Highlights
By Stéfane Marion / Krishen Rangasamy

- The Federal Reserve’s dovish turn in June caused the trade-weighted U.S. dollar to register its first decline in five months. It’s unclear, however, if rate cuts would hurt the U.S. dollar all that much. If the Fed opts for a cut of 50 basis points or lower this year, that could cause the greenback to appreciate rather than depreciate because such action would fall short of market expectations of a 75 bp decrease by the end of the year. Even a 75 bp rate cut or more may not necessarily punish the USD if the stimulus is coming in the context of heightened concerns about the global economic outlook which may instead boost the greenback via safe haven flows. For now, our base-case scenario is one where the U.S. and China agree to at least a truce in their ongoing trade war, something that’s likely to brighten global economic prospects somewhat. The resulting risk-on sentiment may somewhat weigh on the greenback, which explains our call for USD softness to persist over the near term.

- Benefiting from USD weakness, the euro managed to register gains against the greenback for the first time in five months, and that despite soft economic data in the eurozone. Things are unlikely to get easier in the second half of 2019 with Brexit scheduled for October and potential U.S. tariffs on autos in November. So while the euro could appreciate some more amid USD weakness over the near term, we don’t see a lot of upside for the common currency.

- Thanks to June’s surge, the Canadian dollar is the best performing major currency so far this year. Higher oil prices and narrowing Canada-U.S. differentials, courtesy of the Fed’s dovish turn and better-than-expected Canadian economic data, are lifting the loonie. There is room for those two drivers to push USDCAD below 1.30 this summer. We, however, acknowledge risks the loonie may head the other way, i.e. depreciate versus USD should the global economic outlook darken, via say an escalation of trade protectionism.

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*Forecasts for end of period
NBF Economics and Strategy
Fed’s dovish turn hammers USD

The trade-weighted U.S. dollar fell in June for the first time in five months. Interrupting the greenback’s ascent was the Federal Reserve’s sudden dovish turn. While it left the fed funds rate unchanged at 2.25–2.50% in June, the Fed dropped its patient stance by saying instead it “will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion”. In other words, the Fed opened the door to increasing monetary policy stimulus. For the first time in years, the Fed’s dot plots point to a decline in interest rates, with 8 of the 17 FOMC participants seeing at least one rate cut this year.

So why is the Federal Reserve considering cutting interest rates this year? For starters, an inverted yield curve is fueling concerns of recession. A high fed funds rate (which raises the short-end of the yield curve) can be a problem for interest-sensitive sectors of the economy such as business investment, the housing market and even consumption of big ticket items such as durable goods. Low long rates, a result of investor concerns about the economic outlook, can hurt financial institutions which make some of their profits by borrowing short-term and lending long term. So, yield curve inversions are not favourable to financial intermediation and it’s no coincidence such occurrences in the past were often followed, albeit with a lag, by a moderation in credit and hence slower GDP growth.

U.S.: Why is an inverted yield curve concerning? Yield differential between 10-yr Treasuries and 3-month yield versus Loans and leases

Fed participants are also concerned about mounting trade protectionism which is becoming a problem for the U.S. Profits from foreign operations are declining on a year-on-year basis for the first time in three years, hurting overall U.S. corporate profits. If this becomes a trend, job creation and investment spending are likely to soften. But the current main concern at the Fed seems to be low inflation and declining expectations of inflation. At its June meeting, the Fed not only lowered its 2019 forecasts for the annual PCE inflation rate, but it also pointed out that inflation expectations are now declining. The annual core PCE inflation rate indeed remained well below the Fed’s 2% target in the first five months this year while the University of Michigan’s survey of consumers showed inflation expectations falling to an all-time low in the second quarter.

U.S.: Could sinking inflation expectations force the Fed’s hand? Michigan survey of consumer inflation expectations over the next five years versus PCE core annual inflation rate

So, while the Fed expects U.S. GDP growth to be above potential this year — i.e. between 2.0–2.4% on a Q4/Q4 basis according to its June update —, that does not preclude interest rate cuts. Uncertainties with regards to U.S.-China trade could convince the Fed to deliver a pre-emptive cut, instead of waiting for negative spillovers from a global economic slowdown to hit U.S. shores.

It’s unclear, however, if rate cuts would hurt the U.S. dollar all that much. If the Fed opts for a cut of 50 basis points or lower this year, that could cause the greenback to appreciate rather than depreciate because such action would fall short of market expectations of a 75 bp decrease by the end of the year. Even a 75 bp rate cut or more may not necessarily punish the USD if the stimulus is coming in the context of heightened concerns about the global economic outlook which may instead boost the greenback via safe haven flows.

For now, our base-case scenario is one where the U.S. and China agree to at least a truce in their ongoing trade war, something that’s likely to brighten global economic prospects somewhat. The resulting risk-on sentiment may somewhat weigh on the USD, which explains our call for USD softness to persist over the near term.

Euro benefits from USD weakness

Benefiting from USD weakness, the euro managed to register gains against the greenback for the first time in five months. And that despite soft economic data in the eurozone, including retail volumes and industrial production. As a result of weak growth, price pressures seem to be waning as evidenced by an annual inflation rate of just 1.2% in June, down half a percentage point compared to the prior month.

Amid failure to hit its 2% inflation target, the European Central Bank is trying to stimulate the economy further. While it left interest rates unchanged in June, the ECB extended the forward guidance by saying rates will remain unchanged “at least through the first half of 2020.” The ECB also restated its commitment to reinvest in full the principal payments from maturing securities which it had purchased in earlier rounds of QE and gave new information about its new
Targeted Longer-Term Refinancing Operations which is slated to start in September and last through March 2021.

**Eurozone: Another rough quarter**

Industrial production

The eurozone will need all the help it can get because things are unlikely to get easier in the second half of 2019 with Brexit scheduled for October and potential U.S. tariffs on autos in November. So while the euro could appreciate some more amid USD weakness over the near term, we don’t see a lot of upside for the common currency.

**Loonie takes flight**

The Canadian dollar saw its biggest gain since January against the USD in June, taking its year-to-date appreciation to 3.6%. That makes the loonie the best performing major currency so far this year.

**Loonie is the best performer among major currencies this year**

Performance versus USD since start of the year

While GDP growth stagnated in 2018Q4 and 2019Q1 due to mandated oil production cuts, investors were likely encouraged by consensus-topping economic data, including employment and inflation, which point to a sharp rebound in Q2. A rebound in trade, the stabilization of the housing market, and the return of oil production all seem to have given a lift to the economy during the quarter.

**Canada’s economic data has been better than expected**

Index of Economic Surprises

That, coupled with the Fed’s dovish turn, helped significantly narrow the Canada-U.S. differentials. The loonie also benefited from higher oil prices, the latter driven by concerns about tight supply amid U.S. sanctions on two major OPEC producers, namely Iran and Venezuela.

**Loonie benefited from better rate differentials and oil price in June**

Canada-U.S. 2-year interest rate differential versus USDCAD

However, those positive developments do not mean the Bank of Canada will suddenly turn hawkish. Uncertainties with regards to global trade represent a risk that is significant enough to keep the central bank in pause mode for now. Earlier macro-prudential measures also negate the need for monetary policy tightening at this point. What about rate cuts then? For such an outcome to materialize, financial conditions will have to deteriorate enough as to jeopardise the outlook for the second half of 2019. At this point, the evidence does not point in this direction and that’s why we are leaving unchanged our end-of-year target of 1.30 for USDCAD. We, however, acknowledge risks the loonie may head the other way, i.e. depreciate versus USD should the global economic outlook darken, via say an escalation of trade protectionism.
### Canadian Dollar*

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