USDCAD Forecast: It's Still a Growth Story, The Redux

May. 7, 2021

Summary:

1. The thesis of a strong global cyclical growth phase has underpinned our outlook for USDCAD over the past year and that theme has largely played out: Commodity prices are stronger, fiscal stimulus has increased, and vaccine rollouts have (mostly) surprised to the upside.
2. This has led to growth projections being upgraded significantly from earlier this year and no more so than from the Bank of Canada who became the first major G10 central bank to adopt a hawkish stance at their recent April policy meeting.
3. In contrast, the Fed has remained on the sidelines which has led to CAD rallying to three-year highs. Given CAD's leverage to commodity prices, high positive correlation to global growth, and strong housing market we expect the BoC to remain under pressure to maintain a vigilant outlook on interest rates relative to other major central banks in the coming years.
4. Furthermore, the USD remains under longer-term structural pressure from record trade and budget deficits - deficits that imply a weaker USD as the US imports more than it exports, and spends more than it brings in.
5. ***As a result,*** **we continue to see CAD appreciation as the most probable outcome and move our USDCAD targets lower with a 2021 year-end target of 1.1700.**
6. ***Key risks*** **are US growth outperformance pulling the Fed off the sidelines and pushing US rates higher, and a quicker than anticipated supply response across commodity markets particularly in copper and oil.**

Date	Mean	High	Low	ATB FMG Old	*ATB FMG New*
Q221	1.2500	1.2900	1.2000	1.2500	*1.2000*
Q321	1.2400	1.3000	1.1900	1.2300	*1.1800*
Q421	1.2400	1.3000	1.1800	1.2100	*1.1700*
Q122	1.2400	1.3200	1.1800	1.2100	*1.1800*
2022	1.2500	1.3400	1.2000	1.2200	*1.1600*

Bullish Outlook

It's *still* a growth story

- The loonie is a growth currency and the global economy is in the midst of a strong growth phase.
- Record monetary and fiscal stimulus have supported major economies and put them on the path for strong exit velocities from the Covid recession.
- Recent developments in US labour markets have seen slower than expected hiring which will keep the Fed vigilant not to remove monetary stimulus too early - a theme that will provide further near term headwinds for the USD while still ultimately supporting the recovery over the medium term
- Demand for commodities is reaching a fever pitch on the expected boom in global infrastructure spend, restocking of depleted inventories, as well as the push from major G7 nations towards a "greener grid" which is bullish for metals and energy commodities in the early phases of the build-out period.

- CAD is leveraged to energy, metals, and agricultural products and thus stands to benefit from the surge. The supply response across commodities will remain challenged due to under-investment prior to Covid and lack of capital access going forward due to years of sub-par returns and the accelerating push to lower carbon intensity.
- All of this plays in favour of the BoC having to maintain a hawkish stance relative to other major central banks, and that is before considerations regarding long-term overheating in domestic housing markets.

