FX Viewpoint

CAD Year Ahead: FX resilience despite BoC rate cuts

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G10 FX Strategy
Global

Howard Du, CFA
G10 FX Strategist
BofAS
+1 646 743 7017
yuhao.du@bofa.com

BoC: Bank of Canada

Maintain existing 2024 USD/CAD forecast path

We reiterate our 2024 USD/CAD forecast (Exhibit 1) and see the pair falling to 1.30 by end of the year. The broad USD selloff at end of 2023 has drove the pair lower earlier than our forecast, but there is still more room for the pair to fall than rise over the medium-term. We see 2024 as a "sell-the-rip" type of environment for USD/CAD.

CAD can stay resilient despite BoC rate cuts

Our economists currently expect the BoC to cut policy rate by 125 bp in 2024. Although BoC rate cuts on its own should be bearish for the Loonie, in this cycle since 2021, USD/CAD spot has had +90% correlation to the level of the US federal funds rate. This is more than the pair's correlation to various measures of US-CA interest rate differentials.

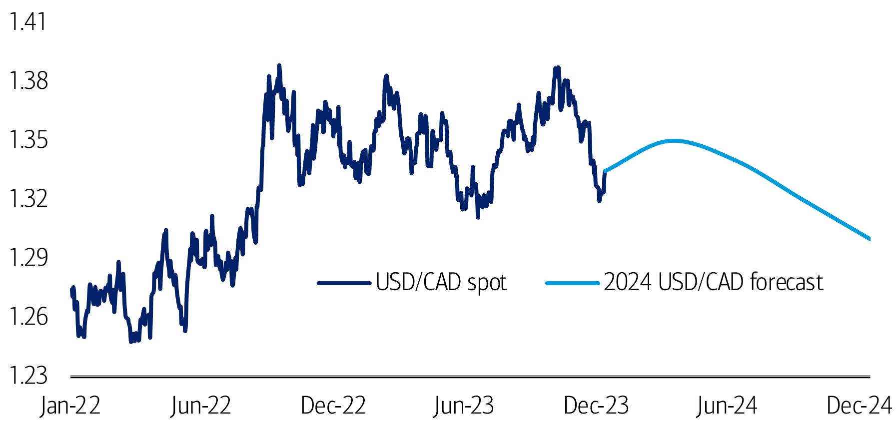
Fed cuts, equity rally, and higher oil can support CAD

We believe as long as the Fed cuts rate largely along the path that our US economists currently expect in 2024 (100 bp Fed rate cuts), USD/CAD could remain in a downtrend, even if the BoC rate cuts turn out to be slightly more aggressive than the Fed. In addition, our constructive equity and energy outlooks for 2024 should further support CAD vs the USD.

Risks to our current view

The risks to our baseline view are 1) further growth decoupling between US and Canada 2) new global geopolitical shock and 3) continuation of the worsening balance of payments dynamic for Canada.

Exhibit 1: We expect USD/CAD to end the year in 2024 below current spot
USD/CAD spot and BofA forecast



Source: BofA Global Research, Bloomberg

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Timestamp: 05 January 2024 12:10AM EST

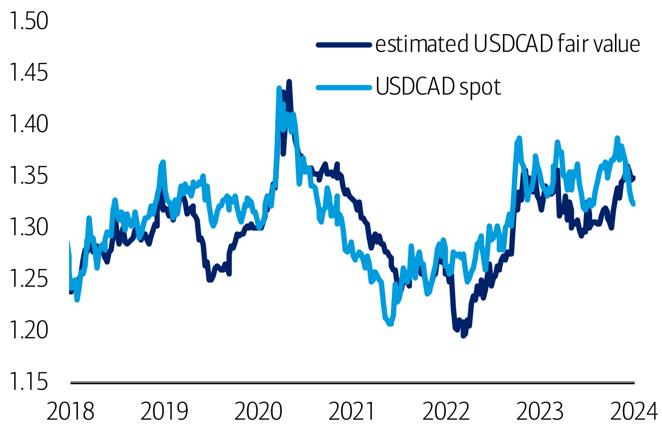
Maintain existing 2024 USD/CAD forecast path

In light of the volatile FX market moves over the past two months, we maintain our USD/CAD quarterly forecast for 2024. We forecast the pair to be around **1.35 in Q1, 1.34 in Q2, 1.32 in Q3, and 1.30 in Q4 2024.** After selling off from an overvalued 1.38-handle at end of October, we see the current USD/CAD spot as slightly cheap versus fair value. Cross-asset factors suggest USD/CAD is undervalued now after the recent selloff (Exhibit 2). Our dynamic factor model for FX also shows CAD is no longer excessively cheap vs the USD (Exhibit 3).

Nevertheless, heading into 2024, we maintain a medium-term bearish USD/CAD view. We argue BoC rate cut should not pose as a major headwind for CAD to rally vs the USD. We also summarize supportive reasons and risks to our view.

