November 2018

Risk off sentiment lifts USD

- Our view that the USD is close to peaking assumes a drop in risk aversion. We are counting on Washington recognizing the threat posed by de-globalization to world GDP growth and hence dialing back its protectionist measures. Moreover, if as we expect U.S. growth and inflation come short of the Fed's forecasts next year, markets could reprice their expectations about monetary policy tightening in the U.S. The accompanying depreciation of the greenback would be amplified by the reversal of massive net long positions on the USD.

- While the euro is likely to remain under pressure in the near term amidst the relative strength of the U.S. economy and ongoing internal strife (e.g. Brexit, Italian politics), it has potential to bounce back sharply over the coming year as market expectations ramp up about the start of ECB policy normalization and/or the end of Fed tightening. We are leaving unchanged our end-of-2019 forecast of 1.23 for EURUSD.

- The loonie's woes continued during October with neither the USMCA trade deal nor the Bank of Canada's hawkish signals able to offset risk off sentiment and weak Western Canada Select oil price. We expect improvements on both of those fronts in the coming months with declining risk aversion (triggered perhaps by a slightly less protectionist Trump administration after the U.S. mid-term elections) and higher WCS prices (as inventories return to normal) giving a lift to the loonie. Rate spreads could also improve further in the C$'s favour if the federal government delivers some stimulus in this month's *Fall Economic Statement*. For now, we are keeping unchanged our forecast for USDCAD to reach 1.27 by year-end.

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NBF Currency Outlook*

	Current 1-nov-18	2018Q4	2019Q1	2019Q2	2019Q3	2019Q4
USDCAD	1.31	1.27	1.25	1.25	1.27	1.28
US cents per CAD	0.77	0.79	0.80	0.80	0.79	0.78
EURUSD	1.14	1.16	1.19	1.21	1.22	1.23
USDJPY	113	113	114	115	115	113
AUDUSD	0.72	0.73	0.74	0.74	0.73	0.71
GBPUSD	1.29	1.30	1.31	1.32	1.30	1.28
USDCNY	6.94	6.90	6.87	6.83	6.80	6.80
USDMXN	20.19	19.40	18.50	18.20	18.40	18.70

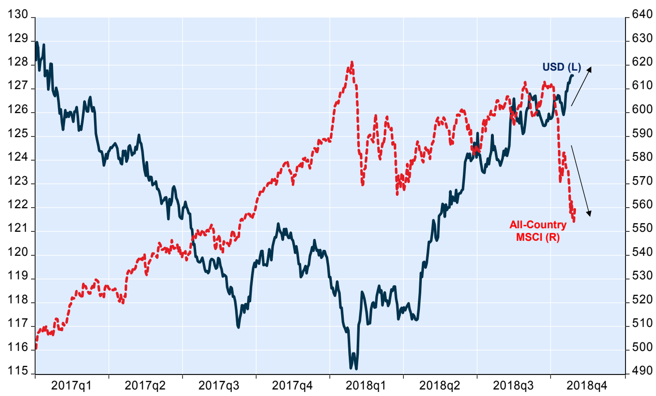
*Forecasts for end of period
NBF Economics and Strategy

Forex

Stock market rout lifts USD

After taking a breather the prior month, the trade-weighted U.S. dollar resumed its earlier uptrend by gaining more than 1% in October. The return of risk aversion, courtesy of the global stock market rout, helped boost the greenback during the month, reinforcing the typically negative correlation between the two variables.

World: Increased risk aversion propelled USD in October
Trade-weighted U.S. dollar versus All-Country MSCI index



NBF Economics and Strategy (data via Datastream)

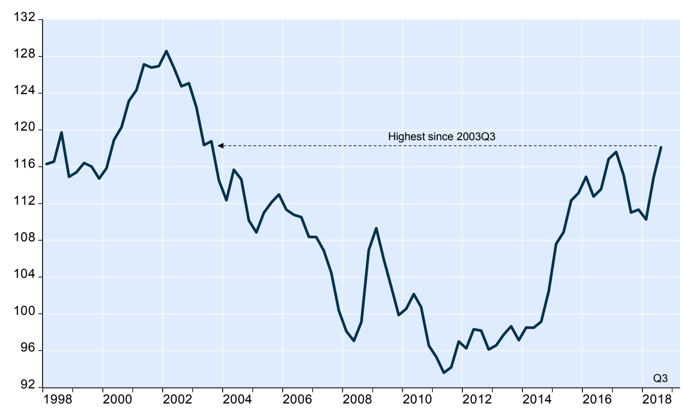
Positive economic data also helped lift the greenback, increasing odds of a December interest rate hike by the Fed. For instance Q3 real GDP results were better than anticipated, with the 3.5% growth print keeping the U.S. on track to register its highest annual growth rate in years. Labour market reports for September also pointed to a buoyant economy. Recall that the jobless rate fell to just 3.7%, the lowest since December 1969. And looking at the quarter as a whole, wage growth accelerated to 3.4% annualized in Q3, the fastest pace in 10 years. And not surprisingly, the core PCE deflator, the Federal Reserve's preferred measure of inflation, rose to the 2% target on a year-on-year basis in the third quarter, the highest since 2012. As such, the Fed is likely to stick with its approach to gradually normalize monetary policy over the near to medium term.

