Forex

Economics and Strategy

NATIONAL BANK OF CANADA FINANCIAL MARKETS

May 2024

Highlights

By Stéfane Marion and Kyle Dahms

- As we pointed out last month, a less certain outlook for the future course of US monetary policy, with a potential divergence from the rest of the world, argued for USD strength as the Fed would be constrained from cutting rates. The longer monetary policy remains restrictive, the greater the likelihood of negative growth and earnings surprises in the second half of the year. Given the unusually strong negative correlation between the S&P 500 and the USD index, we expect weaker equity markets to lead to dollar appreciation
- The Canadian dollar continues to depreciate against the US dollar at the start of the second quarter. As if the interest rate situation wasn't CAD-unfriendly enough, let's not forget the recent federal budget, which raised the capital gains inclusion rate from 50% to 67%, effective June 25. Ottawa expects to see significant profit-taking between now and then as investors decide to avoid the higher taxation, a development that could prompt the sale of CAD assets. Under these circumstances, and given our forecast of a WTI oil price of USD 75, we still see the USD/CAD exchange rate moving above 1.40 in the second half of 2024 in 2024.
- Just when it looked like the yen was on the verge of a comeback, the currency experienced a new bout of weakness. Intraday, it surpassed its lowest level in 34 years and briefly crossed above USD/JPY 160. Although the slide was halted by intervention from the island nation's policymakers, questions remain about the resilience to further disorderly declines. The central bank is caught between containing prices and raising the cost of debt while managing the resulting impact on the currency. The latter appears to be stretched compared to past periods and we expect a slight improvement for the yen by the end of the year, but this will require a narrowing of yield differentials, which may not come until the Fed starts to ease policy.

NBF Currency Outlook

		Current	Forward Estimates			
Currency		May 1, 2024	Q2 2024	Q3 2024	Q4 2024	Q1 2025
Canadian Dollar	*(USD / CAD)*	**1.38**	**1.38**	**1.40**	**1.42**	**1.40**
United States Dollar	*(CAD / USD)*	*0.73*	*0.72*	*0.71*	*0.70*	*0.71*
Euro	*(EUR / USD)*	1.07	1.06	1.04	1.03	1.04
Japanese Yen	*(USD / JPY)*	158	152	148	145	142
Australian Dollar	*(AUD / USD)*	0.65	0.64	0.63	0.63	0.64
Pound Sterling	*(GBP / USD)*	1.25	1.24	1.22	1.20	1.22
Chinese Yuan	*(USD / CNY)*	7.24	7.20	7.25	7.30	7.25
Mexican Peso	*(USD / MXN)*	17.0	17.5	18.0	18.5	19.0
Broad United States Dollar (1)		**122.4**	**122.9**	**124.6**	**125.9**	**125.3**

1) Federal Reserve Broad Index (26 currencies)

Canadian Dollar Cross Currencies

		Current	Forward Estimates			
Currency		May 1, 2024	Q2 2024	Q3 2024	Q4 2024	Q1 2025
Euro	*(EUR / CAD)*	1.47	1.46	1.46	1.46	1.46
Japanese Yen	*(CAD / JPY)*	115	110	106	102	101
Australian Dollar	*(AUD / CAD)*	0.89	0.88	0.88	0.89	0.90
Pound Sterling	*(GBP / CAD)*	1.72	1.71	1.71	1.70	1.71
Chinese Yuan	*(CAD / CNY)*	5.26	5.22	5.18	5.14	5.18
Mexican Peso	*(CAD / MXN)*	12.4	12.7	12.9	13.0	13.6

