NATIONAL BANK
FINANCIAL MARKETS
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Economics and Strategy Group

December 2014

The petro-loonie

- *The U.S. dollar bull run continues. Thanks to a stronger economy, the Fed will tighten monetary policy relative to that of economies such as the eurozone and Japan where the threat of deflation is forcing central banks to inject more liquidity in financial markets. We remain comfortable with our end-of-2015 target of 1.15 for EURUSD, although we have raised our target for USDJPY to 128 after the recent steeper-than-expected yen depreciation.*

- *The oil price slump took the Canadian dollar to a 5-year low against the USD in November, reinforcing the loonie's petrocurrency status. Even if oil prices do not stabilize right away, that doesn't automatically spell doom and gloom for the C$. The currency's correlation with oil, while clearly positive, has diminished in recent years. Perhaps that's because last year's C$ sell-off was more brutal than warranted by fundamentals, and there is now a readjustment by markets. Strong economic data, buoyed by the U.S. resurgence, is also helping the C$ cushion somewhat the blow of lower oil prices this year. That being said, it's clear the loonie is swimming against the tide, and as such we continue to expect it to depreciate further in 2015. The central bank's loose stance on monetary policy, coupled with soft oil prices, should take USDCAD to 1.17 over the next few quarters.*

Stéfane Marion/Krishen Rangasamy

NBF Currency Outlook*

	Current *2-Dec-14*	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
USDCAD	1.14	1.13	1.15	1.17	1.17	1.16
US cents per CAD	*0.88*	*0.89*	*0.87*	*0.86*	*0.86*	0.87
EURUSD	1.24	1.22	1.19	1.17	1.15	1.14
USDJPY	119	122	124	126	128	129
AUDUSD	0.84	0.82	0.81	0.79	0.80	0.82
GBPUSD	1.56	1.54	1.52	1.51	1.50	1.52
USDCNY	6.15	6.13	6.11	6.10	6.09	6.08
AUDCAD	0.96	0.93	0.93	0.92	0.94	0.95

** forecasts for end of period*
Source: NBF Economics and Strategy

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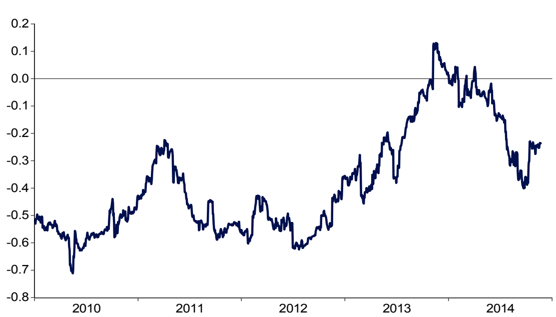
U.S. dollar rally not over

After a difficult start to the year, the U.S. economy made an impressive comeback. GDP grew at annualized pace of 4.6% and 3.9% in Q2 and Q3 respectively, the best two-quarter sequence since 2003. The labour market has accordingly averaged well over 200K net new jobs/month this year, allowing the jobless rate to fall to a six-year low. The end of QE by the Fed was clearly warranted. The FOMC is now starting to think about strategies to prepare markets for interest rate hikes next year when major central banks like the European Central Bank and the Bank of Japan will be going the other way by loosening monetary policy even further. Buoyed by such fundamentals, the U.S. dollar looks unstoppable. The world's reserve currency which, in trade-weighted terms, is at its highest since 2009, has room for further gains as markets more aggressively price in rate hikes, in synch with a strengthening U.S. economy. In that regard, we are keeping our end-of-2015 forecast for EURUSD at 1.15, while raising our target for USDJPY to 128 after the recent steeper-than-expected yen depreciation.

A stronger USD doesn't bode well for oil prices which are often priced in dollars. The negative correlation can be partly explained by the fact that an appreciating greenback makes it more expensive for oil importers to buy oil, thereby capping demand and hence prices. Similarly, when USD depreciates, importers' increasing ability to pay pushes up prices.

