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What's holding back the Canadian dollar?

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Highlights

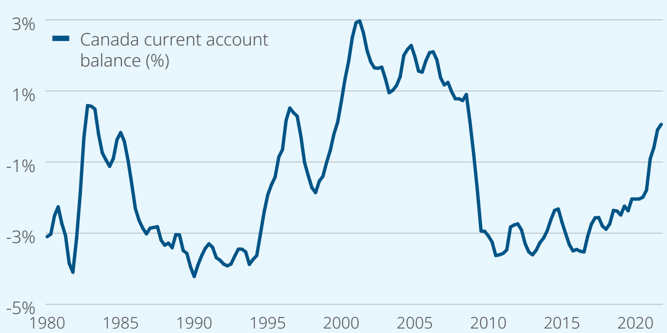
- The current macro context of surging commodity prices and aggressive rate hikes by the Bank of Canada should provide a positive backdrop for the Canadian dollar.
- But the Canadian dollar is down slightly against the US dollar since the beginning of 2022 and remains below its long-term fair value.
- Weakness in the Canadian dollar can be largely explained by the challenging risk environment, as the Canadian dollar tends to trade with global equities, and weak foreign investment inflows to Canada despite rising commodity prices.

Back in November, we highlighted the promising macro backdrop for the currencies of commodity-exporting countries. As the prices of global commodities from oil to copper surged in Q1, deeply undervalued emerging market (EM) commodity currencies like the Brazilian real (+17.4% in Q1) and the South African rand (+9.2% in Q1) gained sharply against the US dollar. By comparison, the Canadian dollar sputtered against the US dollar amidst the commodity rally (+1.1% in Q1).

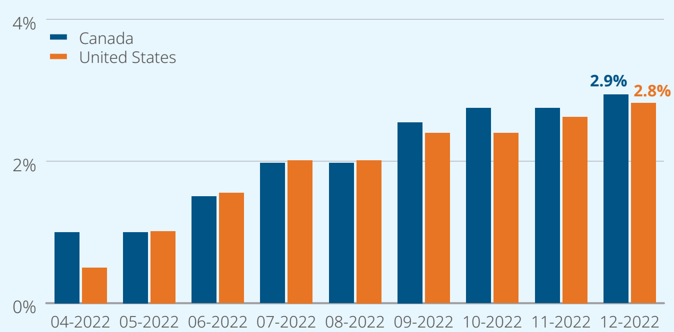
What explains the relatively weaker performance of the Canadian dollar? Stronger commodity prices work through both financial and trade channels. For commodity-exporting EMs, the rise in commodity prices has strengthened national balance sheets and trade balances, which has reduced the immediate risk of balance-of-payments crises and led EM central banks like Brazil's to hike interest rates aggressively to contain inflation. In contrast, Canada is not vulnerable to the same insolvency risks, as a country that mainly issues debt in its own currency. The Canadian dollar should still benefit from higher commodity prices through trade channels, even if the effect on fiscal and external positions is more critical for commodity-exporting EMs. Canada's current account balance, grossly defined as the difference between the value of exports and imports plus net foreign income, is expected to show further improvement in Q1 after turning positive in 2021Q4 for the first time since 2008.

Figure 1. Surging commodity prices and climbing interest rates are a positive backdrop for the C$

Canada's current account balance could improve further in Q1



Market expectations are for the Bank of Canada to bring its overnight rate up to 2.9% in 2022

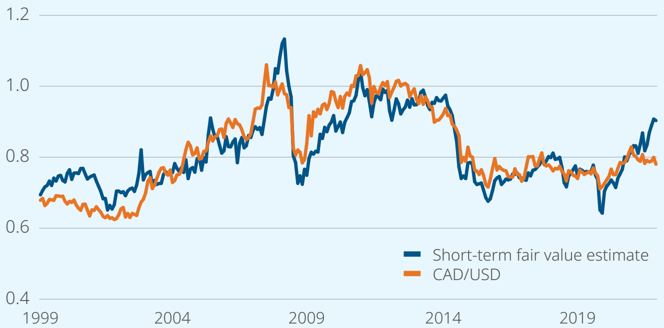


Notes: All data via Bloomberg as of April 26, 2022. Market expectations of the overnight lending rate for Canada derived from overnight interest rate swaps (OIS). Market expectations for the upper bound of the fed funds rate derived from federal funds rate (FFR) futures.