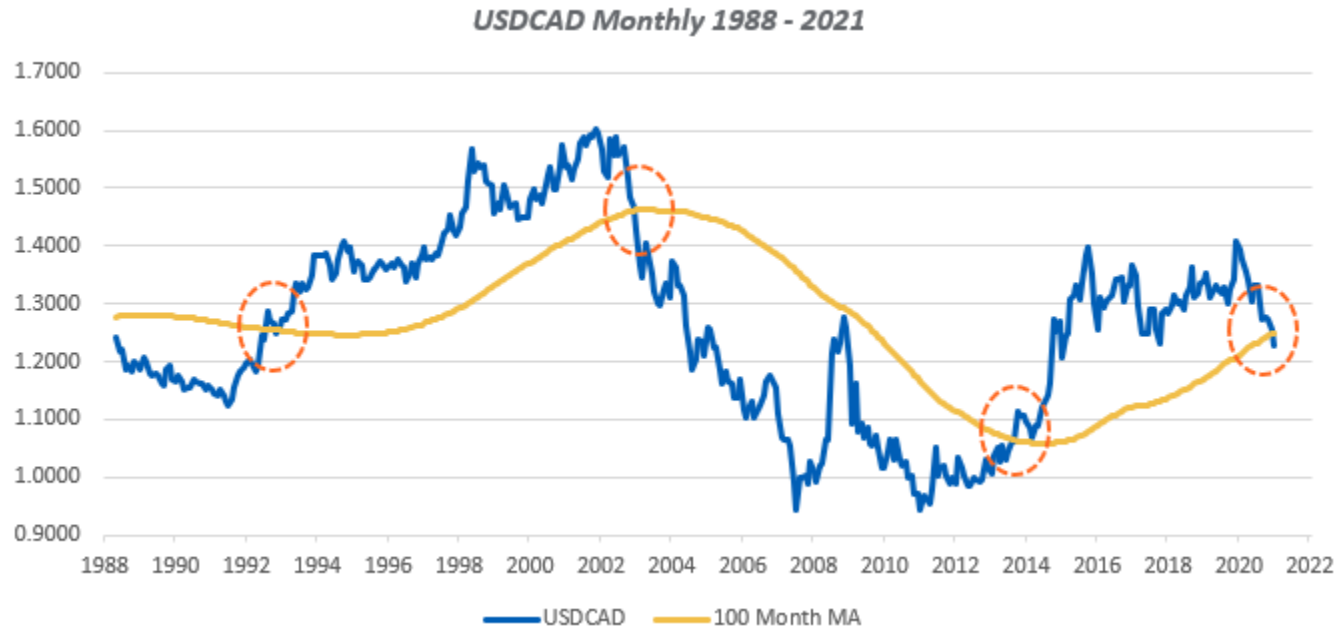
Bearish Outlook

What if the US outgrows the rest of us?

- The BoC may have been the first to move towards a hawkish policy stance - but what if the Fed catches up more quickly than currently anticipated? Alternatively, what if the bond markets begin to act before the Fed thus pushing yields aggressively higher causing a coincident sell-off in the risk trade?
- Growth in the US is expected to be as strong as +10% in Q2/21 - and they are on a faster reopening schedule relative to both Canada and much of the developed world - that could see inflation pick up in the US and thus force the Fed off the sidelines
- Another risk is that the supply response across major commodities such as oil and copper is more abrupt than anticipated which would then put downward pressure on prices and the CAD - however there has been very little signs of activity picking up in US shale yet with oil supply steady, while OPEC+ has remained vigilant and unified, and copper and metals are prone to much longer supply response cycles which limits major impacts to current price trajectories
- Nonetheless, these developments all pose a risk to the outlook - faster inflation in the US or a cooling of the global growth trend and/or commodity prices could close the gap between interest rate yields that are now clearly in favour of the CAD

Fig. 1: USDCAD Broke Major Long Term Support - Will History Repeat Itself?

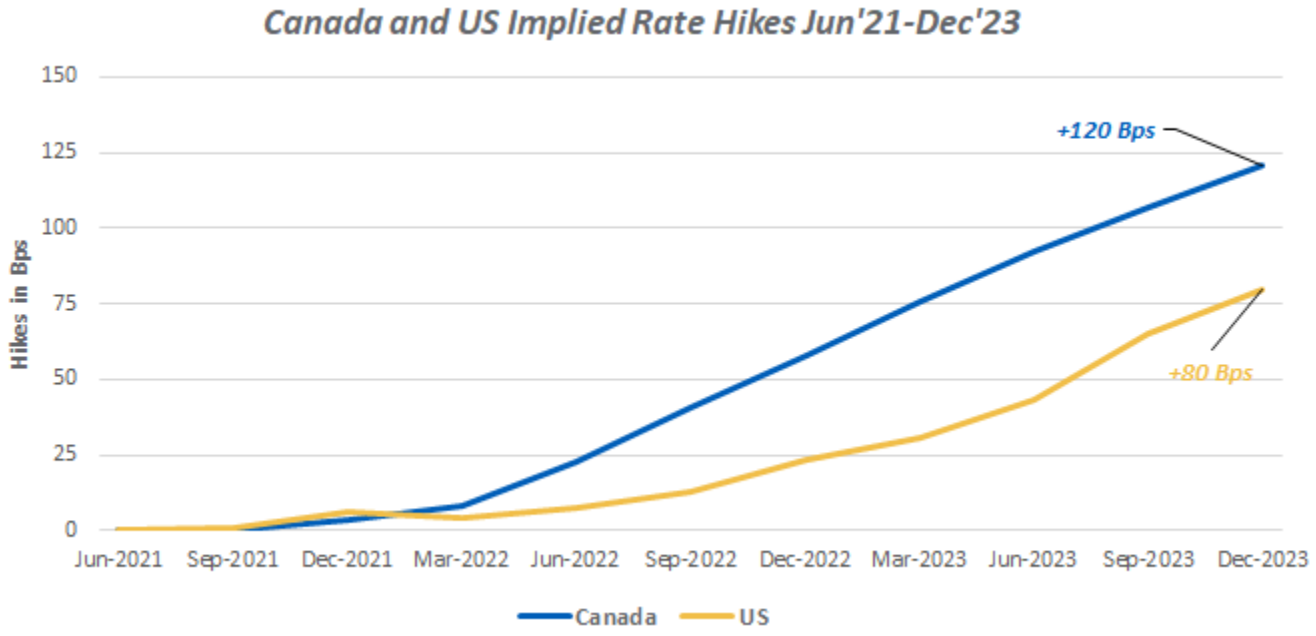
USDCAD recently broke through a key long-term level at the 100-month moving average of 1.2525. The last three times that's happened since 1988 we have observed considerable acceleration in the prevailing trend with the last two occurrences seeing USDCAD decline by -38% (2002-2007) and then rise by +38% (2014-2016). History may not repeat...but it does rhyme.



