



## FX Daily

# The risks & skew in the long USD/CAD trade

- It would not look out of place if the Bank of Canada's April post-meeting statement made no changes from the March 5<sup>th</sup> statement. In contrast the monetary forces shaping the medium-term USD/CAD outlook are exciting....

Even the most committed USD long position of the year, against the CAD, has in the end wavered, raising questions as to whether this is the end in the road for the negative CAD trade?

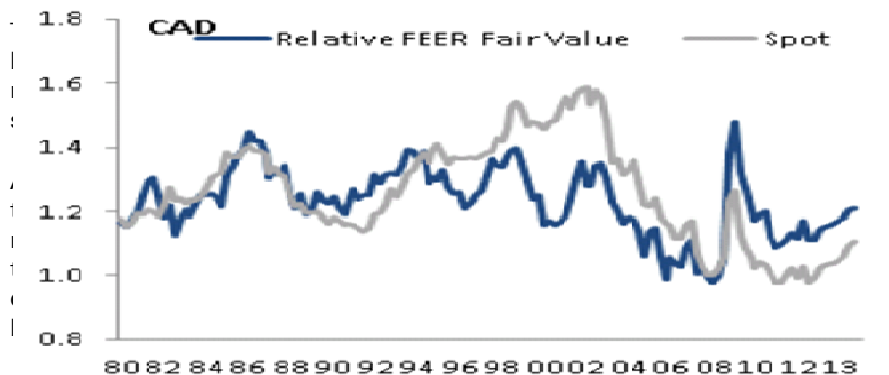
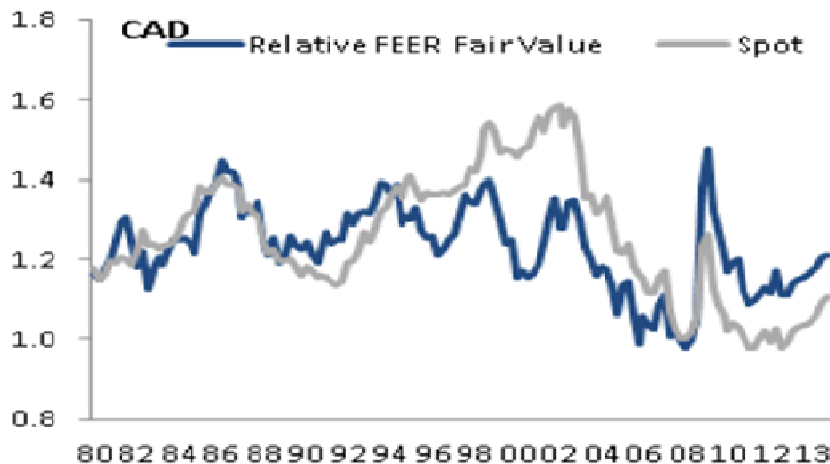


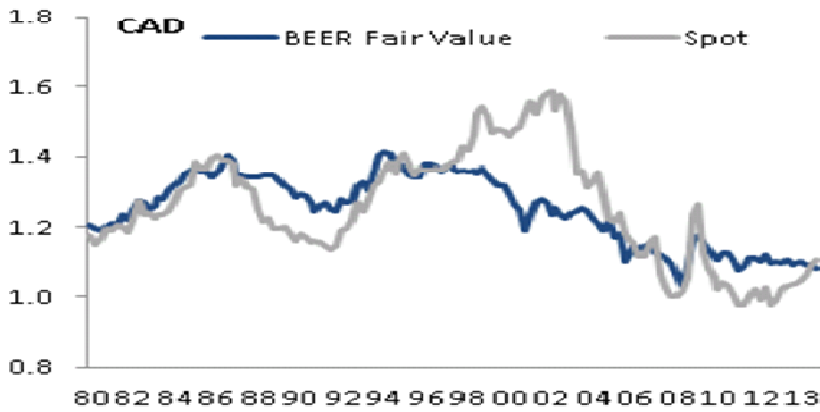
Figure 1: CAD Fundamental Exchange rate equilibrium valuation versus spot