Negative correlation between USD and oil price
100-day moving correlation between changes in Trade-weighted USD and WTI oil price



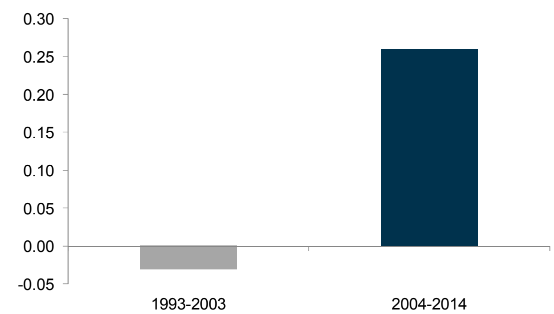
NBF Economics and Strategy (data via Datastream)

The recent decline in oil prices isn't just a result of the USD surge. More fundamentally, excess supply has also been weighing on prices. Thanks to its energy boom, the U.S. is on track to surpass Saudi Arabia as the world's largest oil producer this year. There has also been a ramp up in output in OPEC countries such as Libya, Algeria and Nigeria.

Why does the loonie react to oil?

Sinking oil prices haven't been good for the Canadian dollar. In November, USDCAD averaged 1.13 — or 1 C$ bought just 88 U.S. cents — the weakest the currency has been since mid-2009. The depreciation reinforced the C$'s petrocurrency status. The relationship between the loonie and oil prices has clearly strengthened over the last ten years. After controlling for interest rates, the C$'s oil price elasticity was roughly 0.26 over that period — i.e. a 1% increase in the price of oil led to a 0.26% appreciation of the loonie —, while it was largely insignificant before 2004.

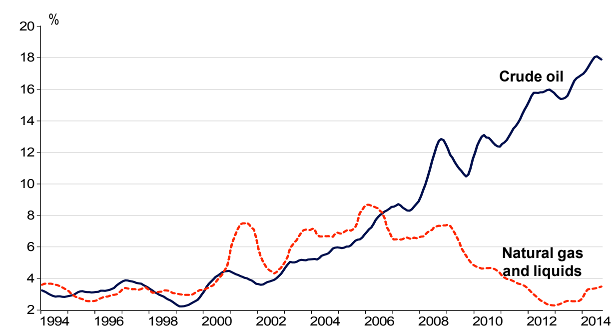
Loonie's petrocurrency status cemented over last ten years
C$ elasticity, i.e. % chg. in C$/US$ exchange rate when WTI oil price rises 1%



NBF Economics and Strategy (data via Bloomberg)

Such an increase in the elasticity reflects the growing influence of oil in Canadian trade. Oil's share of overall exports rose from around 6% in 2004 to 18% in 2014.

Canada: The growing influence of oil
Share of total nominal exports, 12-month moving average



NBF Economics and Strategy (data via Statistics Canada)

That, together with sagging natural gas exports, has allowed oil's share of Canada's energy trade surplus to soar to roughly 80%, four times as much as in 2004.

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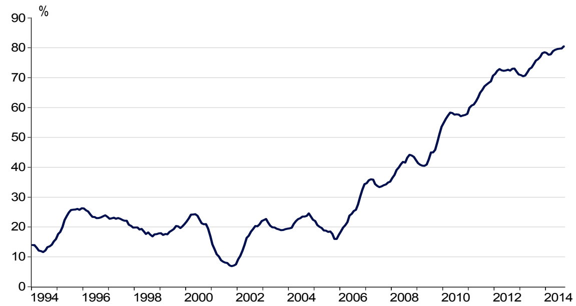
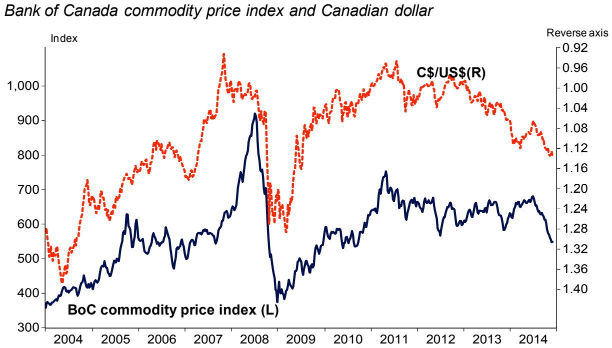
Canada: Oil responsible for bulk of energy trade surplus
Crude oil trade surplus as a share of energy trade surplus, 12-month moving average



NBF Economics and Strategy (data via Statistics Canada)

That is why oil accounts for more than half of the Bank of Canada's commodity price index. The latter's drop to multi-year lows shouldn't really come as a surprise in light of the oil price slump.

