**Highlights**
By Stéfane Marion/Kyle Dahms

- At the start of the fourth quarter, the greenback is already 2.4% above its third quarter average and 8.6% above its level of the previous year. This latest surge was ignited by the U.S. Federal Reserve and its hawkish "dot plot" guidance. Of course, faster and more serious inflation relief, should it come, could alter the FOMC's tightening campaign. If we are right on inflation, we'll get a quicker policy pivot than what FOMC members have contemplated or what financial markets are yet willing to discount. We believe that a less restrictive US monetary policy will pave the way for a weaker US dollar in 2023.

- USD/CAD broke through its 1.32 resistance against the USD in September due to deteriorating global financial conditions and volatile energy prices. With inflation cooling faster in Canada than in the U.S. and the BoC unlikely to overtake the Fed in the coming months, as we expected, we do not see opportunities for a significant strengthening of the CAD against the USD until an FOMC pivot, which we expect in H1 2023. We see USD/CAD at 1.39 at the end of Q4 22 and at 1.30 at the end of Q2 23.

- The pound hit record lows against the USD following an announcement by the government of unfunded tax cuts. The Bank of England was forced to intervene in order to stabilize rocketing yields. If our vision of abating inflation in the US holds true, there will be rate cuts by the Fed in the second half of 2023 and reduce the rate advantage favouring the greenback. In this situation, the Pound could see some appreciation at that time. In the Eurozone, the ECB is still behind the Fed in tightening and could be limited as the common currency area is postured for a recession. We expect that the euro will remain weak until it becomes clear that the Fed will start easing on monetary policy.

### NBF Currency Outlook

<table>
<thead>
<tr>
<th>Currency</th>
<th>Current September 30, 2022</th>
<th>Q4 2022</th>
<th>Q1 2023</th>
<th>Q2 2023</th>
<th>Q3 2023</th>
<th>PPP (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Canadian Dollar (USD / CAD)</strong></td>
<td>1.37</td>
<td>1.39</td>
<td>1.36</td>
<td>1.30</td>
<td>1.25</td>
<td>1.25</td>
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<tr>
<td><strong>United States Dollar (CAD / USD)</strong></td>
<td>0.73</td>
<td>0.72</td>
<td>0.74</td>
<td>0.77</td>
<td>0.80</td>
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<tr>
<td><strong>Euro (EUR / USD)</strong></td>
<td>0.98</td>
<td>0.97</td>
<td>0.99</td>
<td>1.03</td>
<td>1.05</td>
<td>1.45</td>
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<tr>
<td><strong>Japanese Yen (USD / JPY)</strong></td>
<td>145</td>
<td>146</td>
<td>140</td>
<td>132</td>
<td>125</td>
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<td><strong>Australian Dollar (AUD / USD)</strong></td>
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<td>0.65</td>
<td>0.67</td>
<td>0.71</td>
<td>0.74</td>
<td>0.67</td>
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<tr>
<td><strong>Pound Sterling (GBP / USD)</strong></td>
<td>1.12</td>
<td>1.11</td>
<td>1.13</td>
<td>1.16</td>
<td>1.18</td>
<td>1.48</td>
</tr>
<tr>
<td><strong>Chinese Yuan (USD / CNY)</strong></td>
<td>7.09</td>
<td>7.00</td>
<td>6.95</td>
<td>6.85</td>
<td>6.70</td>
<td>4.2</td>
</tr>
<tr>
<td><strong>Mexican Peso (AUD / MXN)</strong></td>
<td>20.1</td>
<td>21.0</td>
<td>21.0</td>
<td>20.5</td>
<td>20.0</td>
<td>9.7</td>
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<tr>
<td><strong>Broad United States Dollar (3)</strong></td>
<td>127.3</td>
<td>128.7</td>
<td>126.7</td>
<td>122.5</td>
<td>119.2</td>
<td>-</td>
</tr>
</tbody>
</table>

1) PPP data from OECD, based in Local Currency per USD
2) Current Account Balance data from IMF, as % of GDP (2020 & 2021 IMF estimates)
3) Federal Reserve Broad Index (26 currencies)