(Source: Bloomberg, ATB FMG)

Fig. 2: BoC Expected to Hike Earlier and Faster Than the Fed

The BoC is on course to start hiking rates in June 2022 while the Fed is not expected to move until Dec 2022 at the earliest. Will this gap narrow? It certainly could, and that is a risk to our USDCAD outlook. But we also note that by the time it does narrow, USDCAD is likely to have already moved lower.



(Source: Bloomberg, ATB FMG)

Fig. 3: US Trade Deficit Should Keep USD Under Pressure

The US trade deficit has ballooned as they import more and export less - part of that is due to stronger domestic growth of course and yes the nominal amount of -$74 billion may be less as a percentage of GDP now than it was in the early 2000's, but the trend is not one that can change quickly and it will put pressure on the USD over the longer term. Looking at the chart it seems that the DXY is quite strong relative to past periods and a decline would make sense given the gap in trade flows.

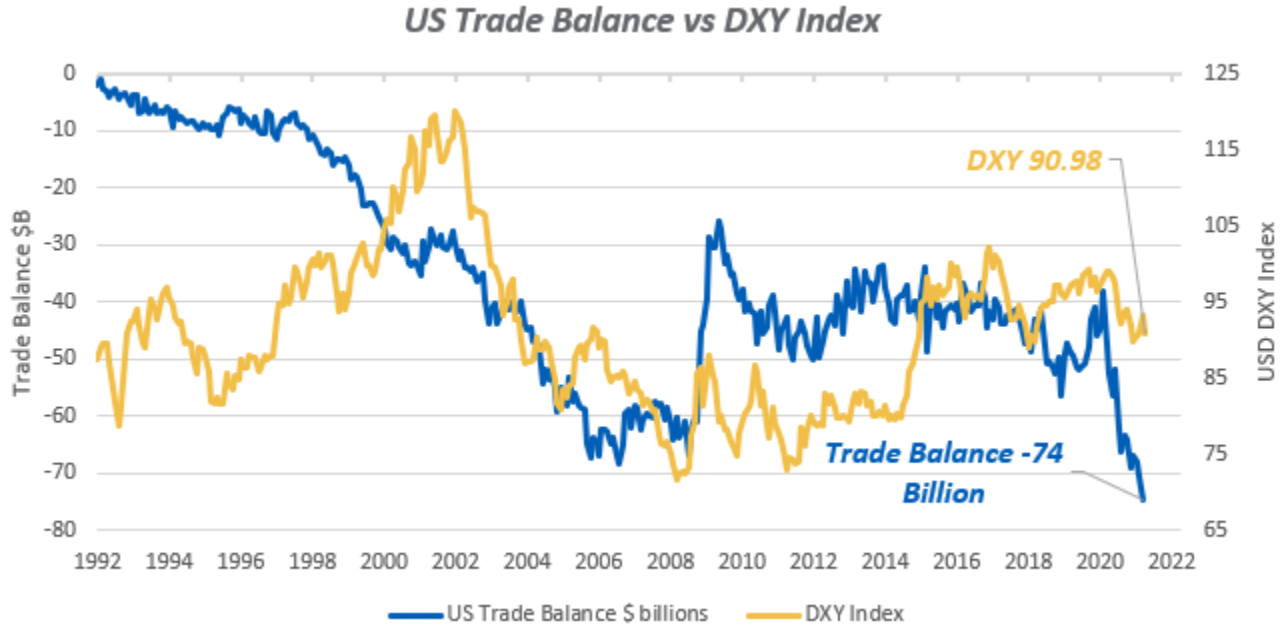
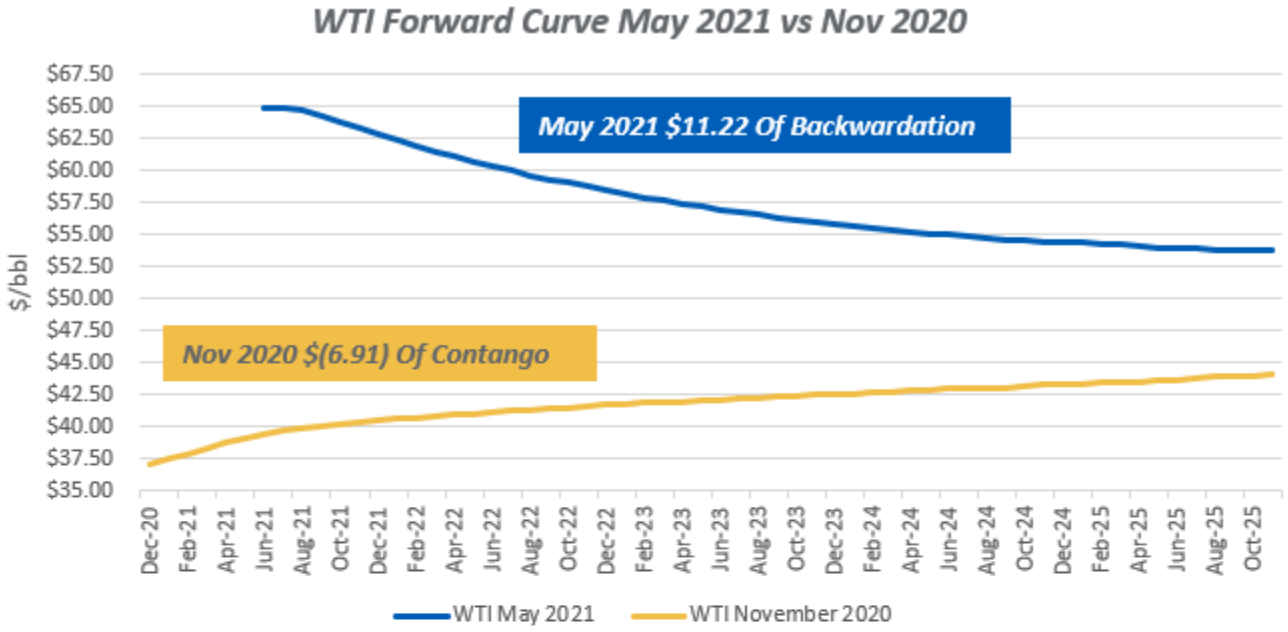
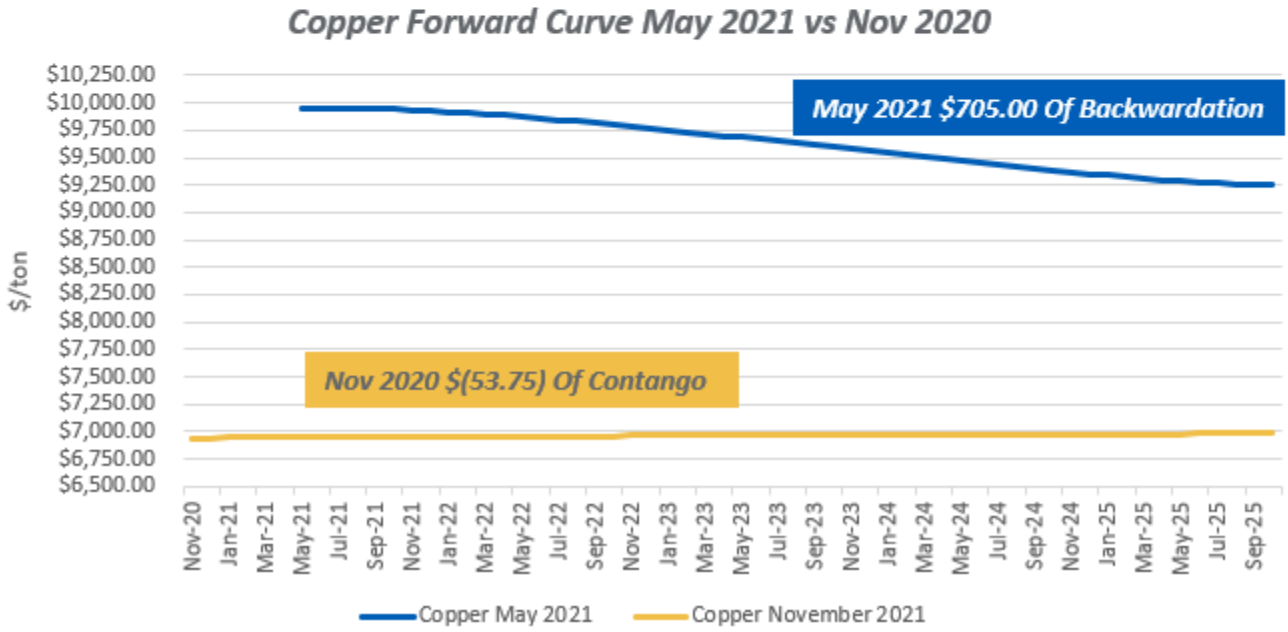