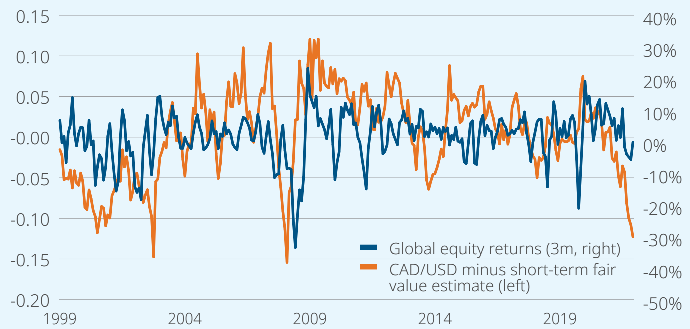
The BoC's aggressive stance on inflation has not been a strong driver for the Canadian dollar this year, since the spread between Canadian and US yield has not widened significantly.** The BoC hiked rates by 0.5% at its April 13 meeting, the first time since May 2000 it implemented a hike larger than 0.25%. After March CPI inflation came in hot at 6.7% year-on-year, economists widely expect the BoC to again hike rates by 0.5% at its June meeting, bringing the overnight lending rate to 1.5% (Figure 1). However, based on implied market expectations, the BoC's pace of rate hikes broadly matches the Fed's. In contrast, large EM commodity exporters like Brazil have widened the spread between their interest rate and the Fed's in recent months.

Figure 2. The CAD/USD exchange rate has been flat despite Canada's strong macro backdrop

The short-term fair value of the CAD based on commodity prices and interest rates is around US89 cents



The fair value discount is the widest in 13 years



Notes: All data via Bloomberg. "Short-term fair value estimate" shows the output of an expanding-window model that includes oil prices, ex-oil commodity prices and the CA-US 2-year yield differential. "Global equity returns" is the 3-month rolling average return of the MSCI All-Country World index.

The Canadian dollar appears undervalued relative to both short-term and long-term estimates of fair value. Figure 2 shows the short-term fair value of the CAD/USD exchange rate based on a simple model using commodity prices and Canada-US yield differentials. The spread between the current exchange rate and this short-term fair value estimate is at its widest in years. And the lingering undervaluation relative to this short-term estimate of fair value is not explained by the C$ valuation relative to its long-term fair value, the equilibrium exchange rate to which C$ should converge in the very long-term. Our estimate for that long-term equilibrium value is about US83.5 cents, 6% above the current exchange rate.

We see two potential explanations for why the C$ is lower than the level implied by current commodity prices and interest rates: the challenging global risk environment and subdued investment flows. Markets have been in a risk-off mood since the turn of the year. Central bank tightening has impacted global liquidity conditions and the Ukraine invasion has heightened global uncertainty. The MSCI All-Country World index is down 12% year-to-date and volatility has been well-above historical levels for both fixed income and equities. Historically, the procyclical Canadian dollar has traded with global equities, and weakened in the face of heightened risk aversion and tighter financial conditions.