### Canadian Dollar Cross Currencies

<table>
<thead>
<tr>
<th>Currency</th>
<th>Current September 30, 2022</th>
<th>Q4 2022</th>
<th>Q1 2023</th>
<th>Q2 2023</th>
<th>Q3 2023</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Euro (EUR / CAD)</strong></td>
<td>1.35</td>
<td>1.35</td>
<td>1.35</td>
<td>1.34</td>
<td>1.31</td>
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<tr>
<td><strong>Japanese Yen (CAD / JPY)</strong></td>
<td>105</td>
<td>105</td>
<td>103</td>
<td>102</td>
<td>100</td>
</tr>
<tr>
<td><strong>Australian Dollar (AUD / CAD)</strong></td>
<td>0.88</td>
<td>0.90</td>
<td>0.91</td>
<td>0.92</td>
<td>0.93</td>
</tr>
<tr>
<td><strong>Pound Sterling (GBP / CAD)</strong></td>
<td>1.53</td>
<td>1.54</td>
<td>1.54</td>
<td>1.51</td>
<td>1.48</td>
</tr>
<tr>
<td><strong>Chinese Yuan (CAD / CNY)</strong></td>
<td>5.16</td>
<td>5.04</td>
<td>5.11</td>
<td>5.27</td>
<td>5.36</td>
</tr>
<tr>
<td><strong>Mexican Peso (CAD / MXN)</strong></td>
<td>14.6</td>
<td>15.1</td>
<td>15.4</td>
<td>15.8</td>
<td>16.0</td>
</tr>
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</table>
USD: FOMC ignites the greenback

The nominal trade-weighted U.S. dollar could not be stopped in the third quarter, hitting a new record high against a basket of 26 currencies. At the start of the fourth quarter, the greenback is already 2.4% above its third quarter average and 8.6% above its level of the previous year – chart.

USD: Greenback surpasses pandemic peak
Trade-weighted USD (26 currencies) – As of Oct 3, 2022

This latest surge was ignited by the U.S. Federal Reserve. While the FOMC September 21 interest rate decision aligned with expectations of 75 basis points hike in the fed funds rate, the medium-term guidance and ‘dot plot’ revealed a plan to take rates into more decisively restrictive territory – chart.

U.S.: FOMC reveals a more aggressive dot plot
Current target range: 3.00%-3.25% (grey area)

It is therefore not surprising that money supply growth has fallen sharply in recent months to a level that historically has not been considered inflationary – chart.

U.S.: Money supply growth has normalized
M2 vs. all-items CPI

Importantly, the Fed is also trying to flag that monetary policy will need to remain in overtly restrictive territory for longer. As our rate strategist says, “there appears to be willingness to tolerate meaningful economic pain if that’s what it takes to wrestle prices under control. It’s tough talk, backed up by aggressive policy rate hikes”.

Of course, faster and more serious inflation relief, should it come, could alter the FOMC’s tightening campaign. Most central banks continue to send the message that it takes more than a year to feel the economic impact of an interest rate hike and that only then will inflation decline. We believe that the impact will be felt much sooner this time. Indeed, the synchronized fight against inflation means that interest rates are rising worldwide. If central banks drain the global liquidity pool at the same time, the water level will surely fall faster. The dramatic tightening of the U.S. financial conditions index – which combines the effect of interest rates, the exchange rate, equity valuations and credit spreads – is a case in point. By our calculations, there is no recent precedent for the rate at which liquidity is being drained from the U.S. economy – chart.
San Francisco Fed, supply constraints add about 3 percentage points to annual PCE inflation – chart.

**U.S.: Supply constraints adding 3pp to PCE inflation**
PCE deflator, y/y variation

But these constraints now seem to be disappearing fast as demand fades, global transportation costs plunge, and Chinese production gets back on track. These developments are beginning to make themselves felt in the U.S. manufacturing sector, with the ISM supplier delivery times sub-index at its lowest level since before the pandemic and input prices registering their smallest progression since June 2020 – chart. This will soon translate into much weaker goods inflation. Service inflation, for its part, would not be immune to a marked slowdown in the job market. On this topic, the ISM report signaled a fourth decline in factory employment in the past five months, as unfilled orders fell to levels insufficient to justify bigger payrolls.

**U.S.: Supply chain constraints a thing of the past**
ISM Manufacturing PMI

If we are right on inflation, we'll get a quicker policy pivot than what FOMC members have contemplated or what financial markets are yet willing to discount. We believe that a less restrictive US monetary policy will pave the way for a weaker US dollar in 2023.

**CAD: A bad month for the loonie**

USD/CAD broke through its 1.32 resistance against the USD in September due to deteriorating global financial conditions and volatile energy prices. Despite being the second best performing G10 currency after the Swiss franc against the U.S. dollar so far in 2022, the loonie is hovering at levels not seen since the COVID recession – chart.

**USD/CAD: Breaking through its resistance**
Canada-U.S. exchange rate (as of Oct 4, 2022)

This performance is not due to a loss of confidence in the CAD by reserves managers. As we pointed out in a recent Market View, the Canadian dollar represents a larger share of foreign reserves in 2022. The problem is the FOMC's very hawkish stance which pushed U.S.-Canada short-term interest rate differentials from negative to the most positive in over three years – chart.

