NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Forex

Economics and Strategy

January 2018

Can the USD bounce back in 2018?

- While the U.S. dollar could remain under pressure over the near term as risk-on sentiment persists, we continue to expect a rebound later in the year. Tighter policy by the Fed, particularly the shrinkage of its balance sheet, could cause investors to rebalance their portfolios globally and give rise to a period of risk-off in world financial markets, boosting safe haven flows towards the world's reserve currency. The tax holiday recently given to U.S. corporations repatriating foreign profits could also temporarily boost the greenback. Any USD appreciation could potentially be amplified as speculators rebuild long positions after last year's cull.

- After outperforming other major currencies in 2017, the euro could see a reversal of fortune this year. Italy's general elections in early March could rattle a European Union already reeling from Brexit. Anti-EU populists could potentially gain power in Italy by capitalizing on a soft economy and a marginalized youth population. And with persistently low inflation in the Eurozone, don't expect a major tightening of policy by the European Central Bank. As such, we do not see much upside for EURUSD from current levels over the forecast horizon.

- Buoyed by higher oil prices and market expectations of tighter monetary policy at home, the Canadian dollar has the wind in its sails. We have accordingly tweaked our near-term USDCAD forecasts to show the currency's strength persisting through Q2. But we're less optimistic about longer-term prospects for the loonie, anticipating headwinds generated by a resurgent USD, an eventual stabilization of oil prices, and the impact of higher mortgage rates.

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NBF Currency Outlook*

	Current *5-Jan-18*	2018Q1	2018Q2	2018Q3	2018Q4	2019Q1
USDCAD	1.24	1.22	1.21	1.24	1.28	1.30
US cents per CAD	*0.81*	0.82	0.83	0.81	0.78	0.77
EURUSD	1.20	1.18	1.18	1.15	1.14	1.12
USDJPY	113	114	115	111	109	108
AUDUSD	0.79	0.80	0.80	0.77	0.75	0.74
GBPUSD	1.36	1.32	1.27	1.23	1.21	1.20
USDCNY	6.49	6.48	6.46	6.44	6.42	6.40
USDMXN	19.18	19.00	19.20	19.80	20.50	20.90

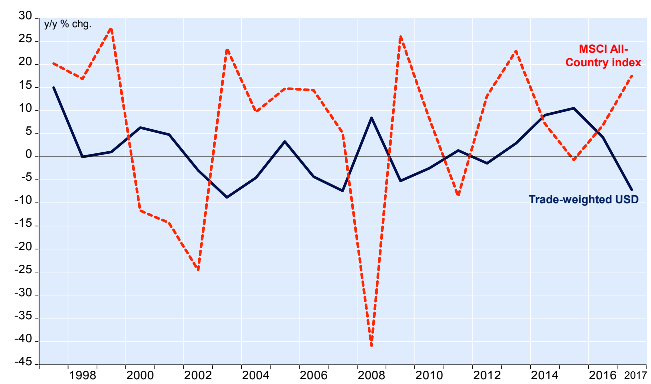
** forecasts for end of period*
Source: NBF Economics and Strategy

Forex

Can the USD bounce back?

It was a rough 2017 for the US dollar to say the least. The trade-weighted greenback depreciated more than 7%, the worst annual performance in 10 years. And that despite stronger economic growth in the U.S. and some monetary tightening by the Federal Reserve. Weighing on the USD last year was persistently low inflation which had markets question the Fed's ability to continue tightening monetary policy. The greenback's woes last year also coincided with surging stock markets worldwide, reinforcing the USD's historically negative correlation with the MSCI All-Country index.