Source: Deutsche Bank

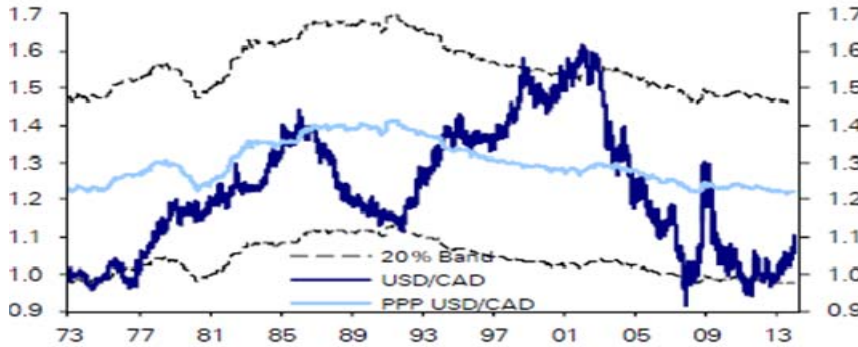


Figure 2: CAD BEER valuation versus spot



Source: Deutsche Bank

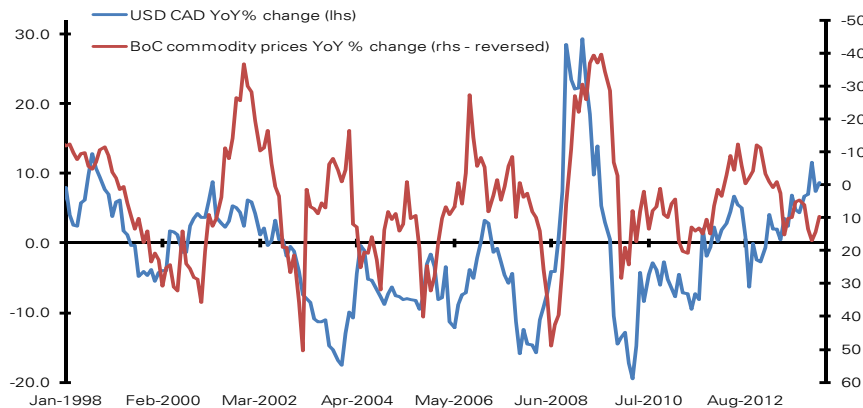
Figure 3: USD/CAD spot versus PPP valuation



Source: Deutsche Bank

In contrast, BEER, behavioral exchange rate models put USD/CAD at very close to 'fair value' currently. BEER tends to be useful for shorter-term profiles and the BEER model reflects the slight improvement in CAD terms of trade, that has slowed the deterioration in Canadian visible trade, and the short CAD trade.

Figure 4: USD/CAD YoY% change versus BoC commodity prices YoY %

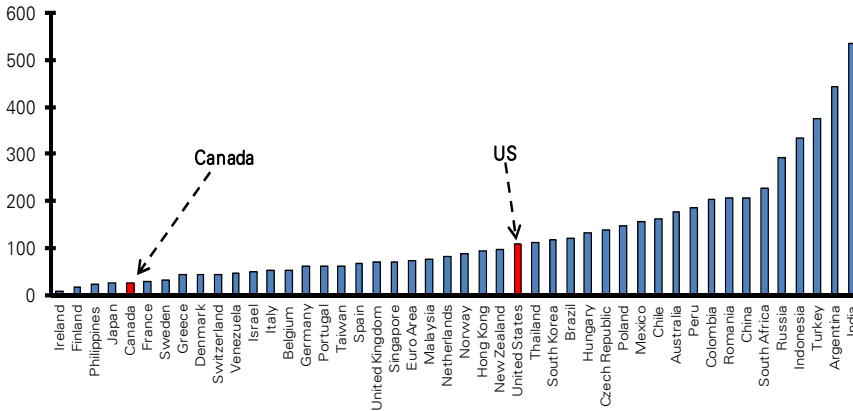


Source: Deutsche Bank, EcoWin



The terms of trade or BEER justification for a steady exchange rate does not take into account the hollowing out of Canada's export manufacturing base from an overly strong currency that has left Canada near the bottom of global export league tables. The Bank of Canada has however been constantly alert to this (Dutch disease) problem, and it has been one factor behind policymakers consistently favoring some additional currency weakness.

