

Global FX Comment

CAD: Higher USDCAD Assumption from BoC

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Global

Bank of Canada keeps rates unchanged

In line with market expectations, the Bank of Canada has kept interest rates unchanged at 50bp. Although bright spots are emerging in the non-energy sector, the labour market and core inflation, the decline in commodity sector investment continues to bite and the positives were not enough to counter the strong headwinds. In particular, the BoC once again revised lower its price assumptions for Western Canada Select prices (from \$50/bbl to \$30/bbl) and excess supply is expected to remain in place for at least another two quarters. A corresponding adjustment to terms of trade was also necessary, and while core CPI is expected to remain at or above 2% through the central bank's forecast horizon to end-2017, this is done now with USDCAD benchmarked at 1.31 rather than 1.25 in the July monetary policy report. The BoC also warned that USDCAD falling below 1.19 would lead to core inflation falling below target this year.

Fiscal impulse could move up the agenda

Although the outlook was deemed as 'balanced', the changes to the underlying conditioning assumptions does render USDCAD difficult to sell, barring material changes to the oil price outlook (which the BoC views as a risk to their base case). With the economy continuing to struggle for growth drivers, we believe fiscal impulse will start to move up the agenda in light of the election result from earlier this week. While a new budget is required for a more comprehensive analysis, the campaign pledge by the newly-elected Liberal Party to run deficits of up to C\$10bn per year (around 0.6% of nominal GDP) for three years may require the Bank of Canada to review its slack assumptions over the coming quarters. A fiscal narrative has not been a feature for the Canadian economy in the past though we acknowledge that this is an area where the BoC may need to tread gently. In light of the central bank's long-standing concerns on productivity, fiscal injections into competitiveness improvement will be encouraged.

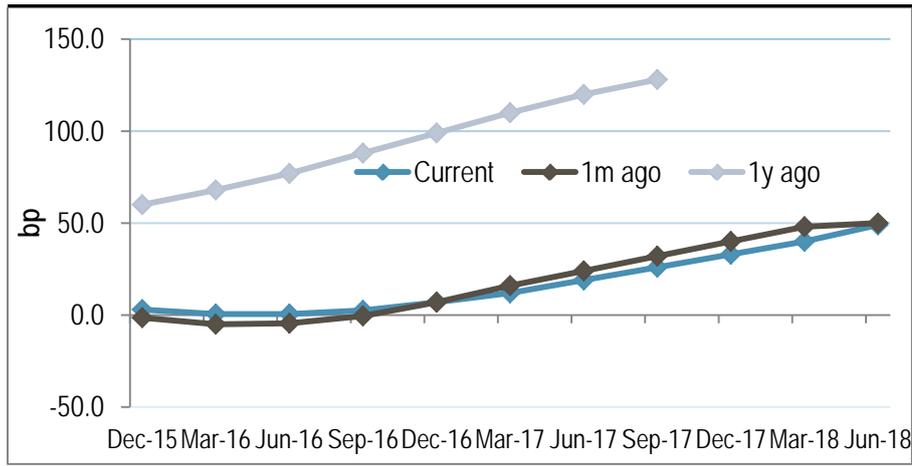
Policy integration moving up the agenda, a sign of confidence in settings

Before the BoC decision, Governor Poloz released a series of remarks on the integration of financial stability into monetary policy. Similar comments were made on the necessity of adopting a monetary policy framework which could take into account financial imbalances. Clearly the frustrations with macro-prudential measures and their efficacy amongst global central banks have been weighing on the BoC for some time. While household debt ratios are manageable (Figure 3), the trajectory and serviceability of household debt is less favourable compared to, for example, the Scandinavian countries. In February, the BoC felt it was appropriate to talk about this relatively hawkish approach to policy (specifically, allowing rates to be set to the detriment of the inflation target, as the last line of defence) after the January cut, which was merely an 'insurance policy'. Clearly conditions were far worse than anticipated and the policy focus had to revert back towards stimulus. Now, given that financial stability is back on the table, we believe the BoC can only do so because they view monetary conditions are commensurate to the accommodation required or more.

