

USDCAD Model Update – Exit of short likely in the wake of CAD CPI

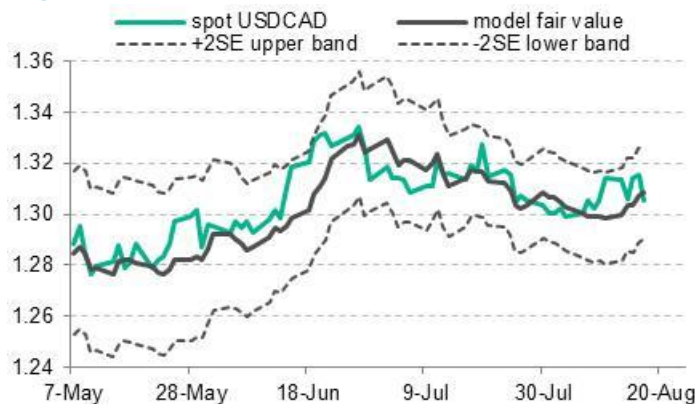
Our rotating financial factor **model** for USDCAD is still short USDCAD—for the moment. It entered that position on the close of 07-August at a spot reference of 1.3053. The model still reads the trend in fair value as downward sloping (see [Figure 1](#)), despite a noteworthy uptick over the past week.

The model presently has **fair value** at **1.3088**. Spot (at 1.3058 as I type) is a few pips below it. If this holds and spot closes below fair value, the model will close the short at a small loss. The model's hit ratio thus far in 2018 has been 10-out-of-12; closing out at a loss today would reduce it to 10-of-13.

The model's **#1 variable remains the 10Y swap rate differential** ([Figure 2](#)). It has been the model's lead variable since 30-April, which is a very long time to hold the pole position compared to the norm. The leading risk appetite gauge, which is the 10Y (USD-denominated) swap spread, is not very far behind it. As a result, the risk appetite category carries a weight that is only slightly smaller than the IRD category in the model's determination of fair value.

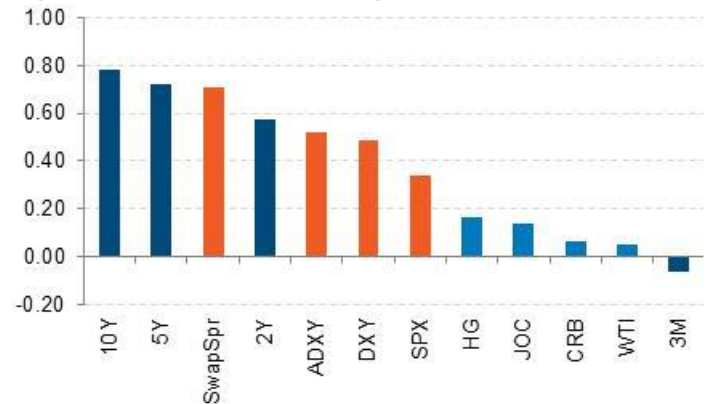
Fair value closed yesterday at 1.3070. It was as low as 1.3050 a few minutes after the **Canadian CPI** data came out this morning. The factor pulling fair value lower at that time was the narrowing of the 10Y IRD, but that **has since reversed** with the equity market. In fact, the 10Y IRD is now up 1bp on the day.

Figure 1. USDCAD spot and model fair value



Sources: Bloomberg, BMO FX Strategy

Figure 2. 3M out-of-sample R² against USDCAD



Sources: BMO FX Strategy

The model utilizes only the lead variable in its three categories (interest rate differentials, risk appetite gauges and commodities). That means that the 2Y and 3M IRDs are dormant at present. That is a key point, because **today's surprisingly strong Canadian CPI** has brought the most action to those tenors. At the **2Y tenor, the IRD has narrowed by 4bp to 0.37%**, as shown in [Figure 3](#). And **at one point this morning, that differential was 6bps narrower**. At the 3M tenor, the IRD has narrowed to the smallest spread since the BoC hiked on 11-July (see [Figure 4](#)). Relative policy expectations have much less play at the 10Y tenor ([Figure 5](#)).

As noted previously, the model's active factor in the risk appetite category is the USD-denominated 10Y swap spread. It has been the category leader since 12-July. Despite today being a risk-on day in the equity realm, **the swap spread has widened by 0.15bps today**, as shown in [Figure 6](#).