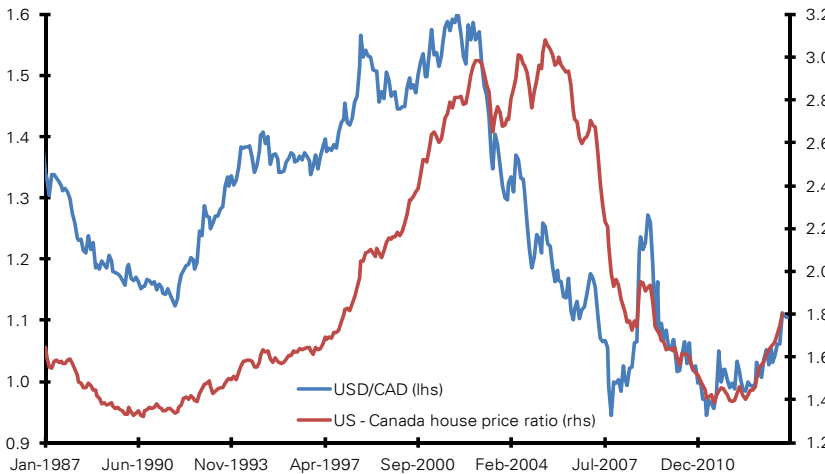
Figure 5: 10 year % change in 3mma of exports



Source: Deutsche Bank, EcoWin

Canada's mix of a sizable external deficit, extended household/real estate leverage/debt, and soft goods inflation, is the perfect macro backdrop to support rebalancing via a weaker exchange rate. Similarly, in these circumstances a weaker exchange rate is the very logical policy response to any housing led weakness in domestic demand.

Figure 6: USD/CAD versus S&P Case-Shiller, Composite-10 index/ Canada new housing price index ratio



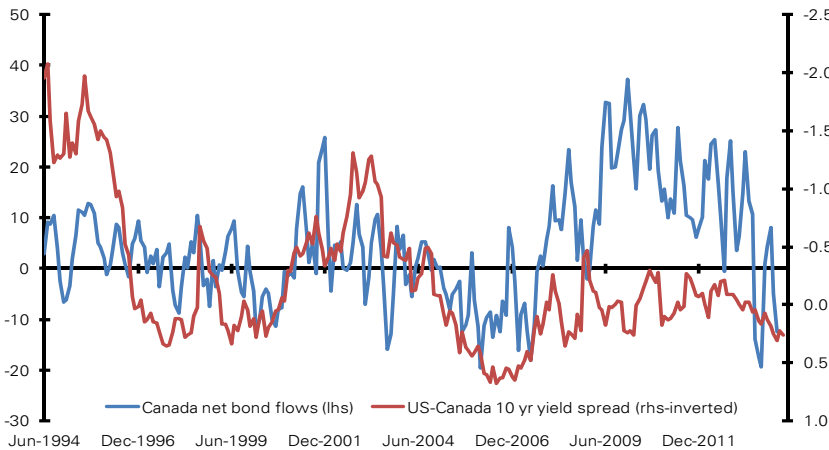
Source: Deutsche Bank, EcoWin

In the last decade, USD/CAD has done a remarkable job following the contours of relative US/Canada house prices, which is a theme that should remain a powerful predictor of the long-term currency trend. Canadian housing briefly threatened to slow precipitously toward the end of 2012, but much like the rest of Anglo world, calling the demise of the housing boom in 2013 proved



distinctly premature. Now a housing soft-landing is expected for 2014, with gloomier thoughts reserved for 2015 and beyond. Long-term pessimism will not change easily which is why there is a mere 10bps of BoC tightening priced in 2 years out, against 90bps if for the Fed. An important part of a long-term negative CAD story is that the BOC can't keep up with Fed tightening because of housing vulnerability. Closing in on that kind of scenario would be the point where USD/CAD would be expected to accelerate to the upside, but again this is a story reserved for 2015. Currently a more compelling and relevant spread story is that 10y US - CAD spreads have already moved to their 85<sup>th</sup> percentile in favor of the USD, and are expected to build further in favor of the USD in coming months, with stronger US data.

