



Is the loonie's surge sustainable?

- In the last Forex, anticipating a change in stance from the Bank of Canada, we had brought forward to October the timing for when we expected an increase in the overnight rate. While right about the change in stance we were not aggressive enough about the timing. The central bank's decision to raise interest rates in July prompts us to lower our 2017 quarterly targets for USDCAD, i.e. stronger C\$ than in our prior forecasts. The loonie's recent surge, however, warrants caution. While momentum could allow for further near term C\$ gains, we expect a giveback afterwards as the USD makes a comeback with markets starting to price Fed rate hikes. We continue to expect USDCAD to remain in the 1.25-1.35 trading range over the next 12 months.
- Under pressure since the beginning of the year, the US dollar could find renewed strength later this year and in 2018 if, as we expect, the Fed surprises markets with rate hikes and balance sheet reduction.
- The euro's upside potential is limited in our view amidst Brexit, next year's Italian elections, and the European Central Bank's loose policies. While the ECB said interest rates will not be cut again, it made clear it stands ready to increase asset purchases if inflation continues to disappoint.

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

NBF Currency Outlook*							
	Current 14-Jul-17	2017Q3	2017Q4	2018Q1	2018Q2	2018Q3	2018Q4
USDCAD	1.27	1.25	1.29	1.30	1.32	1.32	1.34
<i>US cents per CAD</i>	<i>0.79</i>	<i>0.80</i>	<i>0.77</i>	<i>0.77</i>	<i>0.76</i>	<i>0.76</i>	<i>0.74</i>
EURUSD	1.14	1.16	1.15	1.12	1.11	1.10	1.08
USDJPY	113	114	115	113	111	110	110
AUDUSD	0.78	0.80	0.78	0.78	0.77	0.76	0.74
GBPUSD	1.30	1.31	1.28	1.25	1.23	1.21	1.20
USDCNY	6.78	6.75	6.77	6.79	6.80	6.82	6.84
USDMXN	17.67	17.40	17.80	17.90	18.00	18.20	18.70

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

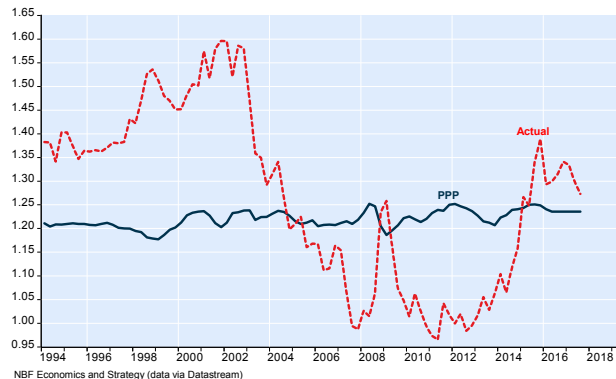
FOREX

Bank of Canada lifts loonie ...

The fortunes of the Canadian dollar have changed quite drastically since May. While USDCAD was lingering near 1.37 just a couple of months ago, it is now in position to test purchasing power parity (PPP) levels of 1.24.

Loonie heads towards PPP

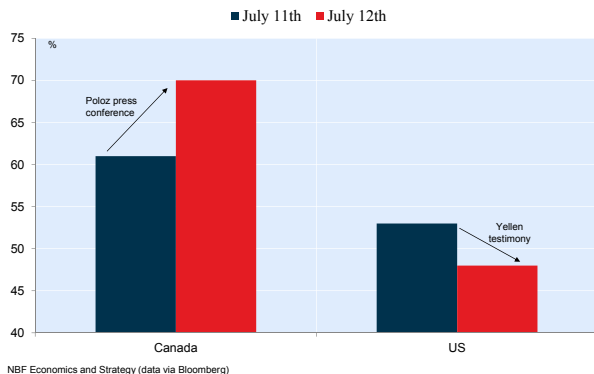
Canadian dollar: Actual versus PPP



A rapid change of policy stance from the Bank of Canada coupled with a dovish sounding Fed fueled the loonie's ascent. The central bank's decision to raise the overnight rate by 25 basis points in July to 0.75% (its first rate hike in 7 years) was backed by a more optimistic take on the economy. Indeed, the BoC raised its 2017 real GDP growth forecast for Canada from 2.6% to 2.8% — the central bank expects a solid follow-up to the strong first half — something it says will close the output gap by year end, two full quarters sooner than what it had estimated back in April.