USD: Greenback back on the rise

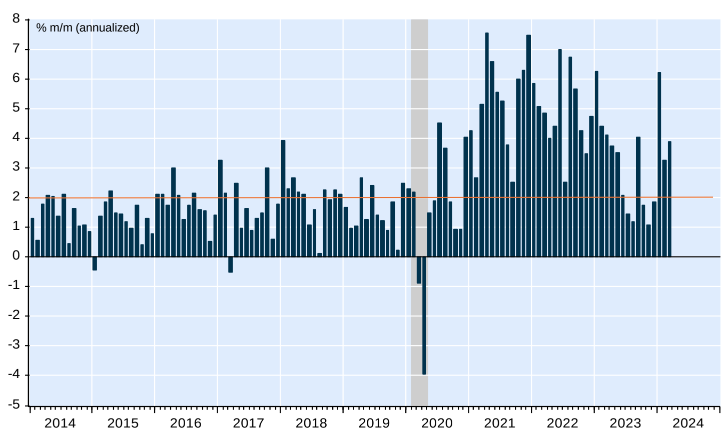
After a pause of several weeks, the greenback is back on the rise. The trade-weighted USD even approached its 2023 high before retreating somewhat in recent days - chart.

USD: Back on the rise
Trade-weighted USD* vs. a basket of 26 currencies

NBF Economics and Strategy (data via Refinitiv)

As we pointed out last month, a less certain outlook for the future course of US monetary policy, with a potential divergence from the rest of the world, argued for USD strength as the Fed would be constrained from cutting rates. We remain of this view. On the inflation front, we note that the core PCE deflator is refusing to stay down, with the latest monthly reading jumping to 4% annualized in March. This was the third month in a row that core PCE inflation grew well above the Fed's 2% target - chart.

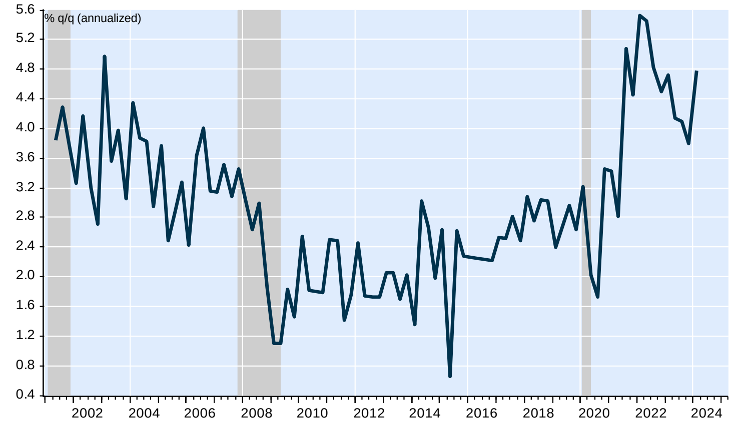
U.S.: Inflation refuses to stay down
Core PCE deflator



NBF Economics and Strategy (data via Fred)

Wages also show little sign of cooperating, with the Employment Cost Index (ECI) - one of the Fed's preferred measures of wage inflation - rising at an annualized rate of 4.8% in Q1 2024, the most significant acceleration since 2022 (chart).

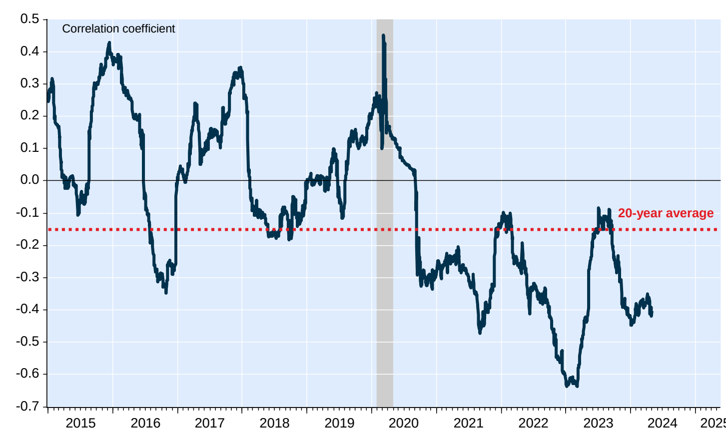
U.S.: Labour compensation costs on the rise
Employment Cost Index (ECI) for all civilian workers