Exhibit 2: Current USD/CAD spot has fallen below fair value implied by cross-asset factors

USD/CAD spot vs estimated fair value using cross-asset factors



Source: BofA Global Research, Bloomberg. We estimate fair value using a 2y rolling regression for logged exchange rate against weekly US equity return, 2y US-CA rate differential, and oil price.

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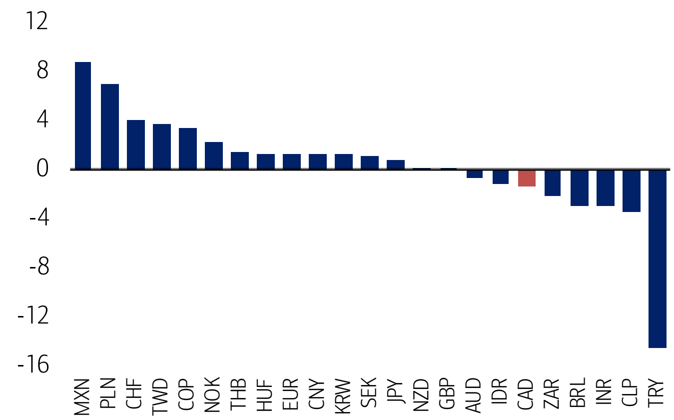
Exhibit 3: Dynamic factor model shows CAD's cheapness vs the USD has reduced to around 1% now

Dynamic factor model estimation of FX over/undervaluation vs the USD



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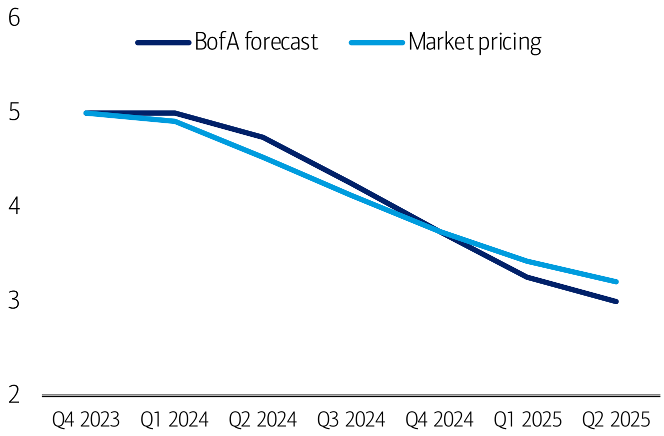
USD/CAD vs monetary policy path and rates divergence

Our BoC policy rate forecast path is largely aligned with market pricing

While we expect the BoC to cut rates fairly aggressively in 2024, our current policy rate forecast is not far from what is already priced-in by the market. Both our economist and market pricing expect BoC rate to fall to 3.75 by year-end 2024 (Exhibit 4). Across major advanced economies that have hiked rates over the past 2 years, the US real policy rate is the most restrictive and should have more room to converge lower to rest of the world in 2024 (Exhibit 5).

Exhibit 4: Market prices about same rate cut path for BoC as us for 2024
BoC rate cut path: BofA forecast vs rates market pricing



Source: BofA Global Research, Bloomberg

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Exhibit 5: Fed real policy rate has plenty of room to converge lower towards rest of the advanced economies
US real policy rate spread over rest of the major G10 central banks

Source: BofA Global Research, Bloomberg. Chart shows the spread between real federal funds rate and the average real overnight policy rate between BoC, ECB (since 1999), RBA, and BoE. Real policy rate is calculated as the difference between nominal policy rate and CPI YoY.

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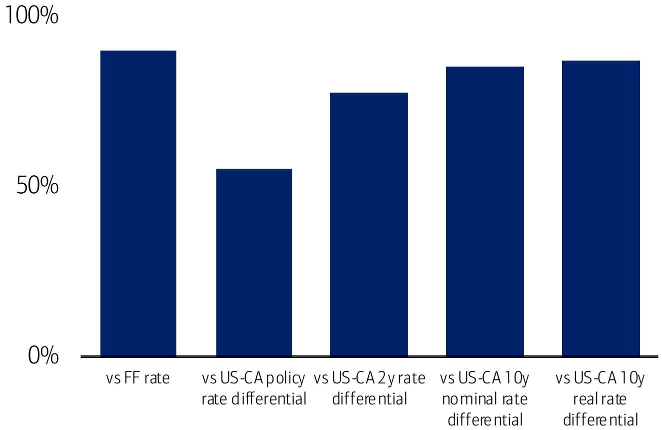
Fed cuts matters more for USD/CAD in 2024

In this cycle since 2021, USD/CAD spot has had +90% correlation to the level of federal funds rate. This is more than the pair's correlation to various measures of US-CA interest rate differentials (Exhibit 6). In comparison, USD/CAD spot has relatively low correlation of +56% to Fed-BoC policy rate differential. So we believe as long as the Fed cuts rate largely along the path that our US economists currently expect in 2024 (US Economic Viewpoint: 18 December 2023), USD/CAD could remain in a downtrend, even if the BoC ends up cutting rates slightly more aggressively than the Fed.

