

### Quick Hit – CAD: Yield differentials increasingly play bigger driving role

So much for commodities re-exerting themselves as the main driver of the Canadian dollar. Turns out the interest rate outlook matters after all. A decidedly more dovish BoC drove the yield differential between US and Canadian 2-year yields to the widest gap in more than a decade and sent the loonie sliding with it—after the report, the USDCAD pair immediately traded higher to the 1.3440 level. The central bank, amid a weaker domestic and global growth outlook, maintained its target for the overnight rate at 1.75%, but it was really the wording around *increased uncertainty* about the timing of future rate increases that sent the FX market into a frenzy as it caught up with the rate spread.

To us, yield differentials might just be the more consistently reliable driver of the loonie. This influence has been undeniable in recent months (and really days) as Canadian yields began to significantly rally compared to their US counterparts. A quick-and-dirty correlation analysis between changes in USDCAD and the US-Canada 2-year interest rate spread shows the rolling 20-day coefficient standing at a lofty 0.8 today—signaling the impact of the recent dovish tone by the BoC on the loonie (Chart 1).

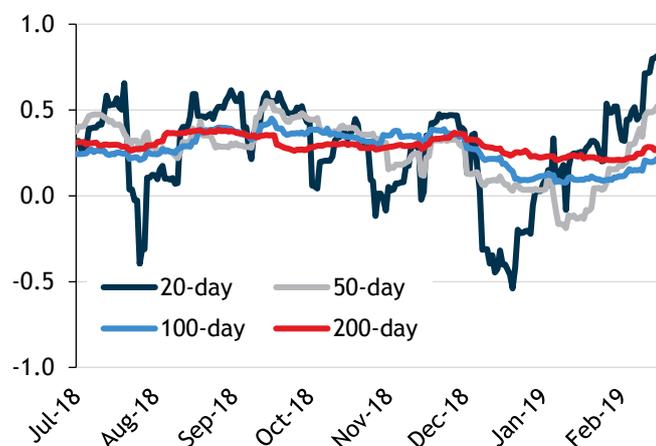
However, don't get us wrong, Canada is still a resource driven economy and oil still wields significant influence on the loonie (our colleagues in Economics and FX would agree). Apply the same correlation analysis between changes in C\$ (versus USD), WTI oil and the Canada-US 2-year yield differential over a 200-day rolling window and we're reminded of oil's power (Chart 2). Still, if the recent trend persists, it means that even greater focus will have to be given to upcoming central bank rate decisions, and the relative yield differentials.

Our colleagues in Economics in this month's [Forex](#) report, expect the USDCAD to mover closer to 1.27 by mid-year, should higher oil prices and unimpeded global trade flows prevail. From a technical outlook, the Relative Strength Index (RSI) indicator on the daily chart continues to stay lower than the 70-mark, suggesting that the USDCAD pair could push a bit higher before making the type of technical correction the forecast suggests. In fact, the recent formation of an inverse head and shoulder implies resistance levels at 1.3602 (Dec. 21 high) and 1.3631 (Jan. 1 high) could be tested in the near-term. Further, results based on an ordinary least squares (OLS) regression model between the loonie and its two fundamental drivers over the past 24 months of trading, might suggest the loonie is trading *cheaper*, compared to the fair value of 1.36. Applying the same regression model, the yield differential would need to narrow by over 50 bps, even if oil prices were to rally to say the US\$60 range, to test the 1.27 handle, all else equal.

While an oversimplified approach to be sure, the bottom line is if the market is going to turn significantly bullish on the loonie, the BoC's shift from the sidelines will be essential, *ceteris paribus*. For a data dependant central bank, that will mean better household spending numbers, continued recovery in the energy sector, and improved market sentiment stemming from resolution of trade conflicts. We expect the BoC to wait until at least the second half of the year to see whether most, if not all, of these factors materialise. Because, if we've learned anything, it's that Canada's central bank is a patient one.

**Chart 1: Yield differential increasingly driving loonie value**

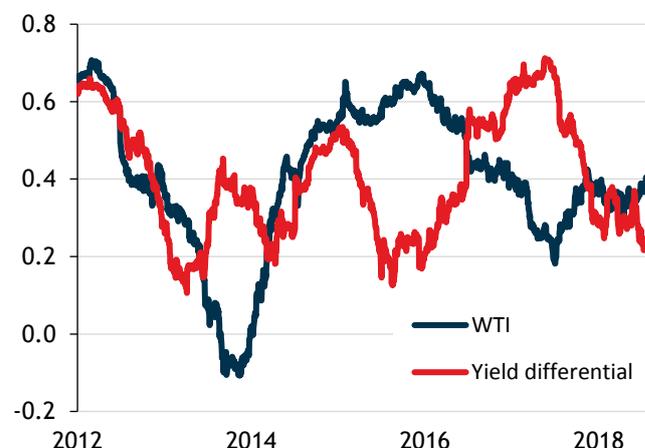
Correlation between  $\Delta$  in USDCAD and yield differential



Source: NBF, Bloomberg

**Chart 2: Oil remains key driver of Canadian dollar**

200-day correlation between  $\Delta$  in CADUSD, yield diff. and WTI oil



Source: NBF, Bloomberg | Note: This chart is inspired by analysis conducted by our colleagues in Economics

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