Worst performance in a decade for USD
Trade-weighted USD



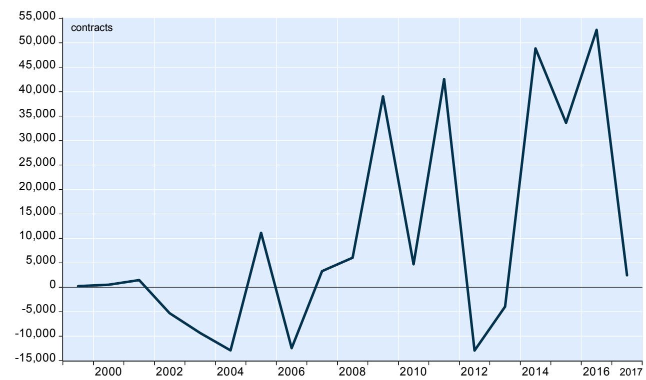
NBF Economics and Strategy (data via Datastream)

Could the greenback's fortunes change in 2018? That could certainly happen if the Fed, emboldened by a strengthening U.S. economy, delivers more than the two interest rate hikes that markets are currently expecting this year. Indeed, fundamentals are strong enough to allow above-potential U.S. growth for a second consecutive year. Consumers are poised to again be one of the major drivers of GDP growth, while improving profits should continue to fuel business investment and support the labour market. The Trump administration's fiscal stimulus will also assist growth somewhat.

The lack of inflation does not preclude monetary policy tightening. Recall that FOMC participants are expressing concerns about financial stability risks which could become a more pressing issue if asset prices including housing and the stock market add to already significant gains in 2018 and/or leveraging intensifies.

Also likely to influence the greenback this year is the Fed's balance sheet reduction. According to the IMF, the balance sheet shrinkage could cause investors to rebalance their portfolios globally and cut flows into emerging economies by as much as $55 billion over the next two years. The resulting uptick in emerging market bond yields could lead to concerns of default in places such as China. As such, one cannot rule out a period of risk-off in global financial markets, something that would boost the world's reserve currency. The tax holiday recently given to U.S. corporations repatriating foreign profits could also increase demand for the USD and hence lift the currency. Another positive for the greenback are speculative long positions on the currency which are the lowest in years. In other words, any USD appreciation could potentially be amplified as speculators rebuild long positions after last year's cull. So, while the USD could remain under pressure over the near term as risk-on sentiment persists, we continue to call for a rebound later on in the year.

Speculative long positions on the USD relatively low after last year's cull
Non-commercial long positions on the USD at the end of every year



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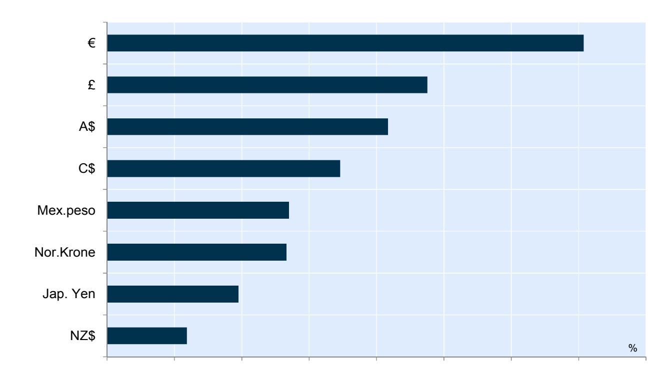
Italian elections could tame euro

The euro was the top performer among major currencies in 2017 appreciating more than 14% against the dollar. The common currency benefited from a much-improved Eurozone economy which saw GDP grow last year at the fastest pace in a decade and the jobless rate sink to an 8-year low. But a repeat of the euro's 2017 performance is unlikely in our view. GDP growth is likely to move back down towards potential making it harder for the European Central Bank to achieve its inflation target.

Euro outperformed other major currencies
Appreciation against USD in 2017



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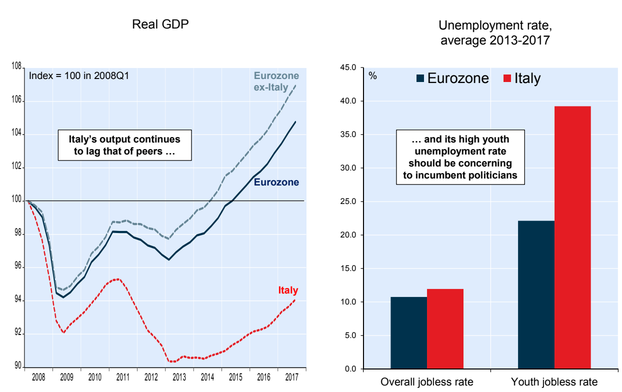
The zone's annual core inflation rate (excluding energy, food, alcohol and tobacco) has averaged roughly 1% over the last six years, i.e. well below the ECB's 2% target. The euro's appreciation has worsened the inflation outlook.

