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# Interest Rate Differentials Taking a Back Seat to Oil

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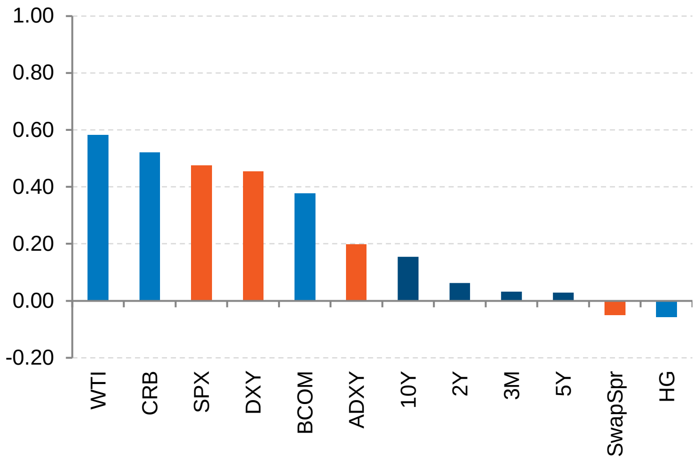
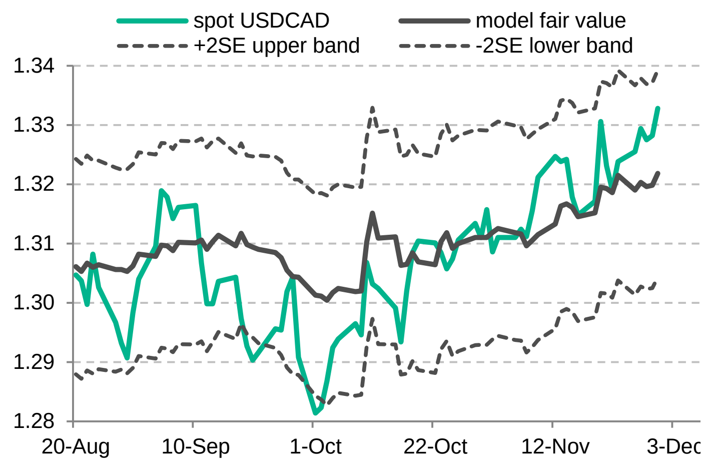
- Our rotating financial factor model for USDCAD is pointing to a new #1 'driver' for the pair. That driver is the price of the WTI crude front future. It rotated ahead of the S&P 500 yesterday. The CRB commodity index is right behind it.
- Perhaps even more interesting is how far the various interest rate differentials have fallen. The 10Y IRD has been the model's #1 variable for 114 of this year's 240 trading days, or 48% of the time. An interest differential of some tenor has been the lead variable 68% of the time. But now the best IRD is all the way down at #7 in our ranking of the ability of model variables to forecast USDCAD one day ahead. See **Figure 1**.
- The model has fair value in USDCAD at 1.3218 at 10:00 EST, so spot is 110 pips or 0.8% above fair value (FV). The model reads the 1M trend in FV as upward sloping, so it would presently seek to 'buy dips' in spot USDCAD. See **Figure 2**.

**Figure 1. 3M out-of-sample $R^2$ against USDCAD**




Sources: Bloomberg, BMO CM

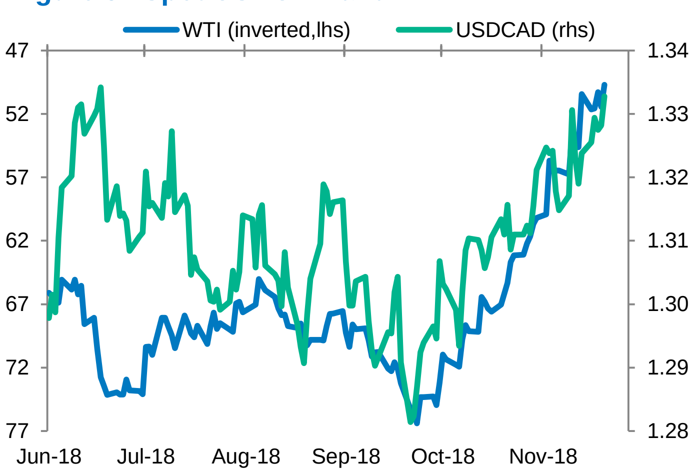
**Figure 2. USDCAD spot and model fair value**




