NATIONAL BANK
FINANCIAL MARKETS
A division of National Bank of Canada

December 2013

Sentiment turns against the loonie

- ***All of a sudden, Canada can't do anything right. At least that's what some investors seem to believe given the speed at which sentiment has turned against the loonie. The deal struck by the international community with Iran, which allows for a gradual relaxation of sanctions under some conditions, will eventually add Iranian oil to the global supply pool. That announcement helped trim risk premiums, putting a dent in oil prices and hence the Canadian currency. Further pressure was applied on the C$ by bearish analyst reports. The loonie's downtrend seems to have momentum, fueled by self-fulfilling negative investor sentiment and partly by a deterioration in the terms of trade. We are adjusting our forecasts accordingly by raising our end-of-Q1 USDCAD target to 1.10, although we expect the currency to stabilize afterwards as economic fundamentals improve.***
- ***The euro rallied on news that the zone's unemployment rate fell one tick to 12.1% and the annual inflation rate rose two ticks to 0.9%. Of course, the bid on the common currency is unwarranted because such awful economic data raises the odds that the European Central Bank will loosen monetary policy not tighten it. We continue to expect the ECB to engage into unconventional monetary policy, e.g. perhaps another LTRO or something a bit more potent early next year, which will incidentally coincide with tapering of the Fed's asset purchase program, presenting a double whammy for the euro. We are maintaining our 1.28 end-of-2014Q1 target for EURUSD.***

NBF Currency Outlook*

	Current *3-Dec-13*	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
USDCAD	1.06	1.10	1.09	1.08	1.05	1.03
US cents per CAD	*0.94*	*0.90*	*0.91*	*0.92*	*0.95*	*0.97*
EURUSD	1.36	1.28	1.30	1.31	1.32	1.33
USDJPY	103	104	106	108	110	111
AUDUSD	0.91	0.88	0.90	0.91	0.94	0.96
GBPUSD	1.64	1.58	1.62	1.65	1.67	1.70
USDCNY	6.09	6.10	6.08	6.06	6.05	6.02
AUDCAD	0.97	0.97	0.98	0.98	0.99	0.99

** forecasts for end of period*
Source: NBF Economic Research

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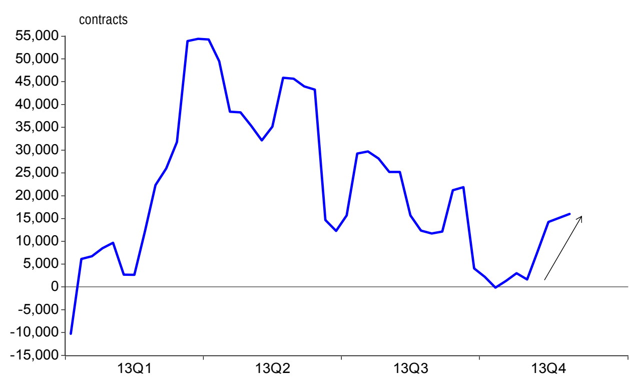
Stéfane Marion, Chief Economist and Strategist

Fed tapering and the USD

The Fed may not have a better opportunity to start tapering its asset purchases. The US economy just topped expectations by growing roughly 3% annualized in the third quarter, while the labour market continues to improve, having created over 185,000 net new jobs per month on average in the first ten months this year. True, there are still some uncertainties with regards to fiscal policy, but given the beating taken in the polls by the instigators of the October government shutdown, there may be little appetite for a repeat performance in early 2014. The December FOMC meeting, which will coincide with new US economic projections being released, seems like a good time for the Fed to finally provide details about its plan to reduce its asset purchases perhaps starting in early 2014. The latest FOMC meeting minutes indeed suggested that the Fed maintains its tapering bias, something that encouraged bids on the world's reserve currency, including from speculators who took their net long USD positions to the highest in over two months.

