

## USDCAD Monthly: New year but similar themes and range (for now)

- USDCAD maintained a 1.25 to 1.29 range in December but faded to that range's bottom late in the month
- Key programmed events in January are a BoC meeting (17<sup>th</sup>), a Fed meeting (31<sup>st</sup>) and a twin payrolls day (5<sup>th</sup>)
- Progress from the 5<sup>th</sup> round of NAFTA renegotiations (23<sup>rd</sup> to 28<sup>th</sup>) will also be a key theme
- Interest rate differentials and the DXY have been more reliable drivers of USDCAD than oil
- Positioning is now nearly neutral and implied vol is mapped on top of historical vol
- Our January strategy would be to buy early dips in USDCAD below 1.2500 and sell any spikes above 1.2750

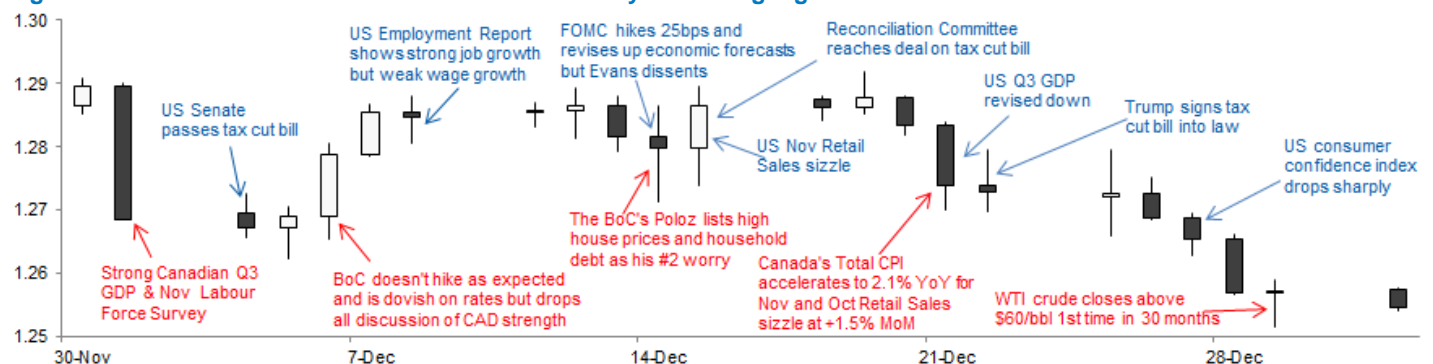
### Recapping December

USDCAD began December hovering near 1.29 but strong Canadian data pushed USDCAD below 1.27 early in the month, as shown in [Figure 1](#). At that point, rising optimism that the US would get the votes to pass a tax cut fueled a USDCAD recovery back up to 1.29. Then, with year-end holidays rapidly approaching and liquidity thin, Canada reported surprisingly strong CPI and Retail Sales data, which sent USDCAD back below 1.27 again. The pair continued to drift lower in the week between the Christmas and New Year's holidays with minimal news flow other than WTI crude printing above \$60/bbl for the first time since June 2015. USDCAD closed December (and the year) near the month's low just above 1.25.

**The range width for December was 3.18% wide. The average monthly range width this century has been 3.79%, so December's range was a bit narrower than normal. However, December's realized volatility in USDCAD (using daily closes) of 8.2% was slightly above the 5Y historical volatility of 7.7%.** Given those mixed results, we'd simply call it a normal month in terms of choppiness and volatility.

In the final analysis, CAD gained 2.6% against the USD in December. The **BoC's trade-weighted CAD index gained 2.8%**. For comparison, commodity cousins AUD and NZD gained 3.2% and 3.8% against the USD, respectively, while NOK gained 1.4%. With that, **we'd characterize CAD's performance as unexceptional for a G10 commodity currency.** However, it should be noted that CAD did outperform EUR (+0.8% against the USD), GBP (-0.1%) and JPY (-0.1%). It should also be noted that CAD appreciated substantially relative to MXN (which fell 5.4% against the USD) due to political turmoil in Mexico. If it holds over the medium term, the present CADMXN level could impact Canada's competitiveness within NAFTA (if that remains through the end of 2018).

