

USDCAD Monthly: spot likely to rise with temperatures over summer

- After the break of 1.36 failed to extend to 1.40, positioning dragged USDCAD lower in the latter half of May
- Key dates in June include the 8th (Poloz press conference) and 14th (FOMC rate decision & Yellen presser)
- Commodity prices and interest rate differentials both say USDCAD should be a bit higher than it is right now
- Positioning has now eased and implied vols are at the lowest level since 2014
- Our model is in a buy-on-dips mode and we concur; we would buy at 1.3450 targeting 1.3700

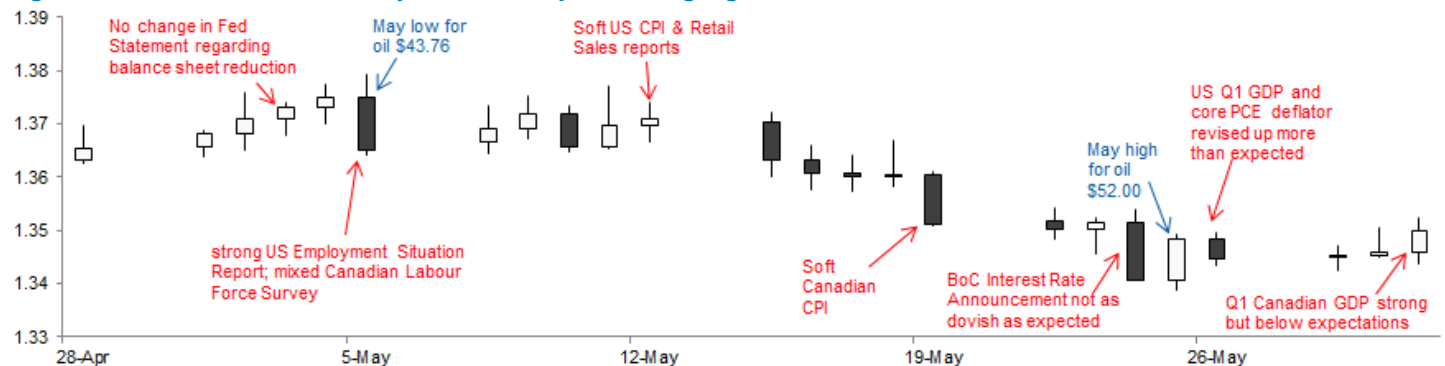
Recapping May

After a dubious beginning, May turned into a strong month for the Canadian dollar. May began with the pair in an apparent breakout higher as it had risen above the old resistance level of 1.3600. In the first week of the month, it made a run at 1.38 as WTI oil dropped below \$45. However, a recovery in oil and an attack on short-CAD positions brought USDCAD all the way back down to 1.34, as shown in [Figure 1](#).

The range width for May was 2.98%. The average monthly range width this century has been 3.83%, so May's range was a bit narrower than normal. May's realized volatility in USDCAD (using daily closes) was 6.0%—substantially below the 5Y historical volatility of 7.7%. So from both perspectives, May was a relatively quiet month in terms of price action.

In the final analysis, CAD gained 1.1% against the USD for the month. EUR was the best performing G10 currency with a +3.1% spot return. Commodity cousin NZD also gained by 3.1%. Fellow oil exporter NOK also outperformed CAD with a 1.8% spot gain. NAFTA cousin and fellow oil currency matched CAD with a 1.1% gain. GBP and AUD were the G10's big losers with 0.5% and 0.8% declines, respectively. Based on those comparisons, **CAD seems to have slightly underperformed its peer currencies. The BoC's trade-weighted CAD index gained 0.8% in May.**

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



Sources: Bloomberg, BMO FX Strategy

Key issues and events for June

The calendar in [Figure 2](#) outlines the most important events and data releases for June. The obvious highlight is the **FOMC on June 14**, which will include updated projections and a press conference. At this stage, a rate hike is completely priced in, so the biggest FX move would result from the Fed standing pat. **BMO's house call is for a 25bp hike.**

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The BoC's next meeting isn't until July 12. However, the BoC does have a couple of noteworthy reports scheduled for release. **On June 8, the BoC will release its semiannual Financial System Review. BoC Governor Poloz will present his thoughts in a press conference.** At month's end, on June 30, the BoC will release its quarterly Business Outlook and Senior Loan Officer Survey.

