The table is set for commodity currencies

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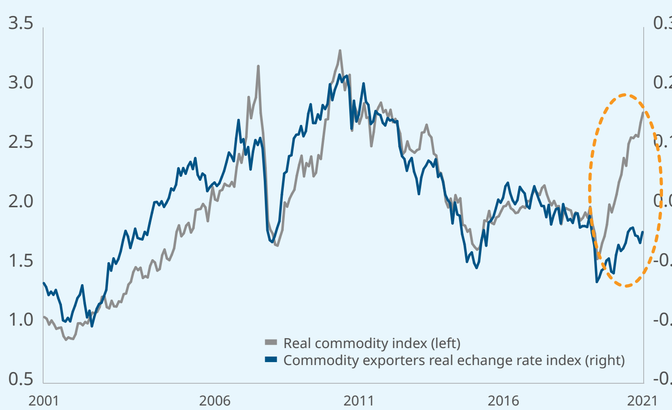
Highlights

- The recent run-up in commodity prices is a tailwind to the currencies of commodity-exporting countries, including the Canadian dollar.
- Pro-cyclical currencies should also benefit as the global recovery broadens and vaccinations progress, leading investors to seek out more attractive expected returns in emerging markets.
- A relatively hawkish outlook for central banks outside safe-haven markets – the US, Europe, and Japan – may also benefit emerging market currencies by enticing investors in search of yield.

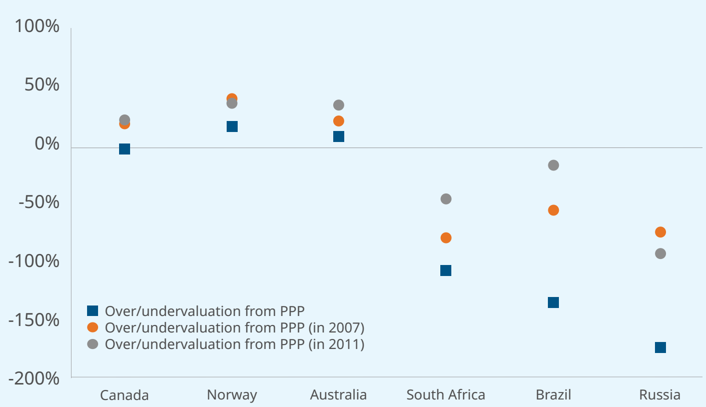
In 2021, global demand for goods surged with unprecedented stimulus supporting household incomes and a shift away from contact-intensive services due to Covid. On the supply side, pandemic-related disruptions and underinvestment have meant that many commodity producers – key ingredients in the manufacturing of industrial goods – couldn't meet this extra demand. As a result, energy and industrial commodity prices have climbed to levels not seen since the early 2010s, when China's industrial push was driving global growth. But even as commodity prices blew up this year, the currencies of many commodity exporters dithered.

Figure 1. Commodity currencies are still historically weak

Exchange rates of commodity exporters have not followed the recent commodity price surge



EM commodity exporters' exchange rates are well below purchasing power parity (PPP)



Notes: Left chart: Data via Bloomberg as of October 20, 2021. The Bloomberg Spot Commodity is deflated by US CPI. The blue line shows the deviation of commodity exporters' real effective exchange rate (REER) index from its historical average. Right chart: OECD, Bloomberg.

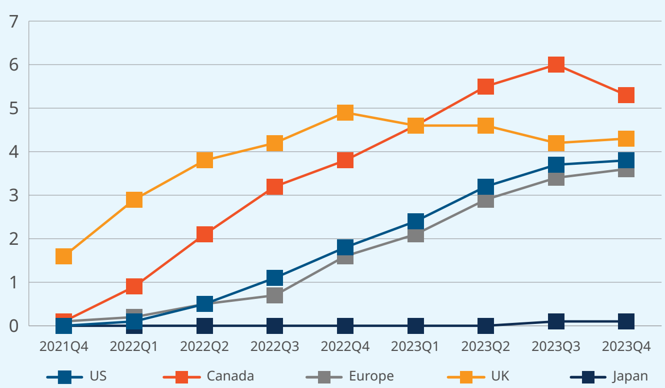
The recent run-up in commodity prices should be a tailwind to the currencies of commodity-exporting countries, including the Canadian dollar. Higher commodity prices imply an upturn in the current account balances of commodity exporters, and higher demand for their currencies. Indeed, we expect Canada's current account balance to turn positive in the second half of 2021, as the value of its exports could exceed that of its imports for the first time since 2008. Other commodity-exporting countries are seeing similar boosts in demand for their exports. And their currencies have room to appreciate: Figure 1 shows that commodity currencies are undervalued relative to long-term fundamental measures, such as purchasing power parity (PPP), when compared to periods of similarly high commodity prices. This is especially true for emerging market exporters like Brazil and South Africa, whose currencies exhibit deep discounts relative to PPP.

