**Highlights**

By Stéfane Marion/Kyle Dahms

- The trade-weighted U.S. dollar was back to a post-recession high against a basket of 26 currencies on September 2. The strength of the greenback is certainly no stranger to the Federal Reserve. Powell’s recent speech in Jackson Hole sets us up for a slightly higher federal funds rate than we had envisioned earlier this summer. For now, the most compelling argument for higher interest rates made by the Fed is the resilience of labor markets. We think things are about to change.

- The Canadian dollar remains the best performing G10 currency against the US dollar so far in 2022 but is still down 3.9% despite a better performing economy, a current account surplus, the best terms of trade on record and a hawkish central bank. Notwithstanding the upcoming slowdown, we still expect economic resilience to translate into a higher policy rate in Canada than in the US. Such a development remains conducive to CAD appreciation vs. the greenback.

- The pound flirted with all-time lows on September 1st, ending 4 tenths away from the pandemic trough. The island nation is composing with a multitude of challenges ranging from inflation to political change. The economic outlook has deteriorated and will pose a navigational challenge for the Bank of England who need to rein in price pressures. The Euro for its part continues to hover around parity with the USD and could remain in this situation for some time as the European Central Bank appears committed to contain inflation with higher interest rates.

### NBF Currency Outlook

<table>
<thead>
<tr>
<th>Currency</th>
<th>September 9, 2022</th>
<th>Q3 2022</th>
<th>Q4 2022</th>
<th>Q1 2023</th>
<th>Q2 2023</th>
<th>ppp (1)</th>
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<tbody>
<tr>
<td><strong>Canadian Dollar</strong></td>
<td>(1.30)</td>
<td>(1.32)</td>
<td>(1.29)</td>
<td>(1.25)</td>
<td>(1.22)</td>
<td>(1.25)</td>
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<td><strong>United States Dollar</strong></td>
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<td>(0.76)</td>
<td>(0.78)</td>
<td>(0.80)</td>
<td>(0.82)</td>
<td>-</td>
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<tr>
<td><strong>Euro</strong></td>
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<td>(0.99)</td>
<td>(1.01)</td>
<td>(1.04)</td>
<td>(1.05)</td>
<td>(1.45)</td>
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<tr>
<td><strong>Japanese Yen</strong></td>
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<td>(142)</td>
<td>(140)</td>
<td>(132)</td>
<td>(128)</td>
<td>99</td>
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<tr>
<td><strong>Australian Dollar</strong></td>
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<tr>
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<td>(1.17)</td>
<td>(1.18)</td>
<td>(1.18)</td>
<td>(1.20)</td>
<td>1.48</td>
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<tr>
<td><strong>Chinese Yuan</strong></td>
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<td>(6.90)</td>
<td>(6.85)</td>
<td>(6.75)</td>
<td>(6.60)</td>
<td>4.2</td>
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<td><strong>Mexican Peso</strong></td>
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<td>(20.5)</td>
<td>(20.0)</td>
<td>(20.0)</td>
<td>(19.5)</td>
<td>9.7</td>
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<tr>
<td><strong>Broad United States Dollar (2)</strong></td>
<td>(124.0)</td>
<td>(125.1)</td>
<td>(122.9)</td>
<td>(120.3)</td>
<td>(117.8)</td>
<td>-</td>
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</table>

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

### Canadian Dollar Cross Currencies

<table>
<thead>
<tr>
<th>Currency</th>
<th>September 9, 2022</th>
<th>Q3 2022</th>
<th>Q4 2022</th>
<th>Q1 2023</th>
<th>Q2 2023</th>
</tr>
</thead>
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<tr>
<td><strong>Euro</strong></td>
<td>(1.31)</td>
<td>(1.31)</td>
<td>(1.30)</td>
<td>(1.30)</td>
<td>(1.28)</td>
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<tr>
<td><strong>Japanese Yen</strong></td>
<td>(110)</td>
<td>(108)</td>
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<tr>
<td><strong>Australian Dollar</strong></td>
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<td>(0.90)</td>
<td>(0.90)</td>
<td>(0.91)</td>
<td>(0.95)</td>
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<tr>
<td><strong>Pound Sterling</strong></td>
<td>(1.51)</td>
<td>(1.54)</td>
<td>(1.52)</td>
<td>(1.48)</td>
<td>(1.46)</td>
</tr>
<tr>
<td><strong>Chinese Yuan</strong></td>
<td>(5.29)</td>
<td>(5.23)</td>
<td>(5.31)</td>
<td>(5.40)</td>
<td>(5.41)</td>
</tr>
<tr>
<td><strong>Mexican Peso</strong></td>
<td>(15.2)</td>
<td>(15.5)</td>
<td>(15.5)</td>
<td>(16.0)</td>
<td>(16.0)</td>
</tr>
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USD: Fed ups the ante on rate hikes