May's price action demonstrated that USDCAD is much more driven by commodity prices and geopolitics than data, but there are a few data events worth highlighting. **Canada's Labour Force Survey is due out on June 9. Canada releases its April monthly GDP indicator on June 30**, while the US will release its 3rd and final print of Q1 GDP on June 29.

Figure 2. June calendar of key events for USDCAD

| Monday | Tuesday | Wednesday | Thursday | Friday |
|--|--|---|---|--|
| | | | 1  Manufacturing ISM (May) | 2  Employment Situation Report (May)  Trade Bal (Apr)  Trade Bal (Apr) |
| 5  Non-Manu ISM (May) | 6  Ivey PMI (May) | 7  Building Permits (Apr) | 8  Housing Starts (May)  New House Prices (Apr)  BoC Financial System Review | 9  Labour Force Survey (May)  Wholesale Trade (Apr) |
| 12 | 13 | 14  CPI (May)  Retail Sales (May)  FOMC rate decision with SOER update and Yellen Press Meeting | 15  Existing Home Sales (May)  Industrial Production (May) | 16  Housing Starts & Building Permits (May) |
| 19 | 20  Wholesale Trade Sales (Apr) | 21 | 22  Retail Sales (Apr) | 23  CPI (May) |
| 26  Durable Goods (May) | 27 | 28 | 29  Real GDP (Q1, 3rd print) | 30  Real GDP (Apr)  BoC Business Outlook & Senior Loan Officer Survey (Q2)  Core PCE Deflator (May) |

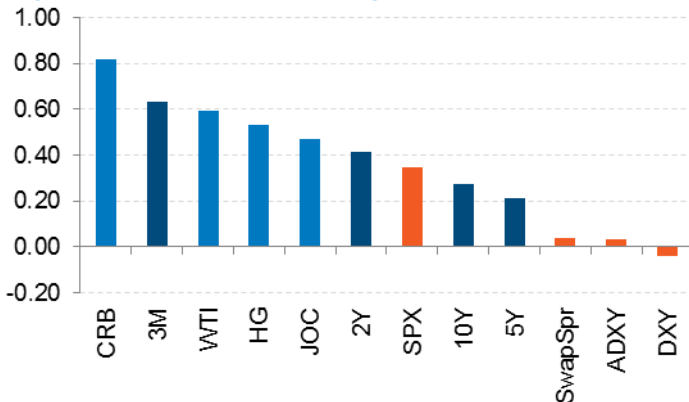
Sources: Bloomberg, BMO FX Strategy

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 CRB commodity price index** (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 0.82. We admit that oil was the #1 point of discussion for USDCAD in May, but the CRB was more

correlated to USDCAD. The CRB's makeup is about 1/3 energy, so its movements in May were clearly influenced by movements in oil.

Figure 3. 3M out-of-sample R² against USDCAD



Sources: Bloomberg, BMO FX Strategy

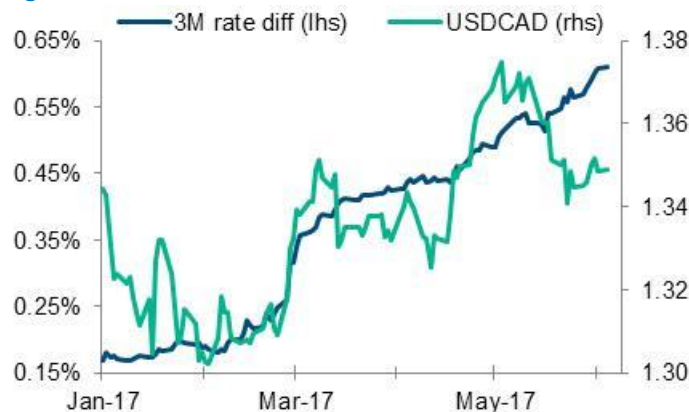
Figure 4. USDCAD and the CRB commodity price index



Sources: Bloomberg, BMO FX Strategy

The second best predictor of USDCAD over the past few months is the **3M interest rate differential**. This differential **has steadily moved in the USD's favor over the past month as the Fed's June rate hike has rolled into the curve**, as shown in **Figure 5**. This factor, taken alone, suggests that USDCAD should be trading near 1.37. Other tenors of IRDs admittedly don't see USDCAD that undervalued, but they haven't been as good of predictors.