NBF Economics and Strategy (data via Fred)

Policymakers were forced to acknowledge recent developments on the inflation front. While leaving interest rates unchanged on 1 May, the FOMC acknowledged that price pressures have been stronger than expected and that there's more uncertainty about the inflation outlook, although it still believes that policy is sufficiently restrictive that inflation should moderate over the rest of the year. As a result, it's "unlikely" that further tightening will be appropriate. As for rate cuts, well, we see some coming, but they should not exceed 50 basis points in 2024 and are unlikely to happen before the end of the summer. The longer monetary policy remains restrictive, the greater the likelihood of negative growth and earnings surprises in the second half of the year. Given the unusually strong negative correlation between the S&P 500 and the USD index, we expect weaker equity markets to lead to dollar appreciation (chart).

USD: Strong correlation with the S&P 500
26-week moving correlation between daily changes in the S&P 500 and USD dollar index (DXY)



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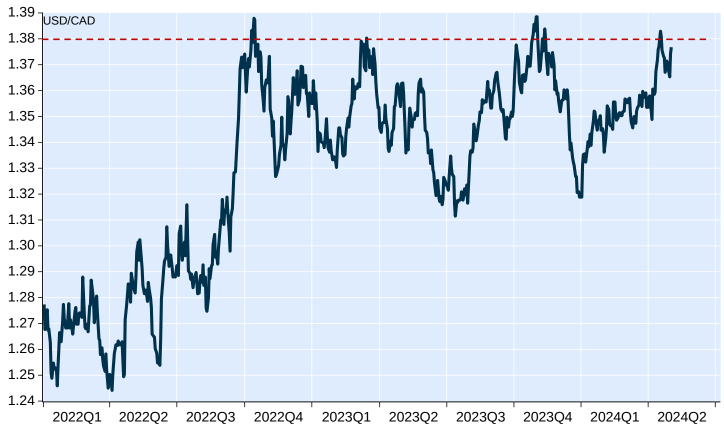
CAD: Not a loonie-friendly budget

The Canadian dollar continues to depreciate against the US dollar at the start of the second quarter, with USD/CAD recently hitting 1.38 for the first time since November 2023 (chart).

CAD: Back to 1.38 resistance
Canada-US exchange rate



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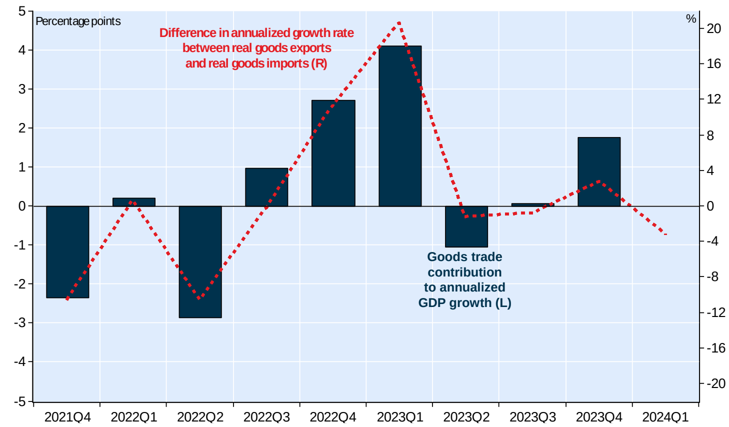
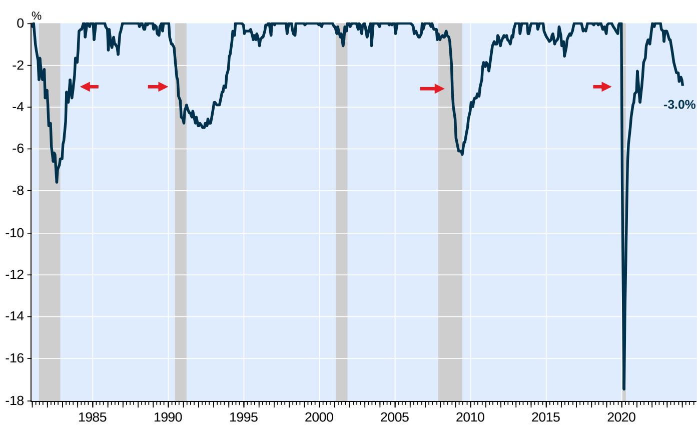
Canada: Goods trade contributed negatively to Q1 GDP growth
Real exports/imports of goods vs. goods trade contribution to GDP



