



# My latest thoughts on USDCAD

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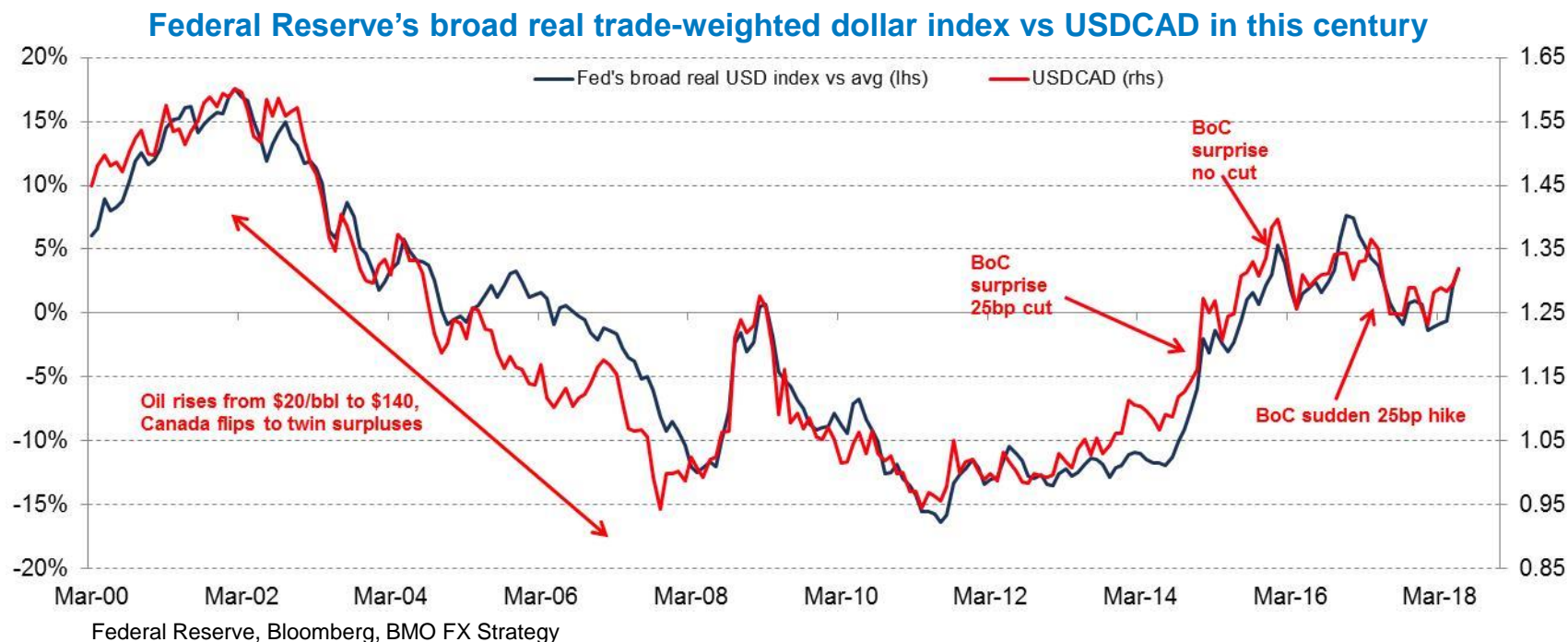
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# Section 1: Long-term considerations

# USDCAD is mostly driven by the 'big dollar'...



- There are a number of junctures where Canadian fundamentals have been truly extraordinary in the 17 years of this century. Arguably the most important was when oil rose from \$20 to \$140 and Canada flipped from being a twin-deficit economy to a twin-surplus economy. Despite that massive move in Canadian fundamentals, CAD only 'outperformed' the USD's general decline by a slight margin.
- Under Poloz, the BoC has shocked the market on 3 occasions. In each occasion, the monthly move in the USDCAD exchange rate has pretty much followed the broader USD index with perhaps a 1-3% deviation.
- Canadian fundamentals matter for 1-5% moves inside a month, but projections of moves bigger than 5% and for periods longer than a month or two should mostly be based on one's USD index outlook.