That said, we doubt the Fed can raise rates as aggressively as suggested by its dot plot. Recall that last September, the FOMC's median projections showed one more rate hike before year end followed by three rate hikes in 2019. We also expect an additional rate hike from the Fed before the end of 2018. But because we're not as optimistic as the Fed about 2019 U.S. GDP growth, we have pencilled in no more than two hikes for next year. While growth should remain above potential next year, we suspect a sharp deceleration from this year's pace amid fading impacts of fiscal stimulus.

True, Congress could vote for another round of tax cuts — Trump recently floated the idea of a "10% tax cut for the middle class" —, something that would prompt us to revise our 2019 growth outlook. But we have serious doubts of such additional tax cuts materializing in light of the deteriorating fiscal picture in the U.S. Recall that the budget deficit rose to nearly 4% of GDP in fiscal year 2018. And according to the non-partisan Congressional Budget Office, even assuming no recession, based on current law the U.S. budget deficit is projected to soar past 5% of GDP by 2022, a clearly unsustainable path.

Another reason we're less optimistic than the Fed about 2019 growth and hence the pace of monetary tightening is the U.S. dollar's surge. The combination of nominal dollar appreciation and rising inflation since the start of the year has pushed the greenback to a 15-year high in real effective terms. This decline in relative competitiveness will eventually hurt American exporters. And this, even before considering the damage done by the White House's trade spat with China.

U.S.: Dollar is the least competitive in 15-years
Real effective USD exchange rate



NBF Economics and Strategy (data via Bank of International Settlements)

The Fed may also be underestimating the sensitivity of the economy to higher interest rates. While consumption spending is unlikely to fold amidst rate hikes — after deleveraging during the Great recession, household balance sheets are largely in good shape —, business investment could struggle if rising borrowing costs cause commercial and industrial loan growth to stall. Moreover, highly levered firms which have arguably over-indulged in corporate bond issuance in recent years, will find it more challenging to roll over maturing debt. Also warranting a go-slow approach from the Fed is a fragile housing market. Home sales and housing starts have indeed been weak this year, coinciding with the ramp up of interest rates. Little surprise then that homeownership rates remain well below pre-recession levels across all demographic groups.

If, as we expect, U.S. growth and inflation come short of the Fed's forecasts next year, markets could reprice their expectations about monetary policy tightening in the U.S. The accompanying depreciation of the greenback would be amplified by the reversal of massive net long positions on the USD. Our view that the USD is close to peaking, however, assumes a drop in risk aversion. We are counting on Washington recognizing the threat posed by de-globalization to world GDP growth and hence dialing back its protectionist measures.

But you never know with politicians. Should trade negotiations between the U.S. and major trade partners such as China and the European Union take a turn for the worse, risk off sentiment will persist and support an already-stretched USD at the expense of other currencies, including the Chinese yuan (which sank in October to a decade low against the USD) and the euro.

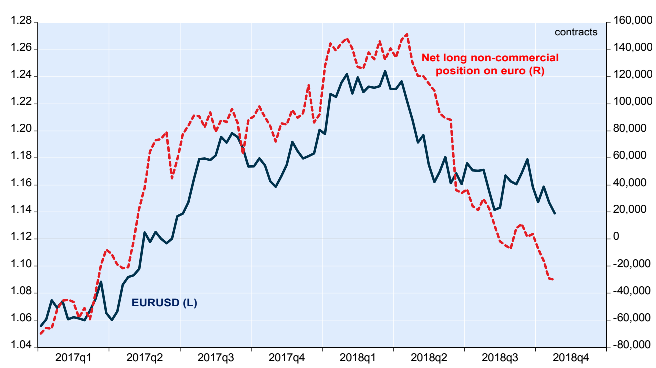
Can the yuan fall further?
Yuan per USD

NBF Economics and Strategy (data via Datastream)

Euro haunted by old problems

The euro lost more than 2% in October, hammered by USD strength but also by domestic problems. Speculators amplified the euro's slump in October by shorting the currency. So much so that net short positions on the euro are now the highest in over a year.