Commodity currencies, while inherently volatile and pro-cyclical, are likely being held back by residual fears from the Covid crisis, keeping capital locked into safe-haven markets like the US, Europe and Japan. As the global economic recovery progresses and vaccination rates increase, capital outflows to foreign markets with more attractive expected returns should resume. In South Africa, for example, only 21% of the population is fully vaccinated, putting the South African economy at risk in the case of a new global Covid wave. With around half a billion people getting vaccinated each month globally[1], we expect Covid-related fears to moderate as we head into 2022, at which point over 60% of the global population should have received at least one vaccine dose.

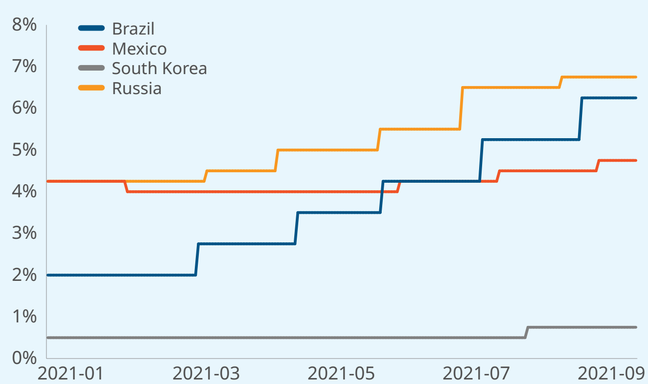
Another reason we could see a rerouting of capital flows to emerging markets is the widening interest rate differentials (or "carry") between safe-haven countries and the rest of the world. Market-implied expectations for rate hikes in G5 countries show that the US Federal Reserve and the European Central Bank are expected to begin raising rates in the second half of 2022, while the Bank of Japan will keep its policy rate at its lower bound for the foreseeable future. Meanwhile, the Bank of Canada is expected to hike about 4 times in 2022 and the difference between 10-year real yields in Canada and the US has widened by 15 bps in the past month. Even more striking, many emerging market central banks have already raised rates throughout 2021 to fight inflationary pressures, including Brazil, Mexico, and Russia (Figure 2). The divergent rate paths are generating carry opportunities that could entice increased portfolio outflows from the safety of the US dollar in search of yield, provided macro fears progressively subside.

Figure 2. "Safe haven" countries will keep interest rates lower for longer

Number of market-implied cumulative rate hikes in G5 countries



EM central banks have already begun hiking this year (central bank policy rates)



Notes: Data via Bloomberg as of October 19, 2021. Market expectations for policy rates derived from overnight index swap curves.

On the other hand, a hasty rise in interest rates as global central banks fight inflation could tighten financial conditions, especially in emerging markets. This would slow the recovery, cool the demand for commodities and could even force some central banks to reverse earlier rate hikes. That said, interest rate normalization amid a solid global economic recovery is a solid base case for pro-cyclical commodity currencies, especially given their long-term undervaluation. As rising energy and commodity prices are also key drivers of inflation, exposure to commodity currencies may add to overall inflation sensitivity in a balanced portfolio mix.

1 Reuters, as of October 25

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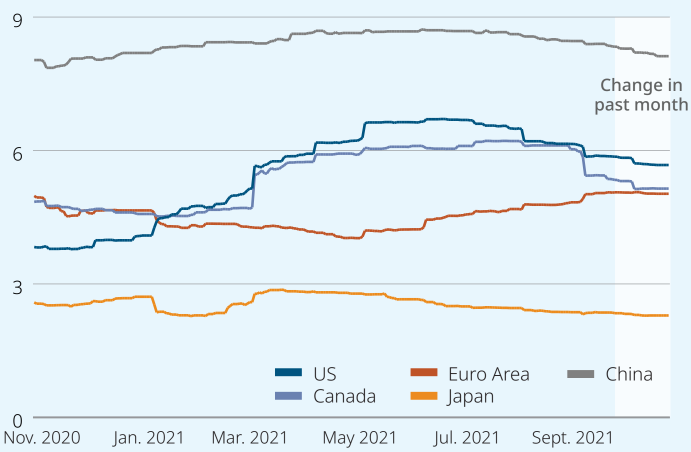
Investments

