November 2017

# Feeding the beast

- The U.S. economy is doing well enough to prompt the Federal Reserve to consider further tightening of monetary policy. A December rate hike is in the cards, assuming of course the extension of positive data and no bad surprises with regards to negotiations surrounding the debt ceiling. Governor Jerome Powell, who will be leading the Fed as from February 2018, is likely to continue gradual normalization of monetary policy. That equates to further interest rate hikes, more so if fiscal stimulus is deployed. And since markets are not yet pricing those hikes, the USD could do well next year.

- The euro struggled in October as the European Central Bank opted to extend its asset purchase program by at least another 12 months. While the zone's economy is revving up, inflation remains well below target. We remain concerned about Brexit-related headwinds and the potential of Italy's 2018 elections to fracture the eurozone. As such, we do not see a lot of upside for EURUSD from current levels over the forecast horizon.

- The Canadian dollar saw its biggest monthly dive of the year in October despite rallying oil prices. Interest rate spreads with the U.S. have become unfavourable for the loonie courtesy of a dovish sounding Bank of Canada. The central bank now says the economy is more sensitive to interest rates and hence it will have to go slow on rate hikes going forward. That's a bit like saying it will keep feeding the beast it created after years of ultra-loose policy — overleveraging and housing taking a disproportionate share of the economy — for fear of being bitten. While we have pushed to early 2018 the timing for when we expect the next interest rate increase (in response to the central bank's expressed reluctance to tighten policy), we still think the BoC will be forced by strong data to deliver more rate hikes in 2018 than what markets are currently expecting. If we're right, then expect the Canadian dollar to make a comeback early next year.

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## NBF Currency Outlook*

| | Current *2-Nov-17* | 2017Q4 | 2018Q1 | 2018Q2 | 2018Q3 | 2018Q4 |
|---|---|---|---|---|---|---|
| USDCAD | 1.28 | 1.27 | 1.25 | 1.26 | 1.28 | 1.32 |
| *US cents per CAD* | *0.78* | 0.79 | 0.80 | 0.80 | 0.78 | 0.76 |
| EURUSD | 1.17 | 1.16 | 1.18 | 1.17 | 1.14 | 1.12 |
| USDJPY | 114 | 115 | 114 | 112 | 110 | 108 |
| AUDUSD | 0.77 | 0.78 | 0.79 | 0.77 | 0.75 | 0.74 |
| GBPUSD | 1.31 | 1.30 | 1.32 | 1.27 | 1.23 | 1.20 |
| USDCNY | 6.61 | 6.60 | 6.58 | 6.57 | 6.56 | 6.55 |
| USDMXN | 18.98 | 18.90 | 18.70 | 19.10 | 19.50 | 19.70 |

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

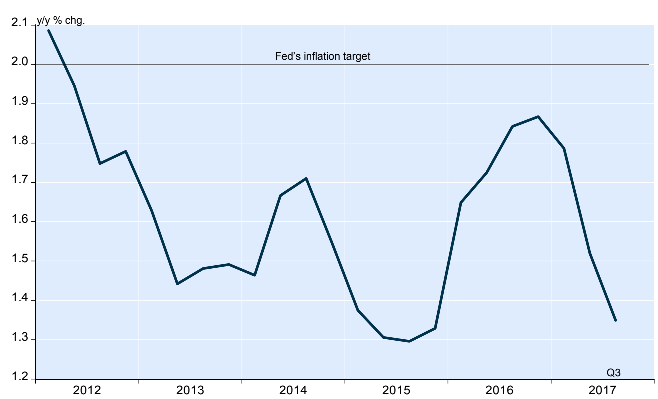
NATIONAL BANK OF CANADA FINANCIAL MARKETS

## Strengthening U.S. economy gives Fed licence to hike

The U.S. dollar jumped more than 1% in trade-weighted terms in October, its best performance so far in 2017. Solid U.S. economic data, including GDP which grew 3% annualized in Q3 for a second consecutive quarter, had markets almost fully price a December Fed interest rate hike. The world's largest economy is on track to grow about 2.2% this year and accelerate further in 2018 assuming the debt-ceiling is raised come December and fiscal stimulus is deployed ahead of mid-term Congressional elections. The labour market also remains hot this year as evidenced by the 170K net new jobs created per month on average over the January to October period.

At its meeting in November, the Fed acknowledged the lack of inflation. But it pointed to economic activity rising "at a solid rate" and expressed confidence it will hit its inflation target "over the medium term".

