FOREX

CURRENCY OUTLOOK

NATIONAL BANK FINANCIAL MARKETS
A division of National Bank of Canada

November 2013

No exit for now

- ***With economic data continuing to disappoint, central banks in the developed world are finding it difficult to exit or even pare back stimulative monetary policies. The tapering of the Fed's asset purchase program, which until very recently was viewed as imminent, now seems to have been delayed to next year thanks to weak US growth and a deceleration in employment creation. And with economic slack opening up rather than narrowing down in the last couple of quarters, the Bank of Canada finally threw in the towel and abandoned its tightening bias, a feature in its statements for over a year. On the other side of the Atlantic, with credit contraction threatening to derail the recovery, the European Central Bank looks poised to add stimulus rather than withdraw it, more so with inflation continuing to drop. Ditto for the Bank of Japan which has yet to meet its inflation target. We expect Fed tapering to start only in Q1 of next year, something that should allow the US dollar to regain some strength relative to most majors. We have adjusted our near term yuan forecasts to reflect October's ascent, but have left our other targets largely unchanged.***

- ***The Canadian dollar took it on the chin when the Bank of Canada abandoned its tightening bias in October. While the currency should continue to slide towards our end-of-Q1 USDCAD target of 1.06, we remain upbeat about the loonie's longer term outlook, expecting it to return to stronger than parity with the greenback by the end of 2014.***

NBF Currency Outlook*

	Current *31-Oct-13*	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
USDCAD	1.04	1.04	1.06	1.03	1.00	0.99
US cents per CAD	*0.96*	*0.96*	*0.94*	*0.97*	*1.00*	*1.01*
EURUSD	1.36	1.35	1.28	1.30	1.31	1.32
USDJPY	98	98	102	104	106	110
AUDUSD	0.95	0.93	0.92	0.95	0.98	1.00
GBPUSD	1.60	1.61	1.58	1.60	1.62	1.63
USDCNY	6.09	6.09	6.10	6.08	6.06	6.05
AUDCAD	0.99	0.97	0.98	0.98	0.98	0.99

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

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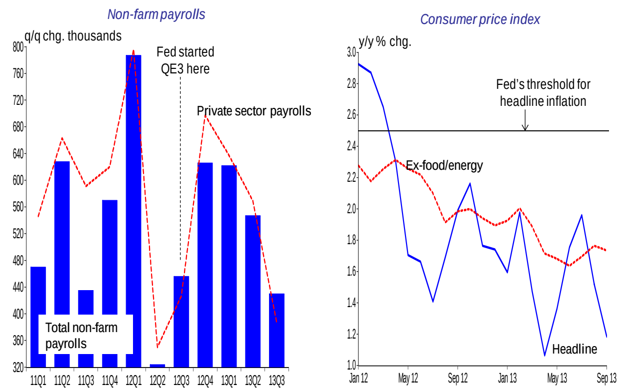
Fed tapering delayed

The Fed's no-change decision on monetary policy was widely expected in October. That's because economic data continues to disappoint and the Fed had little alternatives other than delay tapering of its asset purchase program. The labour market decelerated and the inflation rate moved further away from the Fed's threshold in the third quarter.

U.S.: Labour market is decelerating and inflation remains low



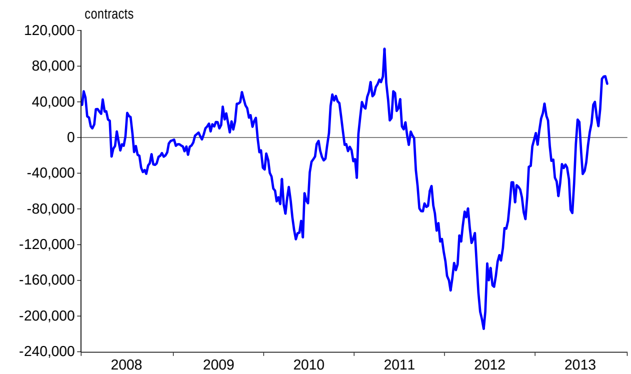
NBF Economy & Strategy (data via BLS)

Employment remained weak in early Q4 according to October's ADP report. While we may see some rebound in employment later, it's unclear if there will be much of an improvement. GDP growth for Q3 wasn't available at this writing, but it seems that growth held up to a bit above 2% annualized in part due to inventory accumulation. But those unsold inventories could weigh on economic performance in Q4, a quarter which has already been impaired by the 16-day government shutdown. So, there may not be sufficient evidence of a sustainable improvement before year-end to prompt the Fed to change its stance so soon. Interestingly, the US dollar gained after the October statement was released, as some investors somehow interpreted the Fed's continuing tapering-bias as less dovish. We expect that type of flight towards the US dollar to become more pronounced in early 2014 as we get closer to an actual tapering of the Fed's asset purchase program.