The trade-weighted U.S. dollar was back to a post-recession high against a basket of 26 currencies on September 2. Versus the currencies of advanced economies, the greenback rose to a new record high – chart.

USD: A new post-recession high
Nominal broad-based U.S. dollar index (26 currencies)

The strength of the U.S. dollar is certainly no stranger to the Federal Reserve. On August 26, Jerome Powell referenced none other than Paul Volcker, who ran the Fed during the worst years of stagflation in the late 1970s and early 1980s, in his determination to bring inflation down during his Jackson Hole speech. Powell was about as hawkish as you can be as a central banker. This speech also sets us up for a slightly higher federal funds rate than we had envisioned earlier this summer, as yields on two-year U.S. Treasuries hit new post-COVID highs - chart.

For now, the most compelling argument for higher interest rates made by the Fed is the resilience of labor markets. While payroll employment has indeed surprised on the upside in recent months, the additional headcounts have been part-time. Full-time employment, meanwhile, has stagnated since the beginning of 2022 (chart).

U.S.: Full-time jobs are stalling
Full-time workers as per household employment survey

This suggests that companies may be on the verge of cutting back on hiring in the coming months. If we are right, the FOMC may soon recognize that the end of U.S. monetary tightening campaign is in sight, a development that could weaken the greenback.

An easing of China’s “zero COVID” policy would also help limit the appreciation of the U.S. currency. Beijing’s health policies pushed the diffusion index of manufacturing activity in the Middle Kingdom into negative territory in August, for the third time already in 2022. This is exacerbating Yuan depreciation – chart.

China: Covid policies negatively impact the currency
Chinese Yuan per USD

Chinese policymakers do not seem comfortable with the latest bout of weakness in their currency. On September 5, the People’s Bank of China said it would reduce the foreign exchange reserve requirement for commercial banks from 8 per cent to 6 per cent from September 15, in an attempt to support the country’s weakening currency. This is a step in the right direction to stabilize the Yuan, but the impact will not last without an easing of COVID restrictions.
CAD: Another current account surplus

The Canadian dollar remains the best performing G10 currency against the US dollar so far in 2022, but is still down 3.9% despite a better performing economy, a current account surplus, the best terms of trade on record and a hawkish central bank. Even then, 1.32 USDCAD is in danger of being breached following the latest GDP report—chart.

Even though Canadian real GDP growth surprised to the downside in Q2, it was still above potential at 3.3%. Final domestic demand also remained strong, rising at an annualized rate of 2.9%. The resilience of the Canadian economy in the first half of 2022 is impressive considering that U.S. GDP has already declined for two consecutive quarters. Canada’s performance was even more surprising in nominal terms, as the economy grew by 17.9% annualized as the terms of trade reached a record high. Despite the recent decline in the price of domestically produced commodities sold on world markets, Canadian producers continue to sell at historically high levels—chart.

Canada: Goods keeping current account positive

These high prices are benefitting Canada’s current account balance, which recorded a second consecutive surplus in the second quarter for the first time in 14 years. This improvement was entirely due to an improved trade surplus in goods. The trade deficit in services was the largest in two years—chart.

Canada: Bumper crop expected in 2022

The current account balance remains on track to end the year in surplus as we don’t foresee much downside for the price of energy and food. The impact of EU sanctions on Russian oil could indeed be a source of support for the Canadian sector. Also, unlike many other major food suppliers that have been hit by drought, Canada is set to enjoy a bumper crop in 2022 (chart).

Canada: Commodity prices remain very high

Record production combined with high prices could very well result in the largest trade surplus ever recorded for Canadian crop producers. In 2021, the surplus was $16 billion. This year’s surplus could easily double that amount.