# ...but the big dollar cycle is suddenly tricky to decipher

Federal Reserve's broad real trade-weighted dollar index since Bretton Woods

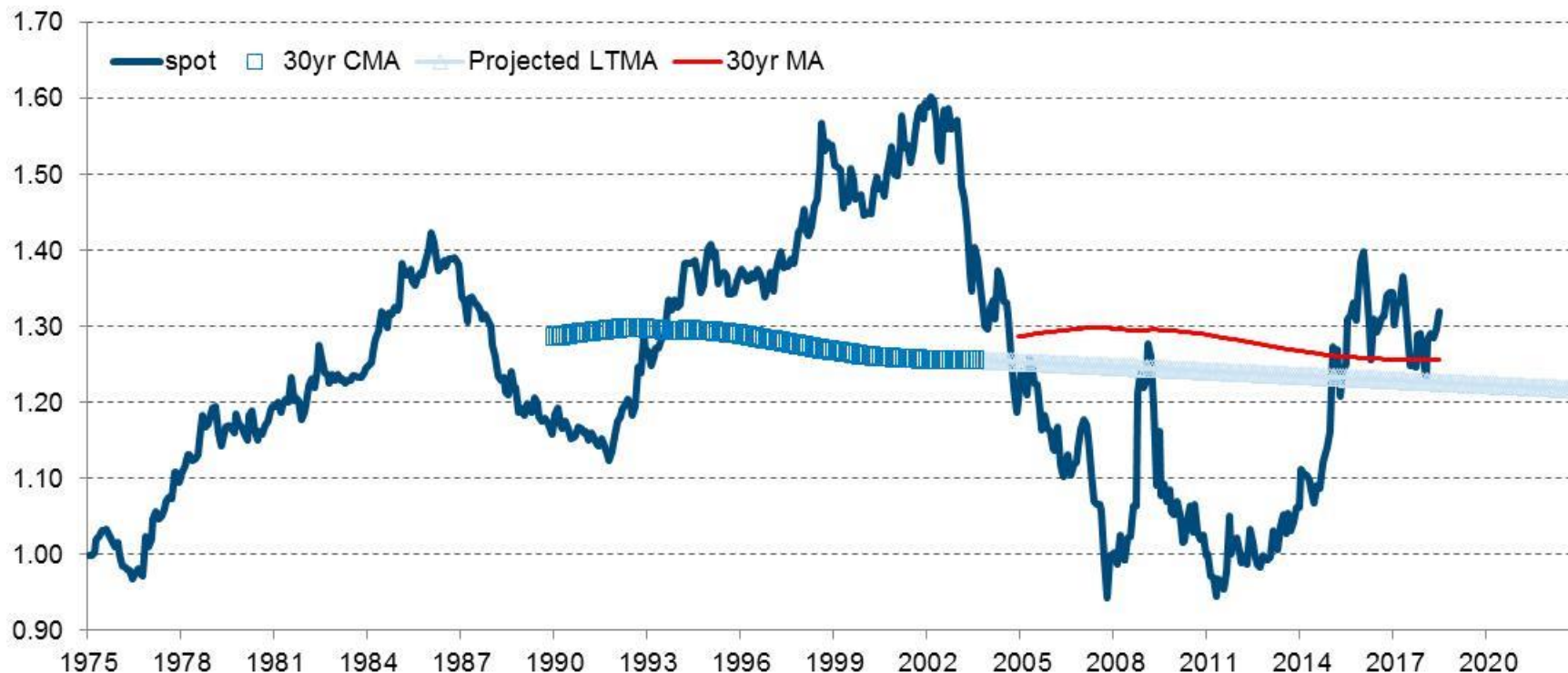


- The Fed's broad real trade-weighted USD index has shown three distinct cycles in the modern period of floating exchange rates. At present the USD is about 6% above its 30Y average and 4% above its post Bretton Woods average.
- A few months ago, it was easy to say that December 2016 was a peak and that the USD was in a downtrend. Now the picture isn't so easy to diagnose in that way. We could be in an incomplete USD uptrend, although it would be the longest in history if true.
- With the US expansion more mature than the ROW's, it makes sense that the USD is slightly strong.



