

# ECONOMIC RESEARCH AND STRATEGY



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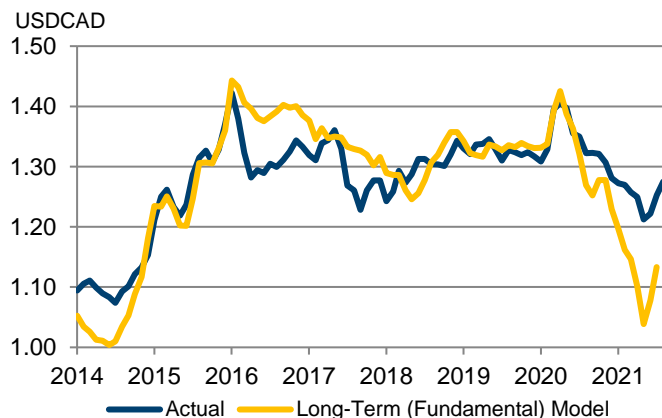
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## Canadian Dollar – Downside risks to weigh on the currency in the near-term

After reaching a six-year high in May, the Canadian dollar pared back a significant portion of its gains this summer. The currency touches 1.28 as of writing on the back of the publication of the Minutes of the Federal Reserve Open Market Committee (FOMC) on August 18<sup>th</sup>. The FX market incorporates the possibility that the Fed starts tapering the pace of its asset purchases (QE) earlier than expected, sometimes in 2021 instead of at the beginning of 2022. Next week's August 24-26 Jackson Hole economic symposium will provide more details relative to the timing and pace of QE tapering and could lead to further, but limited, upside pressure on the USDCAD. This leads us to revise up our 2021Q3 end-of-period target to 1.30, with year-end 2021 target moderating to 1.27 (up from our previous 1.22 forecast in May), before reaching a long-run equilibrium value of 1.25 in mid-2022. The USDCAD remains around 10% overvalued based on the current level of energy and non-energy commodity prices (chart 1). However, downside risks in the short-term should prevent the Canadian dollar from reaching back its early-2021 multi-year high value.

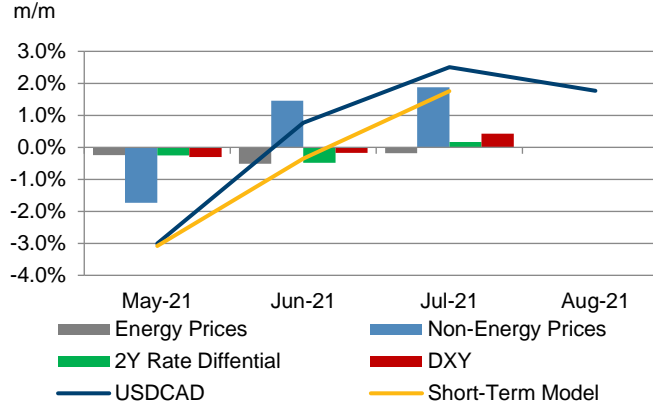
First, non-energy prices, the largest contributor to the June and July USDCAD appreciation based on our short-term currency modeling (chart 2), are unlikely to go back to the record-levels reached earlier this year amidst the height of the *reflation trade*. As U.S. homebuilders and wholesalers secured wood supply for the summer and labour shortages hamper construction, lumber prices collapsed 50% from May to July according to the Bank of Canada commodity price index and have turned negative year-to-date according to futures contracts. The reopening process in North America, combined to continued progress on the vaccination front should lead to a reallocation of household consumption away from housing toward services by the end of this year, alleviating demand for lumber and preventing another flare up in spot pricing. Meanwhile, metal and mineral prices flattened over “peak growth” concerns and a slowdown in Chinese demand (charts 3 and 4). [Reports](#) suggest that Chinese authorities will ramp up monetary and fiscal support in the second half of this year. This should support metal and mineral prices without bringing back early-2021 commodity prices and USDCAD levels.

Chart 1: The Canadian dollar remains undervalued versus its fundamentals



Source: LBS Econ. Res. and Strategy.

Chart 2: Non-Energy prices contributed the most to USDCAD appreciation in June and July

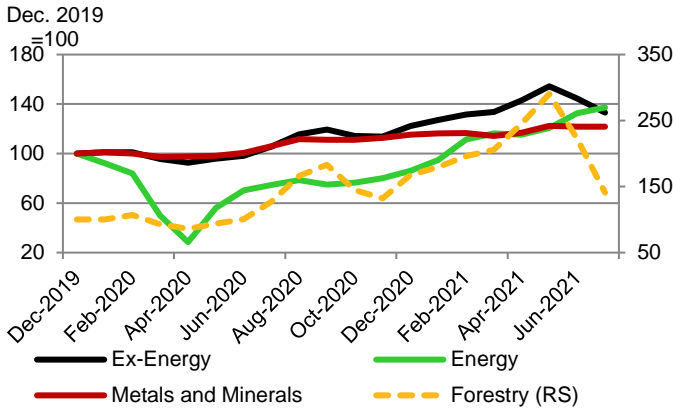


Source: Bank of Canada/Haver, Refinitiv, LBS Econ. Res. and Strategy calculations.