**CAD: Interest rate spread does not favour the loonie**
U.S.-Canada interest rate spread on 2-year Treasuries (as of Oct 4, 2022)
With inflation cooling faster in Canada than in the U.S. and the BoC unlikely to overtake the Fed in the coming months, as we expected, we do not see opportunities for a significant strengthening of the CAD against the USD until an FOMC pivot, which we expect in H1 2023.

Canada: The pace of inflation is slowing faster than in the US.

3-month change in headline CPI inflation

The path forward for the currency remains challenging to say the least. The BoE’s commitment to raise interest rates should hold but it will start facing worse economic data. While the intervention in the bond market helped avoid a complete blowout in long yields, the latter remain nearly double the level they were 2 months ago. This upwards shift is certainly going to be felt by households in the form of mortgage interest rates. Financing costs for home purchases are now the highest since 2010 based on a 5-year rate.

GBP & EUR: Challenging times

The United Kingdom briefly flirted with disaster in the last week of September. Was the island nation sinking? No, but its currency certainly was. The pound hit record lows against the USD following an announcement by the government of unfunded tax cuts. The latter combined with borrowing to fund new spending to cap energy prices were the metaphorical last straw that broke the camels back.

While the government has since backed down from its most egregious tax cuts, it remains that the past week agitated markets. The pullback in sterling was accompanied by an over 5 standard-deviation move in long bond yields. Indeed, 10y Gilts reached their highest level since 2008 which prompted intervention by the central bank. The interjection by the Bank of England to wrangle yields to a more reasonable level came at an already strenuous time. Headline inflation has failed to significantly moderate despite a temperance in oil prices. Core inflation for its part continued to surge on a monthly basis and brought the 12-month change to a multi–decade high.

If our vision of abating inflation and a slowing economy in the US holds true, there will be rate cuts by the Fed in the second half of 2023 and reduce the rate advantage favouring the greenback. In this situation, the Pound could see some appreciation at that time but will likely continue to be weak in the shorter term on the basis of tighter financial conditions. It remains that Sterling is currently trading far from its PPP level.
The situation in the Eurozone is far from being better. They are also contending with inflation and energy security. The coming winter will only exacerbate the natural gas component. The ECB is still behind the Fed in tightening and could be limited as the common currency area is postured for a recession.

The war in Ukraine no longer appears to be geographically limited. The Baltic Sea was the source of some action in the form of pipeline explosions. As a result of a series of ruptures, the Nordstream pipelines are offline and effectively mark the divorce of the energy relationship between Russia and Germany. The latter, among a slew of other European nations, has built up sizeable gas reserves for the upcoming winter. Those reserves will be crucial in the next few months, but likely means that Europe will enter next summer with very low storage levels. Moreover, rebuilding gas inventory for the following winter will be problematic and require alternative suppliers. Essentially, the longer-term outlook for the Eurozone is not particularly bright with these latest developments.

The aforementioned long-term challenges are unfortunately not supported by recent strength. Indeed, the eurozone marked a third consecutive month of contraction in private sector activity according to the Markit Flash PMI. These contractions are taking place in both manufacturing and services. We expect to see further deteriorations especially if energy rationing forces a slowdown in activity while high prices limit consumption.

Analysts are not comforted by the data on hand. The Zew survey of expectations which measures sentiment of nearly 350 economists/analysts is nearing a record low. The current level is consistent with a recessionary outlook.

When it rains, it pours for the European Central Bank. The economic situation is worsening during a stretch of elevated inflation. Bringing down prices by tightening policy at such a pivotal time is fraught with peril. Still, there is no denying that inflation is too high for the currency union. Headline prices crested to a new all-time high in September, registering at 10% year-over-year. Core inflation for its part registered at 4.8% over the last twelve months.
But there is little to be done about taming supply driven inflationary pressure. That will take an improvement on the geopolitical front, but the latest developments in the Baltic Sea have made that resolution next to impossible. Nonetheless, we expect the ECB to continue raising rates if only to signal their resolve to tame prices and help avoid further depreciation of the euro. After having spent most of September below parity, the central bank is likely concerned with import price inflation keeping prices stickier. We expect that the euro will remain weak until it becomes clear that the Fed will start easing on monetary policy. As such, euro could see some limited upside in the middle of 2023.
Appendix: Spot rates with their 200d MA

EUR / USD

USD / CAD

USD / JPY

AUD / USD

GBP / USD

USD / CNY
Forex
Economics and Strategy

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