NBF Economics and Strategy (data via Statistics Canada)

Will the 1.38 resistance be broken? We think so. Economic weakness in Canada certainly argues for a divergence in interest rates between Canada and the U.S. February's GDP growth of 0.2% fell shy of both consensus expectations (+0.3%) and the preliminary estimate released by Statistics Canada last month (+0.4%). Although Q1 GDP is currently on track to grow 2.5%, slightly below the Bank of Canada's estimate of 2.8%, this figure should be seen as underwhelming given record population growth (3.7% annualized) in the first three months of 2024. As a result, GDP per capita continues to trend down and is now 3% below its peak of September 2022. A decline of this magnitude has never been seen outside of a recession - chart.

Canada: GDP per capita down sharply since start of monetary tightening
Change since peak of GDP per capita (population 15+)

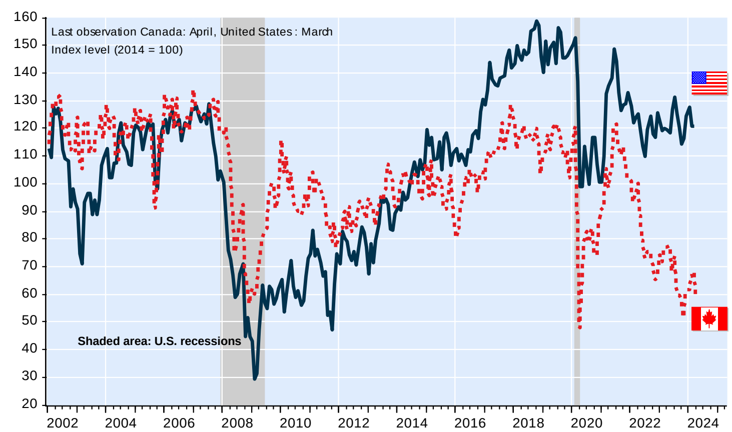


NBF Economics and Strategy (data via Statistics Canada)

What's more, despite a resilient U.S. economy, external trade is not improving. The merchandise trade balance swung from a surplus of C$0.48 billion in February (initially estimated at C$1.39 billion) to a deficit of C$2.28 billion in March. This is far from the C$1.21-billion surplus anticipated by analysts. We estimate that trade in goods likely contributed negatively to GDP growth in Q1 by the most in almost two years, as real exports contracted (-1.3% annualized) while real imports expanded (+2.0% annualized) - chart.

With private-sector jobs stalling and with the unemployment rate rising, inflationary pressures are abating much faster on this side of the border. Testifying to the Senate committee on banking on May 1, BoC governor Tiff Macklem acknowledged that interest rates are biting harder in Canada than in the U.S. Overtly restrictive monetary policy will not be needed for much longer north of the 49th parallel based on the latest reading of consumer confidence (chart).