Subdued foreign investment flows could explain the low C$ sensitivity to commodity prices. Pre-2014, a rise in commodity prices, especially oil prices, was typically accompanied by increased investment flows into Canada. But with the combination of (1) regulatory hurdles to fossil fuel extraction and (2) dismal profitability in the energy sector in the past decade, oil and gas investments have been anemic in the post-pandemic era. Even with oil prices surpassing their pre-pandemic level as early as February 2021, real investment expenditures in the oil and gas industry in 2021 were 30% lower than in 2019, and 80% lower than in 2014. But the trend could change in 2022 if high energy inflation is persistent, putting pressure on governments to fast-track extractive projects. Last month, the federal government gave the green light to the $16 billion Bay du Nord offshore oil project in Newfoundland, the first upstream greenfield megaproject in Canada in nearly a decade. If this project, helmed by a Norwegian company, ends up being the harbinger of a paradigm shift in foreign direct investment flows, the C$ sensitivity to higher energy prices could recover.

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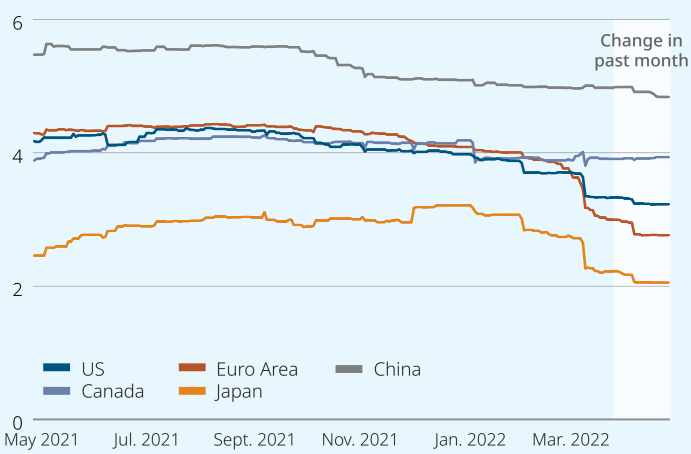
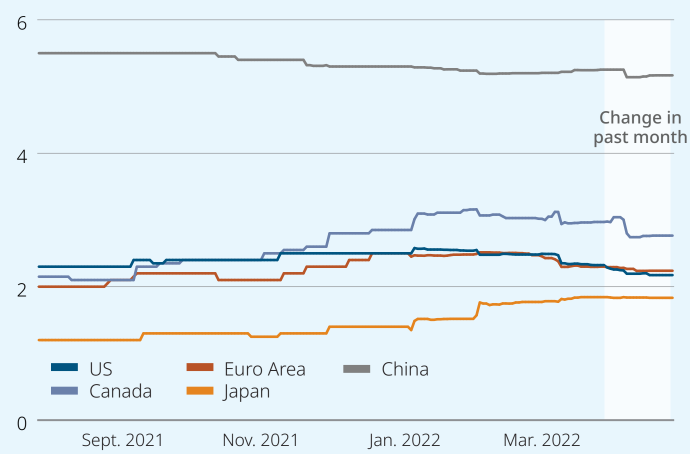
Global macro update

- The **Canadian job market** continued on its hot streak last month, with 92k full-time jobs created in March vs. a historical average of around 30k per month. On April 7, the federal government released its 2022 Budget, which includes approximately $30 billion in additional net spending over the next five years. This figure does not include any earmarks for health transfers to provinces and universal pharmacare, two major policies very likely to be implemented in next year's budget. This expansionary budget will likely contribute marginally to inflationary pressures over the coming years and lays the weight of controlling inflation entirely on the BoC's shoulders.
- Japan is a major importer of energy commodities and, as such, is being impacted by the spike in global energy prices triggered by the invasion of Ukraine. But even with these imported price pressures, forecasters still expect **Japanese inflation** to come in below the Bank of Japan's 2% target, as a testament to persistently weak consumer demand in Japan. To stimulate demand, the Bank of Japan has capped long-term interest rates in the country, using a policy of "yield curve control" to prevent 10-year government bond yields from exceeding 0.25%. With yields in other advanced countries skyrocketing, the incentive to invest savings outside of Japan increases, which explains the recent collapse in the value of the Japanese yen.