Double boost for the loonie

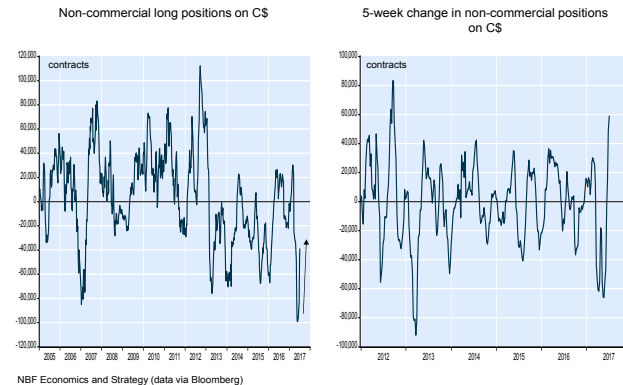
OIS probability that central bank policy rate by end-2017 is higher than 0.75% in Canada and 1.25% in the U.S.



More favourable yield differentials pushed up the loonie but so did speculators who chopped their short positions in half in just a few weeks. The last time we

saw such a reversal in speculative short positions was back in 2012. Those factors allowed the loonie to gain altitude despite headwinds from depressed oil prices.

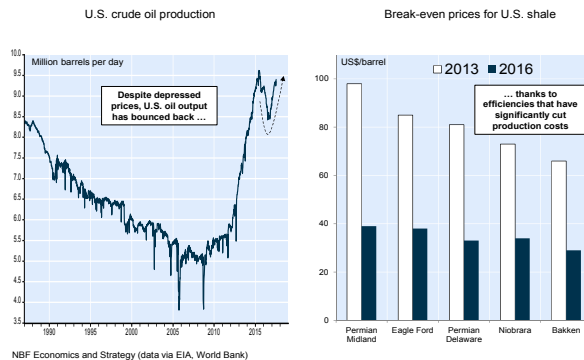
Speculators reduce C\$ short positions



...offsetting dull outlook for oil

Indeed, saddled with a supply glut, the price of WTI oil remains below \$50/barrel. Saudi Arabia's efforts to boost world oil prices via output cuts are not having the intended impacts because non-OPEC oil producers are offsetting those cuts with increased production of their own. U.S. oil output jumped to a 2-year high of 9.4 million barrels/day in July according to the Energy Information Administration. Shale production, which fell sharply in 2015/16 in the aftermath of the oil price slump, is now bouncing back. U.S. shale producers have been able to find efficiencies and cut their production costs in half in just three years, allowing them to be profitable even at currently low prices. Worse for the Saudis is their waning influence even within OPEC. The deterioration in relations between the Saudis and Qatar is unlikely to help. Iran, which made clear it will not participate in OPEC's output reductions, has pushed its output to a 9-year high. As such, we believe the oil supply glut is unlikely to be absorbed anytime soon.

Commodities: U.S. shale producers have halved production costs in just three years



FOREX

Can the C\$ rise further?

But as we've seen in recent weeks, the persistence of soft oil prices does not preclude C\$ appreciation. Momentum could allow for further near term C\$ gains, more so if speculators continue to cut their short positions. But given the recent surge, we're now less upbeat about the loonie's longer term prospects.

