the two superpowers fail to reach an agreement expect risk off sentiment to lift the greenback further.

Could the Federal Reserve interrupt the big dollar’s ascent with interest rate cuts? Last month, Chair Jerome Powell raised the bar for additional rate cuts saying that only “a material reassessment of our outlook” could get the Fed to ease policy further. The likely moderation of U.S. GDP growth in Q4 would probably not qualify as “material” considering temporary factors at play, e.g. disruptions caused by the GM strike. If we’re right about a rebound of GDP growth in Q1 and a slight ramp up in underlying inflation next year (courtesy of a positive output gap), the Fed is likely to stand pat through 2020.

However, any escalation of the trade war could be viewed as “material” by the Fed. True, the U.S. economy continues to expand as consumer strength is offsetting trade-related weakness in exports and business investment. But sustained employment creation, the main reason behind consumer strength, is no guarantee if the trade war escalates enough as to hurt corporate profits. It’s unclear further Fed rate cuts (if any) would significantly hamper the U.S. dollar in a risk-off environment. If our base-case assumption of de-escalation of the trade war proves too optimistic, the greenback could remain strong for longer than we are currently expecting.

Euro relapses

After surging the prior month, the euro fell back in November amid generalized USD strength. The eurozone’s weak economic data did not help. For instance, Markit’s composite purchasing managers index pointed to continued stagnation in Q4.

World: Eurozone continues to stagnate
Eurozone real GDP versus Markit’s composite purchasing managers index

Highest USD since 2003 in real effective terms
Real effective U.S. dollar, annual average
Worse, are downside risks which seem to be intensifying. And here we’re talking about increasingly belligerent U.S. politicians who are threatening further tariffs on European goods, but also the uncertainty brought by Brexit. A hard Brexit (no negotiated deal between the UK and European Union) by January 31st cannot be ruled out considering Prime Minister Johnson, a proven Brexiteer, is currently leading in the polls ahead of the UK’s December elections. True, a hard Brexit would hurt the UK more than the EU. But considering ongoing stagnation, even a small negative impact would be difficult for many EU economies to absorb.

The European Central Bank, which resumed quantitative easing last month – assets are being purchased at a pace of €20 billion/month, with no formal expiration date – could opt to increase the size of purchases to rekindle inflation. All told, the euro could remain under pressure over the near term, especially if the U.S.–China trade war escalates. There is room for speculators to amplify any euro depreciation considering short positions on the common currency are now about a quarter what they were during the slump of 2012 and 2015. For now, we’re keeping our EURUSD end-of-Q1 target of 1.14 unchanged, under the assumption that the U.S. and China can strike a deal before then.

**Euro weakness amplified by speculative shorts**

Non-commercial net long positions on the euro

That explains why inflation pressures continue to build. Note that wages & salaries, which account for 86% of overall compensation in Canada, rose 5.1% on a year–on–year basis in Q3, even topping U.S. wage growth for the first time in 18 months. So, one should not be all that surprised that, despite the current economic slowdown, the Bank of Canada’s annual core inflation measures remain sticky near 2%, right in the middle of the central bank’s 1-3% target range.

The Bank of Canada left the overnight rate unchanged at 1.75% in December, acknowledging on–target inflation is “consistent with an economy operating near capacity”. The central bank’s message was arguably more upbeat than the one put out last October. Upward revisions to Canadian GDP were not directly mentioned, although emphasis on “resilience” of the economy suggests the BoC is now more comfortable about the Canadian outlook. As such, barring a significant deterioration in the global economy, we continue to expect the central bank to refrain from cutting interest rates over the near to medium term.
While the loonie drifted away from our targets recently, we’re not throwing in the towel just yet. Things can suddenly change for the better for the Canadian dollar and other commodity currencies if, as we expect, the U.S. and China agree to a truce in their ongoing trade war, and the U.S. Congress finally approves USMCA. As such, we are keeping unchanged our forecast for USDCAD to head towards 1.28 by 2020Q1.

That said, we’re less bullish about the loonie’s longer term prospects given Canada’s chronic external deficit and the way it is financed. Note that the current account deficit for the first three quarters of 2019 adds up to almost C$39 bn. And financing of the external deficit remains short term in nature. And here we’re talking about portfolio net flows (i.e. foreigners purchasing Canadian stocks and bonds) but mostly currency and deposits. In fact in the last two years, currency and deposits have been the major source of financing of Canada’s external deficit.

It’s hard to know for sure why that is the case. It could be that foreign money is being parked at Canadian banks (instead of being invested in the economy) until uncertainty dissipates e.g. USMCA, regulations in the energy sector, etc ... In fact, we saw a similar trend of rising currency and deposits back in 2014-2015 when the oil shock had foreign investors question Canada’s prospects. Regardless, the continued reliance on such easily reversible capital flows leaves the Canadian dollar vulnerable.
Annex

**Economics and Strategy**

**Forex**

**Annex**

- **Euro**
- **Canadian dollar**
- **Japanese yen**
- **Australian dollar**
- **British pound**
- **Chinese yuan**

**Canadian Dollar***

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*Forecasts for end of period*

NBF Economics and Strategy
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