Oil assumptions crucial but foundations firming

We doubt the BoC would want to second-guess itself on currency valuations but at 1.31 in USDCAD, complemented by robust language, there seems to be enough room relative to terms of trade to ensure that the currency is no longer a headwind. The foundations for stronger growth, however, are clear: rebalancing away from energy coupled with labour market strength look set to continue and the inflation outlook is also relatively comfortable. As the USDCAD anchor is best left alone, we believe upside surprises in the CAD should be expressed through relative value trades, in particular the AUD, for which the policy and rebalancing outlook is far more challenging.

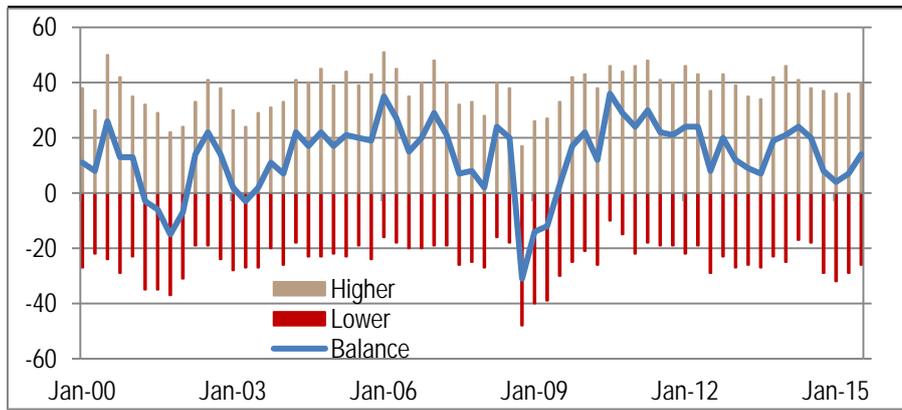
Figure 1: Bankers Acceptances Futures pricing changes



Source: UBS Calculations, Bloomberg

We believe current pricing of BoC rate expectations remains too cautious. The latest MPR continues to envisage the output gap closing by mid-2017 and this would require tightening to commence beforehand. Nonetheless, given the uncertainty and downside risks surrounding potential output a material increase in investment growth is required for rate expectations to adjust

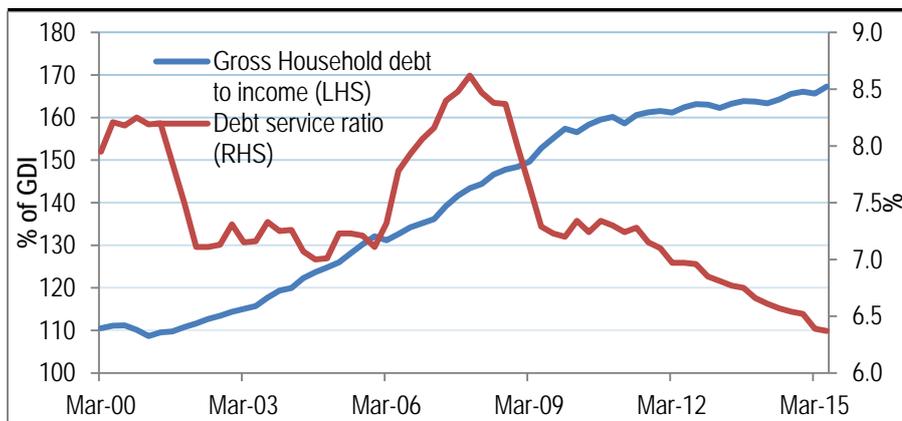
Figure 2: BOC QBSO – Investment Outlook



Source: Bank of Canada QBSO

The latest QBSO shows the improvement in the investment balance is ongoing but the BoC warns that non resource-sector expansion at present is not strong enough to offset the 'adjustment from the oil sector'. Labour market resilience may also take time to translate into wage growth (as is the case elsewhere) but conditions are unlikely to deteriorate up ahead

Figure 3: Household debt trajectory



Source: UBS Calculations, Statistics Canada

Household imbalances continue to move up the agenda and as of Q2, gross household debt to disposable income stands at over 165%. There is very limited room for rates to materially lower servicing ratios any further and the policy imperative has likely shifted again to limiting further increases in household debt. For now, rate rises despite weak growth are off the agenda but the BoC is more willing than others to use this instrument

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