Greg Anderson, Global Head of FX Strategy, +1 212 605 1409

Stephen Gallo, European Head of FX Strategy, +44 20 7664 8124

Canada Sales

Toronto +1 416 359 8681
Montreal +1 514 282 5950

U.S. Sales

Chicago +1 312 845 4080
New York +1 212 702 1284
San Francisco +1 415 591 2102

Europe Sales

London +44 20 7248 0424

Asia Sales

Guangzhou +86 20 8669 5148
Hong Kong +85 2 3406 0670
Shanghai +86 21 6136 3628

Figure 3. USDCAD and the 2Y swap rate differential



Sources: Bloomberg, BMO FX Strategy

Figure 4. USDCAD and the 3M OIS differential



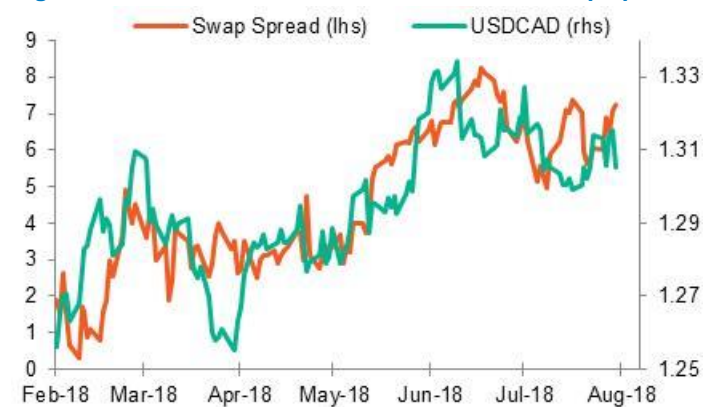
Sources: Bloomberg, BMO FX Strategy

Figure 5. USDCAD and the 10Y swap rate differential



Sources: Bloomberg, BMO FX Strategy

Figure 6. USDCAD and USD-denominated 10Y swap spread



Sources: Bloomberg, BMO FX Strategy

The model's lead commodity factor has been copper since 26-June. My best explanation for why copper has been a better predictor of USDCAD than oil or the CRB is that copper is a more pure gauge of Chinese and global growth risk. **Copper is up 1.5% today (Figure 7).** That move exerts a minor downward tug on FV, but with the commodity category having such a small weight, its influence is overshadowed by the interest rate and risk appetite categories.

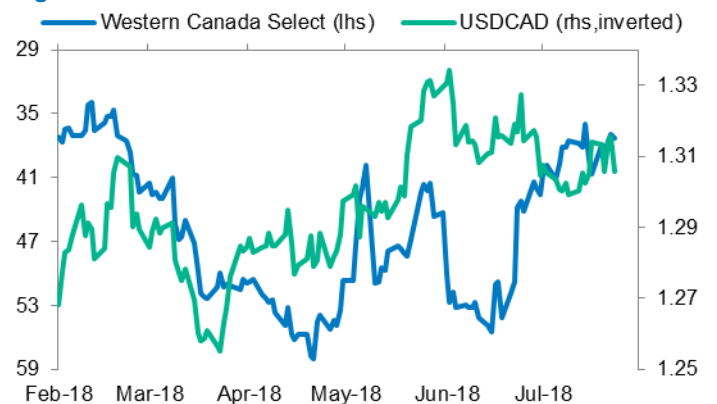
The impact of oil on the model's fair value remains zero. It ranks last within the commodity category in terms of its ability to forecast USDCAD out of sample. However, because it has historically been the biggest driver of USDCAD in the long run, we continue to track it. **The WCS blend rebounded by 0.8% today (Figure 8).**

Figure 7. USDCAD and the front copper future



Sources: Bloomberg, BMO FX Strategy

Figure 8. USDCAD and WCS-blend oil



Sources: Bloomberg, BMO FX Strategy

Appendix – A brief model explanation

BMO FX Strategy's proprietary short-term fair value model for USDCAD is designed to compare the level of USDCAD to other financial prices and determine whether it is in alignment or exhibiting anomalous behavior. 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 over a three-month lookback window. The model then combines the forecasts from the best variable from each of the three categories into a joint forecast or fair value. The model takes a long position if fair value is trending higher and spot is below fair value. Conversely, it gets short if fair value is trending lower and spot is above fair value. It is neutral the rest of the time.

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