

## USDCAD Monthly: Oversold and too risky to be too bold

- Strong Canadian data CAD appreciate 3.8% in July but that performance is in-line with peer currencies
- Key events in August are the Jackson Hole Symposium, the NAFTA re-negotiation talks and Q2 GDP releases
- Interest rate differentials have been driving USDCAD while oil has been pushed far into the background
- Positioning has now eased and implied vols are at the lowest level since 2014
- USDCAD should bounce at some point but the long-term trend is now lower so we'd look to sell spikes above 1.27

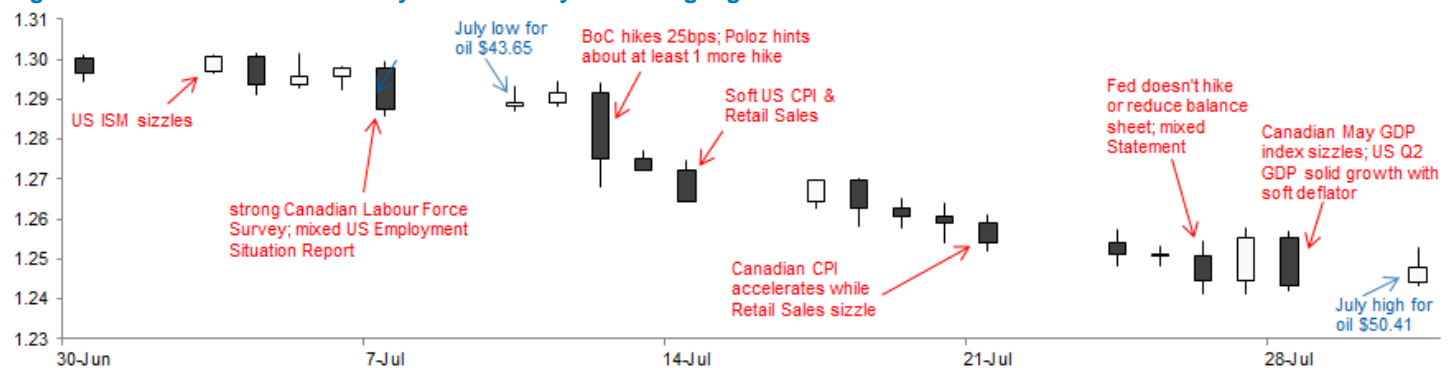
### Recapping July

July marked the second consecutive month of exceptionally strong performance for the Canadian dollar, as shown in [Figure 1](#). A strong Canadian Labour Force Survey got the ball rolling and pushed USDCAD below 1.2900. The BoC's less-neutral-than-expected tone following its rate hike pushed the pair below 1.2700 the next week. Then came strong Canadian CPI and Retail Sales, which pushed USDCAD down to where it was sitting just above key support at 1.2500 (just below 0.8000 in loonie notation). The support was broken as oil rallied to \$50 in the closing days of July, while a sizzling May GDP number put an exclamation point on the month's stream of strong Canadian data.

In the final analysis, CAD gained 3.8% against the USD for the month. The **BoC's trade-weighted CAD index also gained 3.8% in July**. This gain needs to be kept in perspective, though. Fellow oil currency NOK gained 6.0% against the USD. Commodity cousins AUD and NZD gained 4.0% and 2.4%, respectively. EUR gained 4.0% against the USD while JPY gained 1.9%. Based on those comparisons, **CAD's performance is roughly in line with its peers**.

The range width for July was 4.73% wide. The average monthly range width this century has been 3.83%, so July's range was wider than normal. July's realized volatility in USDCAD (using daily closes) was 8.3%—somewhat above the 5Y historical volatility of 7.7%. So from both perspectives, July was a volatile month.

Figure 1. USDCAD bar chart of July 2017 with key events highlighted



Sources: Bloomberg, BMO FX Strategy

### Issues and events in August

The calendar in [Figure 2](#) outlines the most important events and data releases for August. As is normal, **neither the Fed nor the BoC has a policy meeting**. There is one key monetary policy event, though. The **Jackson Hole Symposium, scheduled for August 24-26**, will focus on the topic of "Fostering a Dynamic Global Economy." The final speaker list has not yet been published, so it is **unclear if Yellen or Poloz will speak**, but even if they don't, the meetings may

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nevertheless set the tone for monetary policy for the remainder of the year. The **rapid decline of the USD over the past six months will undoubtedly be a focus of private discussions** between central bankers.