# FWIW, USDCAD is 5-8% above long-term 'equilibrium'

USDCAD and USDCAD PPP proxy using equal inflation rates and projecting forward a 30Y MA



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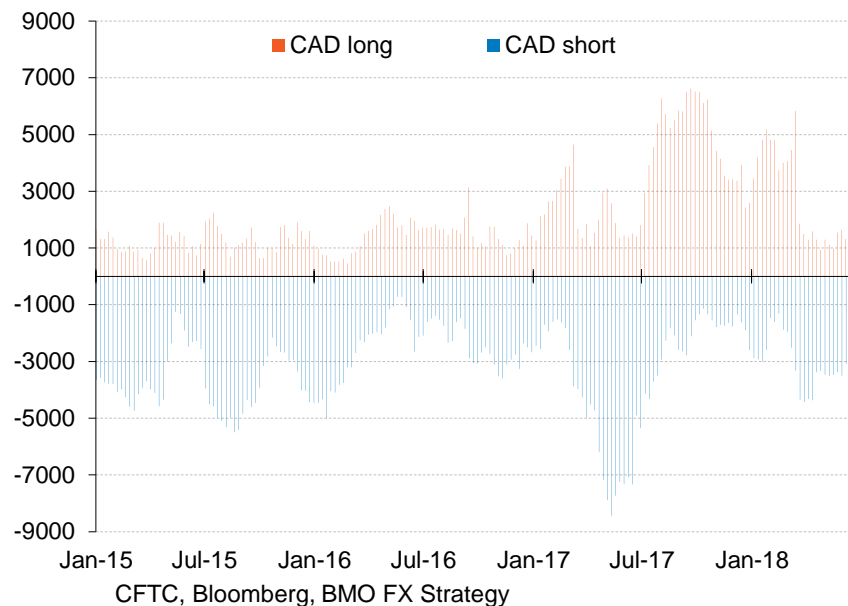
- The US and Canada have both average 2.1% inflation since 1990 and both have a 2.0% inflation target, so inflation shouldn't lead to a creep in 'fair value' but a productivity differential may.
- A 30Y MA covers roughly two USD cycles and should give a very good read of the long-run average. It comes in at 1.26 today. If we allow a bit of crawl by projecting forward a centered 30Y MA, we get a long-term 'fair value' or 'equilibrium' of 1.23. This would put USDCAD some 5-8% above equilibrium today.

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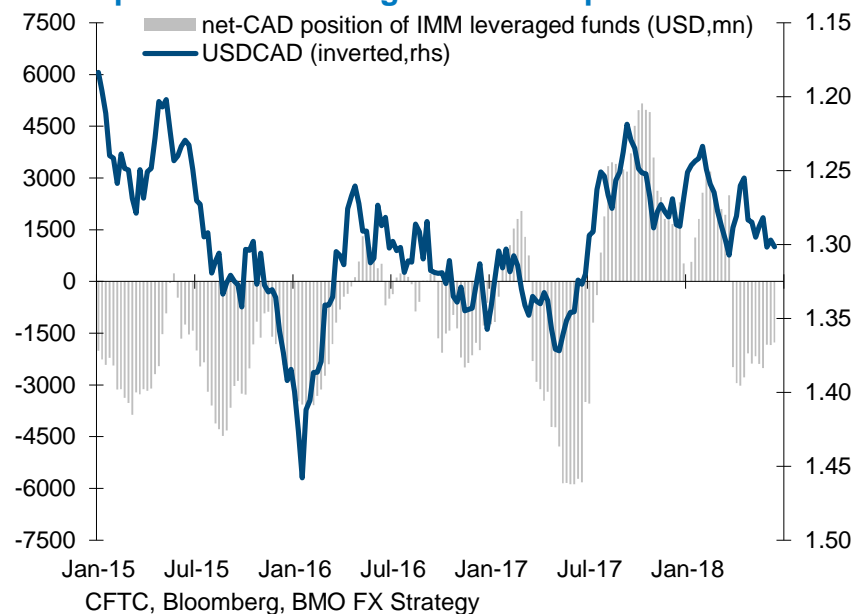
# Section 2: Short-term factors