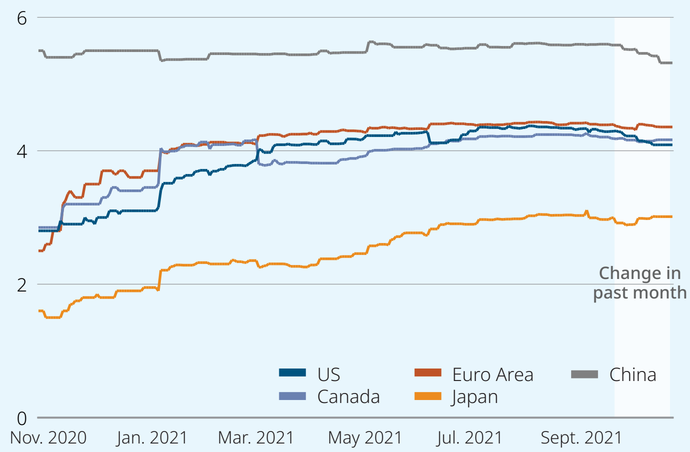
Global macro update

- Even as **consumer price inflation in Japan** turned positive for the first time in over a year (+0.2% yoy in September), 2021 and 2022 consensus forecasts of Japanese CPI deteriorated in past weeks. The contrast with the high inflation forecasts in other developed markets is striking. But the low observed inflation in Japan is partly the result of politically-driven reductions in cellphone charges, without which core inflation in Japan would currently be around 1.4%, the highest reading since 2015. This doesn't mean that Japan is emerging out of its long-term deflationary trap. Much of the underlying inflation is due to rising global commodity prices, and Japanese growth is still expected to severely lag that of its peers. Once global supply pressures ease, Japan will likely find itself fighting against negative core inflation once again.
- In October, markets aggressively pulled forward expectations for G10 central bank rate hikes, as investors parsed through hot inflation prints and hawkish speeches by policymakers, notably officials at the Bank of England. Everything else equal, early rate hikes in the face of supply-driven inflation mean lower **global growth**. In fact, even with global Covid cases and deaths falling in October, forecasters revised their expectations for global growth downwards. GDP growth forecasts for 2022 are still solid, but accelerated tightening, especially by the US Federal Reserve, could trigger a slowdown.

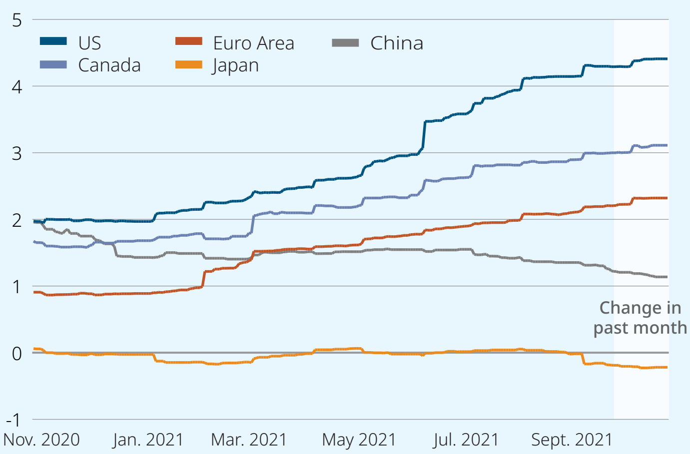
2021 real GDP growth forecast (%, consensus)



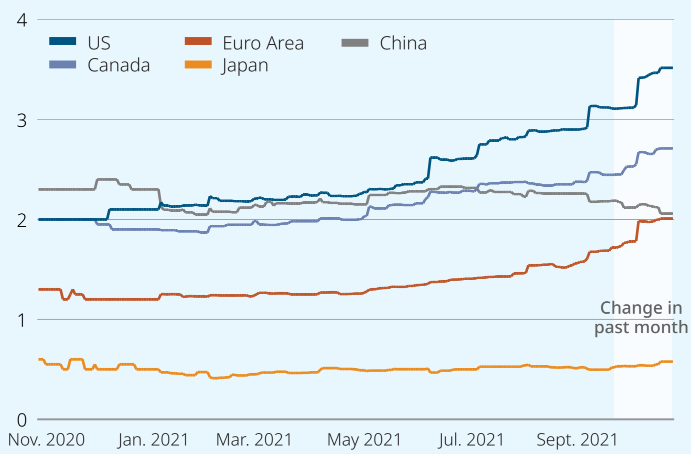
2022 real GDP growth forecast (%, consensus)



