

JULY 11, 2014

## Reloading USD/CAD Longs

**Bottom Line:** We have added a long USD/CAD position to our Strategic FX Portfolio, as today's Canadian labor market report reinforces our conviction that Canada is not nearly as poised to gain from US growth as it was in the past. We think the time is right for this reload, as USD/CAD positioning has shifted net short and USD/CAD has undershot rate differentials. We buy USD/CAD at market with a target of 1.12 and stop at 1.0550.

**Lagging Labor Markets:** Today, Canada reported a net job loss of 9k versus expectations of a 20k gain. A first glance at the underlying details tells a less bearish story, with the job losses all coming from part-time employees and a 33k gain in full-time employment. And as [Statistics Canada](#) points out, there are meaningful seasonal factors which likely skewed the number. But the big picture is that Canada's YTD labor market performance has been dire compared to that in the US. US employment is gaining at a 230k per month pace in 2014, whereas Canada's monthly average is a meager 8k a month (just over 80k if Canada's population equaled that in the US). Moreover, hours worked is down 0.2% YoY, which offsets the modest gains in average hourly earnings and is keeping a lid on nominal labor income growth.

**Imbalances Dominate:** The industry split in today's job report highlights ongoing imbalances in Canada's economy, with construction jobs rising by 32k and manufacturing jobs down 10k, showing five out of six months of net manufacturing job losses in 2014. This should not be too surprising, given Canada's elevated unit labor costs and loss of competitiveness in manufacturing over the last decade or so. The BoC's desired rotation away from housing and toward exports and investment remains elusive, and recent CAD strength will undermine this transition, as we discussed in [CAD: A Bad Rally](#), June 26, 2014.

**BoC Next Week:** The Bank of Canada may have to acknowledge higher-than-expected inflation and revise upward its inflation forecasts when it releases its Monetary Policy Report next Wednesday, but we think this is mostly priced in. Indeed, there is plenty of room for Governor Poloz to take a page out of Fed Chair Janet Yellen's book, looking past recent inflation surprises as 'noise.' The recent increases in inflation are concentrated in components like energy, food, motor vehicle costs and other factors that tend to be more temporary and do not conflict with the BoC's view that there is still plenty of slack in the economy. Indeed, the headwinds of recent CAD strength and the inflation expectations in the Business Outlook Survey may justify a cautious stance from Poloz. The survey, which commands a great deal of focus in the Poloz-led BoC, showed that inflation expectations among businesses have not risen on recent prints; in fact, expectations for input prices have been sharply reduced this quarter.

**The Time Is Now:** USD/CAD has now undershot 2-year rate differentials, and our high frequency misalignment model, which takes into account a number of variables including oil prices, suggests USD/CAD is misaligned by about 3% (see page 23 in [FX Pulse: Volatility Wake-Up Call](#), July 10, 2014). Sentiment towards CAD has shifted radically over the past month. According to our metrics, over 80% of the market is currently bullish CAD. This level of extreme positive sentiment has not been seen since September 2012. Unsurprisingly, this shift in sentiment has been reflected in market positioning, which has also moved a long way over the summer. Non-commercial IMM accounts have now net bought CAD for past three straight weeks, which leaves CAD positioning on the IMM in net long territory for the first time since February 2013. The main risk to our trade would be a reversal of recently upbeat US economic data, which would likely keep a lid on US yields.

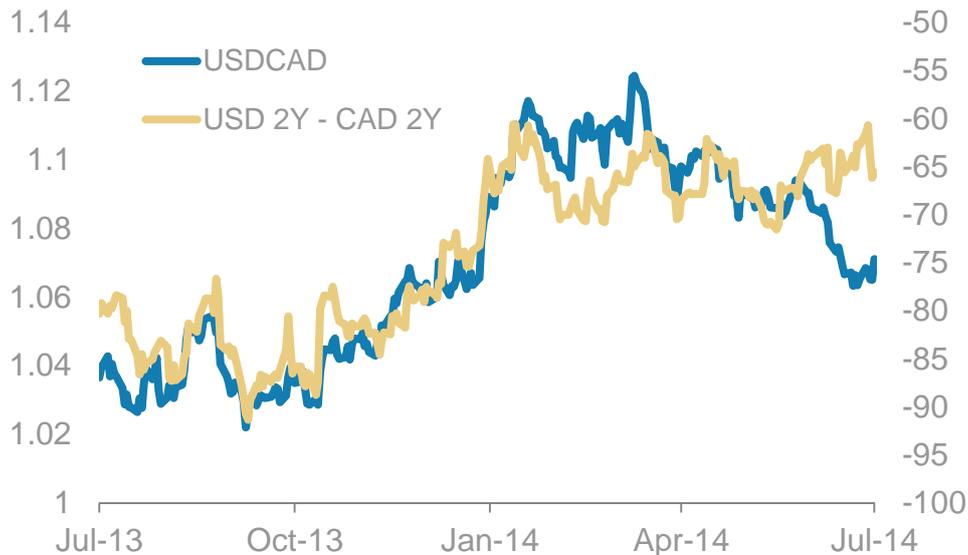
### Morgan Stanley Research FX Strategy

Morgan Stanley &amp; Co. LLC

**Evan Brown, CFA** ✉Currency Strategist  
Vice President  
(1 212) 761 2786**Calvin Tse** ✉Currency Strategist  
Vice President  
(1 212) 296 5423

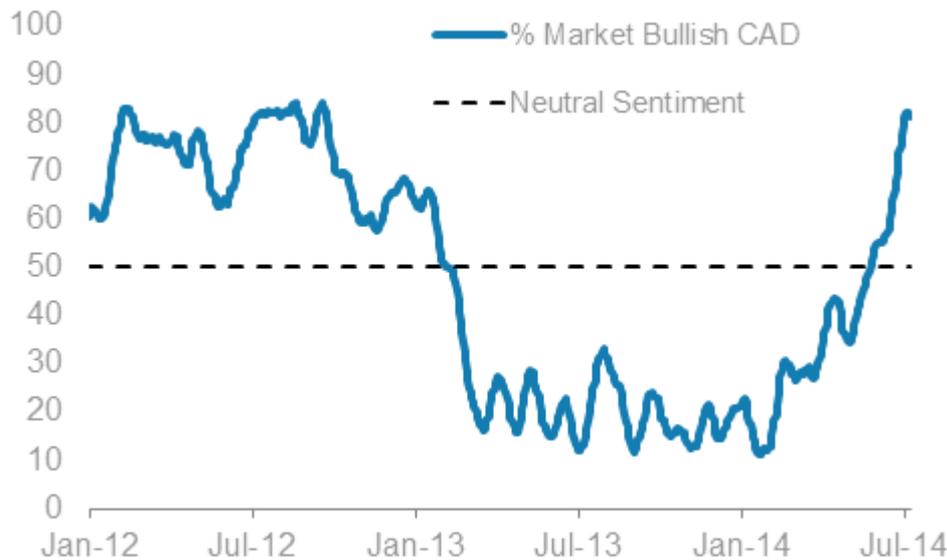
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## USD/CAD Has Undershot Rate Differentials



Source: Bloomberg, Morgan Stanley Research

## Market Has Turned Bullish CAD



Source: Trade Futures Morgan Stanley Research

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