In addition to monetary policy, trade policy will also be a factor that impacts USDCAD in August. The **opening talks of NAFTA renegotiation will begin on August 16** and will run for four days. The US was required by law to publish its objectives in the renegotiation and already did so. The published set of US objectives was relatively benign so we presume **USDCAD is priced for the talks to be nondisruptive** to financial markets. However, there is a risk that one of the participants in the talks takes a hardline public stance that catches markets off-guard.

The economic data highlights for July are the **‘twin’ employment reports on August 4**, the Canadian CPI reading to be published on August 18, the 2<sup>nd</sup> print of US GDP to be published on August 30 and the initial release of **Canadian Q2 GDP on August 31**.

**Figure 2. August calendar of key events for USDCAD**

Monday	Tuesday	Wednesday	Thursday	Friday
	1  Manufacturing ISM (Jul)	2	3  Non-Manu ISM (Jul)	4  Labour Force Survey (Jul)  Trade Bal (Jun)  Ivey PMI (Jul)  Employment Situation Report (Jul)  Trade Bal (Jun)
7  Market Holiday	8	9  Housing Starts (Jul)  Building Permits (Jun)  Wholesale Trade (Jun)	10  New House Prices (Jun)	11  CPI (Jul)
14	15  Existing Home Sales (Jul)  Retail Sales (Jul)	16  Housing Starts & Building Permits (Jul)  NAFTA Renegotiation Talks (run thru 20 <sup>th</sup> )	17  Industrial Production (Jul)	18  CPI (Jul)
21  Wholesale Trade Sales (Jun)	22  Retail Sales (Jun)	23	24  Jackson Hole Policy Symposium (Aug 24-26)	25  Durable Goods (Jul)
28	29	30  GDP (Q2 2 <sup>nd</sup> print)	31  GDP (Q2)	

Sources: Bloomberg, BMO FX Strategy

## Key driver breakdown

Among the set of financial variables that we track, **the variable that stands out as being the best out-of-sample predictor of USDCAD over the last three months is the two-year swap rate differential** (see [Figures 3 and 4](#)). On a

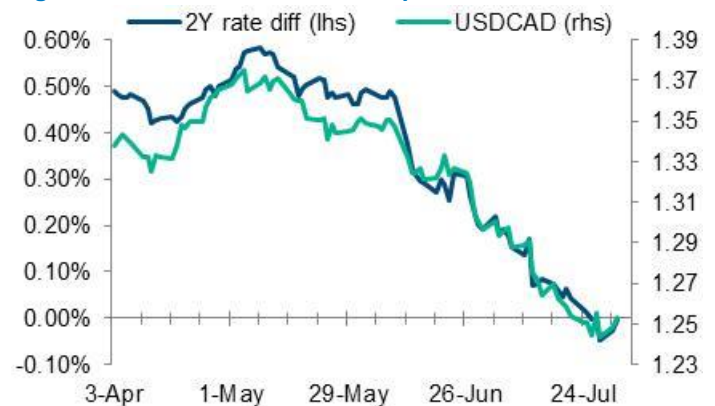
rolling 3M basis, the CRB's out-of-sample R-squared (computed via day-ahead forecasts from a rolling regression on USDCAD) comes in at 0.95. This is an extraordinarily high reading that suggests this variable has been the overwhelming driver of USDCAD. The next two variables in the pecking order are also interest rate differentials. Given how little USD-denominated interest rates have moved, perhaps **the most accurate statement is that Canadian interest rates have been driving USDCAD**. This is not usually the case. **It is likely that global drivers, like oil and USD-denominated rate movements, will reassert their control over USDCAD when CAD-denominated rates settle a bit.**

**Figure 3. 3M out-of-sample R<sup>2</sup> against USDCAD**



Sources: Bloomberg, BMO FX Strategy

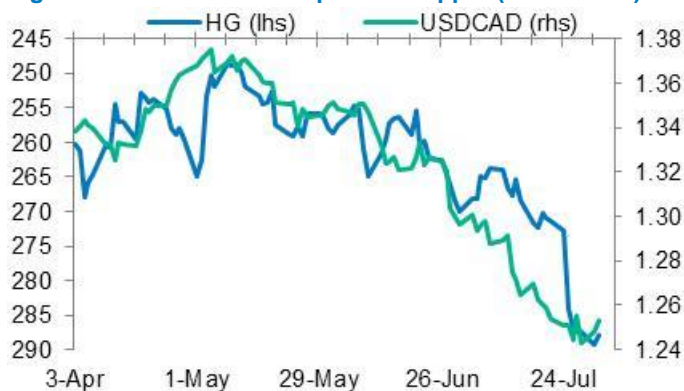
**Figure 4. USDCAD and the 2Y swap rate differential**