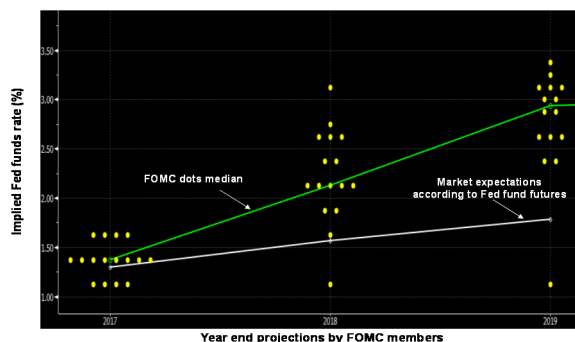
Inflation remains stubbornly low and below the Bank of Canada's 2% target. The central bank said it is confident inflation will return to 2% in 2018, blaming currently low inflation on temporary factors and "the lag between monetary policy actions and future inflation". But it also acknowledged some risks to that forecast, saying that the slowdown in inflation of some advanced economies (including Canada) may be due to "common factors" such as downward trend in inflation expectations. That would be a motivation for being cautious with rate hikes.

So, while we wouldn't be surprised to see further C\$ gains over the near term, we expect a giveback afterwards as the USD makes a comeback with markets starting to price Fed rate hikes. We continue to expect USDCAD to remain in the 1.25-1.35 trading range over the next 12 months.

Markets skeptical about Fed

For now, markets remain very skeptical the Fed can deliver the rate hikes it says it expects. Who can blame them, particularly after Fed Chair Yellen's recent testimony in front of Congress? While the Chair expressed confidence inflation will move back up to target, she admitted there were more than just temporary factors that are keeping inflation low. Chair Yellen also added that the fed funds rate would not have to rise very much to get to a neutral stance.

Markets do not believe the Fed can deliver significant rate hikes
FOMC member expectations versus Market expectations for Fed funds rate



NBF Economics and Strategy (data via Bloomberg)

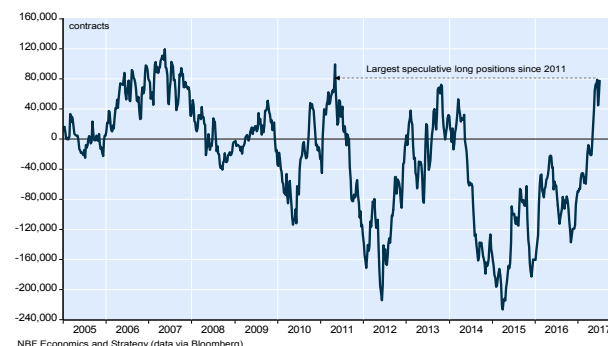
The Fed Chair reiterated that the FOMC planned to proceed with gradual interest rate increases in the coming years and is likely to start shrinking its \$4.5 trillion balance sheet "relatively soon". But no decisions have been made regarding the sequencing of actions. Based on that statement, one could argue that the FOMC will announce the beginning of the reduction in the balance sheet before a next rate hike. If, as we expect, U.S. GDP growth picks up next year — courtesy of fiscal stimulus being dispatched before the 2018 mid-term elections — the Fed may surprise markets with a combination of rate hikes and balance sheet reduction. As such, the trade-weighted USD could bounce back next year.

Common currency struggles despite improving economy

The Eurozone had a better first half of 2017 than many (including us) expected. Growth has picked up and employment is now at all-time highs, having recovered all the ground lost during the recession. Economic sentiment is also the best in a decade. With all those tailwinds, why then is EURUSD stuck near 1.14?

Old problems may be restraining the common currency. Reforms have stalled and economic growth, while improving overall, is not broad-based, as evidenced by continuing struggles in southern Europe. Uncertainties with regards to Brexit and next year's elections in Italy — the latter's economic weakness puts incumbent Prime Minister Paolo Gentiloni at risk of falling to anti-EU populists — also cast a shadow over the eurozone. Persistently low inflation also cast doubts about the European Central Bank's abilities to withdraw policy stimulus. As such, we do not see a lot of upside for EURUSD from current levels over the forecast horizon, more so considering the massive amounts of speculative long positions on the common currency.