Figure 5. USDCAD and 3M interest rate differential



Sources: Bloomberg, BMO FX Strategy

Figure 6. USDCAD and the S&P 500 equity index



Sources: Bloomberg, BMO FX Strategy

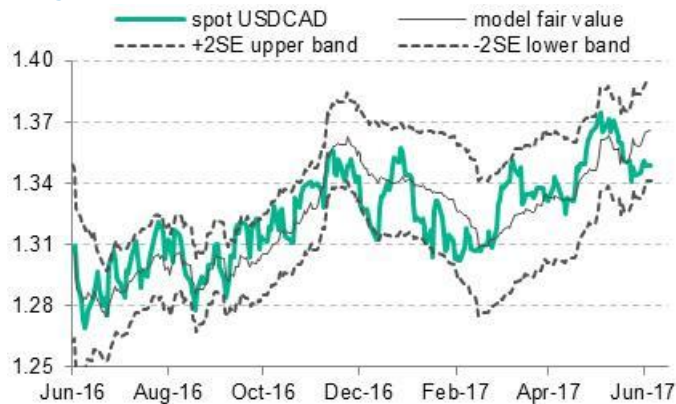
The third category of USDCAD drivers is risk appetite indicators. The risk appetite indicator that has been the best predictors of USDCAD in 2017 has been the S&P 500 index. It has had a noteworthy positive correlation with USDCAD, as shown in **Figure 6**. There are a couple of reasons why USDCAD now tends to move higher in periods of equity risk-on trading. First, long USDCAD is now a carry trade and carry trades are almost always correlated with equities. Second, both the S&P 500 and USDCAD are being somewhat driven by expectations regarding US tax reform. We expect the positive correlation between USDCAD and SPX to continue—at least until we have closure on tax reform.

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**

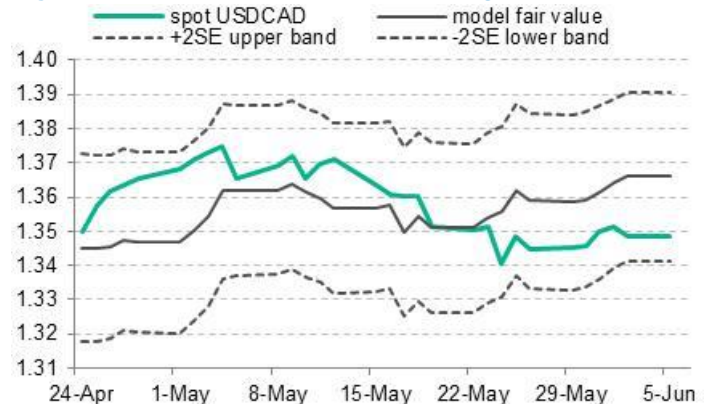
presently puts the highest weight on the CRB, but its fair value is also influenced by the 3M interest rate differential and the S&P 500. **Figures 7 and 8** depict our model's central range along with spot USDCAD.

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) rose to 1.3616 on May 31 from 1.3468 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 upward-sloping for now. Consequently, **the model is in a buy-on-dips mode** (and has been since March 10). **The model got long at 1.3511 on the close of May 19 and is still holding that position.**

Seasonality stories

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. June is roughly a neutral month. In raw terms, **the average decline in USDCAD during May has been 0.22%**. Adjusted for the year's trend (as shown in **Figure 10**), the June seasonality been -0.06%.

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



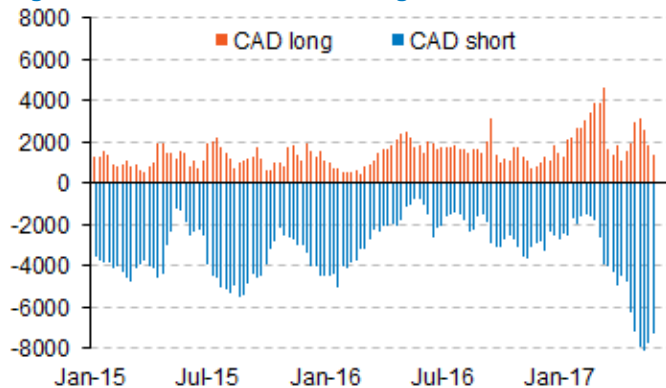
Sources: Bloomberg, BMO FX Strategy

Market positioning and options implied volatility considerations

According to the CFTC's Commitment of Traders data from the May 30 survey, **IMM leveraged funds remain extremely short of CAD (long-USDCAD)**. As shown in **Figure 11**, their long-CAD side was 18,325 contracts (worth USD 1362mn) while their short-CAD side was 97,516 contracts (worth USD 7245mn). The long-CAD side stood at 40% of its rolling 3Y maximum and 82% of its rolling 3Y average. **The short-CAD side stood at 86% of its 3Y extreme** (which occurred earlier in the month on May 16) and at 215% of its 3Y average. Speculative open interest in USDCAD stood at 171% of the 3Y average. We think the short-CAD side has been trimmed a bit since the survey, but we think that leveraged money is still short-CAD (long USDCAD) in decent size.