Sources: Bloomberg, BMO FX Strategy

When one thinks of USDCAD drivers, oil (and the more general commodity category) is normally what comes to mind first. However, oil has had almost no relationship with USDCAD over the past few months. **Strangely, the commodity price that has been the most correlated with USDCAD is copper**, as shown in **Figure 5**. Other than to note that copper is probably a better proxy for global growth than oil right now, we won't try to explain why this correlation is high. **We expect oil to resume its normal role as the commodity price that is most relevant to USDCAD over the next few months, but that may require a meaningful oil breakout from the \$45-50 range.**

**Figure 5. USDCAD and the price of copper (front future)**



Sources: Bloomberg, BMO FX Strategy

**Figure 6. USDCAD and the DXY dollar index**



Sources: Bloomberg, BMO FX Strategy

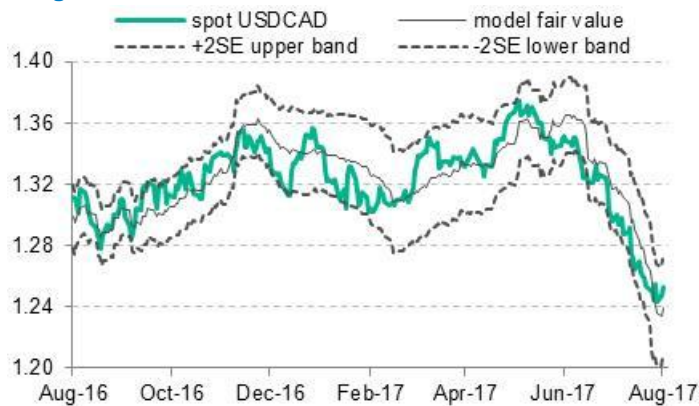
**The risk appetite indicator that has been the best out-of-sample predictor of USDCAD over the past three months is the DXY dollar index**, as shown in **Figure 6**. Since the euro is the biggest component of DXY, this is another way of saying that EUR and CAD have become substantially correlated in their day-to-day movements. This normally happens when the 'big dollar' is driving both EURUSD and USDCAD, but in this case, it appears that **global investors came to expect monetary tightening by both the BoC and ECB at about the same time.**

## Fair value model

BMO FX Strategy has a proprietary short-term fair value model for USDCAD. Our model compares USDCAD to four interest rate differentials (3M, 2Y, 5Y and 10Y) along with four commodity price variables (oil, copper, CRB index, JOC

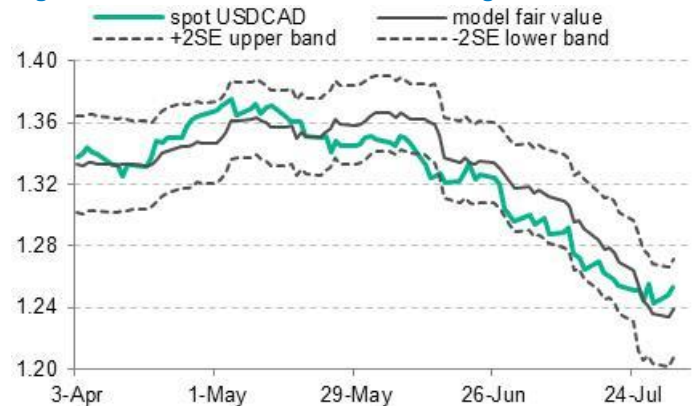
index) and four risk appetite variables (S&P 500 index, 10Y USD swap spread, DXY index, ADXY index). The model selects the variable from each category that is the best at forecasting the exchange rate out of sample. The model then combines the forecasts from the best variable from each of the three variable types in to a weighted average forecast or 'fair value' that gives the highest weight to the variable that forecasts the day-ahead exchange rate the best. **Our model presently puts the highest weight on the 2Y interest rate differential, but its fair value is also influenced by the price of copper and the DXY.** Figures 7 and 8 depict our model's central range along with spot USDCAD.

**Figure 7. USDCAD and BMO 'fair value' wide view**



Sources: Bloomberg, BMO FX Strategy

**Figure 8. USDCAD and BMO 'fair value' tight view**



Sources: Bloomberg, BMO FX Strategy

**Our model's fair value (FV) fell to 1.2337 on July 31 from 1.2964 at the start of the month, as shown in Figures 7 and 8.** The model uses a 1M lookback period to judge FV trend, so it judges the trend as sharply downward-sloping. Consequently, **the model is in a sell-on-spikes mode** (and has been since June 19). **The model got short at 1.2554 on the close of July 27 and is still holding that position.**

## August has a benign seasonality story

Data from the past 30 years would suggest **there are two major seasonalities in the pair**, as shown in Figure 9. Those seasonalities are in April-May and November-December. August is roughly a neutral month. In raw terms, **the average rise in USDCAD during August has been 0.10%**. Adjusted for the year's trend (as shown in Figure 10), the August seasonality been -0.05%. We normally ignore monthly seasonalities smaller than 0.5%.