Also of concern to the ECB are geopolitical uncertainties which could derail growth. Italy's general elections in early March could rattle a European Union already reeling from Brexit. Indeed, anti-EU populists could potentially gain power by capitalizing on a soft economy and a marginalized youth population. In the last five years, the jobless rate for Italians under the age of 25 has averaged a shocking 39%, nearly double the eurozone's youth jobless rate. All told, ECB policy is likely to remain loose for a while and hence we do not see a lot of upside for EURUSD from current levels over the forecast horizon.

Eurozone: Could populists win Italy's 2018 elections?



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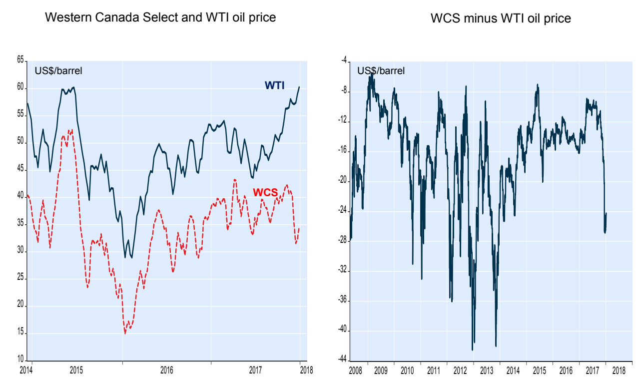
Loonie has momentum

It was not a Merry Christmas for Bank of Canada Governor Stephen Poloz who had to stay on the sidelines — no speeches or TV interviews during the holidays — and watch the Canadian dollar appreciate courtesy of rising oil prices. As such, the loonie's correlation with oil prices is now slowly returning to normal after a year in which the currency was driven largely by Canada-U.S. interest rate spreads and hence Bank of Canada messaging.

While the currency has reacted favourably to the WTI oil price increase, Canada is yet to fully benefit from the recent run up in world oil prices. That's because Western Canada Select prices have remained low, resulting in WTI-WCS differential of over $20/barrel, the highest in four years. As it turns out, the spill and shutdown of the Keystone pipeline slowed the flow of oil to the U.S., leading to an increase in inventories of Canadian oil as the pipeline was being repaired. So, this is a temporary setback for Canada and the WTI-WCS differential should return to more normal levels soon.

Canada not yet reaping benefit of rising oil prices

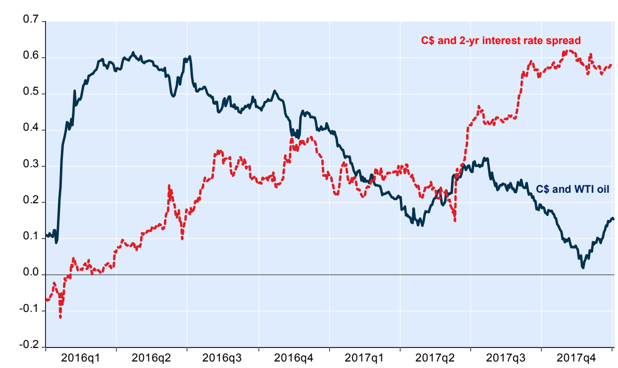


NBF Economics and Strategy (data via Bloomberg)

Regardless, the C$'s correlation with spreads remain stronger than with oil meaning that the loonie remains at the mercy of the Bank of Canada, at least over the near term.