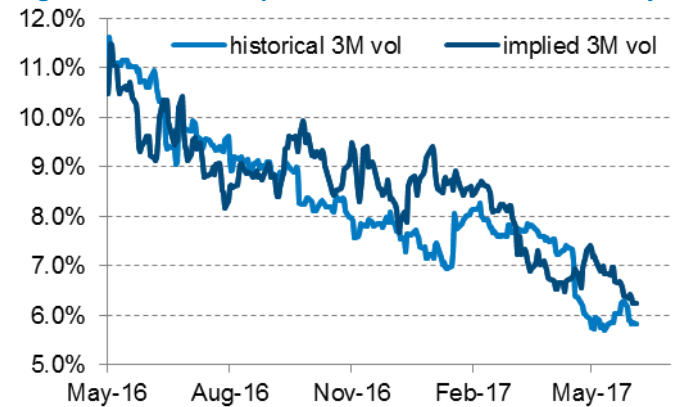
Like the spot market, the **options market** has been fairly tranquil. **ATMF implied vols are at the lowest level since 2014**, as shown in **Figure 12**. The markup of implied 3M vol over historical 3M vol is presently trading at about 0.4 vols versus a historical average of 0.6 vols. These factors suggest that options markets aren't afraid of a major breakout over the next three months. **Risk reversals at the 1W and 3M tenors are near their averages**.

Figure 11. Positions of IMM leveraged funds in CAD



Sources: CFTC, Bloomberg, BMO FX Strategy

Figure 12. 3M atmf implied vols and 3M realized volatility



Sources: Bloomberg, BMO FX Strategy

Outlook summary

We have put our 1M outlook at 1.36 as shown in **Figure 13**. That outlook reflects our expectation that USDCAD will revert to what our model considers 'fair value'. We expect the Fed to hike in June, but we don't think that hike will bring any upside to USDCAD. If the Fed were to shock markets by not hiking, we think USDCAD would trade down to 1.3300. We aren't making any type of call on oil or the CRB with our 1.36 projection; we assume that both will trade roughly flat in June.

Figure 13. Strategy team view summary

| Strategy team view | 1M | 3M | 6M | 9M | 12M |
|--------------------|------|------|------|------|------|
| | 1.36 | 1.37 | 1.34 | 1.32 | 1.30 |

Source: BMO FX Strategy

We have put our 3M outlook at 1.37. Movements earlier in the years suggest that USDCAD will be driven by the prospects for US tax reform when that issue is at play. It isn't at the moment, but we think it will return to being an active theme in August through September period. **We continue to believe that the passage of any version of tax reform would be positive for USDCAD**, with reform proposals that incorporate either a VAT or BAT being the most positive. **We are skeptical that anything passes, but financial markets should bid USDCAD higher during the debate period** as a way of partially pricing in the possibility of reform. The 3M window should also roughly cover the opening salvos of NAFTA renegotiation.

Our 12M base case scenario is a reversal in USDCAD back down to 1.30. That outlook is based on our expectation that commodity prices will gain ground in late 2017 and early 2018. We would expect an oil price average around \$55 for **Q2 of 2018. We also expect the first BoC rate hike at about that time.** Even though we expect the Fed to hike one or two times more than the BoC over the next twelve months, Fed rate hikes don't have any shock value. By contrast, the first BoC hike will be viewed by the FX market as a very important signal of a changing policy imperative. **The biggest risk to this view is the US passing meaningful tax reform**, which we think would cause USDCAD to rally above 1.40.

Trading thoughts

In conjunction with our model, we would look to buy dips in June. Specifically, **we would look to get long USDCAD at or below 1.3460 with a target of 1.3700** trading at some point later this summer. We would set a **stop loss at 1.3370** for any position entered on a 1.34 round figure.

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