**U.S.: Inflation remains mild**
Core PCE deflator



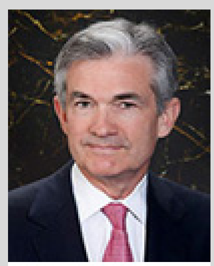

NBF Economics and Strategy (data via Datastream)

Given its track record, we are skeptical about the Fed's ability to deliver inflation and the three interest rate hikes it expects in 2018. But we view the market's expectation of just one additional interest rate increase in 2018 (after this December's hike) as being too low in light of an improving economic outlook.

Governor Jerome Powell, who will be leading the Fed as from February 2018 (see box), is likely to continue gradual normalization of monetary policy. That equates to further interest rate hikes, more so if fiscal stimulus is deployed. And since markets are not pricing those hikes, the USD could do well next year. Another positive for the USD is the current level of speculative positions. If as we expect current shorts are reversed, the dollar's ascent will be amplified.

**Speculators are shorting the USD**
Non-commercial net long positions on the USD


NBF Economics and Strategy (data via Bloomberg)



Picture from Federal Reserve

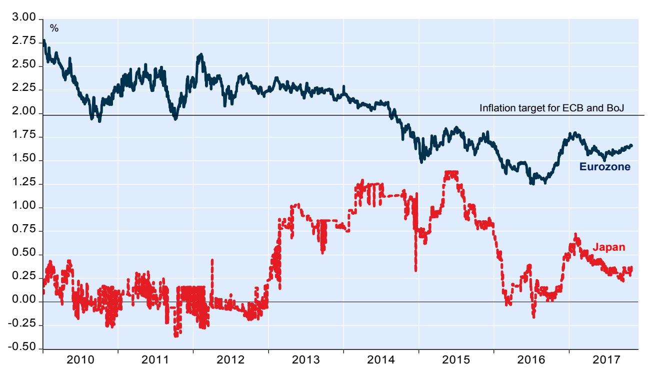
**Jerome Powell** has been nominated as the next Chair of the Federal Reserve. While Governor Powell is not an economist — he has a law degree from Georgetown — he has plenty of experience in financial markets (having worked at the Treasury department and in private equity) and more importantly in monetary policy, having been a voting member of the FOMC since 2012. He is currently Chairman of five of the Fed's eight committees including Supervision and Regulation, Smaller Regional and Community Banking, and Payments, Clearing, and Settlement. Like current Fed Chair Janet Yellen, Governor Powell embraces a gradual approach to normalization of policy and hence is unlikely to spark a major change in the Fed's policy stance. He has always voted with Chair Yellen and the majority on the FOMC. As far as regulations are concerned, Governor Powell is perceived as being open to adjustments to legislation, something that no doubt played in his favour with a White House intent in cutting red tape. Markets will likely welcome this appointment because it represents continuity. Confirmation is expected to be smooth considering the Republican majority in the Senate is unlikely to vote down the choice of a Republican President. Even some Senate Democrats may join their Republican counterparts in confirming Governor Powell who, many will recall, was first nominated to the FOMC by President Obama in 2012. Governor Powell is expected to become Chair of the Board of Governors of the Federal Reserve System in February 2018 when current Chair Yellen's term expires.

# Forex

## Euro hammered by QE extension

The euro, which depreciated for the second consecutive month in October, could continue to struggle amidst USD strength. The European Central Bank's loose policies are unlikely to help. Recall that, despite an improving economy, the ECB decided in October to extend its asset purchase program to at least September next year, although the amount purchased every month will be cut in half to €30 bn as from January 2018. The ECB made clear that in light of the lack of inflation — the annual core inflation rate fell to just 0.9% in October — "an ample degree of monetary stimulus remains necessary". The central bank may be concerned about inflation expectations getting dis-anchored if inflation remains below target for much longer.