Canada – U.S.: Index of consumer confidence
Monthly



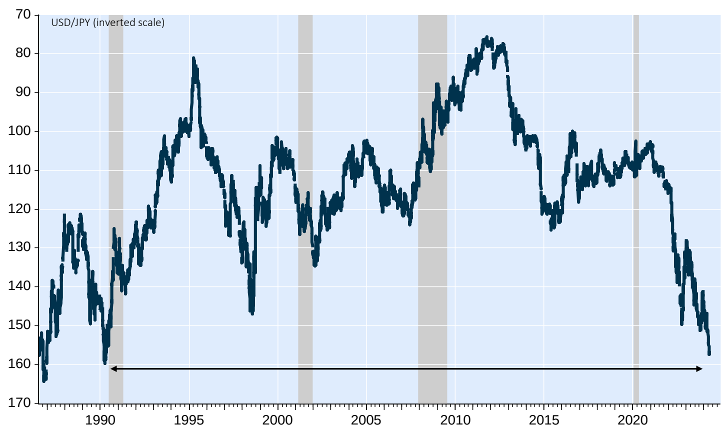
NBF Economics and Strategy (data from Conference Board of Canada)

As our rate strategists **argue**: "Whether June or July marks the start of the easing cycle, it's increasingly clear to us that the Bank of Canada will be cutting earlier than the Federal Reserve or many other peer central banks". As if this interest rate situation wasn't CAD-unfriendly enough, let's not forget the recent federal budget, which raised the capital gains inclusion rate from 50% to 67%, effective June 25. Ottawa expects to see significant profit-taking between now and then as investors decide to avoid the higher taxation, a development that could prompt the sale of CAD assets. Under these circumstances, and given our forecast of a WTI oil price of USD 75, we still see the USD/CAD exchange rate moving above 1.40 in the second half of 2024.

JPY: Intervention

Just when it looked like the Yen was on the verge of a comeback, the currency experienced a new bout of weakness. Intraday, it surpassed its lowest level in 34 years and briefly crossed above USD/JPY 160. Although the slide was halted by intervention from the island nation's policymakers, questions remain about the resilience to further disorderly declines. The divergence in monetary policy between Japan and the United States has only become more pronounced in the past two weeks and could continue to underpin a bout of depreciation. To make matters worse, the Bank of Japan is stuck between a rock and a hard place on monetary policy.

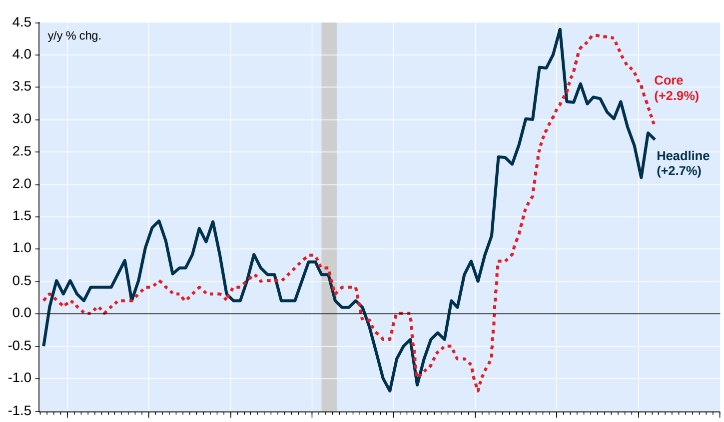
Japan: Intraday yen surpassed its lowest point in 34 years
USD/JPY



NBF Economics and Strategy (data via FRED)

With inflation rising to levels not seen in nearly a decade, the Bank of Japan took the first step toward ending its era of ultra-accommodative monetary policy. Coupled with wage negotiations that fueled fears of an inflationary spiral, the central bank appeared poised for further action. That hasn't necessarily been the case, and officials have admitted that they are willing to let inflation run above target in order to see prices reliably stay above the deflationary threshold. The BoJ is walking a fine line between increasing debt servicing costs for the developed nation with the highest debt-to-GDP ratio and containing the potential for runaway prices. For now, prices remain too high for comfort and could be exacerbated by a weakening currency.