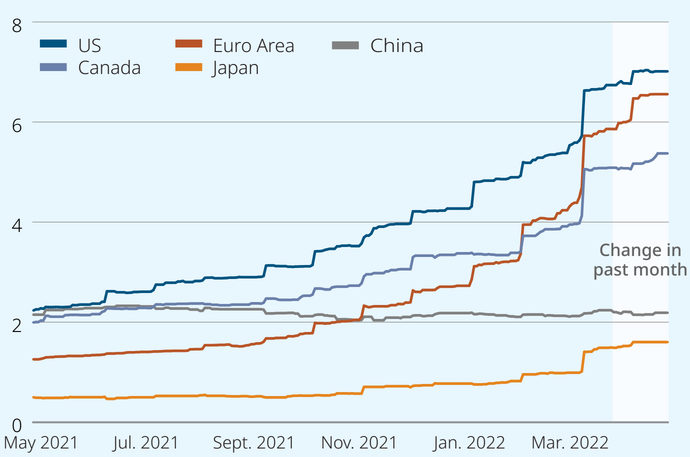
2022 real GDP growth forecast (%, consensus)



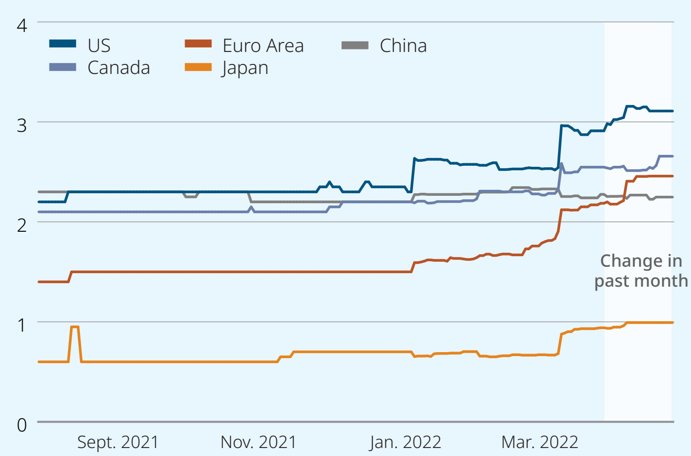
2023 real GDP growth forecast (%, consensus)



2022 inflation forecast (%, consensus)



2023 inflation forecast (%, consensus)

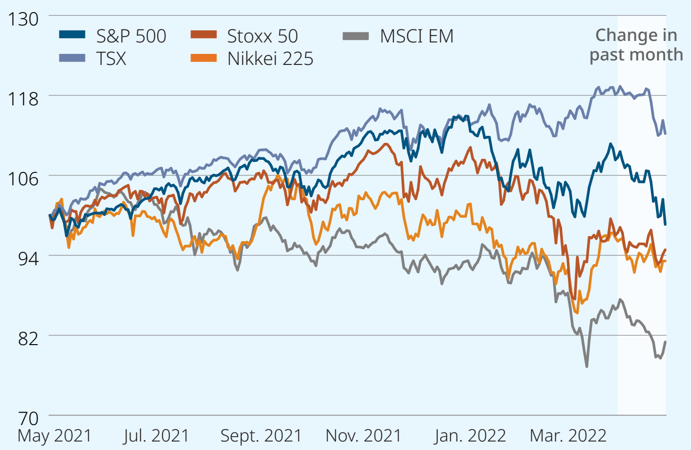


Notes: Forecasts from Consensus Economics as of April 30, 2022.

