NATIONAL BANK OF CANADA
FINANCIAL MARKETS

February 2019

Highlights

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- A flat yield curve coupled with a near-neutral fed funds rate, restrains the ability of the Federal Reserve to tighten U.S. monetary policy much further. So, while the U.S. dollar could see occasional bouts of strength – e.g. coinciding with Fed signals or the return of risk aversion – we continue to expect a mostly downward trend over the forecast horizon for the trade-weighted greenback. Besides small tweaks to near term GBPUSD and USDCNY targets to reflect a stronger-than-expected start to 2019 for the British pound and the Chinese yuan, our currency forecasts are largely unchanged from last month.

- We continue to expect common sense to prevail among world leaders, enough to leave global trade flows largely unimpeded. Under this base case scenario, we see the euro appreciating against the greenback over the forecast horizon helped by USD weakness and expectations of yields improving in favour of the common currency.

- Amid a backdrop of decelerating domestic demand, there's arguably little need for an aggressive monetary policy stance from the Bank of Canada. That's not to say the Canadian dollar will necessarily struggle this year. The influence of Canada-U.S. interest rate spreads on the loonie is waning, in sharp contrast with oil which is now reasserting itself as the main driver of the Canadian currency. If we're right about further increases for WTI oil and unimpeded global trade flows, USDCAD could move closer to our mid-year target of 1.27.

NBF Currency Outlook*

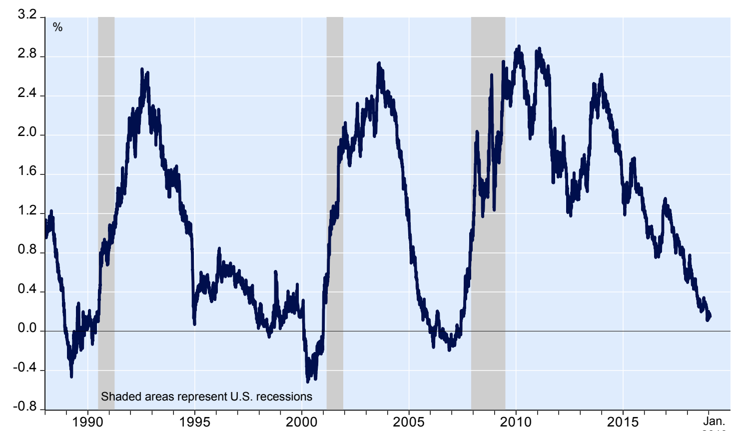
	Current 1-Feb-19	2019Q1	2019Q2	2019Q3	2019Q4	2020Q1
USDCAD	1.31	1.30	1.27	1.27	1.28	1.30
US cents per CAD	0.77	0.77	0.79	0.79	0.78	0.77
EURUSD	1.15	1.15	1.19	1.22	1.23	1.21
USDJPY	109	111	114	115	113	112
AUDUSD	0.73	0.74	0.77	0.77	0.76	0.75
GBPUSD	1.31	1.32	1.34	1.30	1.28	1.27
USDCNY	6.74	6.72	6.70	6.68	6.65	6.65
USDMXN	19.15	19.10	18.80	18.50	18.70	19.00

*Forecasts for end of period
NBF Economics and Strategy

USD weakness persists

The trade-weighted U.S. dollar started 2019 just like it ended last year, i.e. painfully. The return of risk, as evidenced by surging global stock markets in January, lifted most major currencies at the expense of the big dollar, the latter registering a third consecutive monthly decline in trade-weighted terms. Risk-on sentiment and resulting woes for the greenback are largely due to the Fed's more cautious tone. Concerning developments in the global economy and financial markets and their potentially negative implications for the U.S. economy have indeed convinced the Fed to adopt a less aggressive path to policy normalization. But domestic issues, particularly the potential for an already flat U.S. yield curve to invert, likely also played a part in the Fed's change of stance.

