NATIONAL BANK
FINANCIAL MARKETS
A division of National Bank of Canada

FOREX

Economics and Strategy

August 2017

Is the loonie's surge sustainable?

- In the last Forex, anticipating a change in stance from the Bank of Canada, we had brought forward to October the timing for when we expected an increase in the overnight rate. While right about the change in stance we were not aggressive enough about the timing. The central bank's decision to raise interest rates in July prompts us to lower our 2017 quarterly targets for USDCAD, i.e. stronger C$ than in our prior forecasts. The loonie's recent surge, however, warrants caution. While momentum could allow for further near term C$ gains, we expect a giveback afterwards as the USD makes a comeback with markets starting to price Fed rate hikes. We continue to expect USDCAD to remain in the 1.25-1.35 trading range over the next 12 months.

- Under pressure since the beginning of the year, the US dollar could find renewed strength later this year and in 2018 if, as we expect, the Fed surprises markets with rate hikes and balance sheet reduction.

- The euro's upside potential is limited in our view amidst Brexit, next year's Italian elections, and the European Central Bank's loose policies. While the ECB said interest rates will not be cut again, it made clear it stands ready to increase asset purchases if inflation continues to disappoint.

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NBF Currency Outlook*

	Current *14-Jul-17*	2017Q3	2017Q4	2018Q1	2018Q2	2018Q3	2018Q4
USDCAD	1.27	1.25	1.29	1.30	1.32	1.32	1.34
US cents per CAD	*0.79*	0.80	0.77	0.77	0.76	0.76	0.74
EURUSD	1.14	1.16	1.15	1.12	1.11	1.10	1.08
USDJPY	113	114	115	113	111	110	110
AUDUSD	0.78	0.80	0.78	0.78	0.77	0.76	0.74
GBPUSD	1.30	1.31	1.28	1.25	1.23	1.21	1.20
USDCNY	6.78	6.75	6.77	6.79	6.80	6.82	6.84
USDMXN	17.67	17.40	17.80	17.90	18.00	18.20	18.70

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

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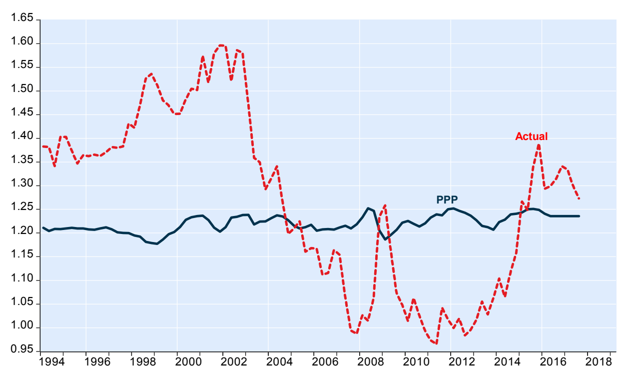
Bank of Canada lifts loonie …

The fortunes of the Canadian dollar have changed quite drastically since May. While USDCAD was lingering near 1.37 just a couple of months ago, it is now in position to test purchasing power parity (PPP) levels of 1.24.

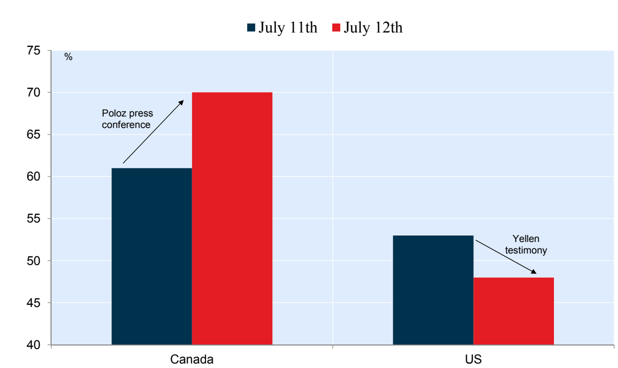
Loonie heads towards PPP
Canadian dollar: Actual versus PPP



NBF Economics and Strategy (data via Datastream)

A rapid change of policy stance from the Bank of Canada coupled with a dovish sounding Fed fueled the loonie's ascent. The central bank's decision to raise the overnight rate by 25 basis points in July to 0.75% (its first rate hike in 7 years) was backed by a more optimistic take on the economy. Indeed, the BoC raised its 2017 real GDP growth forecast for Canada from 2.6% to 2.8% — the central bank expects a solid follow-up to the strong first half — something it says will close the output gap by year end, two full quarters sooner than what it had estimated back in April.