Speculators losing faith in the euro
Net long non-commercial position on euro versus EURUSD



NBF Economics and Strategy (data via Bloomberg)

Speculators and investors in general are not surprisingly being put off by the loss of economic momentum. The zone's real GDP reportedly grew just 0.8% annualized in Q3, the worst performance since 2014Q2. And based on flash purchasing managers indices — the manufacturing PMI declined to a 26-month low in October —, it seems the final quarter of 2018 won't be great either.

Uncertainties to the economic outlook courtesy of Brexit and internal cohesion are also not helping the common currency. Italy's latest budget, which calls for an increase in the budget deficit to 2.4% of GDP (three times larger than what was proposed by the preceding government), was rejected by the European Commission which requested a revised plan by mid-November. Non-compliance could result in Brussels calling for a so-called "excessive budget procedure", which would open the door to sanctions, including fines, in 2019. That could make an already fragile Italian political climate — Italy is being governed by a coalition government — even more unstable. Investors seem to be concerned about Italy's unsustainable fiscal position, ditching Italian bonds and causing yields to soar.

World: Italy's fiscal stance under the microscope
Spread between Italian and German 10-year government bond yields

NBF Economics and Strategy (data via Datastream)

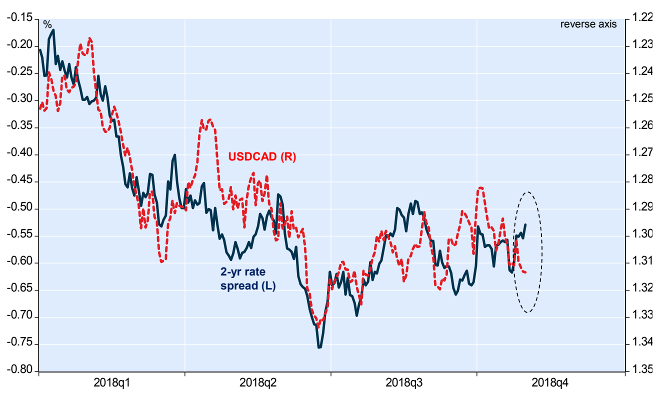
It's unclear how high Italian yields have to go to get Rome to reconsider its populist agenda. But in the meantime the threat of contagion to other European sovereigns should not be underestimated considering what happened in 2011-2012 in the aftermath of the Greek debt crisis.

The European Central Bank admitted in its October statement that data had been weaker than expected but it refrained from signalling a change in stance, expressing confidence that growth and inflation will evolve as to warrant winding down its QE programme by year end. The central bank reiterated that "an ample degree of monetary accommodation is still necessary" and hence expects rates "to remain at their present levels at least through the summer of 2019". But expectations about the start of ECB policy normalization and/or the end of Fed tightening, which would effectively narrow the U.S. yield advantage, could ramp up sooner. So, while the euro is likely to remain under pressure in the near term amidst the relative strength of the U.S. economy and ongoing internal strife (e.g. Brexit, Italian politics), it has potential to bounce back sharply over the coming year. We are leaving unchanged our end-of-2019 forecast of 1.23 for EURUSD.

Not even USMCA could save loonie in October

Like other major currencies, the Canadian dollar struggled in October as the USD reigned supreme. Consensus-topping economic data released during the month, including September employment and August GDP growth, and the new USMCA trade deal did not help the loonie much. Even the Bank of Canada's hawkish signals had limited impacts on the currency despite helping eat into the U.S. yield advantage. The central bank not only raised the overnight rate by 25 basis points in October to 1.75% (which was expected by markets), but surprisingly dropped its reference to future rate hikes being "gradual", which could mean a more aggressive path to monetary tightening than what was expected previously.

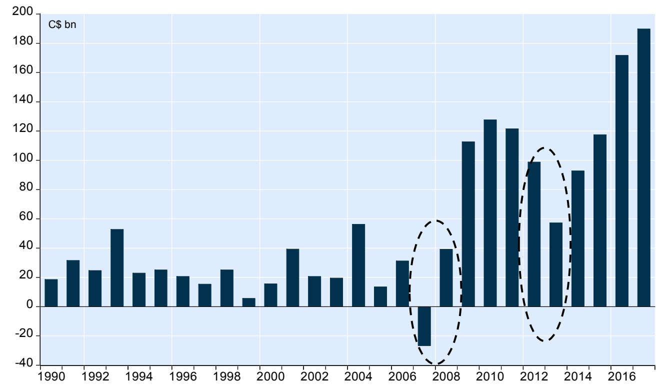
Canadian dollar struggles despite improving spreads
Spread between Canadian and U.S. 2-year government bond yields versus USDCAD