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



Sources: Bloomberg, BMO FX Strategy

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














## Events and issues for January

The calendar in [Figure 2](#) outlines the most important events and data releases for January. The most critical data dates are January 5<sup>th</sup> (twin payrolls, twin trade balances) and the 26<sup>th</sup> (Canadian CPI, US Advance GDP for Q4).

**Both the Fed and the BoC have policy meetings.** The BoC's meeting on January 17<sup>th</sup> is 'on-cycle' in that it includes an update to the MPR and a press conference. **The OIS curve has 11bps of tightening priced in for the BoC meeting, which suggests the potential for a 1-2% move in either direction** depending on what the BoC does. The Fed's meeting on the 31<sup>st</sup> is 'off-cycle' and therefore won't include updated economic forecasts or a press conference. However, it will have a certain amount of intrigue because of the rotation of new regional Fed Presidents into voter slots on the FOMC. It is the last meeting that will be chaired by Janet Yellen. The change of guard makes it **unlikely that the FOMC would hike in January and markets have very little priced in for that meeting**, but markets fully price in a March Fed hike. With that in mind, **a Fed hike would lift USDCAD by 1-2%, but a Fed hold should have little impact.** Our house call is for the BoC to stand pat in January and hike in March, so we view the monetary factor as USDCAD positive in January.

The sixth round of **NAFTA talks are scheduled to be held in Montreal from the 23<sup>rd</sup> through the 28<sup>th</sup>.** With all three countries pushing for resolution by the end of March, this set of talks is critical. However, we wouldn't trust the **headlines** that emerge because they **are likely to exaggerate breakup risk** with all sides refusing to cave on key demands until the bitter end. With that in mind, we would view NAFTA headline risks as another USDCAD positive factor (for now).

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

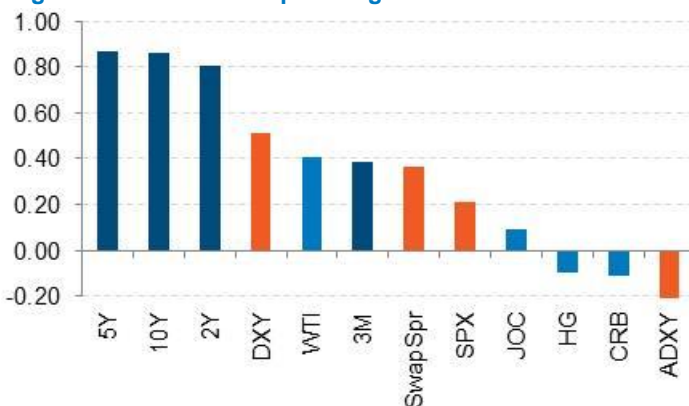
Monday	Tuesday	Wednesday	Thursday	Friday
<b>1</b>  <b>New Year's Day (markets closed)</b>  <b>New Year's Day (markets closed)</b>	<b>2</b>	<b>3</b>  Manufacturing ISM (Nov)  FOMC Minutes	<b>4</b>  Non-Manu ISM (Dec)	<b>5</b>  <b>Labour Force Survey (Dec)</b>  <b>Trade Bal (Nov)</b>  <b>Employment Situation Report (Nov)</b>  Trade Bal (Nov)  Ivey PMI (Dec)
<b>8</b>	<b>9</b>  Housing Starts (Dec)	<b>10</b>  Building Permits (Nov)  Wholesale Trade (Nov)	<b>11</b>  New House Prices (Nov)  PPI (Nov)	<b>12</b>  CPI (Dec)  Retail Sales (Dec)
<b>15</b>  <b>Martin Luther King market holiday</b>	<b>16</b>	<b>17</b>  <b>BoC Policy Announcement, MPR &amp; Press Conference</b>	<b>18</b>  Housing Starts & Building Permits (Dec)	<b>19</b>  Continuing budget resolution expires
<b>22</b>  Wholesale Trade Sales (Nov)	<b>23</b>   <b>Sixth round of NAFTA re-negotiations starts (ends on the 28<sup>th</sup>)</b>	<b>24</b>	<b>25</b>  Retail Sales (Nov)	<b>26</b>  CPI (Dec)  Real GDP (Q4 A)  Durable Goods (Dec)
<b>29</b>  PCE deflator (Dec)	<b>30</b>	<b>31</b>  <b>Monthly GDP (Nov)</b>  FOMC Policy Decision	<b>1</b>	<b>2</b>