# Leveraged funds are moderately long USDCAD

## CAD positions of IMM leveraged funds by side



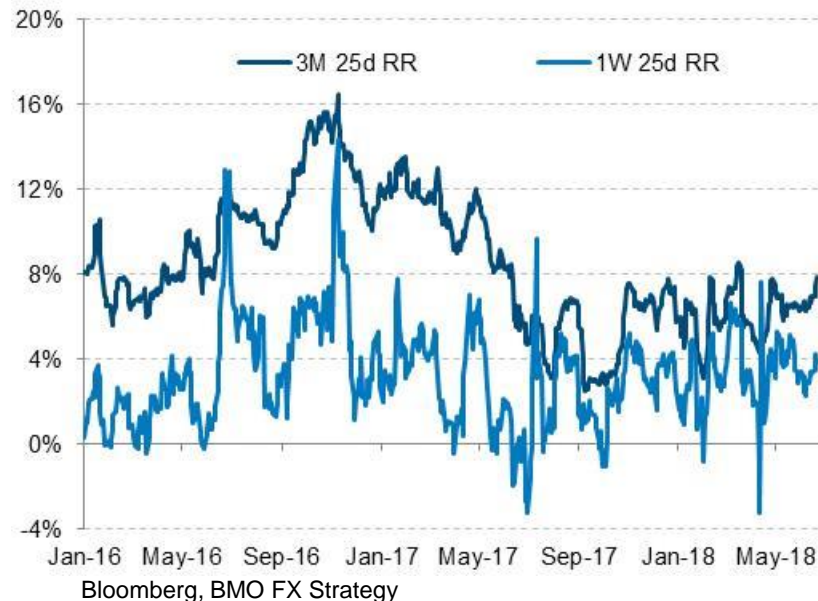
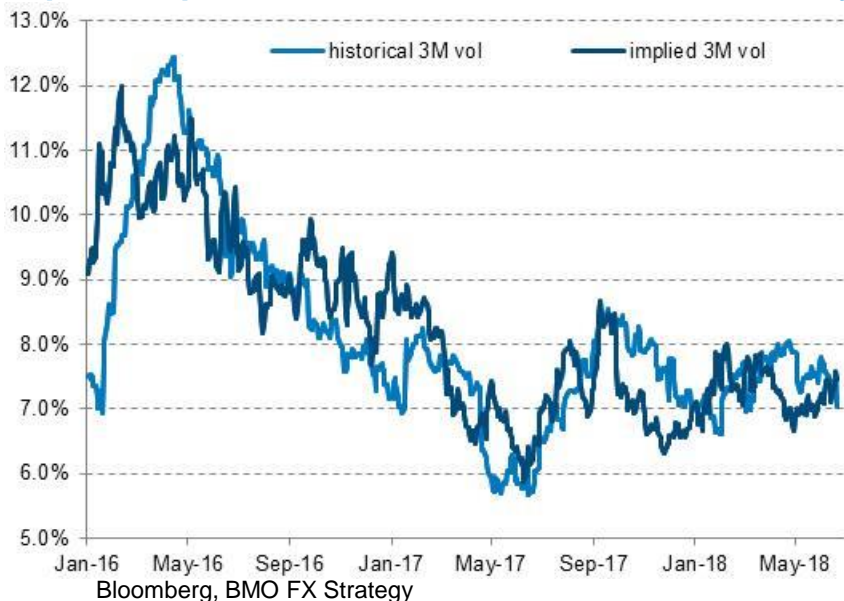
## Net position of leverage funds vs spot USDCAD



- For the 12-Jun survey, IMM leveraged funds held 17,078 **long-CAD** contracts worth USD1,312mn (**down 20%**). The side was only **20% of its 3Y max** and 56% of its 3Y average.
- The survey showed leveraged funds holding 40,139 **short-CAD** contracts worth USD3,084mn—**down 11% from the previous week**. The side was **37% of its 3Y max** and 98% of its 3Y average.
- The **net position was short-CAD (long USDCAD) by 23,061 contracts worth USD1,772mn**.
- IMM leveraged funds' CAD shorts outnumbered CAD longs by a 2.4:1 ratio so the skew is slightly bigger than 2.1:1 ratio from the previous week.
- IMM leveraged funds' **open interest** (sum of longs and shorts) in CAD contracts was worth USD4,396mn, which is **80% of the 3Y average**. With FX open interest at 90% of its average, **CAD is undertraded**.