2021 inflation forecast (%, consensus)



2022 inflation forecast (%, consensus)

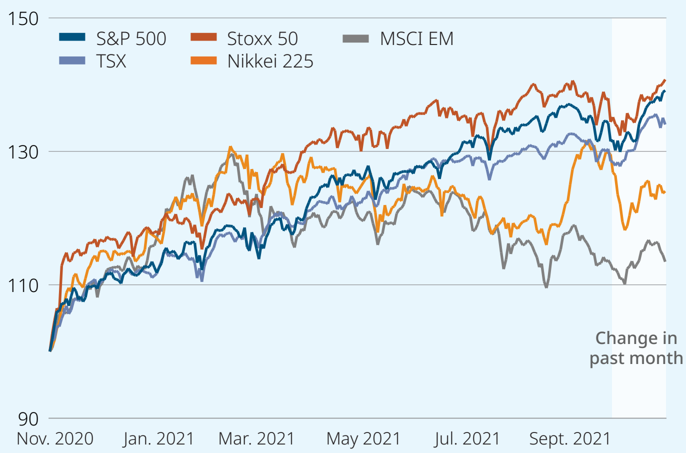


Notes: Forecast surveys from Consensus Economics as of October 31, 2021.

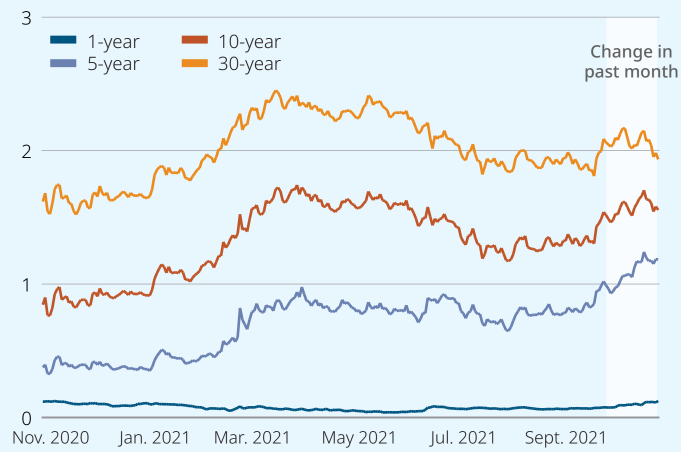
Capital markets update

- Global equities began a multi-week rally after the US Senate voted on October 8 to temporarily raise the federal debt ceiling limit. Failure to do so could have triggered a technical default on US debt in the second half of October, with serious consequences for money markets, bonds and risk assets (see last month's Emerging theme). But the respite will be short-lived: the US government will once again be pushing up against the debt limit in December.
- The **Canadian dollar** appreciated by 2.5% vs. the US dollar in October, its strongest month since August 2020. Oil prices rose on the month, with the Western Canadian Select – a benchmark for oil producers in the Canadian Prairies – crossing above CA$85/barrel, a price not seen since 2014. Higher oil prices mean higher export revenue for Canada, at least in the short term.
- The **Chinese yuan** has stayed remarkedly strong amid China's weakening macro outlook. This is not a misalignment. Unsettled by troubles in the real estate sector, domestic demand will likely slow in coming months. To keep hitting its GDP growth targets, the Chinese government will have to increase public sector investment and bolster export-oriented industries through credit expansions and subsidies. The result will likely be a widening trade surplus, as imports slow but exports stay solid, supporting the yuan in the process.