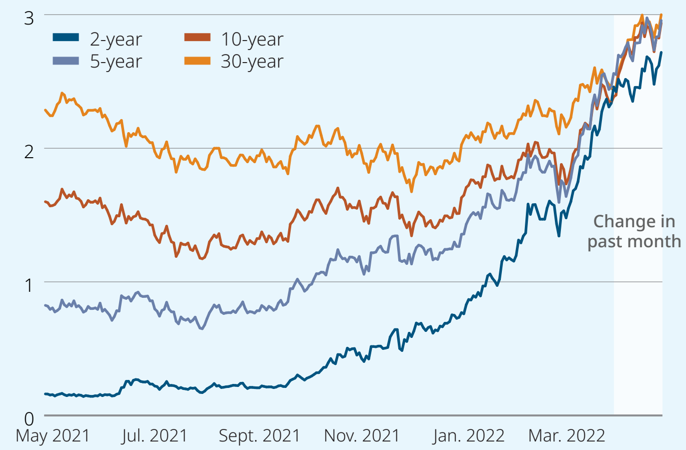
Capital markets update

- Following a strong rally in the second half of March, **equity markets** pared gains in April. After temporarily softening their tone in the wake of the invasion of Ukraine, Western central banks resumed their signalling of aggressive rate hikes for 2022. Canadian equities beat their US counterparts for the fourth month in a row, the longest string of outperformance since 2018.
- For the second month in a row, yields on **US Treasury bonds** surged across the curve. Year-to-date, aggregate Treasuries experienced their worst total return in the four months to start a year since at least 1900. Yields on 10-year inflation-protected Treasuries, also known as TIPS, turned positive for the first time since the start of the pandemic. After inverting briefly a month ago (see last month's commentary), the 10-2 Treasury yield curve is positively sloping once again.
- The **Japanese yen** kept sliding against other major currencies in April, as the spread between Japan's long-term rates and those of other advanced countries widened (see Global macro update). The **Chinese yuan** also weakened towards the end of the month, as lockdowns in large Chinese cities continued and rising US yields drew capital outside of China. In addition, a weaker Japanese yen could mean a deterioration in the competitiveness of Chinese exporters. As opposed to the yen, the yuan had been strengthening against peers before the recent move down.

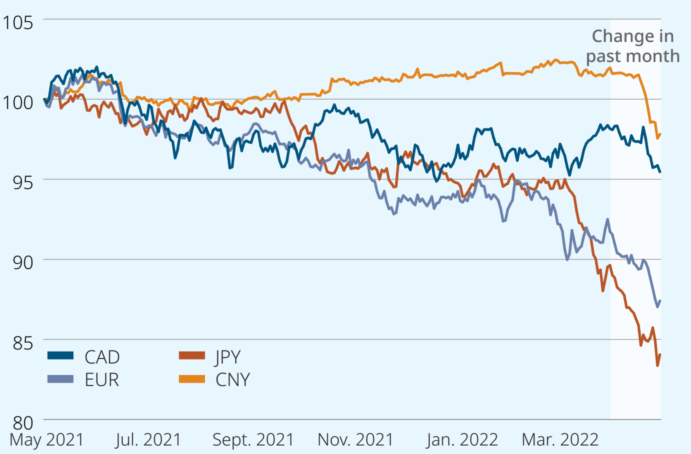
Equity indices (one year ago=100)



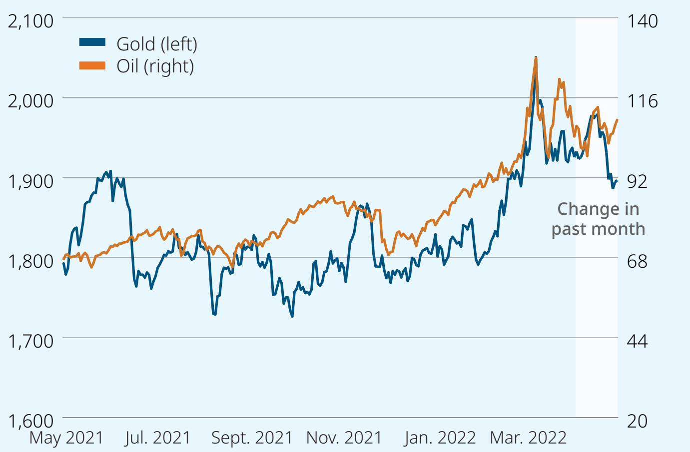
US Treasury yields (%)



Currencies (relative to USD, one year ago=100)