US dollar popular again among speculators
Non-commercial net long positions in US$



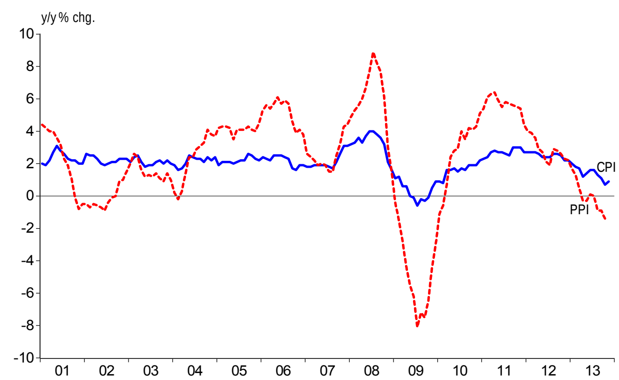
NBF Economy & Strategy (data via Bloomberg)

And since consensus is looking for Fed tapering later in Q1, a decision to start early 2014 may provide further fuel to the greenback right away. However, investors will understand that the Fed's currency debasement policies won't end entirely with tapering — the latter just means the Fed's balance sheet will continue to grow albeit at a slower pace. And the Fed's assets are unlikely to shrink rapidly even when QE is finally over. Moreover, the Fed's announcement is likely to be watered down a bit to soothe markets. As suggested in the recent meeting minutes: "*if the FOMC was going to cut purchases in the future it might be appropriate to offset the effects of reduced purchases by undertaking alternative actions to provide accommodation at the same time*". Indeed, the Fed wants to reduce QE but it also intends to clearly communicate that monetary policy will remain accommodative for a long time. It could do so by accompanying any tapering announcement with either an explicit statement that it is lowering its threshold on the jobless rate and/or by communicating its intention to keep the fed funds rate low for longer in its Summary of Economic Projections. All told, while the greenback is likely to post further gains, don't expect it to rocket all the way to the moon.

Euro defies gravity for now

It's as if the European Central Bank's November rate cut to a record low of 0.25% never happened. After sinking in the aftermath of the surprise ECB announcement, the euro took off again as investors decided to believe that the ECB has ran out of room to provide additional stimulus. Others found comfort in data showing some improvement in the zone's economy after a tepid third quarter. Purchasing managers' readings indeed suggest factory output is expanding, particularly in Germany. But other data point to the continuation of recessionary conditions despite the end of the recession in the technical sense. The zone's jobless rate remains elevated (with the youth unemployment rate hitting an all-time high of 24.4% in October) and the inflation rate is below 1% and possibly heading lower, consistent with an extremely weak economy.

Eurozone: Heading towards deflation?
Consumer and Producer price indices

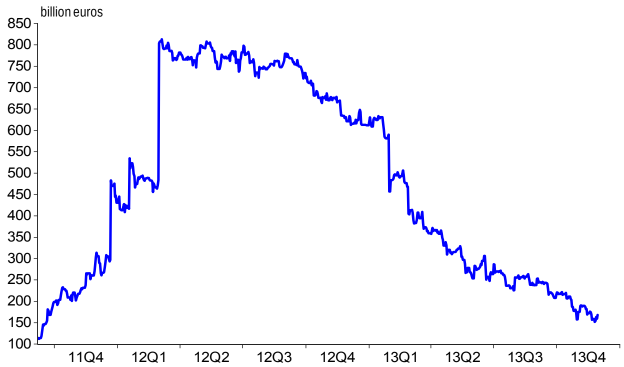


NBF Economy & Strategy (data via Datastream)

Moreover, credit continues to contract on a year-on-year basis, a symptom of a badly beaten banking sector that continues to grapple with decimated balance sheets and increasing amounts of bad loans particularly in the periphery. So what's the central bank to do under those circumstances? As ECB President Draghi made clear in November's press conference, "*it is essential that the fragmentation of euro area credit markets declines further and that the resilience of banks is strengthened where needed*". Further stimulus seems more likely than not, more so now that excess liquidity in the zone's banking system has shrunk to a 2-year low.

Eurozone: Liquidity draining fast

ECB excess liquidity = current acc. holdings + deposit facility – avg. reserve requirements – use of marginal lending facility



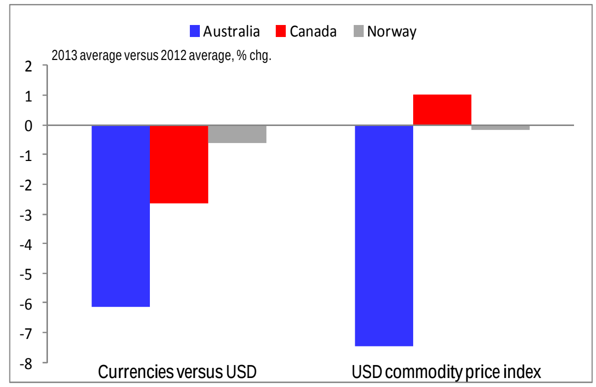
NBF Economy & Strategy (data via Bloomberg)

All told, we continue to expect the ECB to engage into unconventional monetary policy, e.g. perhaps another LTRO or something a bit more potent early next year, which will incidentally coincide with tapering of the Fed's asset purchase program, presenting a double whammy for the euro. We are maintaining our 1.28 end-of-2014Q1 target for EURUSD.