Euro vulnerable to ECB action

The eurozone recovery continued in early Q4, albeit at a modest pace. Purchasing managers' indices for October show a ramp up in output from factories offset somewhat by an apparent relapse in the services sector, particularly with regards to retailing, a strong performer in the prior quarter. So it seems that growth remained soft, much in line with our view that the eurozone's recovery will be slow and bumpy. Speculators seem a bit more optimistic than us based on the net euro long non-commercial positions which are near two-year highs. That explains in part why the euro has been flying high lately. The higher the rise, the bigger the risk of a correction.

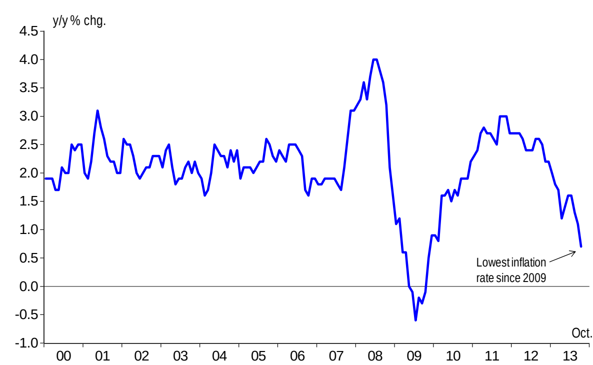
Speculative euro longs near two-year highs
Non-commercial net long positions in the euro



NBF Economy & Strategy (data via Bloomberg)

With growth remaining weak (thanks in part to ongoing austerity), the jobless rate at a record 12.2% in September, and annual inflation in October falling to the lowest since 2009, the European Central Bank seems poised to provide more stimulus. ECB President Mario Draghi has hinted at liquidity injections to revive credit as the latter continues to contract. If recent history is any guide, the euro could lose some steam if, as we expect, another round of LTRO is dispatched by the central bank over the coming months. Added headwinds for the common currency will come courtesy of the Fed's tapering of its QE program. All told, we remain comfortable with our call for EURUSD to depreciate to 1.28 by the end of the first quarter of next year.

Eurozone: Deflation threats rising
All items CPI

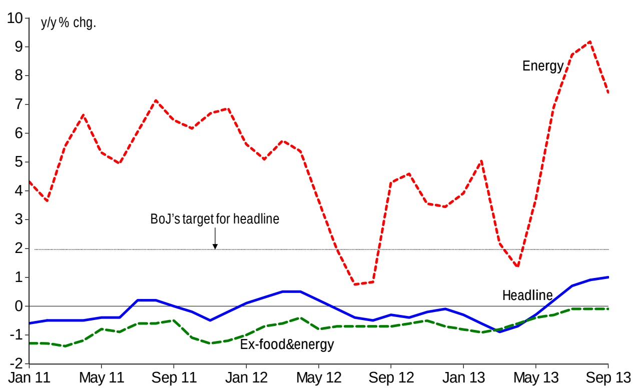


NBF Economy & Strategy (data via Eurostat)

BoJ's printing press to remain busy

Another central bank likely to provide an offset to tight fiscal policy is the Bank of Japan. The Abe government has confirmed that it is going ahead with a planned sales tax hike next year. That should slow down consumption spending, a major contributor to growth this year. But the BoJ can minimize the damage on the economy by maintaining, if not increase, its asset purchase program. Note that deflation is far from conquered. While inflation has picked up, that was mostly due to energy. Moreover, the 2% inflation target is far from being achieved and hence the central bank is unlikely to pull back on stimulus so soon.