# Geopolitical anxiety hasn't sparked volatility (yet)

## Option implied atmf 3M vol vs realized 3M volatility 1M and 3M 25-delta risk reversals (% of atmf vol)



- Implied 3M atmf vol is trading right around 7.4. That's up slightly from about 7.1 at the beginning of the year, but it's well below this century's average of 9.1. Implied 3M vol was 7.5 before the G7, so there has been pretty much no impact of the Trump-Trudeau spat.
- Realized 3M volatility has been between 7.0% and 8.0% since early-February. It is also well below its average for this century of 9.4%. From a volatility perspective, this year's NAFTA drama has shown no obvious impact (although we will never know if volatility would have been lower without it).
- The price of 25-delta USD calls relative to 25-delta CAD calls reached a substantive premium at the time of the US election in November 2016. At present, the premium is small (at either the 3M or 1W tenor) and isn't really marching higher as spot USDCAD trends higher.

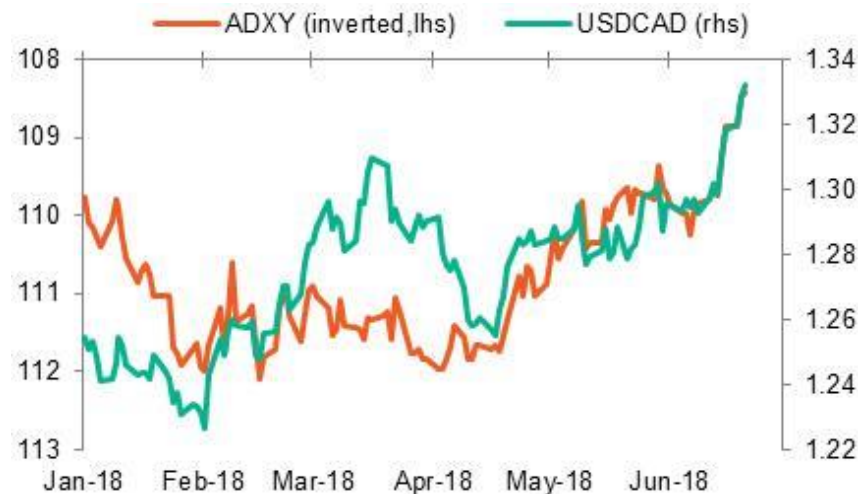


# USDCAD and a few of its most correlated 'factors'

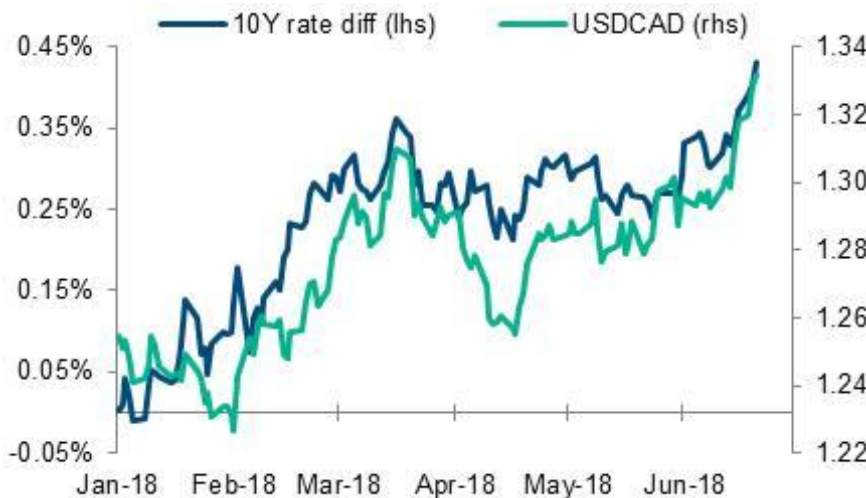
## USDCAD vs Western Canada Select crude