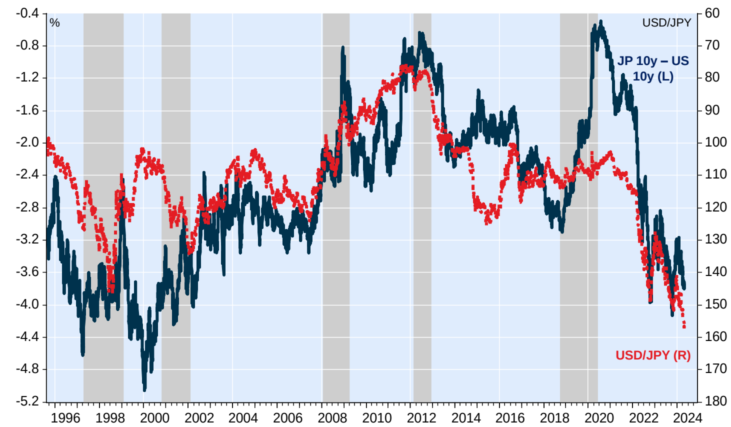
Japan: Inflation remains elevated despite moderation
Headline & Core CPI (ex. fresh food and energy)



NBF Economics and Strategy (data via Refinitiv)

The prospect of a first interest rate cut in the US has been pushed further into the forecast horizon. The resulting rise in Treasury yields has only widened the yield differential with long Japanese bonds. The appetite for a carry trade is obvious and unsurprisingly the currency has stumbled. However, the sell-off (and weakness) in the yen has been much more pronounced than in previous situations.

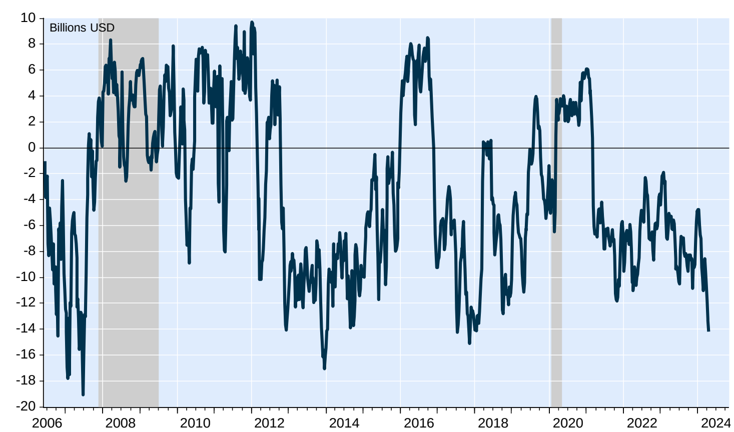
Japan: Currency is stretched despite yield differential
Japan and US 10y yield differential and USD/JPY



NBF Economics and Strategy (data via Bloomberg)

Interventions by the Ministry of Finance in currency markets have been noticeable in the past week, in an attempt to stem the tide. Success has been limited to say the least, with marginal gains coming at a high cost. While the Japanese government has large foreign reserves, this hasn't stopped speculators from holding onto their short positions.

Japan: Speculators are short on the yen
Non-commercial net speculative positions



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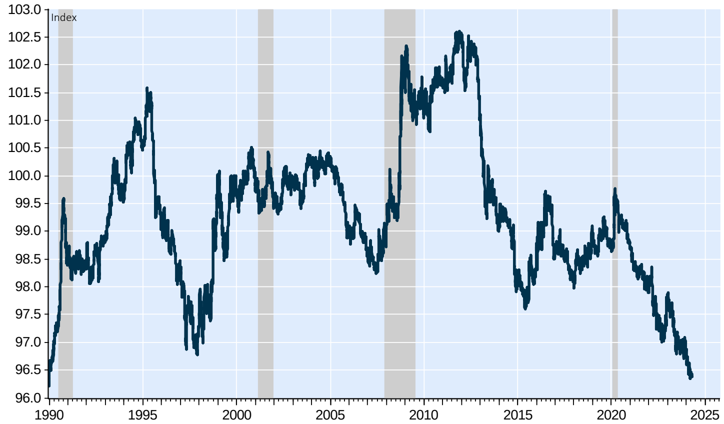
And perhaps the speculators are onto something. The combined effect of a cheaper yen and rising interest rates has led to the tightest financial conditions for Japan in 34 years. Normally a harbinger of slowing growth.

