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FINANCIAL MARKETS
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Economics and Strategy

May 2017

Protectionism hits loonie

- The trade-weighted U.S. dollar is struggling to gain traction, registering its fourth straight monthly depreciation this year. We still expect the world's reserve currency to bounce back courtesy of a more hawkish Fed which is poised to add to last March's rake hike, more so considering upcoming fiscal stimulus from the Trump administration. But with improving economic data globally, central banks of other major economies may follow the Fed and start the process of removing accommodation. So, any USD rebound may prove temporary. We now expect the trade-weighted USD to peak in Q3 instead of the last quarter of the year.

- The euro notched up another monthly gain against the USD, buoyed by improving economic data and French first round election results. While an upset can never be ruled out in the second round of the elections later this month, polls strongly favour pro-Europe candidate Emmanuel Macron becoming President. In light of the improving economic and political outlook, we have raised slightly our forecasts for EURUSD.

- The Canadian dollar has been unable to capitalize on USD weakness this year. The currency sank for a third consecutive month in April despite improving economic data, hammered by a dovish Bank of Canada, soft oil prices and import duties slapped by the U.S. on Canadian lumber exports. The loonie could remain under pressure over the coming months if, as we expect, incoming data shows a sharp moderation in growth after Q1's blockbuster performance. But not all is bleak for the Canadian dollar. We expect a more hawkish tone from the Bank of Canada later in the year in response to a second half rebound and the need to cool a hot housing market. As such, we have brought forward by one quarter to Q3 the timeline when we see the loonie hitting a trough.

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NBF Currency Outlook*

	Current *1-May-17*	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2
USDCAD	1.36	1.36	1.38	1.35	1.34	1.32
US cents per CAD	*0.74*	0.74	0.73	0.74	0.75	0.76
EURUSD	1.09	1.08	1.05	1.07	1.09	1.11
USDJPY	112	113	116	114	113	111
AUDUSD	0.75	0.75	0.73	0.74	0.76	0.78
GBPUSD	1.29	1.27	1.22	1.20	1.21	1.23
USDCNY	6.89	6.90	6.91	6.89	6.87	6.85
USDMXN	18.85	19.30	19.50	19.35	19.20	18.90

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

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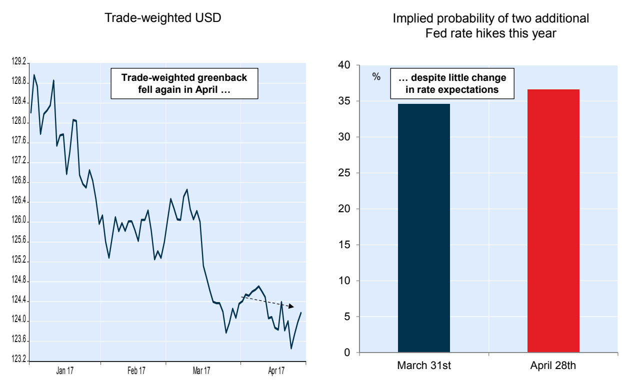
Can USD bounce back?

The trade-weighted U.S. dollar is struggling to gain traction, registering its fourth straight monthly depreciation this year. April's decline was not necessarily due to soft economic data — odds of Fed rate hikes were little changed during the month — but rather due to strength of the euro, the latter accounting for a sizable 17% in the trade-weighted USD. The resilience of yuan (22% weight) also weighed on the greenback during April.

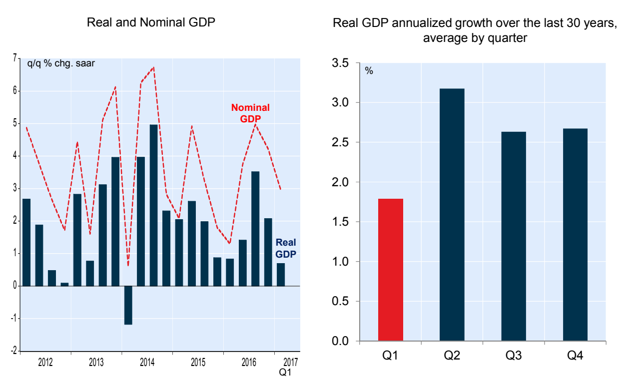
U.S.: Trade-weighted USD continues to slide



NBF Economics and Strategy (data via Bloomberg)

Markets maintained their view about upcoming Fed tightening despite a difficult first quarter that saw real GDP grow just 0.7% annualized. Perhaps investors understand that Q1 U.S. data tends to be plagued with residual seasonality (see May's edition of our *Monthly Economic Monitor*), meaning the data likely understates the strength of the U.S. economy.