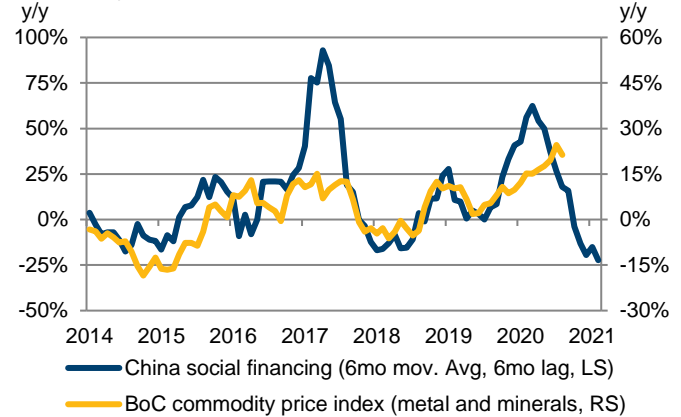
Second, oil prices have significantly come off their recent highs, trading below US\$65/bbl as of writing and matching our 2021 end-of-year target. OPEC+'s [agreement](#) to increase by 0.4M bbl/day production on a monthly basis starting in August, until complete phase out of its 5.8M bbl/day pandemic-related production cuts, will lead to a significant supply increase by the end of this year (+2.4M bbl/day or +2.5% of total forecast demand in 2021). That decision, compounded to revised down annual demand due to the coronavirus delta variant, put mild negative pressure on the Canadian dollar so far in August. While OPEC+ could slow down its production adjustment at its upcoming September 1<sup>st</sup> meeting, slower global demand combined to additional services consumption will prevent higher oil prices and remove a source of strength for the Canadian dollar.

Chart 3: Commodity prices have peaked and started rolling over



Source: Bank of Canada, LBS Econ. Res. and Strategy.

Chart 4: Negative Chinese demand weighs on commodity prices



Source: Refinitiv, LBS Econ. Res. and Strategy.

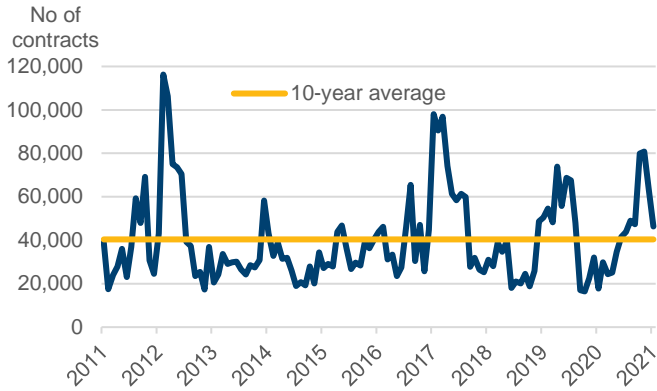
Third, the Canada-US 2-year interest rate differential, a proxy for expected policy divergence between the BoC and the Federal Reserve, have been largely stagnant for the past 16 months. Markets continue to incorporate earlier policy rate hikes in Canada and the Federal Reserve is unlikely to bring forward from late-2023 to 2022 its liftoff date. This being said, our model does not incorporate the impact of QE on the FX channel. The Canadian dollar gained support last Spring when the BoC decided to taper QE before the Fed. However, as mentioned above, the fed could slowly catch-up if it begins tapering at a gentle pace of \$10B/month in November or December, preventing a rapid appreciation of the loonie.

All in all, the macroeconomic outlook is likely to improve in the coming months as vaccines remain highly efficient against the delta variant and growth momentum rotates from the U.S. to Europe, Japan and emerging markets. This should lead to a modestly lower U.S. dollar in the fourth quarter. However, downside risks in the short-term limit potential appreciation in the Canadian dollar. Finally, it is worth pointing out that both long and short option speculative positioning on the Canadian dollar trend close to their historical average (chart 5 and 6). This reduces the odds of a disorderly position unwinding generating sharp movements in the USDCAD.

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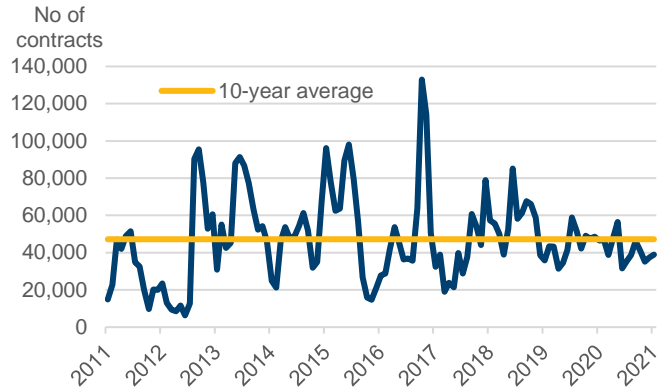


Chart 5 - Canadian Dollar - Long Non-Commercial (speculative positions)



Source: CFTC, LBS Econ. Res. and Strategy.

Chart 6 - Canadian Dollar - Short Non-Commercial (speculative positions)



Source: CFTC, LBS Econ. Res. and Strategy.

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