External trade remains supportive for the currency, and so is the domestic economy. Real household disposable income remains above its pre-covid trend as the federal and
Economics and Strategy

Forex

provincial governments redistribute some of the huge 2022 personal and corporate tax windfall to consumers (chart). This mitigates the possibility of a deep deterioration in the consumer credit cycle on this side of the border and allows the Bank of Canada to maintain a tighter monetary policy stance. Notwithstanding the upcoming slowdown, we still expect economic resilience to translate into a higher policy rate in Canada than in the US. Such a development remains conducive to CAD appreciation vs. the greenback.

GBP: Turmoil on all fronts

The pound flirted with all-time lows on September 1st, ending 4 tenths away from the pandemic trough. The island nation is composing with a multitude of challenges ranging from inflation to political change. The economic outlook has deteriorated and will pose a navigational challenge for the Bank of England.

We need to back an entire year to find a time when cable was trading above its 200-day moving average. The recent deterioration comes on the back of a worsening outlook in the context of energy security and prices pressures. Gas prices have moderated to some extent but remain elevated on a historical basis and while the exposure to Russian gas is somewhat limited, the global nature of prices is offering little respite. The Bank of England expects inflation to remain elevated until the end of next year and are committed to restricting monetary policy to tame prices even if it leads to recession. The BoE meets this month (delayed due to the death of Queen Elizabeth) and it will be interesting to see how they frame the discussion, especially in the context of the arrival of Liz Truss as new PM on September 6. The latter has announced several fiscal measures, most notably a cap on energy bills which would be funded through 100 billion pounds in new borrowing. Although this should provide some relief on consumers and help reduce inflation, it does raise some questions on government finances. Especially with the rise in long-term Gilts.

As the country appears headed for a recession, there is limited possibility for appreciation unless the trade-weighted USD descends from its lofty levels.

EUR: Hoping for a heat wave this winter

A hot and dry summer have stressed watersheds on the European continent. Notably the river Rhine in Germany saw barges bottom out in several sections, impacting the flow of goods. It would be easy to forget current reversion of the river Po in Italy, a crucial source for agricultural use. French nuclear power plants on the Rhône and Garonne rivers saw production cut in August as heat-soaked rivers were unable to adequately cool. Forget not the Valdecanas reservoir, whose retreat has offered us a view of Spain’s own Stonehenge.

Unfortunately, extreme weather events in Europe are not the only headlines moving markets. Indeed, the war in Ukraine continues to rage with sanctions from Brussels being countered with pipeline shutdowns. Although gas prices have moderated a bit, the shutdown of Nordstream 1 is worrisome in the lead to the colder winter months. We find some respite with the Netherlands having hit its target of filling gas reserves to 80% two months ahead of schedule. Recall that EU nations have entered an agreement to reach this level by the 1st of November. Germany’s more aggressive schedule of 85% by October 1st has been reached but its 95% target by the 1st of November should prove to be more difficult due to dwindling supply from Russia. Although these reserves are not made to last a winter, they could help dampen supply shocks and provide time for new sources to come online.

The Euro for its part continues to hover around parity with the USD and could remain in this situation for some time. The common currency area is likely headed for negative growth as its economic situation deteriorates (chart).
Although some improvements have been made on the energy front as highlighted above, it cannot offset already high prices. Fortunately, the European Central Bank appears committed to contain inflation with higher interest rates, a development that could help stabilize EUR/USD. The ECB met on the 8th of September and announced an additional 75bps of tightening. Market expectations are for a terminal rate of around 2.4% by the middle of 2023. While not an impossible goal, the looming specter of slowing economic growth could limit hikes. The central bank did downwardly revise its 2023 growth forecast from 2.2% to 0.9%, however that might not be enough of a downgrade. There is no denying that the ECB would like to avoid the outcome reached in the last tightening cycle back in 2011 (chart).

Especially as expectations crater to their lowest level since 2011 (chart).

That said, the inflation picture is on a whole other planet compared to 2011. The latest figures for August show both headline and core inflation reaching new all-time highs (chart).

We see EUR/USD trading sideways in the coming months before moving higher on the back of trade-weighted USD weakness.
Appendix: Spot rates with their 200d MA
General

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