U.S.: Flattest yield curve in years restricts Fed's ability to tighten policy
Yield difference between 10-yr and 2-yr Treasuries



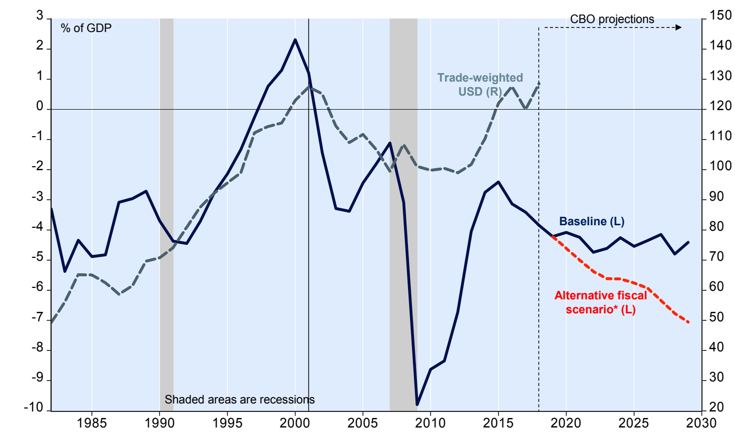
NBF Economics and Strategy (data via Refinitiv)

In January, while it left the fed funds rate unchanged at 2.25-2.50%, the Fed made a significant change to its statement by removing the sentence about the need for further gradual rate increases. Instead, the Fed now says "the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes." The reference to "future adjustments" suggests the Fed may consider not just rate hikes but also rate cuts should the economy need it.

The economy seems to be slowing down in the current quarter, i.e. Q1. True, employment remained strong in January – +304K according to the establishment survey and +237K according to the household survey after removing "population effects". But temporary help, a good leading indicator, was stagnant again while wage inflation fell to 3.2%. Moreover, the services sector, which accounts for about 70% of the U.S. economy, seems to be moving down a gear based on Markit's purchasing managers index which sank to a four-month low in January.

The greenback seems constrained over the near term by a cautious Fed, but the currency's longer term prospects are not rosy either. If current laws governing spending and taxes remain unchanged, the Congressional Budget Office (CBO) projects the budget deficit will rise to 4.7% of GDP by 2022, even assuming no recession. Even small deviations from current laws — e.g. delaying/cancelling spending cuts that are scheduled for 2020 or extending the expensing of investment — would lead to much larger budget deficits. Such an alternative fiscal scenario could yield a budget deficit near 7% of GDP by 2029, again assuming no recession. In other words, the deficit as a % of GDP could easily be in double digits if there's another economic downturn within the next decade. Such fiscal red ink may eventually put off foreign investors and hurt the U.S. dollar in the process.

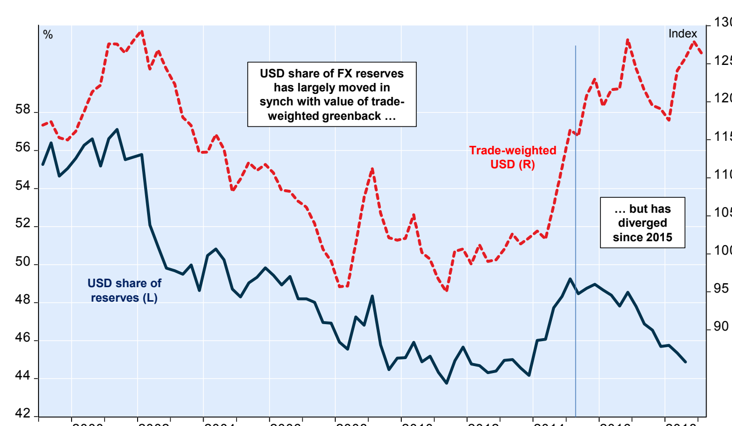
U.S.: No end in sight to fiscal red ink
Budget balance versus Trade-weighted U.S. dollar



* Allowing discretionary funding to grow with inflation beginning in 2020, extending several expiring tax provisions (namely, certain provisions of the 2017 tax act, expensing of certain investments at a 100% rate, and more than 20 other expiring revenue provisions, including trade preference programs), and repealing certain postponed health taxes
NBF Economics and Strategy (data via Congressional Budget Office)

Currency reserve managers around the world, including central banks, seem to have come to a similar conclusion. The IMF's World Currency Composition of Official Foreign Exchange Reserves indeed shows a declining share of allocated U.S. dollar reserves in total currency reserves. Such a trend of diversification by reserve managers is unlikely to end soon given fiscal indiscipline in the U.S. and the growing clout of emerging economies such as China and hence higher demand for their currencies. All told, while the USD could see occasional bouts of strength – e.g. coinciding with Fed signals or the return of risk aversion – , we continue to expect a mostly downward trend over the forecast horizon.