Commodities and loonie both at multi-year lows
Bank of Canada commodity price index and Canadian dollar

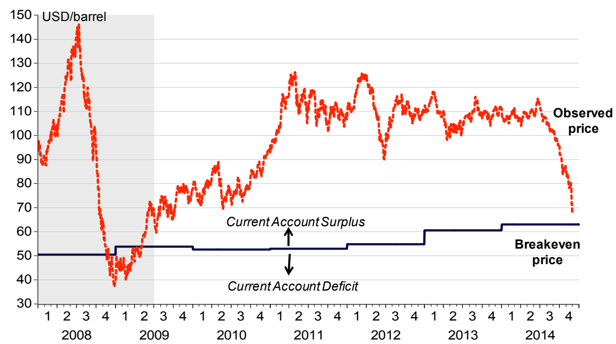


NBF Economics and Strategy (data via Datastream)

OPEC's recent decision to not reduce supply, enhances downside risks to oil prices and hence to the C$. That being said, we're not writing off the loonie. There is a limit to how low oil prices can go over the longer term. High cost producers will eventually be driven out of the market, wiping away some of the excess supply. The demand side also looks promising because lower oil prices are equivalent to a global economic stimulus, particular for heavy users like emerging markets. If, as we expect, those economies strengthen, oil prices will eventually stabilize.

Even the short term may not be as bad as advertised. OPEC could quickly change its mind if the cartel's own survival is at stake. Note that several OPEC countries are running current account deficits and finding it harder to balance their budgets. Under the circumstances, there are incentives to ignore the set quota and grab market share. Venezuela and Nigeria recently announced that they would take forceful action to stabilize their respective deficits. So, while Saudi Arabia claims it can wait for oil prices to stabilize on their own, that strategy risks causing irreparable damage to the cartel. The credibility of this "wait and see" strategy will soon be tested considering that oil prices are now within striking distance of the $63/barrel needed for Saudi Arabia itself to avoid a current account deficit.

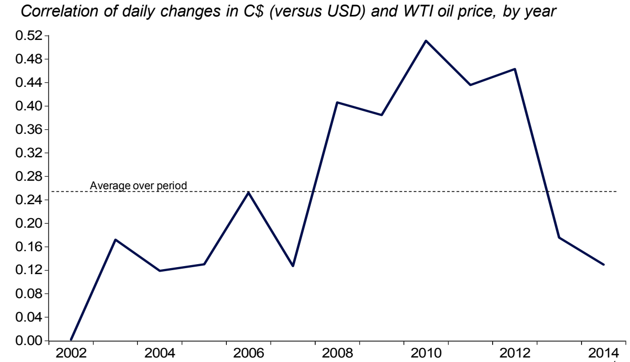
World: Oil prices near a trough?
Price of Brent oil vs. current account breakeven estimate for Saudi Arabia



NBF Economics and Strategy (data via Datastream and Bloomberg)

Even if oil prices do not stabilize right away, that doesn't automatically spell doom and gloom for the C$. The correlation with oil, while clearly positive, has diminished in recent years, likely due to monetary policy. Recall that the Canadian currency went downhill after 2012 despite relatively stable oil prices — coinciding with the appointment of a dovish Governor Poloz in 2013. This year, however, the C$'s depreciation has been smaller than would be expected considering the extent of the oil plunge. Perhaps that's because last year's C$ sell-off was more brutal than warranted by fundamentals, and hence there is now some readjustment by markets. Strong economic data, buoyed by the U.S. resurgence, is also helping the C$ cushion somewhat the blow of lower oil prices this year.