Japan: Headline inflation gains mostly due to energy
CPI inflation



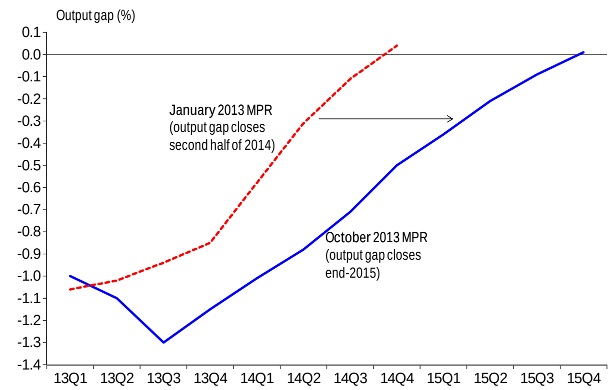
NBF Economy & Strategy (data via Datastream)

We expect BoJ asset purchases to continue through next year, something which together with Fed tapering, should allow the yen to depreciate further. We are maintaining our USDJPY end-of-2014 target of 110.

Canadian tightening bias eliminated

Better late than never. The Bank of Canada finally removed its tightening bias in its October statement after acknowledging that the economy (trade in particular) has been doing much worse than expected. Forecasts for Canada's GDP growth were lowered for 2013 (down two ticks to 1.6%) as well as for the next couple of years. That means the output gap only closes towards the end of 2015 according to the central bank, in sharp contrast to its call at the start of the year for slack to be eliminated by the second half of 2014. The October decision extinguished any hopes for rate hikes over the near to medium term, and not surprisingly took the wind out the Canadian dollar's sails. We believe the loonie has room to fall further, which is why we are maintaining our 1.06 USDCAD target for end of 2014Q1. The expectation of Fed tapering is just one of the near-term headwinds for the Canadian dollar.

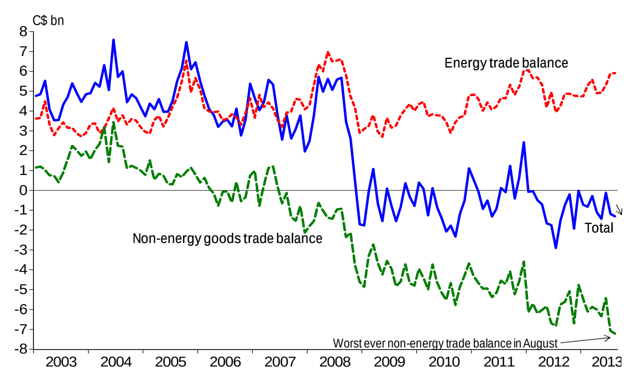
Bank of Canada expects economic slack to persist until end-2015
Output gap projections according to Monetary Policy Report



NBF Economy & Strategy (data via Bank of Canada)

Trade flows have been unfavourable as evidenced by a widening merchandise trade deficit, and a quick and significant turnaround is highly unlikely. Note that in August the non-energy trade deficit was the largest in recorded history.

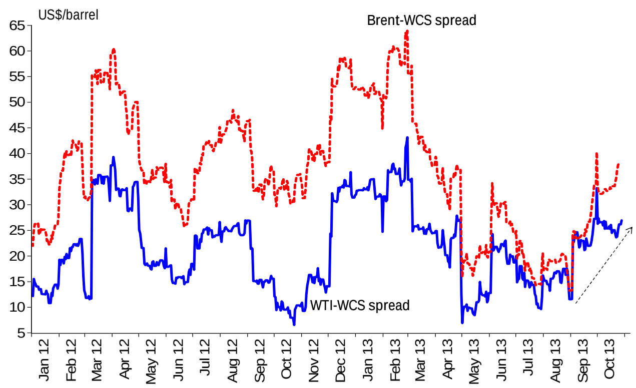
Canada: Trade deficit widened in August
Merchandise trade balance



NBF Economy & Strategy (data via Statistics Canada)

While the energy trade surplus seems to be holding firm, there are concerns even on that front. The surplus is still below the peak reached five years ago despite real exports being 10% above and real imports being 10% below 2008 levels. That's because of the declining oil terms of trade, i.e. the lower prices received by our exporters (e.g. Western Canada Select) and the high prices paid by our importers on the East Coast (e.g. Brent prices). The lack of pipeline capacity has made things worse on that front, as evidenced by large oil spreads for WCS relative to other blends. The recent widening of the spreads aren't positive for Canada and its currency.