World: U.S. dollar's share of FX reserves on the decline
Trade-weighted USD versus Share of allocated U.S. dollar reserves in total currency reserves

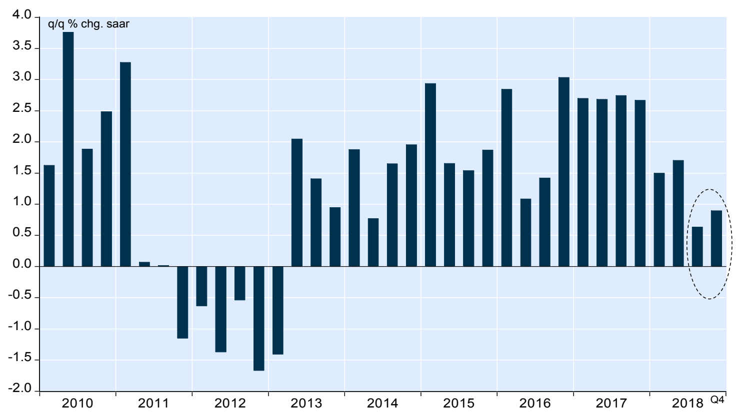


NBF Economics and Strategy (data via Federal Reserve, IMF's World Currency Composition of Official Foreign Exchange Reserves)

Slowing Eurozone hits euro

The euro managed to hold its ground against the USD in January despite ugly economic data that confirmed an economic slowdown. True, the common currency area grew a decent 1.8% last year. But the second semester, which saw real GDP grow less than 1% annualized, was the worst in five years.

Eurozone: Sharp deceleration in the second half last year
Real GDP



NBF Economics and Strategy (data via Eurostat)

The European Central Bank decided to keep monetary policy unchanged in January but acknowledged that risks to the eurozone economy have moved to the downside. In other words, downward revisions to the ECB's 2019 forecasts are likely at its March meeting when updated projections for the eurozone's GDP and inflation will be presented. Does that mean Quantitative Easing, which ended in December last year, will make a comeback? It's unclear what QE could contribute given financial markets are functioning well, as evidenced by healthy growth for credit to non-financial corporations and households. It's possible, however, that the ECB tweaks the forward guidance to push further out the timeline for rate normalization. The common currency could struggle as a result.

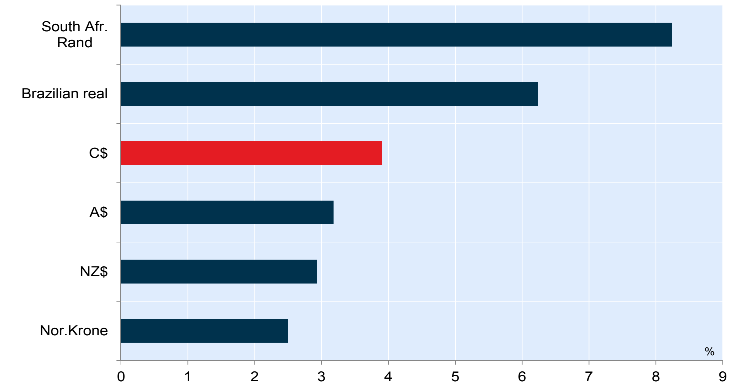
Another risk for the euro is the potential for further distruptions to trade flows. Last year's deceleration of global trade and ensuing moderation in the eurozone's economic growth highlights the common currency's vulnerability. A "hard" Brexit on March 29th, whereby the UK leaves the single market and the customs union, cannot be ruled out amid an apparent paralysis of UK leadership. Our base case scenario is one of a "soft" Brexit and hence minimal interruptions to trade flows, something that could still happen either via a new UK elections or another referendum. But if hardline Brexiteer politicians get their way in the UK parliament, one can expect both the British pound and euro to lose ground against the USD. And already reeling from American tariffs on steel and aluminum, the eurozone and its currency would also struggle should the Trump Administration make use of section 232 of the U.S. Trade Expansion Act to impose tariffs on auto imports on grounds of national security.

We continue to expect common sense will prevail among world leaders, enough to leave global trade flows largely unimpeded. Under this base case scenario, we see the euro appreciating against the greenback over the forecast horizon helped by USD weakness and expectations of yields improving in favour of the common currency given that the U.S. fed funds rate is already close to neutral.