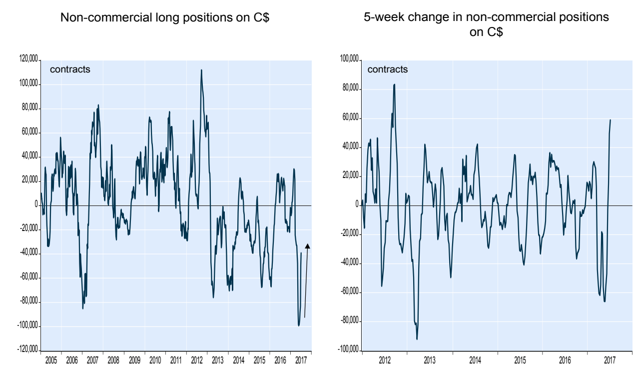
Double boost for the loonie
OIS probability that central bank policy rate by end-2017 is higher than 0.75% in Canada and 1.25% in the U.S.



NBF Economics and Strategy (data via Bloomberg)

More favourable yield differentials pushed up the loonie but so did speculators who chopped their short positions in half in just a few weeks. The last time we saw such a reversal in speculative short positions was back in 2012. Those factors allowed the loonie to gain altitude despite headwinds from depressed oil prices.

Speculators reduce C$ short positions

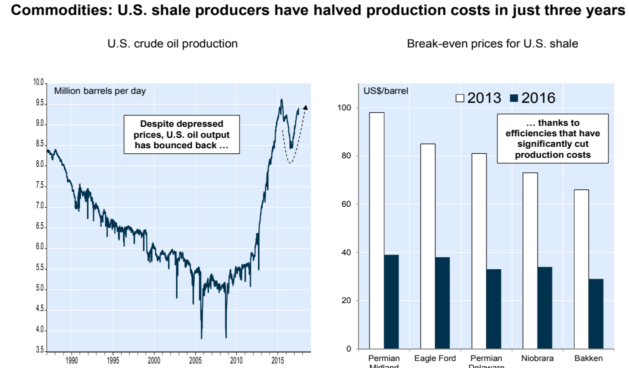


NBF Economics and Strategy (data via Bloomberg)

…offsetting dull outlook for oil

Indeed, saddled with a supply glut, the price of WTI oil remains below $50/barrel. Saudi Arabia's efforts to boost world oil prices via output cuts are not having the intended impacts because non-OPEC oil producers are offsetting those cuts with increased production of their own. U.S. oil output jumped to a 2-year high of 9.4 million barrels/day in July according to the Energy Information Administration. Shale production, which fell sharply in 2015/16 in the aftermath of the oil price slump, is now bouncing back. U.S. shale producers have been able to find efficiencies and cut their production costs in half in just three years, allowing them to be profitable even at currently low prices. Worse for the Saudis is their waning influence even within OPEC. The deterioration in relations between the Saudis and Qatar is unlikely to help. Iran, which made clear it will not participate in OPEC's output reductions, has pushed its output to a 9-year high. As such, we believe the oil supply glut is unlikely to be absorbed anytime soon.

Commodities: U.S. shale producers have halved production costs in just three years



NBF Economics and Strategy (data via EIA, World Bank)

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Can the C$ rise further?

But as we've seen in recent weeks, the persistence of soft oil prices does not preclude C$ appreciation. Momentum could allow for further near term C$ gains, more so if speculators continue to cut their short positions. But given the recent surge, we're now less upbeat about the loonie's longer term prospects.

Inflation remains stubbornly low and below the Bank of Canada's 2% target. The central bank said it is confident inflation will return to 2% in 2018, blaming currently low inflation on temporary factors and "the lag between monetary policy actions and future inflation". But it also acknowledged some risks to that forecast, saying that the slowdown in inflation of some advanced economies (including Canada) may be due to "common factors" such as downward trend in inflation expectations. That would be a motivation for being cautious with rate hikes.

So, while we wouldn't be surprised to see further C$ gains over the near term, we expect a giveback afterwards as the USD makes a comeback with markets starting to price Fed rate hikes. We continue to expect USDCAD to remain in the 1.25-1.35 trading range over the next 12 months.