Loonie decouples from commodities

To say that 2013 wasn't kind to the loonie is an understatement. After a promising start to the year, when it was trading at stronger than parity with the US dollar, the Canadian dollar sank to a three-year low in December, and is on track for a decline of nearly 3% on an annual average basis, the worst in four years. So what exactly hammered the Canadian currency in 2013? For one, the moderation in global growth is partly to blame given that it hurt commodity prices worldwide. But the C$'s decline was arguably disproportionate compared to other commodity currencies like the Australian dollar or the Norwegian Krone considering that our commodities did relatively better. So, it seems investors painted all commodity currencies with the same brush, selling them across the board in 2013.

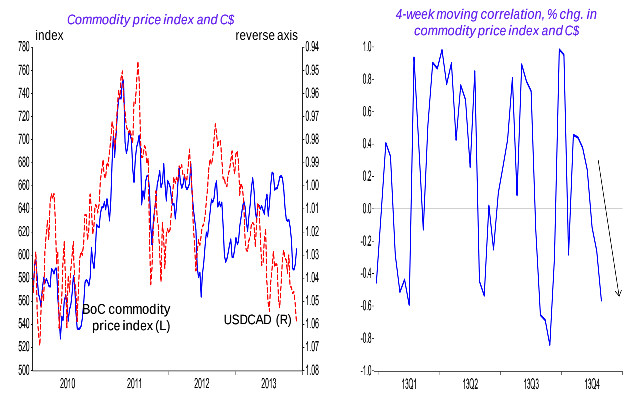
Loonie's decline in 2013 looks overdone compared to Aussie and Krone considering relatively more resilient commodity prices



NBF Economy & Strategy (data via Bank of Canada, RBA, Datastream)

That also explains the apparent decoupling of the Canadian dollar with commodity prices this year, phenomenon that seems to have become more pronounced over the last few months.

Canadian dollar decouples from commodities



NBF Economy & Strategy (data via Bank of Canada, Datastream)

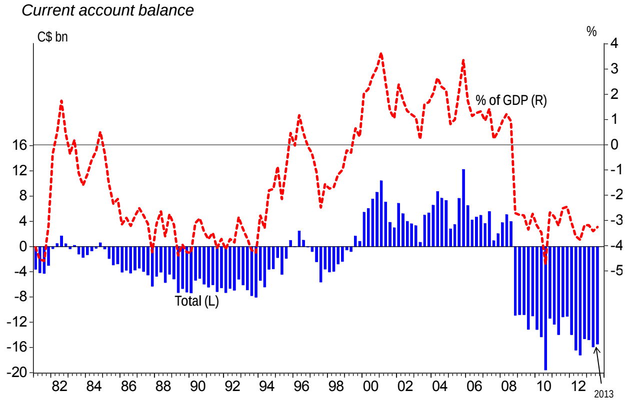
The Bank of Canada's downgraded economic forecasts and the elimination of its tightening bias in October are partly responsible for the loonie's troubles. But the C$'s decoupling from commodities was further reinforced recently by bearish analyst reports, evocative of "The Great White Short" type of stories that plagued the currency earlier in the year. Such is the negativity surrounding the loonie that investors have been shrugging off healthy economic data, e.g. even a consensus-topping Q3 GDP print couldn't stem the C$'s downtrend. Those negative stories about Canada and its currency partly explain why speculators spent much of the year shorting the loonie. In fact, it's the first time in twelve years that there are so many weeks of net short speculative C$ positions in a given year.

Speculators quite bearish on loonie this year
Number of weeks in the year when speculators had net short positions in C$

* *not accounting for the last five weeks of 2013*
NBF Economy & Strategy (data via Bloomberg)

The deal struck in November by the international community with Iran, allowing for a gradual relaxation of sanctions under some conditions, didn't help the Canadian dollar either. That announcement helped trim risk premiums, putting a dent in oil prices in anticipation of extra Iranian oil flowing into the global supply pool next year. An expected drop in food prices will add further pressure on terms of trade. So, the loonie's downtrend seems to have momentum, fueled partly by self-fulfilling negative investor sentiment. Recall that Canada is running large deficits on the current account — the deficit is currently tracking roughly 3.3% of GDP in 2013. So the economy depends on capital inflows to finance its external deficits, which leaves the Canadian currency vulnerable if there is a negative turn in sentiment as we've seen recently. We do not expect foreign investor sentiment to get back to normal just yet and we've, accordingly, adjusted our targets expecting USDCAD to rise further to 1.10 by Q1 next year.