Sources: Bloomberg, BMO CM

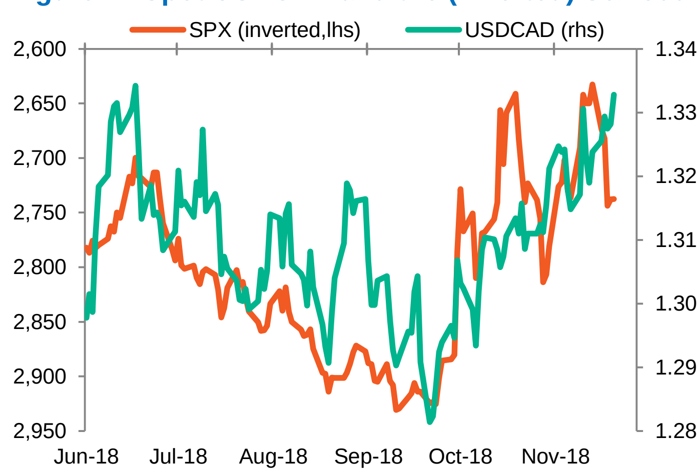
- The decline in oil has mapped tightly with the rise in USDCAD over the past two months. Today WTI has declined by 3.4% (see **Figure 3**), so that is a big factor behind today's 20-pip rise in the model's FV. The one bright spot is that the WCS discount shrank by \$3 to \$30 yesterday and held today. It's the smallest WCS discount since September 10.

**Figure 3. Spot USDCAD and WTI**




Sources: Bloomberg, BMO CM

**Figure 4. Spot USDCAD and the (inverted) S&P500**

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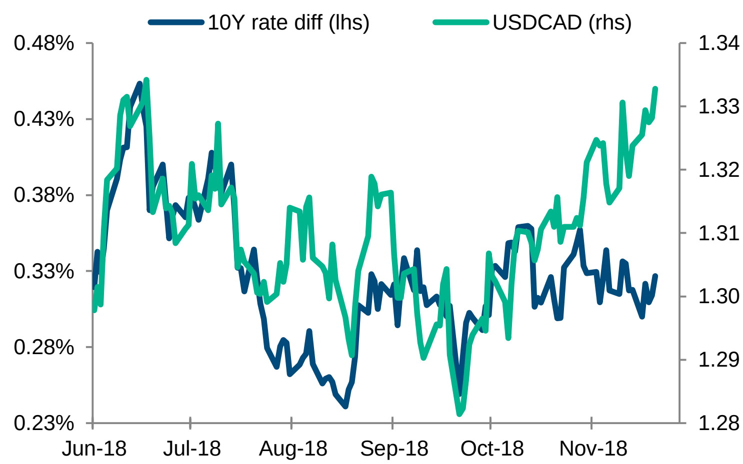
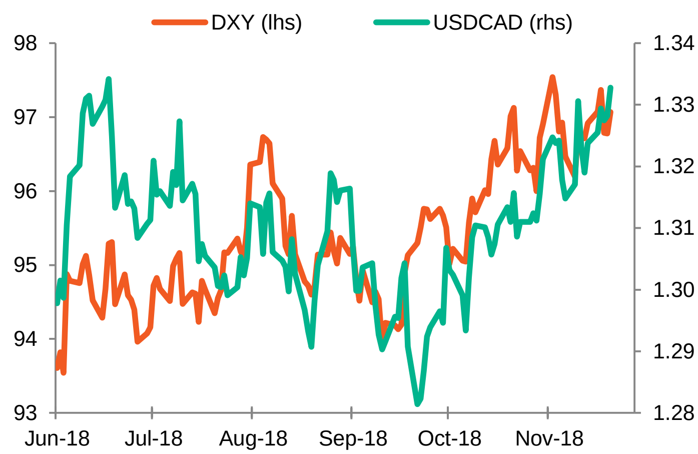
- The S&P 500 index is the model's second active factor. The S&P 500 is essentially unchanged today. Minimal impact on USDCAD would be expected today, but Wednesday's 2.3% rally and Monday's 1.6% rally pushed FV lower. However, there was only a minimal reaction in spot USDCAD. That has left USDCAD is substantially overbought based strictly on equities. See **Figure 4**.
- As mentioned previously, the 10Y interest rate differential (IRD) was the model's #1 variable for the 4-month period encompassing May through September. Now, however, spot USDCAD seems completely divorced from the IRD (see **Figure 5**). The 10Y IRD is up 2bps today, so that is supportive of today's rise in FV.
- The DXY isn't an active factor for the model right now because it's the #2 risk appetite variable (behind the S&P 500). However, it's rising quickly through the rankings, so it deserves a special mention. DXY could easily pull ahead of the S&P 500 and become the risk appetite category leader early next week. European currency weakness (EUR and GBP are 70% of the index) is dragging DXY higher today, and that seems to be pulling USDCAD along for the ride, as shown in **Figure 6**. This seems to be a continuation of a key theme of the past two months.

**Figure 5. USDCAD vs its 10Y swap rate differential**




Sources: Bloomberg, BMO CM

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




Sources: Bloomberg, BMO CM

## Appendix – A brief model explanation

- BMO FICC 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 the exchange rate 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, US 10Y 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 combined forecast. That forecast represents 'fair value' based on the related financial prices.
- 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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