Markets skeptical about Fed

For now, markets remain very skeptical the Fed can deliver the rate hikes it says it expects. Who can blame them, particularly after Fed Chair Yellen's recent testimony in front of Congress? While the Chair expressed confidence inflation will move back up to target, she admitted there were more than just temporary factors that are keeping inflation low. Chair Yellen also added that the fed funds rate would not have to rise very much to get to a neutral stance.

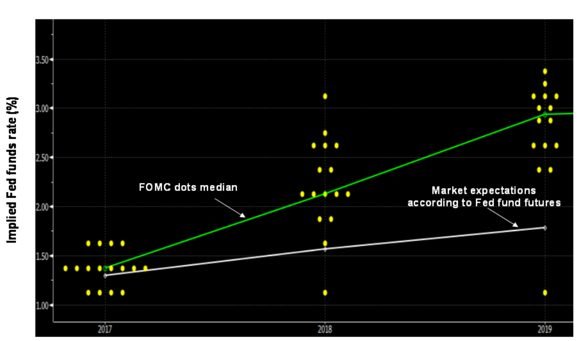
The Fed Chair reiterated that the FOMC planned to proceed with gradual interest rate increases in the coming years and is likely to start shrinking its $4.5 trillion balance sheet "relatively soon". But no decisions have been made regarding the sequencing of actions. Based on that statement, one could argue that the FOMC will announce the beginning of the reduction in the balance sheet before a next rate hike. If, as we expect, U.S. GDP growth picks up next year — courtesy of fiscal stimulus being dispatched before the 2018 mid-term elections — the Fed may surprise markets with a combination of rate hikes and balance sheet reduction. As such, the trade-weighted USD could bounce back next year.

Common currency struggles despite improving economy

The Eurozone had a better first half of 2017 than many (including us) expected. Growth has picked up and employment is now at all-time highs, having recovered all the ground lost during the recession. Economic sentiment is also the best in a decade. With all those tailwinds, why then is EURUSD stuck near 1.14?

Old problems may be restraining the common currency. Reforms have stalled and economic growth, while improving overall, is not broad-based, as evidenced by continuing struggles in southern Europe. Uncertainties with regards to Brexit and next year's elections in Italy — the latter's economic weakness puts incumbent Prime Minister Paolo Gentiloni at risk of falling to anti-EU populists — also cast a shadow over the eurozone. Persistently low inflation also cast doubts about the European Central Bank's abilities to withdraw policy stimulus. As such, we do not see a lot of upside for EURUSD from current levels over the forecast horizon, more so considering the massive amounts of speculative long positions on the common currency.

Markets do not believe the Fed can deliver significant rate hikes
FOMC member expectations versus Market expectations for Fed funds rate



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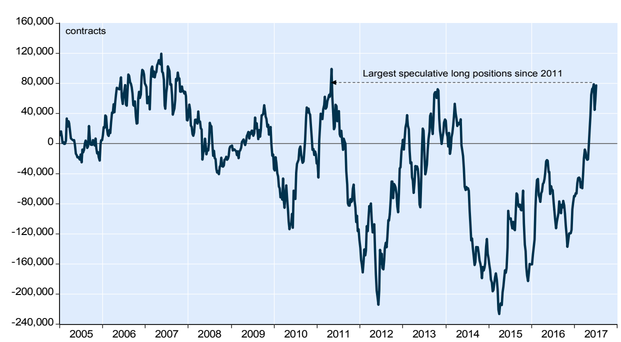
Euro inflated by speculators
Non-commercial long positions on the euro



NBF Economics and Strategy (data via Bloomberg)

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Annex

Euro

Canadian dollar

Japanese yen

Australian dollar

British pound

Chinese yuan

NBF Economics and Strategy (data via Datastream)

Canadian dollar*							
	Current 14-Jul-17	**2017Q3**	**2017Q4**	**2018Q1**	**2018Q2**	**2018Q3**	**2018Q4**
USDCAD	1.27	1.25	1.29	1.30	1.32	1.32	1.34
EURCAD	1.45	1.45	1.49	1.45	1.47	1.45	1.45
CADJPY	89	91	89	87	84	83	82
AUDCAD	0.99	1.00	1.01	1.01	1.02	1.00	0.99
GBPCAD	1.66	1.64	1.65	1.62	1.62	1.59	1.61
CADCNY	5.32	5.39	5.24	5.24	5.15	5.18	5.09
CADMXN	13.87	13.91	13.78	13.80	13.64	13.81	13.91

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

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