U.S.: Residual seasonality apparent in GDP data



NBF Economics and Strategy (data via Datastream)

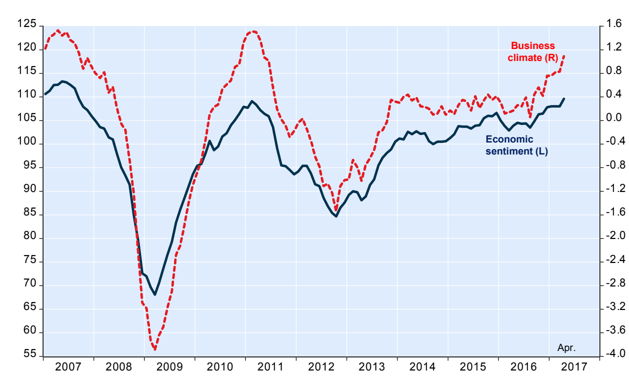
We still expect the world's reserve currency to bounce back courtesy of a more hawkish Fed which is poised to add to last March's rake hike, more so considering upcoming fiscal stimulus from the Trump administration. But with improving economic data globally, central banks of other major economies may follow the Fed and start the process of removing accommodation. So, any USD rebound may prove temporary. We now expect the trade-weighted USD to peak in Q3 instead of the last quarter of the year.

That forecast, however, assumes U.S. trade policy does not take a turn for the worse. Protectionist policies could indeed cause the greenback to appreciate sharply if they have the desired effect of improving the U.S. trade balance and the undesired effect of spooking investors worldwide and increasing safe haven flows.

Euro propped up by better economic outlook

The euro notched up another monthly gain against the USD buoyed by improving economic data. Surging purchasing managers indices point to continued expansion in the first quarter of the 2017 as well as early Q2 in the eurozone. The zone's factory PMI even jumped in April to the highest in six years thanks to continued expansion in Germany and France. The European Commission's Economic sentiment index is now the highest in a decade reflecting increased confidence among both businesses and consumers.

Europe: Economic sentiment highest in years
Indices of economic sentiment and business climate



NBF Economics and Strategy (data via European Commission)

Despite the improvements, the European Central Bank left monetary policy unchanged in April. The ECB acknowledged the improving data by saying the cyclical recovery is becoming "increasingly solid" and that downside risks have diminished. But the central bank refused to give clues about when it will change its stance towards tighter policy, instead saying it continues to see risks "tilted to the downside" due to global factors. The ECB is also concerned about

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below-target inflation which "have yet to show a convincing upward trend". As such, the central bank made clear it will still be involved in quantitative easing until at least the end of the year.

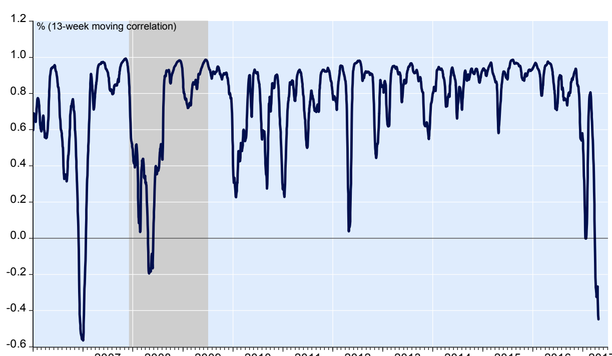
While President Draghi said that the decision to stand pat had nothing to do with political developments in France, the latter's upcoming elections must have been on the minds of Governing Council members. Indeed, after last year's shock results in the UK (Brexit) and the U.S. (Trump), an upset can never be ruled out in France even though polls currently favour pro-Europe candidate Emmanuel Macron, who won the first round last month.

If polls are right and Mr Macron replicates the feat in the second round of the elections, the euro should get a boost in May. While a USD rebound, courtesy of tighter Fed policy, could temporarily interrupt the euro rally, the common currency could resume its appreciation against the greenback after Q3 in anticipation of a slightly more hawkish ECB. In light of the improving economic outlook we have raised slightly our forecasts for EURUSD.

Loonie hit by U.S. trade policy

The Canadian dollar has been unable to capitalize on USD weakness this year. The currency sank for a third consecutive month in April, moving further away from the broad USD — the negative correlation is actually the biggest since 2007.