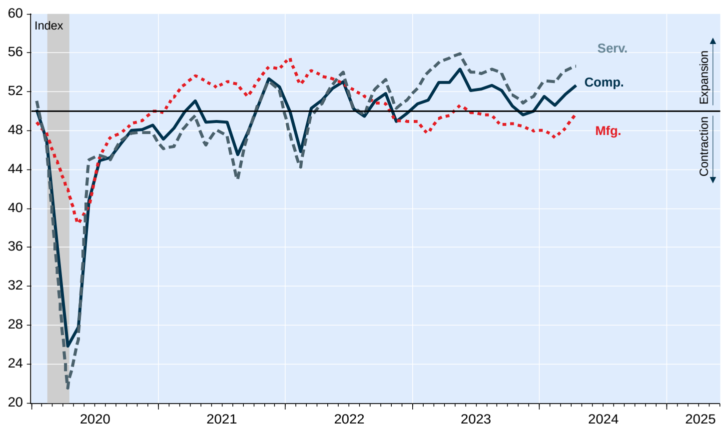
Japan: Cheap yen + higher rates = tighter financial conditions
Goldman Sachs Japan Financial Conditions Index



NBF Economics and Strategy (data via Bloomberg)

True, but recent data in the form of PMIs have shown improvement, with the composite in expansion territory and at its highest level in several months. The manufacturing sub-index is essentially at the midpoint, a marked improvement from the contraction of previous months.

Japan: PMI`s have improved recently
Markit PMI. Last observation: April 2024



NBF Economics and Strategy (data via Refinitiv)

Overall, the outlook for Japan is mixed. On the one hand, there has been some resilience on the growth front, but this has come at the expense of inflation. The central bank is caught between containing prices and raising the cost of debt while managing the resulting impact on the currency. The currency for its part looks stretched compared to past periods and we expect a slight improvement for the yen by the end of the year, but this will require a narrowing of yield differentials, which may not come until the Fed starts to ease policy.

Regional Overview

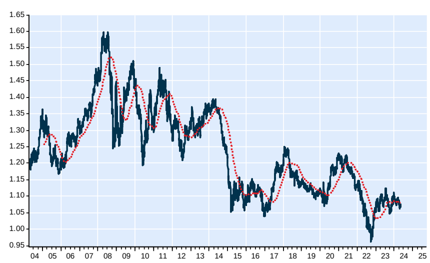
Region	Currency	$		Current USD FX	1M Prior USD FX	% Change 1-Month Performance	Current 2Y Yield	Relative to UST 2Y Spread	Current Policy Rate	Upcoming Next MP Meeting
Canada	**Canadian Dollar**	**CAD**	***(USD/CAD)***	**1.37**	**1.35**	**1.09%**	**4.25**	**-62.6**	**5.00**	**2024-06-05**
United States	*United States Dollar*	*USD*	*-*	*-*	*-*		*4.88*	*-*	*5.50*	*2024-06-12*
Eurozone	Euro	EUR	*(EUR/USD)*	1.07	1.08	-1.02%	2.99	-188.7	4.50	2024-06-06
Japan	Japanese Yen	JPY	*(USD/JPY)*	154	152	1.28%	0.29	-458.7	0.10	2024-06-14
Australia	Australian Dollar	AUD	*(AUD/USD)*	0.66	0.66	0.00%	4.13	-74.6	4.35	2024-05-07
United Kingdom	Pound Sterling	GBP	*(GBP/USD)*	1.25	1.27	-0.93%	4.43	-45.1	5.25	2024-05-09
China	Chinese Yuan	CNY	*(USD/CNY)*	7.24	7.23	0.11%	1.91	-296.8	2.00	2024-06-13
Mexico	Mexican Peso	MXN	*(USD/MXN)*	17.0	16.5	2.68%	10.64	576.6	11.00	2024-05-09