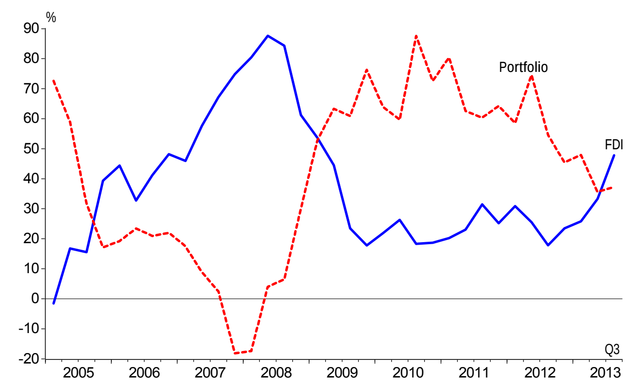
Canada: External deficit remains large
Current account balance



NBF Economy & Strategy (data via Statistics Canada)

Looking beyond the near term challenges, and the sometimes exaggerated negative media reports about Canada, foreign investors may eventually realize that fundamentals are reasonably good in the Great White north. Canada, with its sound public finances, is a fixture in an otherwise shrinking list of AAA-rated countries — the Netherlands became the latest victim of S&P's ratings update. Such attributes will encourage foreign bids on Canadian portfolio securities. Canada's resource base is also an attractive feature, made even more enticing by diminishing political risks thanks to a recent agreement on pipelines between BC and Alberta. The deal between Canada's two westernmost provinces opens up the Asian market for Albertan oil, something that, in time, will allow Canadian oil exporters to reap world prices instead of having to accept sharply discounted prices from American buyers because of pipeline constraints, as is currently the case. The BC-Alberta deal may also rekindle foreign direct investment in the resources sector. That should help reinforce recent trends showing FDI grabbing a larger share of inflows into Canada.

Canada: Foreign Direct Investment grabs larger share of inflows
Share of foreign inflows (4-quarter cumulative) into Canada

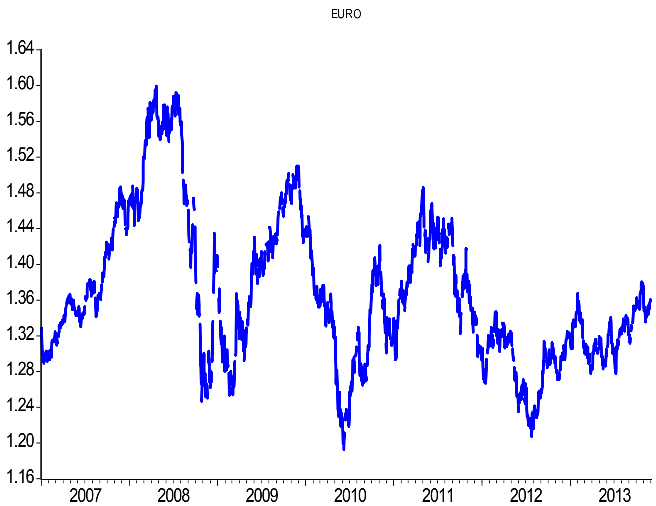


NBF Economy & Strategy (data via Statistics Canada)

The latter trend is positive for the Canadian dollar, given that FDI flows are much more stable than say portfolio flows which have a larger potential to reverse when sentiment sours. All told, looking beyond the near term headwinds, we continue to see potential in the loonie. Improving economic fundamentals should allow the currency to stabilize somewhat by mid-2014 before strengthening again against the US dollar. But given the projected steeper near term decline, it will now take a bit longer for the Canadian dollar to return to parity with the greenback.