Euro inflated by speculators
Non-commercial long positions on the euro



NBF Economics and Strategy (data via Bloomberg)

FOREX

Annex



NBF Economics and Strategy (data via Datastream)

Canadian dollar*							
	Current	2017Q3	2017Q4	2018Q1	2018Q2	2018Q3	2018Q4
	14-Jul-17						
USDCAD	1.27	1.25	1.29	1.30	1.32	1.32	1.34
EURCAD	1.45	1.45	1.49	1.45	1.47	1.45	1.45
CADJPY	89	91	89	87	84	83	82
AUDCAD	0.99	1.00	1.01	1.01	1.02	1.00	0.99
GBPCAD	1.66	1.64	1.65	1.62	1.62	1.59	1.61
CADCNY	5.32	5.39	5.24	5.24	5.15	5.18	5.09
CADMXN	13.87	13.91	13.78	13.80	13.64	13.81	13.91

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

FOREX

Montreal Office 514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

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

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Matthieu Arseneau
Senior Economist
matthieu.arseneau@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Toronto Office 416-869-8598

Warren Lovely
MD, Public Sector Research and Strategy
warren.lovely@nbc.ca

General – National Bank Financial (NBF) is an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on Canadian stock exchanges.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete. The opinions expressed are based upon our 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.

Research Analysts – The Research Analyst(s) who prepare these reports certify that their respective report accurately reflects his or her personal opinion and that no part of his/her compensation was, is, or will be directly or indirectly related to the specific recommendations or views as to the securities or companies.

NBF compensates its Research Analysts from a variety of sources. The Research Department is a cost centre and is funded by the business activities of NBF including, Institutional Equity Sales and Trading, Retail Sales, the correspondent clearing business, and Corporate and Investment Banking. Since the revenues from these businesses vary, the funds for research compensation vary. No one business line has a greater influence than any other for Research Analyst compensation.

Canadian Residents – In respect of the distribution of this report in Canada, NBF accepts responsibility for its contents. To make further inquiry related to this report, Canadian residents should contact their NBF professional representative. To effect any transaction, Canadian residents should contact their NBF Investment advisor.

U.S. Residents – With respect to the distribution of this report in the United States, National Bank of Canada Financial Inc. (NBCFI) is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC). This report has been prepared in whole or in part by, research analysts employed by non-US affiliates of NBCFI that are not registered as broker/dealers in the US. These non-US research analysts are not registered as associated persons of NBCFI and are not licensed or qualified as research analysts with FINRA or any other US regulatory authority and, accordingly, may not be subject (among other things) to FINRA restrictions regarding communications by a research analyst with the subject company, public appearances by research analysts and trading securities held a research analyst account.

All of the views expressed in this research report accurately reflect the research analysts' personal views regarding any and all of the subject securities or issuers. No part of the analysts' compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report. The analyst responsible for the production of this report certifies that the views expressed herein reflect his or her accurate personal and technical judgment at the moment of publication. Because the views of analysts may differ, members of the National Bank Financial Group may have or may in the future issue reports that are inconsistent with this report, or that reach conclusions different from those in this report. To make further inquiry related to this report, United States residents should contact their NBCFI registered representative.

UK Residents – In respect of the distribution of this report to UK residents, National Bank Financial Inc. has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). National Bank Financial Inc. 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 thereto. The value of investments can go down as well as up. Past performance will not necessarily be repeated in the future. The investments contained in this report are not available to retail customers. 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. National Bank Financial Inc. is authorised and regulated by the Financial Conduct Authority and has its registered office at 71 Fenchurch Street, London, EC3M 4HD.

National Bank Financial Inc. is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

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) regulated activity, 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 NBF, 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 National Bank Financial.



**NATIONAL
BANK**

FINANCIAL MARKETS

A division of National Bank of Canada