Country / Central Bank	United States / Federal Reserve			Canada / Bank of Canada			Eurozone / European Central Bank		
Current Policy Rate	5/3/2024	5.5	▲ current level	5/3/2024	5	▲ current level	5/3/2024	4.5	▲ current level
Next meeting	6/12/2024	5.292	-0.208	6/5/2024	4.822	-0.178	6/6/2024	3.683	-0.817
Subsequent meeting	7/31/2024	5.213	-0.287	7/24/2024	4.710	-0.290	7/18/2024	3.573	-0.927
Subsequent meeting	9/18/2024	5.072	-0.428	9/4/2024	4.554	-0.446	9/12/2024	3.406	-1.094
Subsequent meeting	11/7/2024	4.971	-0.529	10/23/2024	4.466	-0.534	10/17/2024	3.297	-1.203
Subsequent meeting	11/7/2024	4.825	-0.675	12/11/2024	4.332	-0.668	12/12/2024	3.174	-1.326
Subsequent meeting	12/18/2024	4.908	-0.592						

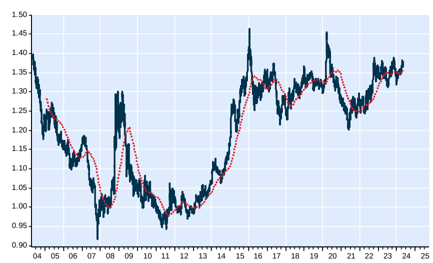
Country / Central Bank	Japan / Bank of Japan			United Kingdom / Bank of England		
Current Policy Rate	5/3/2024	0.1	▲ current level	5/3/2024	5.25	▲ current level
Next meeting	6/14/2024	0.115	0.015	5/9/2024	5.175	0.175
Subsequent meeting	7/31/2024	0.162	0.062	6/20/2024	5.090	0.090
Subsequent meeting	9/20/2024	0.193	0.093	8/1/2024	4.957	-0.043
Subsequent meeting	10/31/2024	0.236	0.136	9/19/2024	4.864	-0.136
Subsequent meeting	12/19/2024	0.271	0.171	11/7/2024	4.755	-0.245
Subsequent meeting				12/19/2024	4.682	-0.318

Appendix: Spot rates with their 200d MA

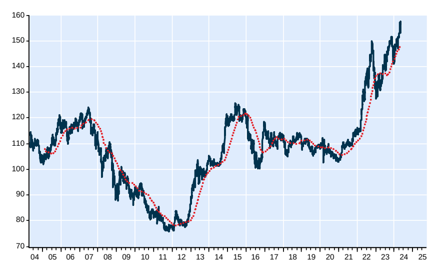
EUR / USD



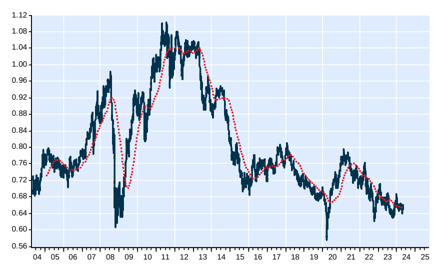
USD / CAD



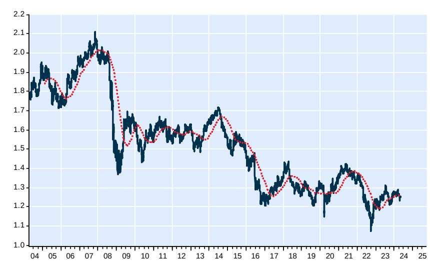
USD / JPY



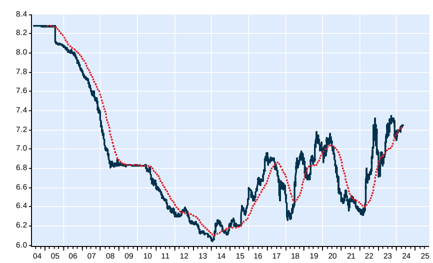
AUD / USD



GBP / USD



USD / CNY



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