## Key driver breakdown

Among the set of financial variables that we track, **the variable that is the best out-of-sample predictor of USDCAD over the last three months is the 5Y swap rate differential** (see [Figures 3](#)). On a rolling 3M basis, the 5Y IRD's out-of-sample R-squared (computed via day-ahead forecasts from a rolling regression on USDCAD) comes in at 0.89. That reading (and the fact that the 10Y and 2Y IRD's are #2 and #3 in our pecking order) suggests that relative monetary policy (and market expectations thereof) continue to drive USDCAD much more than commodity prices or risk appetite.

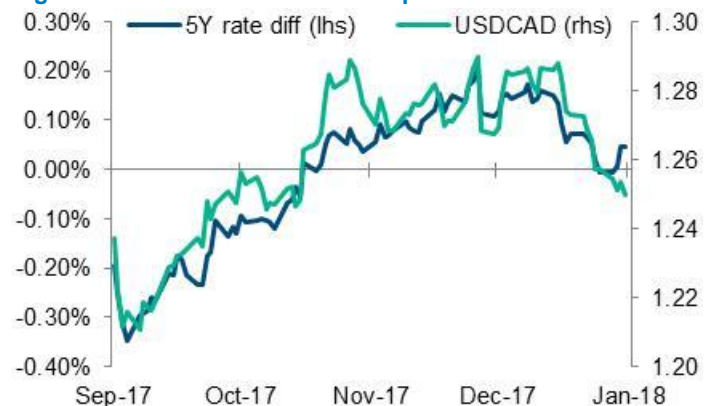
**The 5Y IRD moved 22bps in CAD's favor in December**, although it has reversed and moved 6bps in the USD's favor in the first three trading days of January. **Canadian rates rose 26bps while USD rates rose 4bps last month.** The CAD OIS curve shifted from pricing in two BoC hikes in 2018 to three while the USD curve retained an expectation of 2-3 Fed hikes this year. As shown in [Figure 4](#), the movements in USDCAD during December tracked the move in the 5Y IRD quite closely, although the weakness in USDCAD in early January doesn't match the uptick in the IRD.

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



Sources: Bloomberg, BMO FX Strategy

**Figure 4. USDCAD and the 5Y swap rate differential**



Sources: Bloomberg, BMO FX Strategy

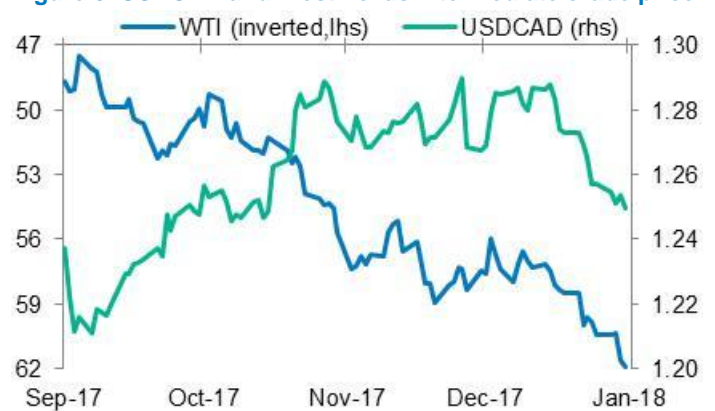
After the three interest rate differentials, the variable that comes in at #4 in our pecking order is the DXY dollar index. As shown in [Figure 5](#), the waves in USDCAD generally mapped with the waves in DXY during December. However, the DXY lost only 1.0% in December (vs 2.6% for USDCAD). With IMM leveraged funds long-USD against other G10 currencies despite analysts expressing bearish sentiment in forecast surveys, **we see the potential for a further USD decline in January and would nominate the 'big dollar' factor as the most bearish factor this month.**

