

CAD: Challenges ahead

USD-CAD forecasts

Q4 2020: 1.25

Q1 2021: 1.26

Q2 2021: 1.27

Q3 2021: 1.27

Q4 2021: 1.28

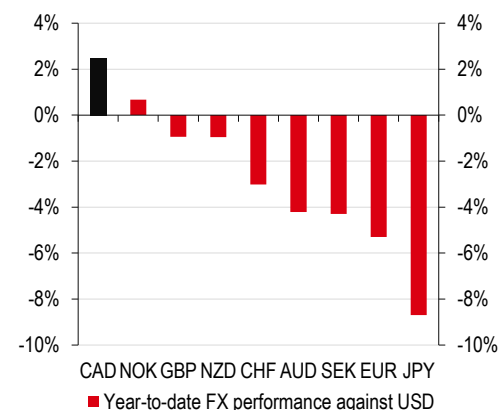
The CAD has spent much of 2021 as the best-performing currency within G10 FX, buoyed by a combination of accelerating activity (globally in H1, locally thereafter), rising oil prices, elevated risk appetite and a marked hawkish shift in Canadian rate expectations. We expect 2022 to be more challenging for the currency. A lot of hawkishness is priced into the CAD and high debt levels may curb the ability of the BoC to deliver in full. Oil prices look lofty and, while global economic momentum should not weaken much, activity is less likely to spur the CAD stronger.

As for many currencies in 2022, the interest rate outlook will be pivotal to CAD fortunes. The difficulty for the CAD is that it is not clear where the additional upside for the currency will come from on this front. At the time of writing, the market was priced for six 25bp hikes by the BoC before the end of 2022. HSBC expects the first hike to come in April 2022, earlier than we previously expected, but with follow-up hikes only in July 2022, October 2022 and January 2023, it would leave the policy rate short of market expectations.

The additional problem for the CAD is that the economy's burgeoning debt levels may make a sequence of rate hikes difficult. Our economists point out that the economy's total debt was almost 350% of GDP as of Q2 21. They fear that financial frailties that were evident before the pandemic may emerge quickly as rates begin to rise. In some respects, this is captured in the market's rate profile which sees hikes being delivered quickly but then little thereafter. In fact, the CAD has some modest inversion in rate expectations between the 1Y and 3Y parts of the curve, in similar though less pronounced fashion to the NZD. This suggests that as the BoC begins to raise rates, the market may swiftly begin to ponder when the tightening cycle might stop. It is not a debate that points to prolonged currency strength.

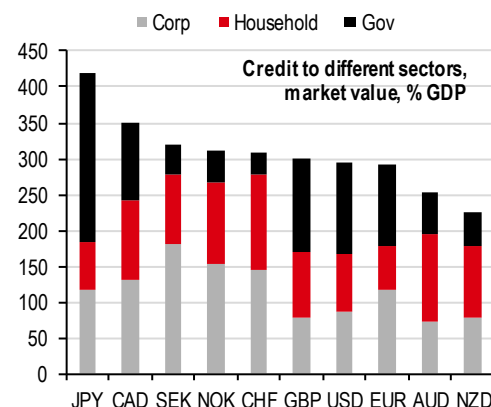
The CAD's relationship to growth dynamics has not been straightforward and it may remain a little complicated. The peaking out in global growth saw the CAD face a challenging Q3 21 but the emergence of Canada's economy from lockdown has seen the CAD reverse roughly half of those Q3 losses against the USD. For 2022, we expect global growth to move mostly sideways but Canada's is likely to see quarterly growth momentum fade through 2022 from an expected strong finish to 2021. As we expect oil prices also to retreat from current levels (and Canada's local prices already tracking well below WTI), the currency may see less uplift from this factor also. We continue to expect USD-CAD to finish 2022 at 1.29.

1. The CAD has outperformed its G10 peers



Note: YTD FX performance as of 10 November 2021
 Source: Bloomberg, HSBC

2. Leverage may limit tightening



Source: HSBC, RBNZ