Commodity prices (in USD)



Notes: Financial data from Bloomberg as of April 30, 2022. Total return equity indices are in local currencies, except MSCI EM, which is denominated in USD

What we'll be watching in May

May 11: US April Consumer price index (CPI) release

- Hidden beneath last month's eye-watering headline inflation print (+1.2% month-on-month), several core components showed signs of moderation. Durable goods, which have been driving core inflation for the past year, dropped in price in March (-0.9% month-on-month). Durables are highly sensitive to both consumer demand and supply chain soundness.
- Above-target inflation in the US will probably persist into 2023. But an inflection in the trend would assuage fears of an uncontrolled spiral. It would allow the Fed to focus on delivering, in an orderly manner, the many hikes already priced in by markets – a total of 10 in 2022.

May 18: Canada April Consumer price index (CPI) release

- Unlike the US release, Canadian data for March showed no signs of a slowdown in inflation. Price increases were broad-based, with both core goods – especially durable goods – and services climbing.
- Compared to the US, Canada's labour market is tighter and its nominal GDP growth will likely be significantly higher in 2022 as the value of its exports soar. This could imply more persistent price pressures, and a higher terminal rate for the Bank of Canada if it hopes to cool the overheating economy.

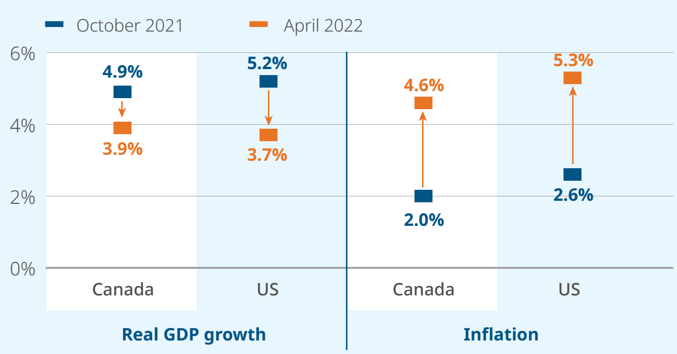
May 31: Canada Q1 GDP release

- The average economist in Bloomberg's survey expects Q1 real GDP growth to come in around 4% annualized. Nominal GDP, which measures the dollar value of total income in the Canadian economy, will likely grow by double-digits, boosted by a surge in the value of commodity exports, housing price appreciation and overall price inflation.

Emerging theme

- The International Monetary Fund (IMF) released its bi-annual World Economic Outlook in April, which includes country-specific macro forecasts. Like most advanced countries, Canada and the US saw their **growth forecasts get revised down**, while their **inflation forecasts ballooned**.
- Even with strict lockdowns shutting down sections of its economy in the early weeks of 2022, **Canada's growth prospects were uniquely resilient**. In last Fall's IMF outlook, Canada was forecasted to have the second slowest real GDP growth of the G7; six months later, its 2022 forecast is the highest of the group.
- The North American economy is in an **inflationary boom**, which the IMF outlook illustrates. Growth is expected to be well above potential, even if the Omicron variant, the Ukraine invasion and accelerated rate hikes have dulled forecasts somewhat. That doesn't mean that a recession is impossible. Aggressive policy tightening could end up slowing the economy to a grind. But, in our view, "stagflation" remains unlikely. Stagflation describes a very unique macro environment and the conditions for its emergence are distinctive. The US has only once found itself in a lasting stagflationary environment, in the 1970s. Many of the drivers of that stagflation are not present today: cost-of-living adjustments in worker contracts, an artificial cap on interest rates in savings accounts and a complacent Fed. The latter might have been true a few months ago, but not anymore, with the Fed signaling quantitative tightening and a slew of rate hikes over the rest of 2022.

IMF forecasts for 2022 from last two Outlooks



Notes: From the IMF's World Economic Outlook, October 2021 and April 2022 editions.