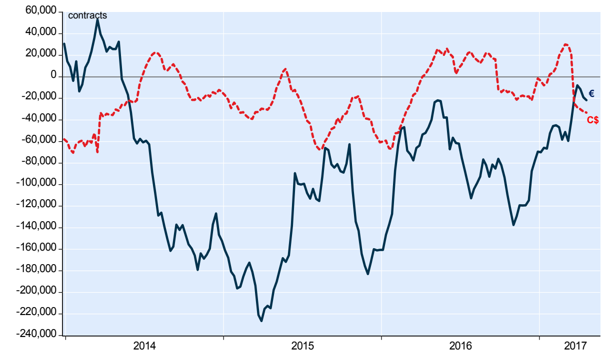
Perspective on Canadian dollar vs. broad USD
Moving correlation of U.S. dollar trade weighted (26 currencies) and USDCAD (daily data)



NBF Economics and Strategy (data via Datastream)

As it turns out, good news from improving Canadian economic data was offset by a persistently dovish Bank of Canada, soft oil prices and import duties slapped by the U.S. on Canadian lumber exports. Speculators amplified the loonie's decline by increasing their short positions. So much so that for the first time in three years speculative shorts on the C$ are now larger than even those placed on the euro.

Speculative shorts now larger on the C$ than on the euro
Non-commercial net long positions on the Canadian dollar and the Euro

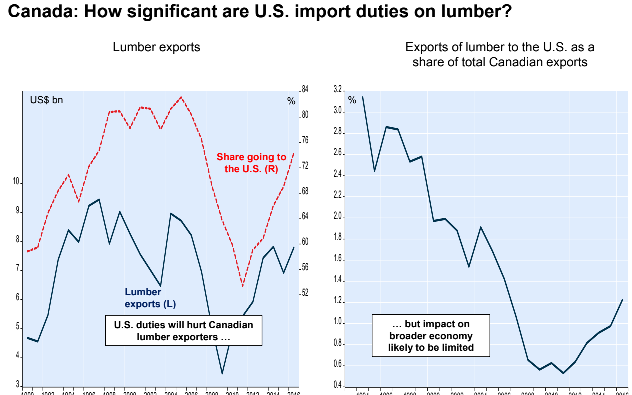


NBF Economics and Strategy (data via Bloomberg)

Why the lack of faith on the Canadian economy? After all, Canada is set to show a Q1 growth print close to 4% annualized and employment creation has been strong as a result. Perhaps investors are taking their cue from the Bank of Canada who doesn't seem to hesitate to highlight negative aspects of the economy. Indeed, while the central bank revised up its growth forecast for this year to 2.6%, it still thought there was "material excess capacity in the economy" and highlighted exporters woes, "broad-based" softness in hours worked, weak business investment, subdued wage growth, and falling core inflation. Perhaps a more valid reason to stand pat is the BoC's concern about U.S. trade policy.

Recall that the U.S. just slapped an import duty of as much as 24% on Canadian lumber. While that will hit the forestry industry on the chin, the overall impact on Canada's economy is likely to be limited. Note that Canada exported less than US$6 billion worth of lumber to the U.S. last year, accounting for just 1.2% of total exports.

Canada: How significant are U.S. import duties on lumber?



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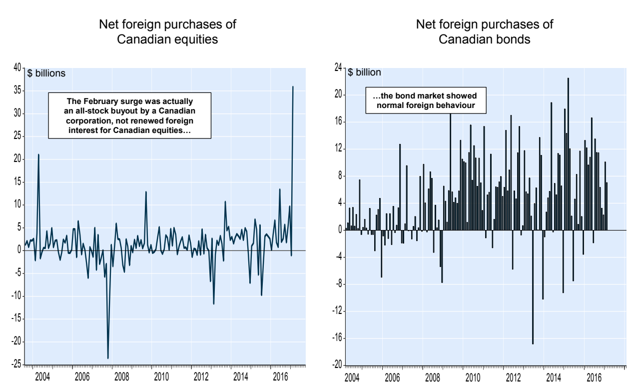
In other words, even if lumber exports to the U.S. dives to zero — which has never occurred in the three decades of lumber-related trade disputes between the U.S. and Canada —, the net impact on Canada's GDP would be less than half a percentage point. While not significant in itself, this latest chapter in the softwood lumber dispute is now getting markets to question U.S.-Canada trade relations and the very existence of NAFTA. The loonie is taking a beating as a result.

And things could potentially get worse for the Canadian dollar. Souring U.S.-Canada trade relations and the likelihood of tax cuts for American corporations may divert investment away from Canada and towards the U.S. or even encourage Canadian firms to relocate operations stateside. In other words, net Foreign Direct Investment which has now been negative for three years in a row, is unlikely to improve.