Interest rate spreads driving the C$

100-day moving correlation for changes in C$ versus changes in WTI oil and Canada-U.S interest rate spread



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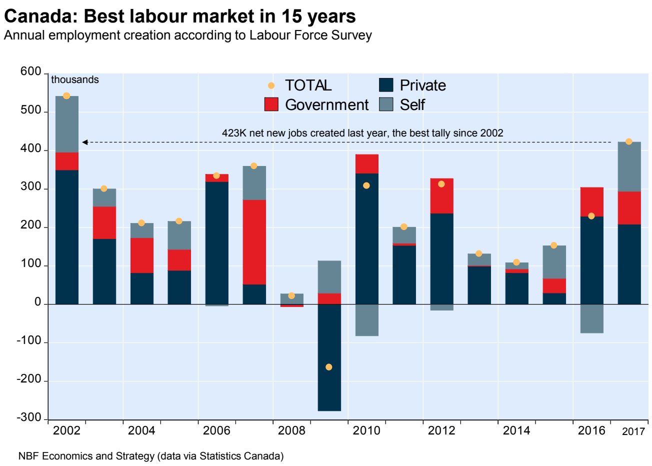
The central bank will spin its dovish message as long as it can, but we continue to think it will be forced by strong data to change its stance sooner rather than later. Indeed, after last year's stunning performance, the Canadian economy is now at capacity. The Bank of Canada's lack of urgency to normalize monetary policy has led to an unprecedented situation outside of a Canadian recession, i.e. a combination of a near-zero output gap and a negative real overnight rate. In other words, monetary policy is too loose given where we are in the economic cycle and that is increasing risks to financial stability via overleveraging and inflated asset prices. Moreover, wage growth and core inflation are on the rise, reflecting a solid labour market which created a massive 423K jobs last year (an average of 35 K/month), mostly in full-time occupations.



So, don't rule out the possibility of a change in stance at this month's Bank of Canada monetary policy meeting. The central bank could also raise its 2018 Canadian growth forecast in January's Monetary Policy Report to reflect fiscal stimulus which is currently not included in its forecasts. To be sure, government spending will ratchet up as pre-election handouts in Quebec and Ontario complement an expected uptick in infrastructure spending at the federal level. Last year's stronger-than-expected economic growth boosted public coffers, leaving federal and provincial governments with enhanced flexibility to increase outlays.

A change of stance from the Bank of Canada could help push USDCAD towards 1.20 over the near term. But we're less optimistic about longer-term prospects for the loonie, anticipating headwinds generated by a resurgent USD, an eventual stabilization of oil prices, and the impact of higher mortgage rates.

Forex

Annex

Euro

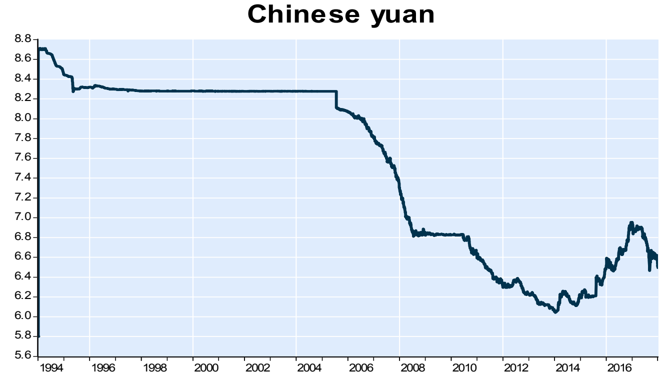
Canadian dollar

Japanese yen

Australian dollar

British pound

Chinese yuan



NBF Economics and Strategy (data via Datastream)

Canadian dollar*

	Current 5-Jan-18	2018Q1	2018Q2	2018Q3	2018Q4	2019Q1
USDCAD	1.24	1.22	1.21	1.24	1.28	1.30
EURCAD	1.50	1.44	1.43	1.43	1.46	1.45
CADJPY	91	93	95	89	85	83
AUDCAD	0.98	0.98	0.97	0.96	0.96	0.96
GBPCAD	1.68	1.61	1.54	1.53	1.55	1.56
CADCNY	5.22	5.31	5.33	5.18	5.01	4.93
CADMXN	15.44	15.58	15.84	15.94	15.99	16.09

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

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