**Figure 9. 30-year avg USDCAD by date and 30Y avg trend**



Sources: Bloomberg, BMO FX Strategy

**Figure 10. Average deviation in USDCAD from trend by date**



Sources: Bloomberg, BMO FX Strategy

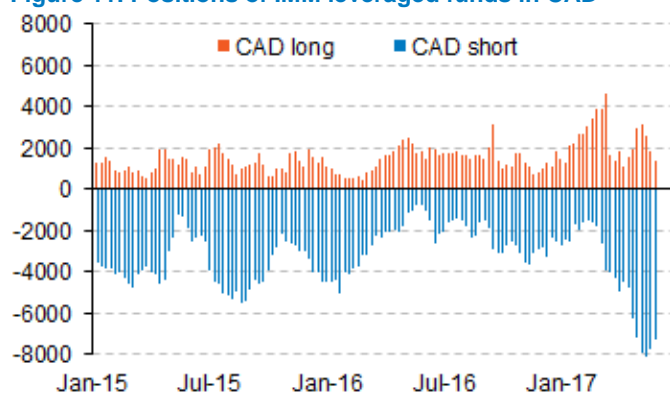
## Market positioning and implied volatility considerations

According to the CFTC's Commitment of Traders data from the July 25 survey, **IMM leveraged funds are substantially long-CAD (short-USDCAD)**. As shown in Figure 11, their long-CAD side was 56,934 contracts (worth USD4551mn) while their short-CAD side was 46,441 contracts (worth USD3713mn). **The long-CAD side stood at 98% of its rolling**

**3Y maximum and 282% of its rolling 3Y average.** The short-CAD side stood at 44% of its 3Y extreme and at 108% of its 3Y average. Speculative open interest in USDCAD stood at 164% of its 3Y average.

Implied FX volatility has risen over the past month. At the 3M tenor, **implied ATMF vol has risen to 7.9 today from below 7.0 at the end of June and levels 6.0 in mid May.** With realized 3M volatility at 7.3%, implied vol is trading at roughly its normal markup over realized volatility. Once the rise in vol is factored in, **25-delta risk reversals are showing a smaller premium for USD calls than has been the norm** over the past year, as shown in [Figure 12](#). This suggests that end-user demand for CAD calls has risen relative to demand for USD calls.

**Figure 11. Positions of IMM leveraged funds in CAD**



Sources: CFTC, Bloomberg, BMO FX Strategy

**Figure 12. 25-delta risk reversals divided by atmf implied vols**



Sources: Bloomberg, BMO FX Strategy

## Outlook summary

**We have put our 1M outlook at 1.26** as shown in [Figure 13](#). That outlook reflects our expectation that USDCAD is a bit oversold and is likely to rebound at some point. We think the pair is overdue to bounce to the 1.27-1.28 range. The difficulty in making such a call is getting the timing right. We suspect that the corrective rebound will happen in the first half of the month and that USDCAD will be back down to 1.25-1.26 by the end of the month.

**Figure 13. Strategy team view summary**

Strategy team view	1M	3M	6M	9M	12M
	1.26	1.25	1.25	1.24	1.23

Source: BMO FX Strategy

**We have put our 3M outlook at 1.35.** We do expect the BoC to hike on October 25, but that hike is already priced into the money market and shouldn't cause a stir. We expect the Fed to begin balance sheet reduction in October, but we don't think that will be a market-moving influence.

**Our 12M call is 1.23.** That outlook is based on our expectation of **2 BoC hikes and 2 FOMC hikes over the next year.** We expect oil to rise moderately to average in the low \$50s by next summer. We expect the US's twin deficits to continue to deteriorate, which is a background USD-negative factor that should keep the general trend in USDCAD downward sloping for the next few years. Where US tax reform was a big USD-positive risk factor earlier this year, now it more balanced. The US could pass a HIA2-type amnesty window that would be mildly USD positive, but it's also possible that the US could end up passing a budget-busting tax cut in 2018 that would be mildly USD negative.

## Trading thoughts

Our model is in a sell-on-spikes mode. We agree with our model in terms of that general idea, although we think it probably jumped the gun a bit. **For August, we would sit neutral to start the month,** looking for a spike above 1.2700. **We would look to get short USDCAD at or above 1.2780** with a target of revisiting 1.2450. We would set a stop loss of 1.2940 for any short position entered on a 1.27 round figure.

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