Latest data on Canadian securities transactions support that argument. While there were record net inflows of C$35 billion into Canadian equities in February, that wasn't due to purchases of Canadian securities by foreigners. Instead, the "inflows" reflected an M&A deal in which a Canadian company purchased a U.S. operation via an all-stock buyout.

Canada: Caution in interpreting February transactions in CA securities



NBF Economics and Strategy (data via Statistics Canada)

Weak FDI just means Canada will have to continue relying on volatile portfolio flows to finance the large current account deficit. But with interest rate differentials favouring the U.S. and the TSX's valuations seemingly stretched, it's unclear how much longer foreigners will be enticed to buy Canadian financial assets. For now, foreign appetite remains strong for Canadian bonds in particular — net purchases stood at healthy $7 billion in February, in line with the monthly average of the last two years. But there's no denying the Canadian dollar remains vulnerable to a negative turn in foreign investor sentiment.

The loonie could remain under pressure over the coming months if, as we expect, incoming data shows a sharp moderation in growth after Q1's blockbuster performance — the Syncrude production shutdown may restrain Q2 GDP growth to less than 1% annualized.

But not all is bleak for the Canadian dollar. A second half rebound in growth is more likely than not. There's a limit to how long the Bank of Canada can hang on to its loose stance amidst improving data and growing risks to financial stability e.g. housing. The central bank's own analysis suggests the new measures of core inflation (whose soft numbers the BoC highlights to support its stance) are lagging indicators. In other words, core inflation may be reflecting last year's soft Canadian economy instead of current conditions. If, as we expect, core inflation rises in the second half of the year, the BoC will have to ditch its dovish language or risk eroding its credibility. As such, we have brought forward by one quarter to Q3 the timeline when we see the loonie hitting a trough.

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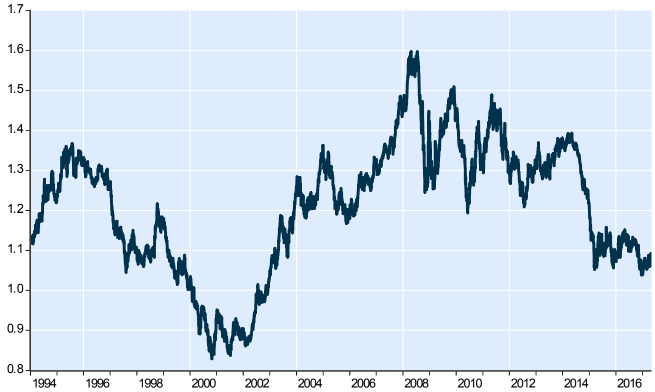
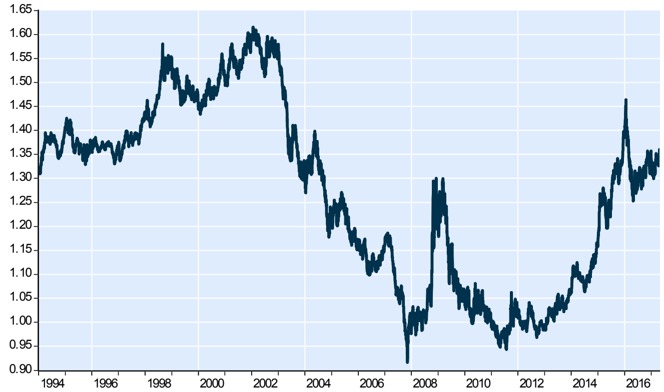
Annex

Euro



Canadian dollar

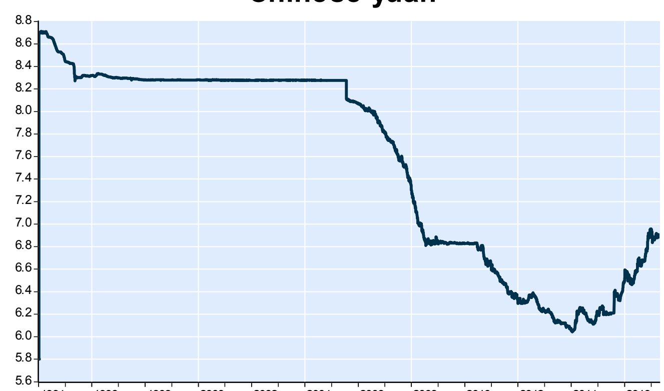


Japanese yen

Australian dollar

British pound

Chinese yuan



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