NBF Economics and Strategy (data via Datastream)

So why is the loonie not responding to improving rate spreads? It's possible that foreign capital inflows weakened further in October. True, the lack of timely data does not allow us to confirm this. But note that amidst NAFTA-related uncertainties, foreign inflows have been particularly disappointing with just C$65 bn in net foreign purchases of Canadian securities in the first eight months of 2018, i.e. less than half the tally over the same period last year. With October's generalized increase in risk aversion, it's no stretch to imagine foreigners further slowing down purchases of Canadian assets, if not divesting from the latter. We've seen such response from foreign investors in earlier periods of financial stress (think 2007-2008 and 2012-2013).

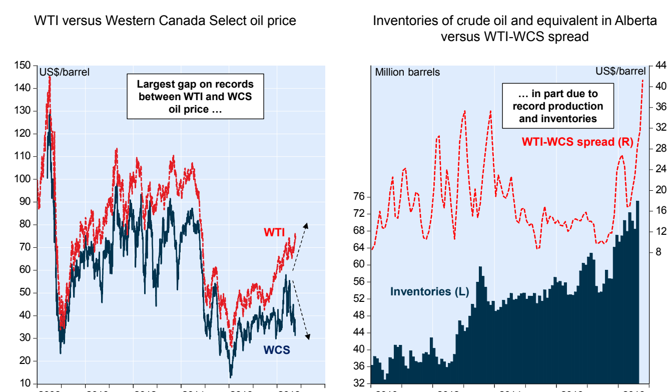
Canada: Foreign purchases of securities weak in periods of stress
Net foreign purchases of Canadian securities, by year



NBF Economics and Strategy (data via Statistics Canada)

The loonie's woes may also be explained in part by a persistently low Western Canada Select oil price. The WTI-WCS spread is now more than US$40/barrel, the highest ever recorded. Canadian producers are being forced to accept discounted WCS prices largely because of record inventories, the latter of course a result of limited transportation capacity (e.g. lack of pipelines and oil freight trains) and record oil production. In that environment, foreign investment in the oil patch is unlikely to be forthcoming.

Canada: Can the WTI-WCS oil price spread get any larger?

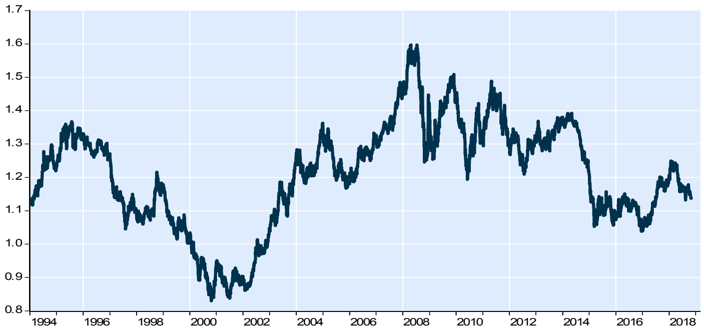


NBF Economics and Strategy (data via Datastream, Alberta Energy Regulator)

We expect improvements on both of those fronts with declining risk aversion (triggered perhaps by a slightly less protectionist Trump administration after the U.S. mid-term elections) and higher WCS prices (as inventories return to normal) giving a lift to the loonie in the coming months. Rate spreads could also improve further in the C$'s favour if the federal government delivers some stimulus in this month's *Fall Economic Statement*. For now, we are keeping unchanged our forecast for USDCAD to reach 1.27 by year-end.

Forex
Annex

Euro



Canadian dollar

Japanese yen

Australian dollar

British pound

Chinese yuan

NBF Economics and Strategy (data via Datastream)

Canadian Dollar*						
	Current 1-nov-18	2018Q4	2019Q1	2019Q2	2019Q3	2019Q4
USDCAD	1.31	1.27	1.25	1.25	1.27	1.28
EURCAD	1.49	1.47	1.49	1.51	1.54	1.58
CADJPY	86	89	91	92	91	88
AUDCAD	0.94	0.92	0.93	0.93	0.92	0.91
GBPCAD	1.69	1.65	1.64	1.65	1.65	1.64
CADCNY	5.31	5.45	5.50	5.46	5.37	5.30
CADMXN	15.45	15.33	14.80	14.56	14.54	14.59

*Forecasts for end of period
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Forex

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