Loonie's correlation with oil has declined in recent years
Correlation of daily changes in C$ (versus USD) and WTI oil price, by year



NBF Economics and Strategy (data via Datastream)

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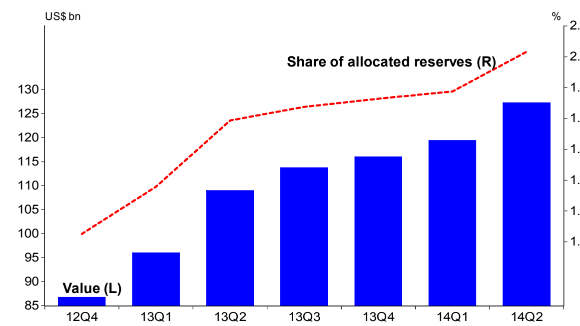
There are also other sources of support for the Canadian currency. The loonie remains a currency of choice for global central banks aiming to diversify their currency reserves. In the second quarter, the C$'s share of total allocated reserves in the IMF's COFER (currency Composition of Official Foreign Exchange Reserves) jumped to 2%, the highest on records.

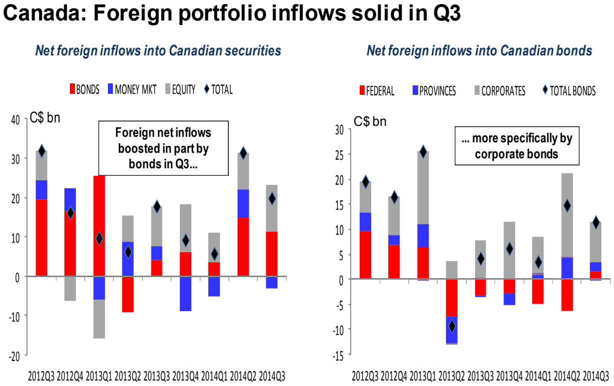
Loonie's share of global FX reserves on the rise
Canadian dollar holdings in COFER allocated reserves



NBF Economics and Strategy (data via IMF's COFER)

And it's not just central bankers who like Canada. Foreign investors poured their savings into Canadian securities for the 23rd quarter in a row, as evidenced by the roughly C$20 bn net inflows in Q3. Foreigners continue to find Canadian equities attractive (sixth consecutive quarter of net inflows into such securities), while appetite for bonds, corporate bonds in particular, remains strong. While slumping commodity prices may cause a temporary reversal, portfolio inflows should quickly bounce back as investors reset their focus on fundamentals such as sound public finances and highly rated securities.

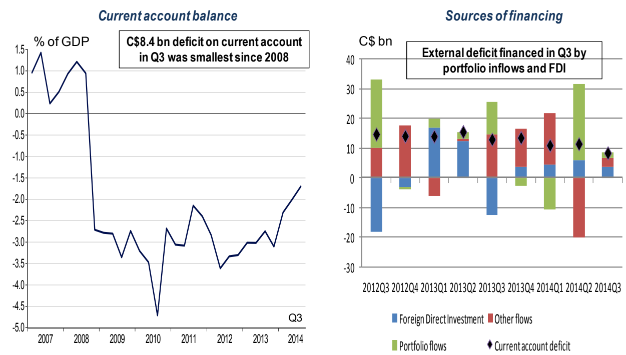
Canada: Foreign portfolio inflows solid in Q3



NBF Economics and Strategy (data via Statistics Canada)

Another positive for the Canadian dollar is the reduced dependence on capital inflows. In Q3, the current account, the broadest measure of trade, was showing a deficit of C$8.4 bn, or just 1.7% of GDP, the smallest in years. It's also encouraging that the deficit was yet again partly financed by foreign direct investment, a more stable source of inflows than, say, portfolio flows. FDI has now been a source of financing for the current account deficit for the sixth time in the last seven quarters. That's a step in the right direction in terms of reducing the Canadian dollar's vulnerability to flows which can be volatile in nature.