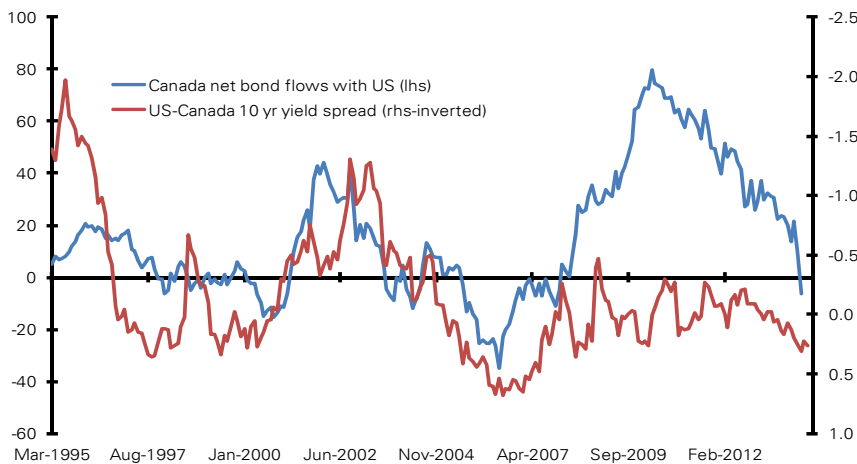
Figure 7: Canada net bond flows (CADbn - 3m rolling sum) vs US - Canada 10 year yield spread (inverse axis)



Source: Deutsche Bank, EcoWin

When USD long-term rates are trading at a premium to CAD rates, there are large net negative CAD bond flows, both in terms of net flows to the US and more general net bond outflows globally.

Figure 8: Canada net bond flows with US (CADbn - 12m rolling sum) vs US - Canada 10 year yield spread (inverse axis)

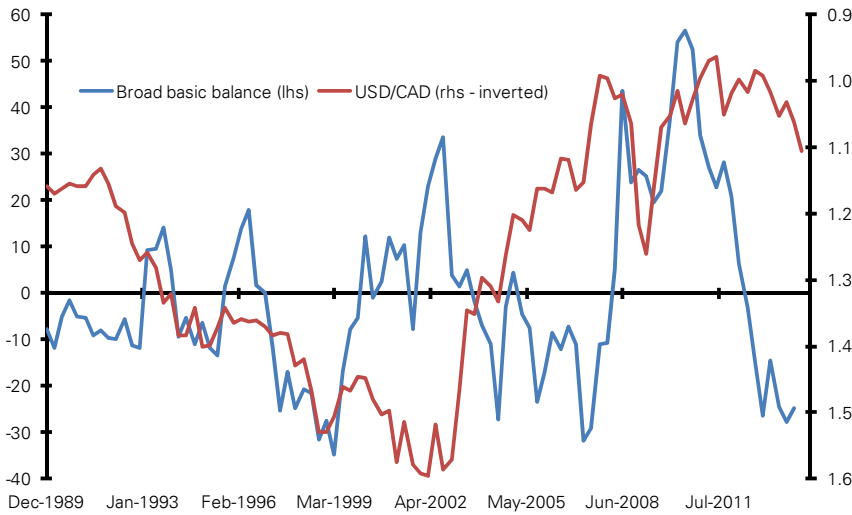


Source: Deutsche Bank, EcoWin



In turn, these bond flows tend to act as a dead-weight on Canada's broad basic balance.

Figure 9: Canada broad basic balance (CADbn - 4Q rolling sum) vs USD/CAD (inverse axis)