Fig. 4: Commodity Prices are Rallying for a Reason - Supply is Tight and Demand is Strong

Here we show the change in the forward curves for WTI and Copper from Nov 2020 to May 2021. You can see that the shape of the curves moved from contango into material backwardation for both commodities - that is an indication of tight supply and strong demand. While it is easier to bring oil supply back on line, copper is a much longer duration asset and thus the supply response is much slower meaning that copper prices could remain elevated for a number of years. These levels of backwardation imply that both WTI and Copper prices are more likely to remain strong in the near to medium term.

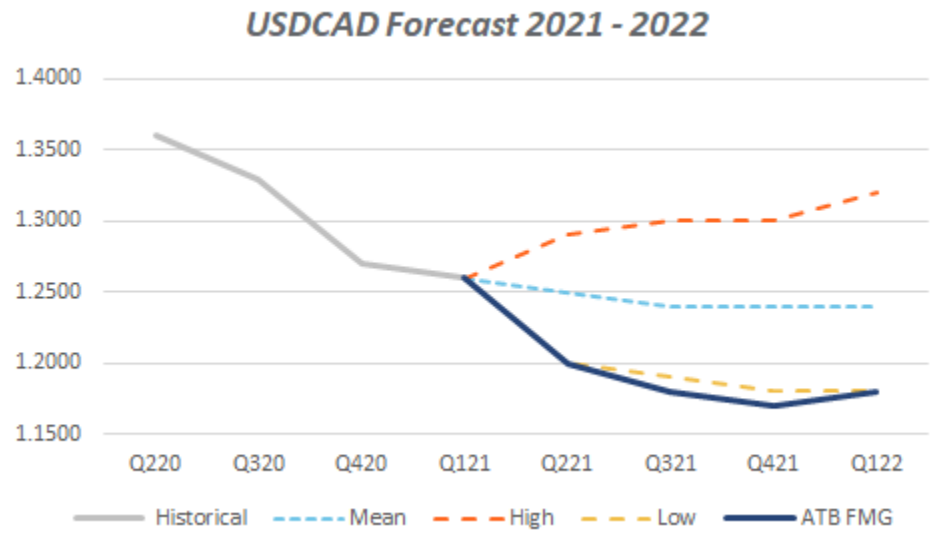




(Source: Bloomberg, ATB FMG)

Fig. 5: FMG Forecast

USDCAD Forecast with high, low, mean for reference



(Source: Bloomberg, ATB FMG)

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