Flying start to 2019 for loonie

After a rough 2018, the Canadian dollar is bouncing back nicely. The loonie advanced almost 4% against the USD in January, outperforming several other commodity currencies such as the Norwegian Krone, Australian dollar and New Zealand dollar.

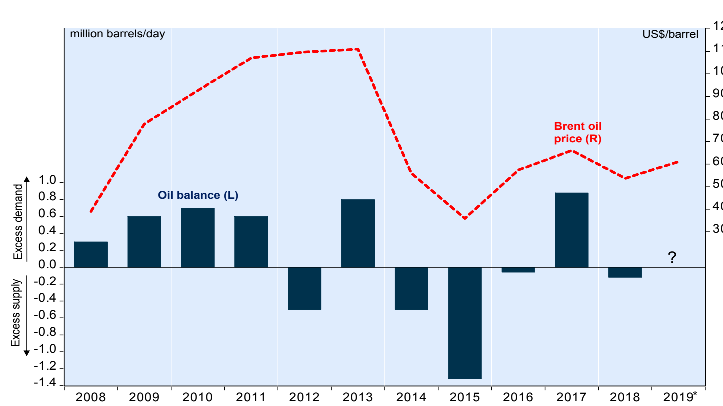
Commodity currencies enjoyed a good start to 2019
Gains versus USD in January



NBF Economics and Strategy (data via Bloomberg)

The major driver of the loonie was, not surprisingly, oil. The price of WTI indeed jumped 18% in January to close the month at US$54/barrel. Despite those massive gains, oil's run may not be over just yet. Recall that Saudi Arabia is delivering on last December's pledge (with Russia) to cut oil production. Latest data from OPEC indeed shows Saudi output falling from a record 11 million barrels per day to just 10.6 million barrels per day in December. This 4% monthly decline was complemented by a 5.4% cut in sanction-hit Iran. And with further OPEC production cuts in the cards, excess supply in the global oil market may soon be absorbed. The oil market is so close to balance that a larger-than-expected decline in supply (e.g. unscheduled disruptions to production due to political and economic chaos in places such as Venezuela) or larger-than-expected increase in demand (e.g. global GDP growth surprises on the upside) could be enough to return it to an excess demand situation, boosting global oil prices in the process.

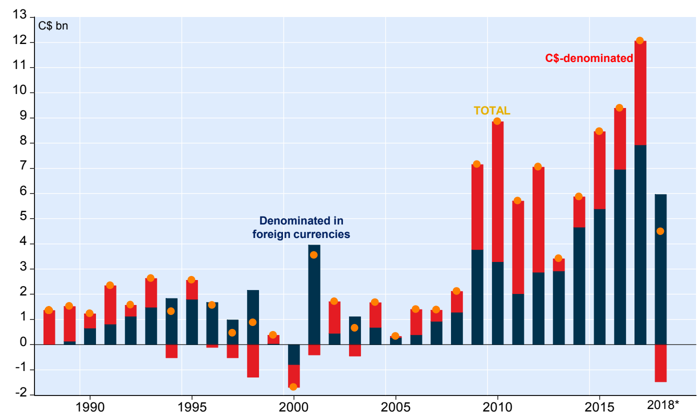
World: Has excess oil supply been absorbed already?
Oil balance versus Brent oil price



* 2019 shows latest price for Brent oil
NBF Economics and Strategy (data via OPEC, Bloomberg)

Another channel through which the loonie could benefit this year is through capital inflows. Prior uncertainties may have been responsible for last year's weakness in foreign purchases of Canadian securities. The roughly C$88 bn worth of net foreign purchases from January to November is the weakest 11-month inflow since 2013, with weakness in equities but primarily in bonds – foreigners were net sellers of C$-denominated bonds for the first time since 2003. But with a better outlook for the Canadian dollar (amid USD weakness) and possibly less uncertainty with regards to trade (once the USMCA is ratified by the U.S. Congress), foreign investors may find Canadian assets a bit more attractive.