Canada: Best external balance in six years



NBF Economics and Strategy (data via Statistics Canada)

BoC sticks to dovish message

While oil remains the C$'s Achilles heel, Bank of Canada policy has also proven to be a major drag on the currency in the last couple of years, with consistently dovish communications successfully keeping rate expectations low. At its December meeting, the central bank again shrugged off the strong economic data in Canada. It did acknowledge Statistics Canada's upward GDP revisions for the last three years, and Q3's consensus-topping results (the economy grew a solid 2.8% annualized in the quarter), but it remained fixated on downside risks to the economy, highlighting the disappointing global economy and the potential negative impacts of the oil price slump on both growth and inflation in Canada. The BoC is likely to stretch that story for another few months to justify delaying rate hikes as to keep the loonie grounded and support the ongoing export recovery. That, coupled with a more aggressive Fed, and lower projections for oil, should cause USDCAD to depreciate to 1.17 over the next few quarters.

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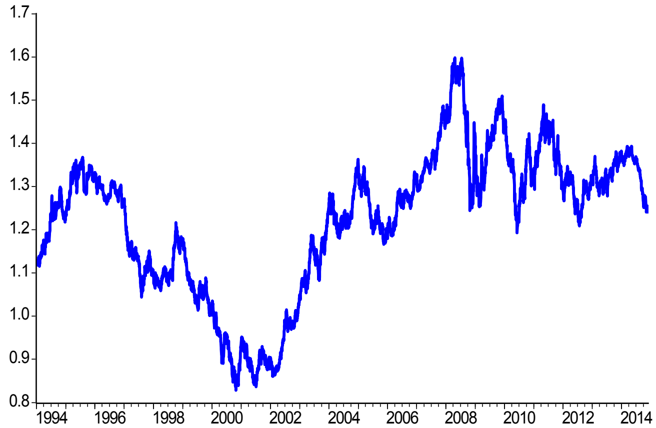
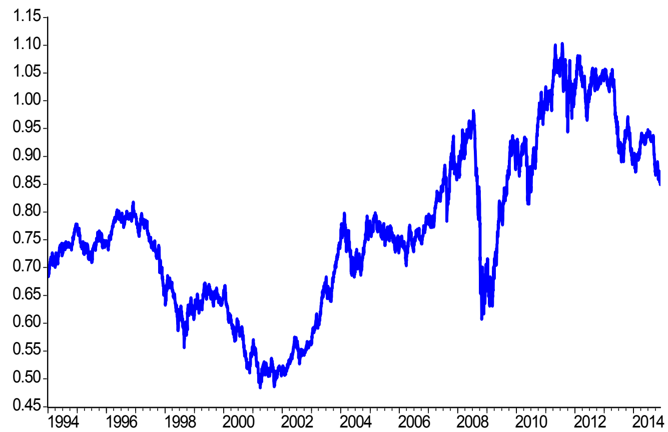
Euro



Canadian dollar

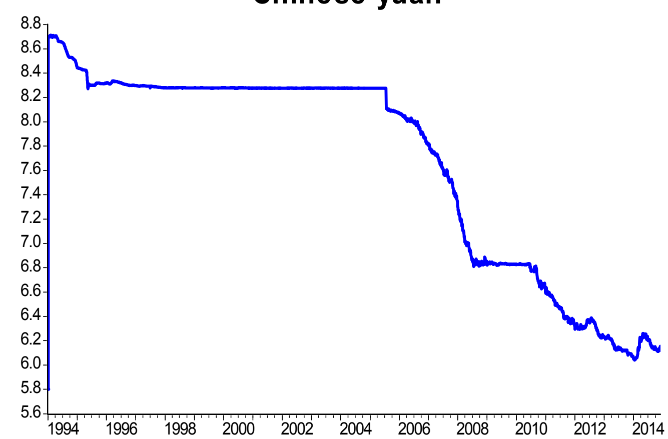
Japanese yen

Australian dollar



British pound

Chinese yuan



NBF Economics and Strategy (data via Datastream)

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