**Some central banks are still struggling to push up inflation expectations**
Inflation expectations in 5 years for the next five years




NBF Economics and Strategy (data via Bloomberg)

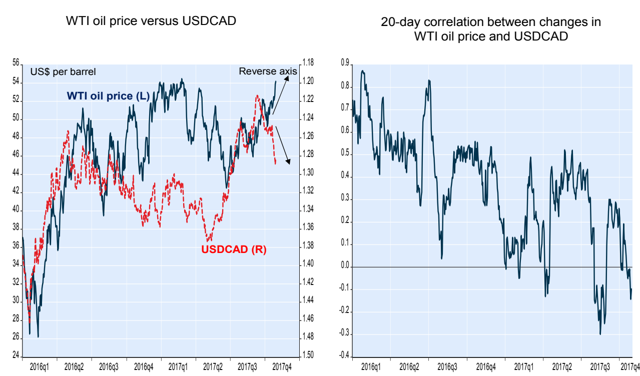
Also at the back of the ECB's mind are uncertainties including geopolitical ones which could derail economic growth and make it even harder to hit its 2% inflation target. Italy's elections next year, which could hand over power to an anti-EU populist party, present an existential risk for the eurozone, while Brexit could produce major headwinds for the Eurozone via EU-UK trade linkages. So, while the zone's economy is on the right track, the ECB is likely to remain patient. As such, we do not see a lot of upside for EURUSD from current levels over the forecast horizon.

The Bank of Japan is in a similar bind with above-potential economic growth but low inflation and the risk of inflation expectations dis-anchoring. In October, the BoJ left monetary policy unchanged and reaffirmed its commitment to its *Quantitative and Qualitative Monetary Easing with Yield Curve Control* for as long as necessary to achieve its 2% inflation target in a sustainable way. It's unclear if Prime Minister Shinzo Abe, fresh from a decisive election win, will reshuffle the ranks at the BoJ. But with loose monetary policy being an essential plank of Abenomics, we doubt there will be much change to the BoJ's policies. As such, the yen should remain under pressure from unfavourable yield differentials and carry trades, until of course risk-off makes an unwelcome return to world financial markets.

## Bank of Canada opts to feed the beast it created

Just looking at the surge in oil prices, one could have expected to see USDCAD near 1.20 or stronger. But instead, the cross is now flirting with 1.30, having depreciated more than 2.5% in October, the worst monthly performance this year. So much so that the loonie's correlation with oil has turned negative.

**Loonie cannot capitalize from oil surge**




NBF Economics and Strategy (data via Datastream)

As it turns out, the positive impacts of the oil price increase were dwarfed by a sharp move in interest rate spreads with the U.S. Stronger data boosted U.S. yields, while Canadian yields were hammered by the Bank of Canada's dovish message in October.

**Interest rate spreads do not favour Canadian dollar**
Two year government bond yields, Canada minus U.S.

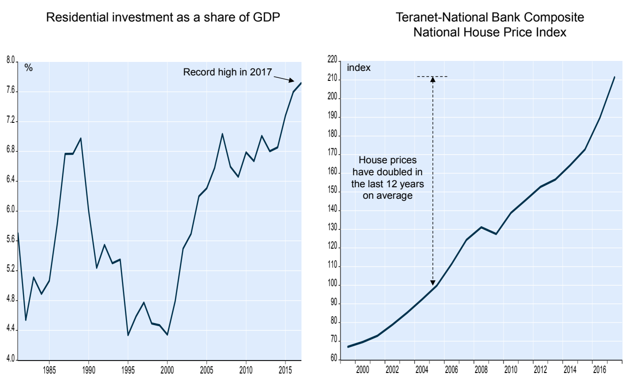

NBF Economics and Strategy (data via Datastream)

# Forex

In its latest *Monetary Policy Report* the central bank raised its GDP growth forecasts and admitted the economy is at capacity. But it refrained from tightening monetary policy, saying the economy is now more sensitive to interest rates and hence it will have to go slow on rate hikes going forward.

Years of loose policy from the central bank have led to the creation of a beast. Low interest rates for too long have encouraged overleveraging and inflated the housing market. Houses prices have doubled in the last 12 years (on a national average basis) while residential investment now accounts for a record 7.7% of GDP. And rather than face the consequences of dealing with the problem it created, the Bank of Canada is seemingly opting to feed the beast further.

**Canada: Housing share of the economy at all-time high**




NBF Economics and Strategy (data via Statistics Canada, Teranet-National Bank)

While additional regulations on housing proposed by the Office of the Superintendent of Financial Institutions should help curtail over exuberance in the housing market — e.g. higher qualifying rates for uninsured residential mortgages —, they do nothing to curb consumer credit. As such, the household debt burden and the lack of incentives to reduce it, remain major risks to long term financial stability.