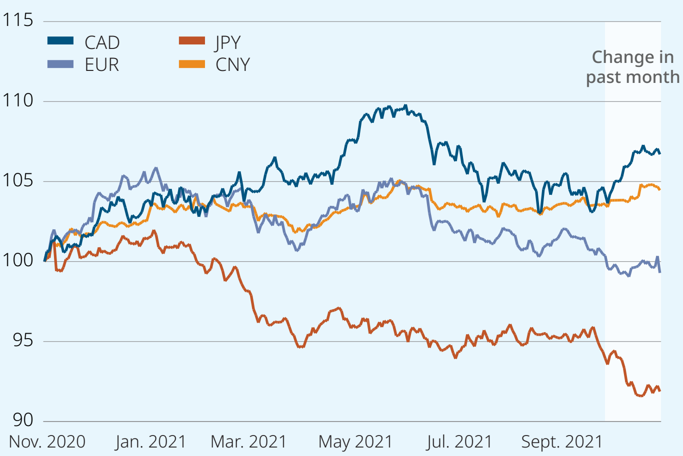
Equity indices (one year ago=100)



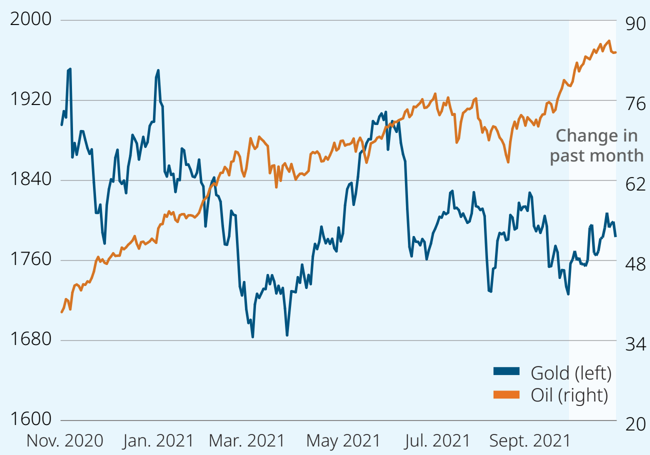
US Treasury yields (%)



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



Commodity prices (in USD)



Notes: Financial data from Bloomberg as of October 31, 2021.

What we'll be watching in November

November 3: US Federal Reserve policy decision

- The Fed is widely expected to announce a tapering of its bond buying program, currently set at $120 billion in net purchases per month.
- We expect the taper to last around 8 months, an accelerated version of the 2013 taper timeline, when the Fed took a full year to bring its net asset purchases down to zero. We see little chance that the Fed begins hiking rates before its taper is completed around the summer of 2022.

November 4: Bank of England rate decision

- The Bank of England (BoE) could become the first major central bank to raise its policy rate. Investors see a 60% probability of the BoE hiking rates in November according to market expectations derived from overnight index swaps.
- As we saw when Bank of England officials talked up rate hikes last month, a hawkish turn by the BoE would increase market pricing of future hikes by other central banks. Accordingly, a November hike by the BoE would indirectly tighten financial conditions globally.

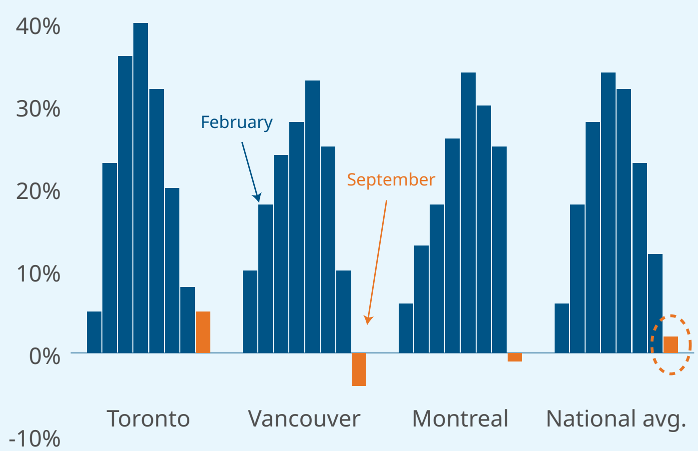
November 5: Canada employment release

- The strong employment numbers for September (+157k jobs) were accompanied by a jump in the participation rate, the ratio of Canadian adults working or looking for a job. At 65.5%, it is now back to pre-pandemic levels, a striking development considering the US participation rate is still at depressed levels (61.6% vs. 63% pre-pandemic).