Canada: Oil spreads widening again
Western Canada Select spreads with Brent and WTI



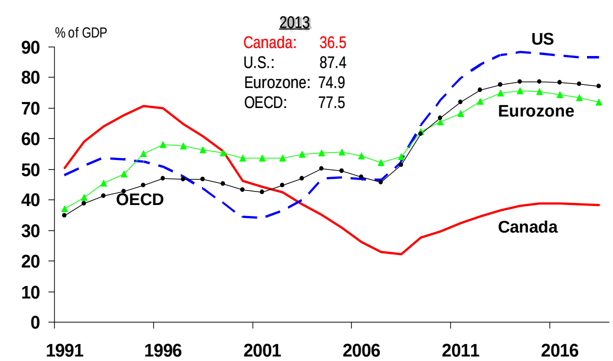
NBF Economy & Strategy (data via Bloomberg)

Wide oil spreads will be a recurring feature in Canada's economic landscape unless pipeline projects come to fruition. That remains one of the major risks for the Canadian dollar over the longer term. But we remain optimistic on that front, more so with the Federal government reiterating, in its recent Throne speech, that energy is a key priority: "*for Canadians to benefit fully from our natural resources we must be able to sell them. A lack of key infrastructure threatens to strand these resources at a time when global demand for Canadian energy is soaring*". In other words, expect the federal government to push for a resolution among provinces as to clear the way for pipeline projects either westwards towards the Pacific to open up the Asian market to our exporters, or eastwards as to reduce the need to import oil at elevated Brent prices. True, even if East-West pipeline projects are approved next year, benefits may not accrue immediately to energy exporters given that it will take years before the infrastructure is built. But the ability to diversify our oil exports away from the US will be a powerful message to foreign investors about Canada's prospects, and could bring some support to the loonie well before any oil flows through those new pipelines.

The federal government also made clear in the Throne speech that it "*will continue to ensure that our natural resource sectors remain open to foreign investment when it is market-oriented and in the long-term interests of Canadians".* That's not only an important positive signal to international investors but a necessary reassurance after tighter rules were imposed on foreign ownership following the takeover of Nexen by a foreign entity. Canada's chronic current account deficits need to be financed, and foreign direct investments are arguably the best way to do so given that they are relatively stable (e.g. not as easily reversible as portfolio flows) and tend to be associated with positive spillovers like knowledge transfer and productivity. FDI inflows in the oil patch should pick up, more so if pipeline projects get the go ahead.

Another long term positive for the Canadian dollar, is the net inflow of portfolio investment. Canada's superior fiscal standing and AAA rated government bonds are attractive features for foreign investors and will remain so for years to come. Central banks worldwide also continue to diversify their foreign exchange reserves away from the US dollar and one of the beneficiaries is the Canadian currency whose share of allocated reserves continues to grow. That the Canadian dollar is now a reserve currency in the IMF's Currency Composition of Official Foreign Exchange Reserves is an added incentive for foreign investors, including central banks worldwide, to gravitate towards the loonie.

Canadian general government net debt relatively low
At year end, as % of GDP (IMF projections for 2013 to 2018)

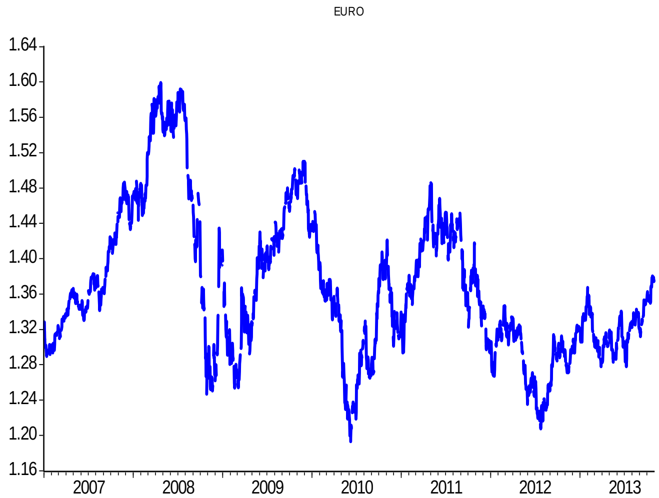


NBF Economy & Strategy (IMF Fiscal Monitor, October 2013)