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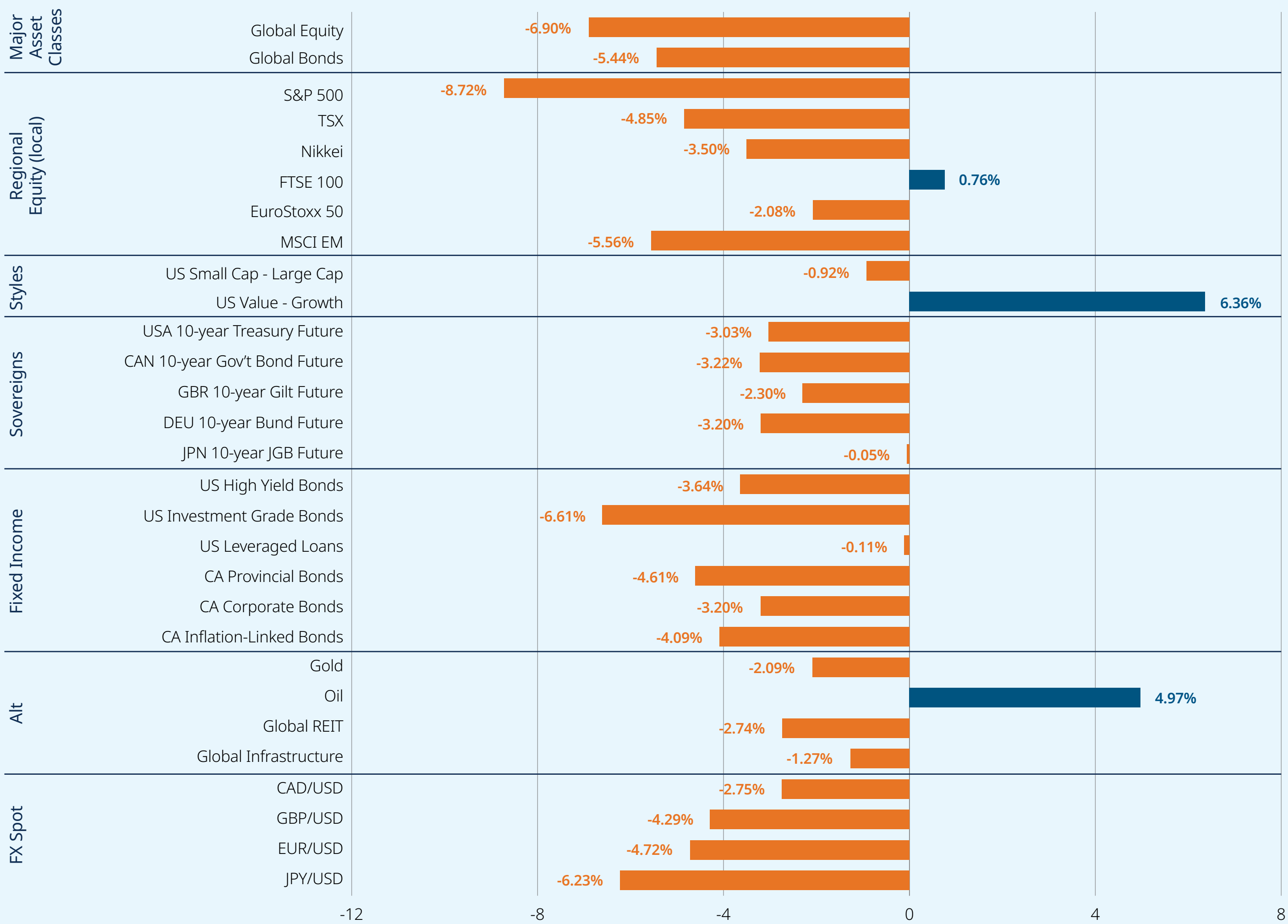
Capital market returns in April



Notes: Market data from Bloomberg as of April 30, 2022. Index returns are for the period: 2022-04-01 to 2022-04-30. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite 60 (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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