**Figure 5. USDCAD and the DXY dollar index**



Sources: Bloomberg, BMO FX Strategy

**Figure 6. USDCAD and West Texas Intermediate crude price**



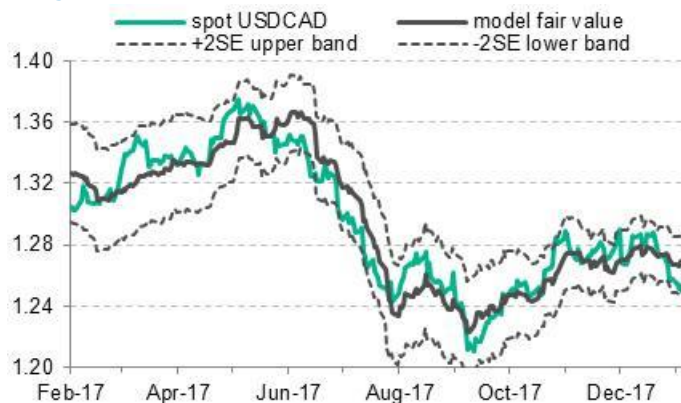
Sources: Bloomberg, BMO FX Strategy

Oil had a tenuous and inconsistent relationship with USDCAD in 2017 so WTI crude comes in at only #5 in our pecking order based on a 3M mapping of variables with USDCAD. However, [Figure 6](#) shows that **USDCAD has mapped fairly tightly with the WTI crude price since mid November**. One interesting side note is that while West Texas crude gained \$3.02 or 5.3% in December, Western Canadian Select didn't follow. In fact, the WTI-WCS spread widened by \$8.90 and the **WCS spot price fell by \$5.88 or 14.6% in December.**

## Fair value model

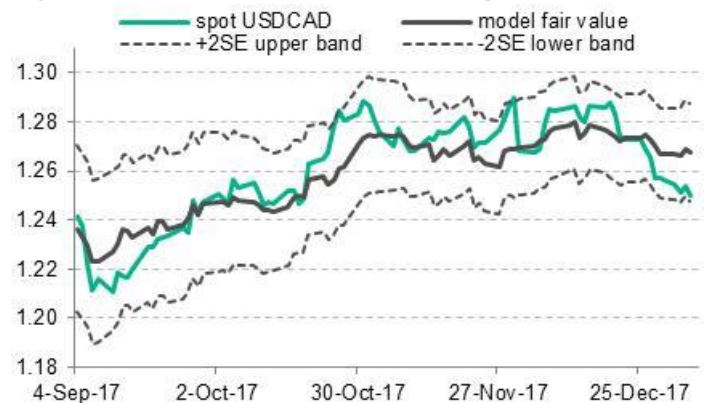
BMO FX Strategy has a proprietary short-term fair value model for USDCAD. Our model compares USDCAD to four interest rate differentials (3M, 2Y, 5Y and 10Y) along with four commodity price variables (oil, copper, CRB index, JOC index) and four risk appetite variables (S&P 500 index, 10Y USD swap spread, DXY index, ADXY index). The model selects the variable from each category that is the best at forecasting the exchange rate one day ahead. The model then combines the forecasts from the best variable from each of the three categories into a joint forecast or 'fair value'. **Our model presently puts the highest weight on the 5Y interest rate differential, but its fair value is also influenced by the DXY and oil.** 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 1.2672 on December 29 from 1.2686 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 mildly downward-sloping. Consequently, **the model is now in a sell-on-spikes mode. The model is likely to remain in a sell-on-spikes mode for at least the first half of January.** The model had two bad trades in December. It got short at 1.2789 on the close of December 6<sup>th</sup> and closed out the trade at 1.1.2848 two days later. It got long on the close of December 22<sup>nd</sup> at 1.2729 and closed the position at 1.2512 on January 2<sup>nd</sup>. For 2017, the model had 12 successful trades and 5 losing trades.