Stéfane Marion/Krishen Rangasamy

Annex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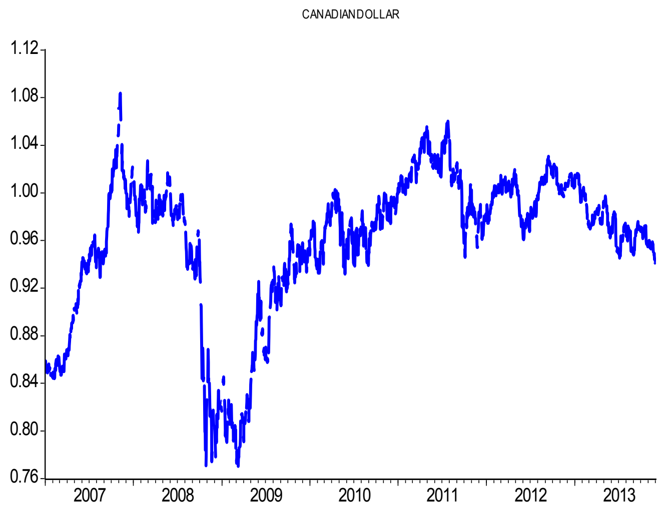
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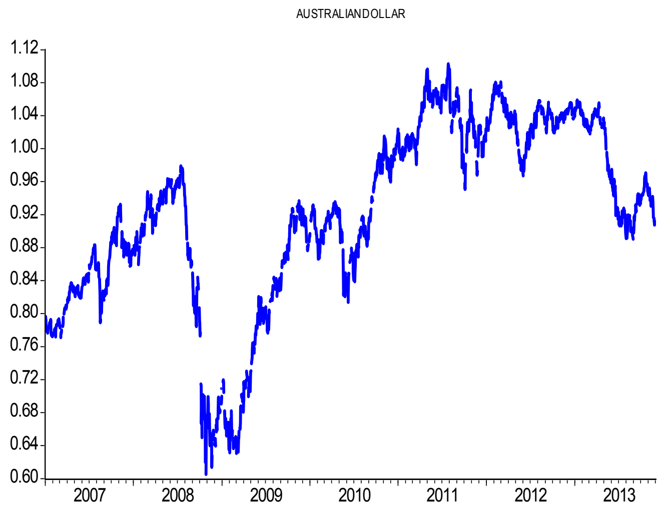
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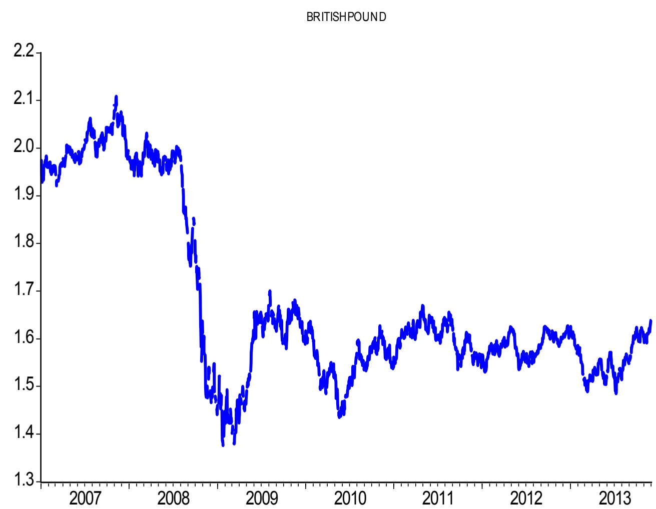
BRITISHPOUND
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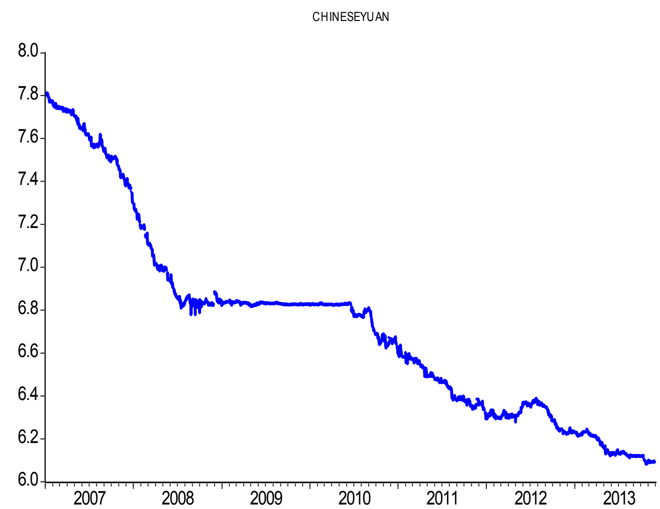
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