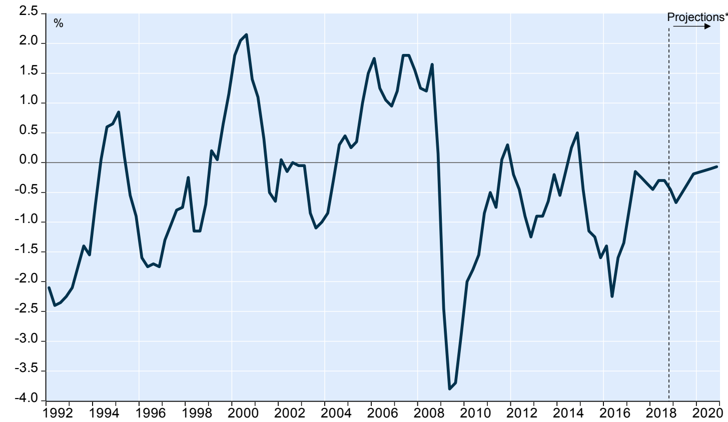
Canada: Foreigners ditched C$-denominated bonds last year
Net international purchases of Canadian bonds, monthly average



** 2018 is based on January-November average*
NBF Economics and Strategy (data via Statistics Canada)

The USMCA deal and trade in general are indeed crucial for Canada's economic prospects in light of an expected moderation in domestic demand. Consumption spending is already struggling amid a heavy household debt load and fading housing wealth effects (see February edition of the *Monthly Economic Monitor*). With such a backdrop, there's arguably little need for an aggressive monetary policy stance from the Bank of Canada. The central bank signalled just that in January's Monetary Policy Report, downgrading its 2019 forecast for Canadian GDP growth. And with the central bank's projected growth forecast over 2019-2020 averaging close to the estimated potential of 1.8%, the output gap is set to remain open for several quarters. In other words, Canada-U.S. interest rate spreads are unlikely to improve all that much in 2019.

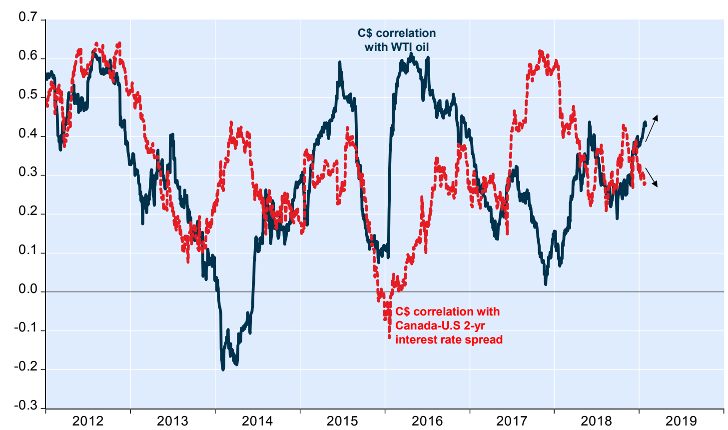
Canada: Output gap likely to remain open for several quarters
Bank of Canada's estimate of the output gap (average of Integrated framework and Extended multivariate filter)



* Projections based on BoC's GDP growth forecasts and Potential GDP growth of 1.8% over forecast horizon
NBF Economics and Strategy (data via Bank of Canada)

That's not to say the Canadian dollar will necessarily struggle this year. The influence of Canada-U.S. interest rate spreads on the loonie is waning, in sharp contrast with oil which is now reasserting itself as the main driver of the Canadian currency. If we're right about further increases for WTI oil and unimpeded global trade flows, USDCAD could move closer to our mid-year target of 1.27.

Canada: Oil is now the main driver of loonie
100-day correlation between changes in C$ (versus USD), WTI oil, and Canada-U.S. 2-yr interest rate spread



NBF Economics and Strategy (data via Refinitiv)

Annex

Euro

Canadian dollar

Japanese yen

Australian dollar

British pound

Chinese yuan

Canadian Dollar*						
	Current 1-Feb-19	2019Q1	2019Q2	2019Q3	2019Q4	2020Q1
USDCAD	1.31	1.30	1.27	1.27	1.28	1.30
EURCAD	1.50	1.49	1.51	1.54	1.58	1.57
CADJPY	83	85	90	91	88	86
AUDCAD	0.95	0.96	0.97	0.97	0.97	0.97
GBPCAD	1.71	1.71	1.70	1.65	1.64	1.65
CADCNY	5.16	5.17	5.29	5.28	5.19	5.12
CADMXN	14.65	14.71	14.85	14.62	14.59	14.63

*Forecasts for end of period
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