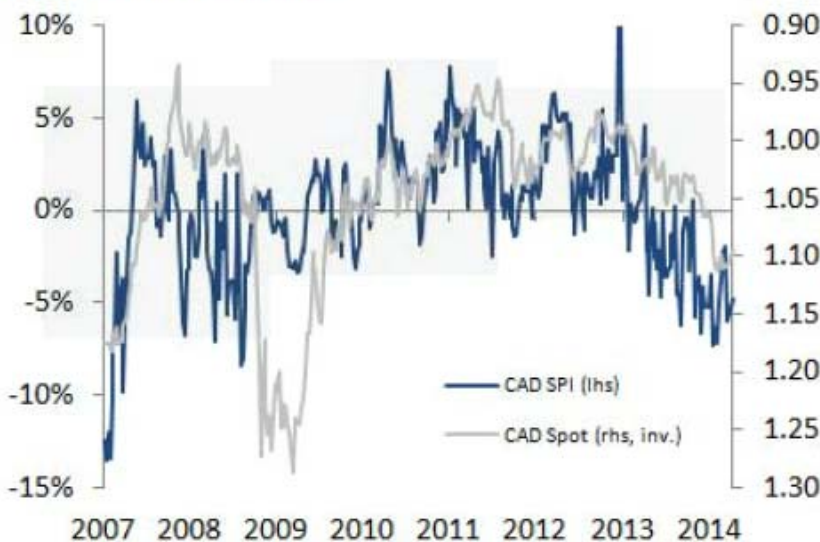
Source: Deutsche Bank, EcoWin

So what could go wrong with the negative CAD view?

In the short-term there are still some obvious risks that relate to the sizable CAD short positioning. DB Select data suggests USD/CAD would be below 1.08 were all the shorts to be squeezed out on say more unexpected downside US data surprises.

Figure 10: CAD select positioning indicator versus USD/CAD

CAD SPI and USD/CAD



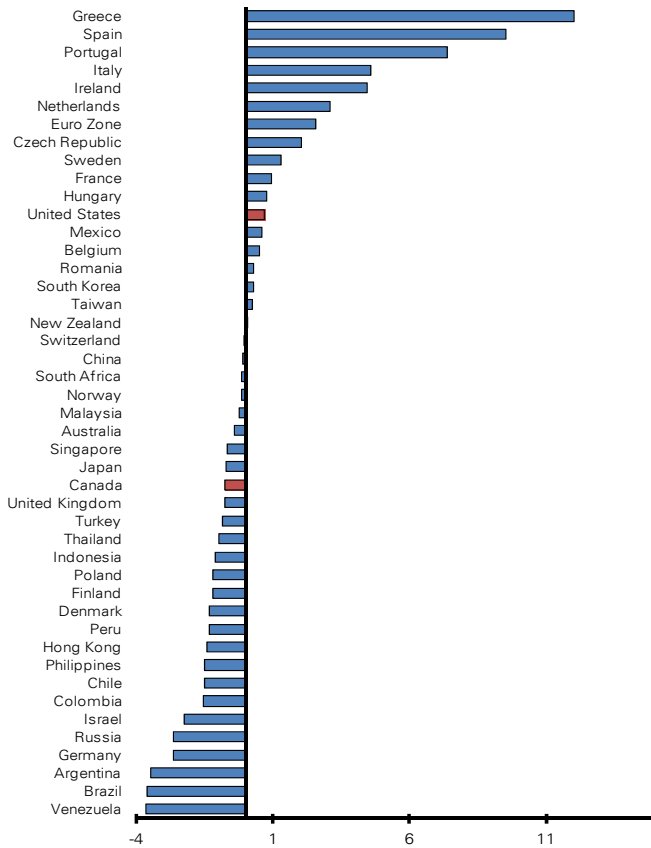
Source: Deutsche Bank

In the medium-term, risks to the bearish CAD view, come from both a CAD and a USD angle, and include:



1. BoC policy could end up not nearly as dovish as expected, under a scenario where: i) Canadian housing proves resilient; goods disinflation dissipates; and, the unemployment rate moves below what can be considered the natural rate of unemployment. As one indication why this is a meaningful risk – Canada’s unemployment rate is already trading 0.6% below the 20yr average. The small Canadian employment gap is something the BoC has been deliberately very quiet about, instead focusing on underemployment, in an effort to avoid more hawkish conclusions. BoC can only maintain this stance while wage inflation remains subdued.

Figure 11: Unemployment rate deviation from 20 year average



Source: Deutsche Bank, EcoWin

2. The less positive USD scenarios include US growth data that is not strong enough to prompt a shift from zero rates, and/or inflation fails to accelerate. This fits with a secular disinflation or stagnation story.

It is worth keeping in mind that even a prolonged weak US growth story will likely result in CAD weakness, since this could form the backdrop of a Canadian housing hard-landing.

Perhaps the most compelling part of the long USD/CAD story is that even under some of the less USD positive scenarios, it is hard to see USD/CAD trade consistently below 1.05, whereas any Canadian hard-landing scenario skews the risks well above fair value, to 1.30 and beyond.