Those are the reasons why we've remained bullish about the Canadian dollar's long term prospects, expecting the currency to return to stronger than parity with the USD by the end of 2014. An added positive for the loonie is the low bar that's now been set for the economy by the Bank of Canada after the massive downgrades in its October Monetary Policy Report. The central bank's forecasts are now in line with our own for both this year and next. So, in our view, BoC upgrades are now more likely that downgrades. If, as we expect, the economy picks up next year in sych with the US, the BoC may turn less dovish as a way to "lean" against the oft-stated problem of household imbalances.

Stéfane Marion/Krishen Rangasamy

Annex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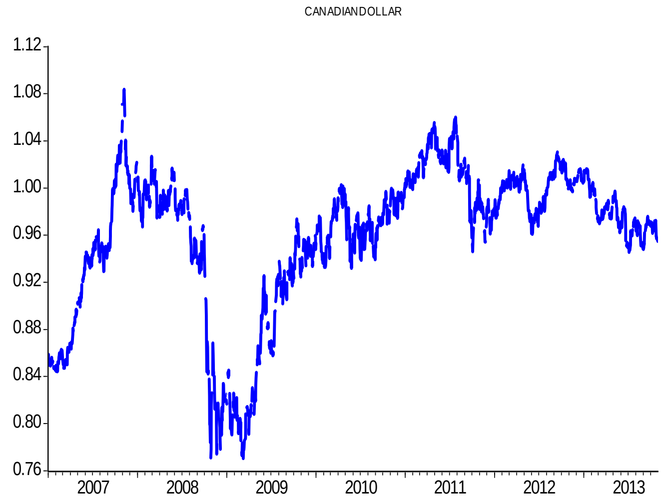
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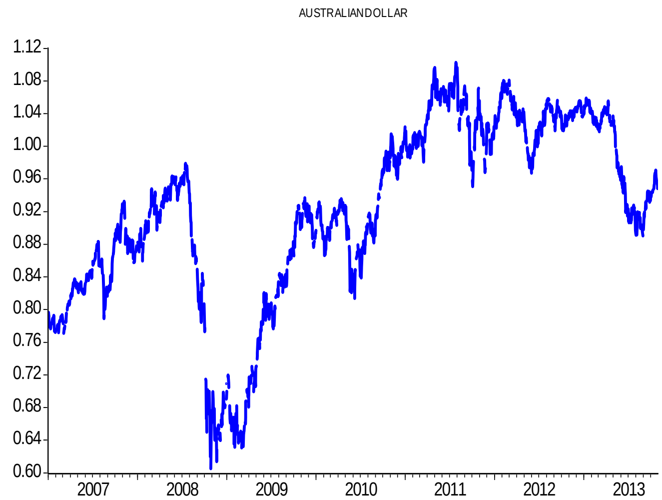
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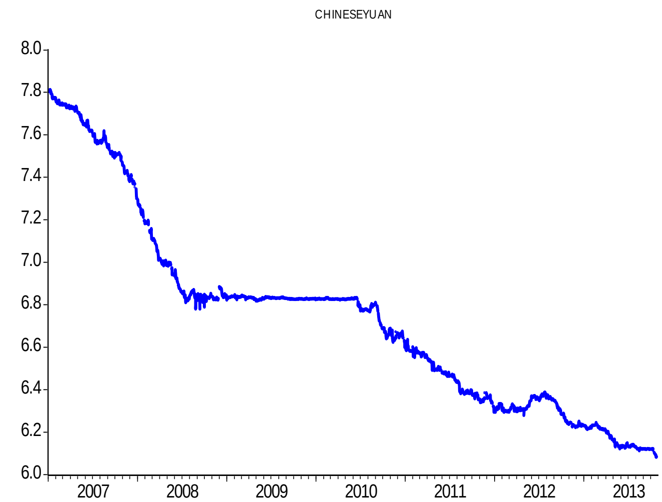
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