## USDCAD vs the ADXY Asian currency index



## USDCAD vs 10Y interest rate differential

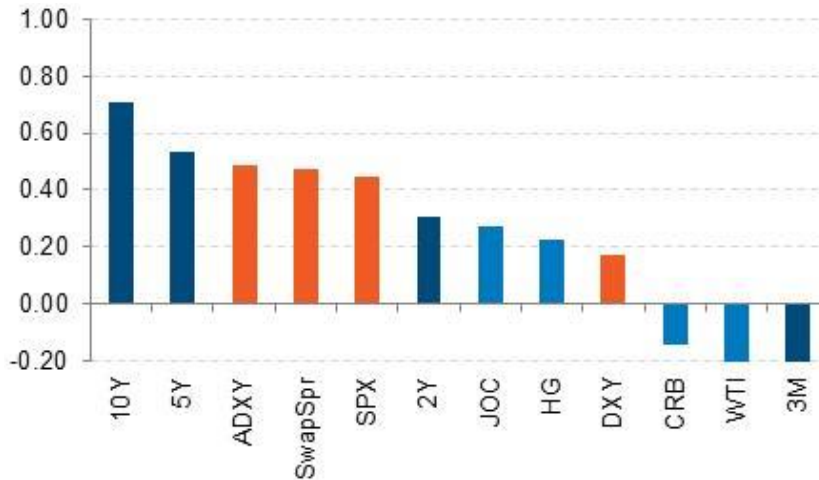


## USDCAD vs JOC industrial commodity index



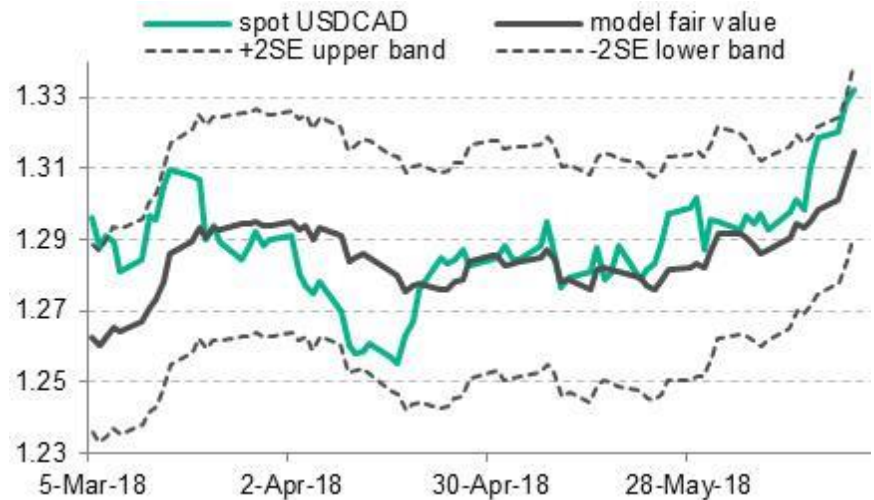
# Our model has spot above fair value with fair value rising

## 3M out of sample R-squared of single factors used to forecast USDCAD 1 day ahead



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## Spot USDCAD and BMO model fair value bands



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- Nine of the twelve variables we track improve day-ahead USDCAD forecasts relative to simply using the previous day's USDCAD close as the forecast for today. The 10Y interest rate differential provides the best day-ahead forecasts. Surprisingly, the CRB, WTI crude and the 3M interest rate differential make day-ahead forecasts worse.
- The best risk appetite variable (the Asian dollar index or ADXY) is better than the best commodity variable (the JOC/ECRI industrial commodity price index).
- Our model's fair value is trending higher so the model wants to buy on dips below fair value.
- Our model has fair value at 1.3147 (mid day 20-June).
- The model would register a spot level above 1.3387 as more than 2 SEs above fair value, though, and would look to short that level.