## Seasonals are roughly neutral

Data from the past 30 years would suggest there are two major seasonalities in USDCAD, as shown in Figure 9. The March-April and November-December seasonalities are both bigger than 1.0%. The month of January has a slight +0.4% seasonality. Adjusted for the year's trend (as shown in Figure 10), that seasonality is 0.5%. That is small enough that **we are ignoring the seasonal in our January outlook.**

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



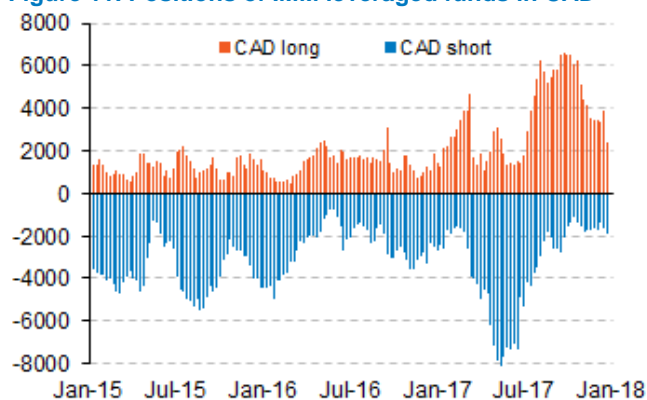
Sources: Bloomberg, BMO FX Strategy

## Market positioning and implied volatility

According to the CFTC's Commitment of Traders data from the December 26 survey, **IMM leveraged funds are very slightly long-CAD (short-USDCAD)**. As shown in **Figure 11**, their long-CAD side was 30,763 contracts (worth USD2425mn) while their short-CAD side was 24,114 contracts (worth USD1901mn). The **long-CAD side stood at 37% of its rolling 3Y maximum while the short-CAD side stood at 23% of its 3Y maximum**. Speculative open interest in USDCAD stood at 82% of its 3Y average. **All these data points suggest that speculators have left USDCAD for other exchange rates**. We conclude that positioning is a neutral factor for now.

Implied FX volatility rose moderately in December, as shown in **Figure 12**. At the 3M tenor, implied ATM vol rose a half vol to about 7.0 for the start of 2018. Realized 3M vol is at 7.1% and was steady between 7.0% and 7.5% in December. Implied vol therefore maps on top of realized volatility, which suggests the market isn't expecting any dramatic shifts in either the exchange rate or market conditions.

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



Sources: CFTC, Bloomberg, BMO FX Strategy

**Figure 12. Implied 3M vols and realized 3M volatility**



Sources: Bloomberg, BMO FX Strategy

## Outlook summary

**We have put our 1M outlook at 1.27** as shown in **Figure 13**. That outlook reflects our view that the BoC won't hike and that NAFTA headlines will be mostly negative for the future of the agreement. However, while we are projecting spot 2 big figures higher, **we think January's range will be 1.24 to 1.28**, which is a big figure lower than December's range.

**Figure 13. Strategy team view summary**

	1M	3M	6M	9M	12M
<b>Strategy team view</b>	<b>1.27</b>	<b>1.24</b>	<b>1.23</b>	<b>1.22</b>	<b>1.21</b>

Source: BMO FX Strategy

**We have put our 3M outlook at 1.24**. We base this on the expectation one the Fed and BoC each hiking in March and on NAFTA talks will ultimately reach a successful conclusion in late March (just in time for the presidential election campaign season in Mexico).

**Our 12M call is 1.21**. That outlook is **based on our expectation that strong global growth will continue to weigh on the broad USD, which will pull USDCAD along with it**. As a secondary factor, we also think that widening US twin deficits will also put downward pressure on the USD index and USDCAD. In percentage terms, we have USDCAD moving 3-4% lower in 2018 after dropping 6.6% in 2017. Note that we expect further USDCAD downside even those we expect the Fed to hike 3 times and the BoC to hike only twice (the same as 2017).

## Trading thoughts for January

Our model is in a sell-on-spikes mode. We agree with our model in terms of that general idea. **We would sell USDCAD above 1.2750 with a stop at 1.2920**. We wouldn't take profit on any shorts that might result from that strategy until 1.23000. However, **we would also look to buy USDCAD below 1.2500 early in the month targeting a rally to 1.2650 post-BoC**. Our stop for any such short-horizon trade would be quite tight at 1.2420 or so.

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