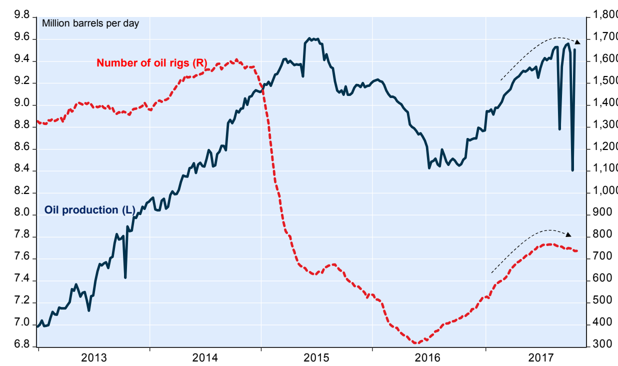
With the economy now seemingly operating at capacity, inflation pressures are building. Thanks to a hot labour market — which created an average of 26K jobs/month so far this year, the best performance over January-October in a decade —, wages and salaries are growing at the fastest pace in years and it's a matter of time before that translates to a higher annual core inflation rate. And that's even *before* considering the impact on inflation of upcoming minimum wage hikes in Ontario and Alberta.

## Better prospects for oil

Could oil lift the Canadian dollar? Yes, if the impacts of monetary policy stops dominating and normal oil-loonie correlation resumes. We have long been skeptical about the ability of OPEC to reduce the supply glut amidst the U.S. shale production surge. But the latter now seems to be flattening out, in synch with a peak in the number of rigs. That, coupled with improving world demand, explains the recent uptick in oil prices. But there's a limit to how much prices can increase before shale production which is largely profitable at prices above $45/barrel, resumes its upward trend and adds to supply. So while WTI should be above levels of recent years and be supportive of the Canadian dollar going forward, we expect it to remain below $60 for the foreseeable future.

**U.S.: Oil production seems to be flattening out**

Oil production versus Number of oil rigs




NBF Economics and Strategy (data via Energy Information Administration, Baker Hughes)

We question the Bank of Canada's 2018 Canadian GDP growth forecast of just 2.1% because it takes no account of provincial fiscal stimulus. As such, we expect upgrades to the BoC's growth forecasts in its upcoming *Monetary Policy Reports* after budget season. So, while we have pushed to early 2018 the timing for when we expect the next interest rate increase (in response to the central bank's expressed reluctance to tighten policy), we still think the BoC will be forced by strong data to deliver more rate hikes in 2018 than what markets are currently expecting. If we're right, then expect the Canadian dollar to make a comeback early next year.

# Forex

## Annex

Euro

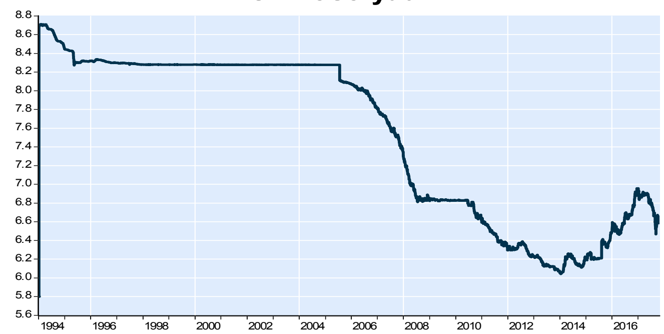
Canadian dollar

Japanese yen

Australian dollar

British pound

Chinese yuan



*NBF Economics and Strategy (data via Datastream)*

| Canadian dollar* | | | | | | |
|---|---|---|---|---|---|---|
| | Current 2-Nov-17 | 2017Q4 | 2018Q1 | 2018Q2 | 2018Q3 | 2018Q4 |
| USDCAD | 1.28 | 1.27 | 1.25 | 1.26 | 1.28 | 1.32 |
| EURCAD | 1.50 | 1.47 | 1.48 | 1.47 | 1.46 | 1.47 |
| CADJPY | 89 | 91 | 91 | 89 | 86 | 82 |
| AUDCAD | 0.99 | 0.99 | 0.99 | 0.97 | 0.96 | 0.97 |
| GBPCAD | 1.68 | 1.65 | 1.65 | 1.60 | 1.58 | 1.58 |
| CADCNY | 5.16 | 5.21 | 5.26 | 5.22 | 5.12 | 4.98 |
| CADMXN | 14.80 | 14.93 | 14.96 | 15.18 | 15.21 | 14.97 |

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

# Forex

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