# Risk dates (with trade issues hanging like unfinished tweets)

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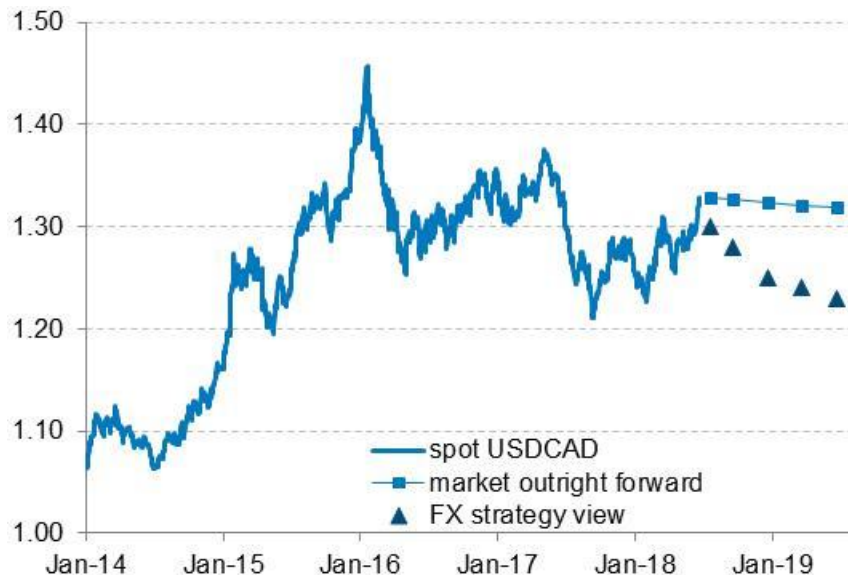
- 22-Jun: OPEC semi-annual communique
- 27-Jun: BoC's Poloz formal speech
- 01-Jul: Mexican election (an informal deadline for NAFTA renegotiation talks)
- 02-Jul: Canada Day banking holiday in Canada
- 04-Jul: Independence Day banking holiday in the US
- 06-Jul: Both the US and Canada publish their primary employment data sets
- 11-Jul: BoC Rate Decision (includes QIR update and a Poloz press conference)
- 16 to 20-Jul: Center of gravity for US earnings season (will uncover the impact of USD strength in Q2)
- 27-Jul: The US reports Q2 GDP (may well have a 4-handle on it)
- 01-Aug: FOMC (no SOEP update or press conference)
- 06-Aug: Civic Day banking holiday in Canada
- 23 to 25-Aug: KC Fed's Jackson Hole Symposium (Powell and/or Poloz may or may not speak)
- 30-Aug: Canada reports Q2 GDP (could have a 3-handle on it)
- 03-Sep: Banking holiday in both Canada and the US
- 05-Sep: BoC Rate Decision (no updated forecasts or press conference)
- 07-Sep: Both the US and Canada publish their primary employment data sets
- 26-Sep: FOMC (includes updated projections and a Powell press conference)

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## Section 3: My outlook 1M to 1Y

# USDCAD should begrudgingly turn like Poloz and big dollar

## USDCAD outlook relative to forward curve



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## USD index outlook



Bloomberg

- USDCAD outlook curve: 1M – 1.30, 3M – 1.28, 6M – 1.25, 9M – 1.24, 1Y – 1.23
- The key drivers for USDCAD in 2018 (thus far) has been NAFTA and the interest rate differential. The IRD has arguably also incorporated NAFTA uncertainty into it, so that variable somewhat counts twice.
- The market is now expecting a ‘zombie NAFTA’ scenario which means that talk proceed slowly as leaders await the US midterm election results and the seating of Mexico’s new government. Resumption of talks in 2019 would be CAD-positive. I’m still somewhat less pessimistic about this factor than the market.
- The BoC has hiked once in 2018 (Jan) and the Fed twice (Mar, Jun). From here on out, we expect the BoC to hike twice more in 2018 (add Jul & Oct) and the twice more (add Sep & Dec). For 2019, the Fed will be closer to done hiking and the market will probably trade USDCAD around that theme.



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