Emerging theme

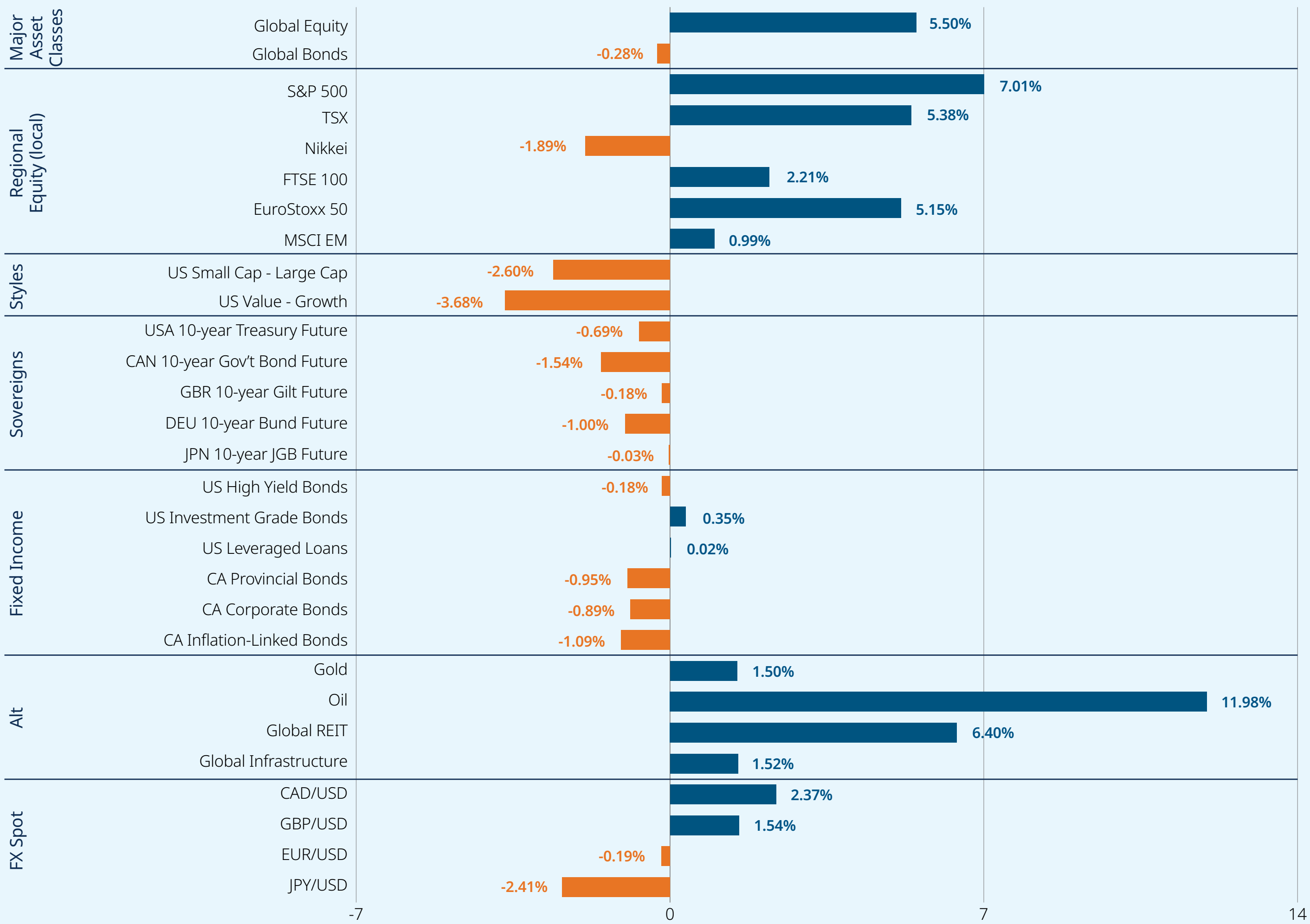
- **Canadian house price growth has slowed significantly** since its peak last Spring. The most recent Teranet house price release shows prices barely budged in September, edging up by 0.1% (1.2% annualized) on average across Canada.
- The deceleration in prices is observed in major cities across the country. And **housing activity has slowed overall**, with both sales and construction numbers dropping in past months.
- With the Bank of Canada set to begin raising rates in 2022, **mortgage rates should progressively increase across Canada next year**, further quelling housing demand. But with permits and construction data coming in below expectations recently, lower demand will be met by decreasing supply, limiting downsides for prices.
- As we emphasized back in August, **a deceleration of housing activity is not a condemnation for the Canadian economy**, in part because a slowdown in real estate borrowing will allow the Bank of Canada to conduct monetary policy without fearing to inflate or burst housing bubble.

Monthly house price growth in 2021 (annualized)



Notes: Teranet-National Bank as of October 31,2021.

Appendix:
Capital market returns in October



Notes: Market data from Bloomberg as of October 31,2021. Index returns are for the period: 2021-10-01 to 2021-10-31. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite (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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