Some investors are concerned that widening 10y real rate differential (to +30 bps since December) in favor of the USD over CAD should prevent USD/CAD from selling off next year. We would note empirically over the past 20 years, USD/CAD has seen negative one-year subsequent return 60% of the time during regimes of positive US-CA real rate differential like now (Exhibit 7, observations in bottom-right quadrant vs observations to the right of the y-axis). In fact, sharp USD/CAD rallies historically have occurred when the US-CA real rate differential was negative, due to recessionary risk-off shocks that drove the US yield below CA yield (Exhibit 7, top-left quadrant).

Exhibit 6: In this cycle USD/CAD has higher correlation to level of federal funds rate than US-CA rate differentials

USD/CAD spot's correlation vs various interest rate measures since 2021



Source: BofA Global Research, Bloomberg

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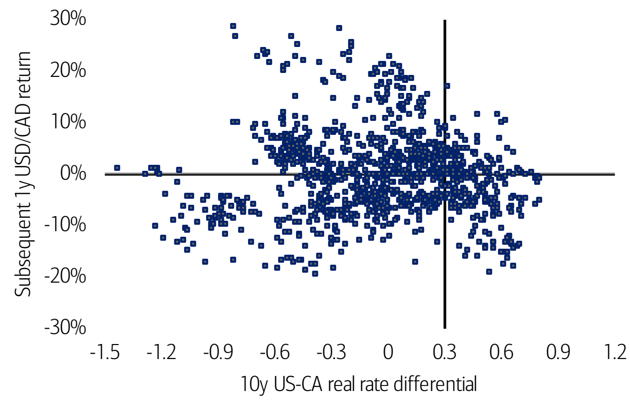
Exhibit 7: When 10y US-CA real yield differential was above 30 bp, USD/CAD was more like to fall than rise over the next year (60% hit ratio)

10y US-CA real rate differential vs subsequent 1y USDCAD return



Source: BofA Global Research, Bloomberg.

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Fed cuts, equity rally, and higher oil can support CAD

In 2024, despite a real rate differential currently in favor of the USD, we believe the pair could still move lower due to Fed cuts, equity rallies and higher oil price.

- **Fed cuts**: Our economists currently expect the Fed to cut rates by -100 bp in 2024. Since the 1990s, the Fed has only cut rates this aggressively in 1990, 1991, 2001, 2008, and 2020. Real GDP across these 5 years averaged around 0% YoY, but consensus forecast sees 1.3% YoY real growth for the US in 2024. This amount of monetary policy easing amid a year of still-resilient growth should be broadly bearish for the USD (G10 FX Year Ahead: 20 November 2023), in our view. The CAD may not be the currency that rallies the most vs the USD, but certainly should still benefit from a broadly weaker USD.

- **Equity rally:** in 2024, our equity strategists see S&P 500 rising to a new-high (New S&P high without Mag 7 leadership? Easy. 07 December 2023), with the Canadian TSX also bouncing off from the low (Canada Year Ahead 2024: 04 December 2023). The CAD is a risk-sensitive "high-beta" currency that should also receive support from the risk sentiment channel.

- **Oil rally:** our commodity strategists believe oil price has more upside than downside in 2024. They see OPEC+ and US SPR (Strategic Petroleum Reserve) refill acting as puts for oil price in 2024 and expect WTI to average $86/bbl (Energy Strategist: 19 November 2023). CAD has regained its sensitivity to oil in 2023; resilient oil price should serve as an additional bearish factor for USD/CAD.

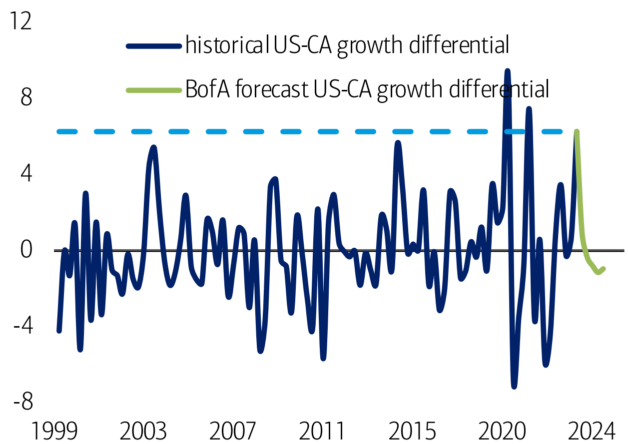
Risks: US-CA decoupling, geopolitics, weak Canada BoP

The risks to our bullish CAD outlook are US-Canada growth decoupling, another global geopolitical shock, and continuation of weak balance of payment for Canada into 2024.

- **US-Canada growth decoupling**: one of the reasons that USD/CAD surged to 1.3899 from August to October was wider than expected Q3 growth differential between the US and Canada (Exhibit 8). We would expect the growths between the two countries to converge in the next two quarters. But should the growth differential persistently stay wide in favor of the US, it could prompt the BoC to have to cut rates a lot more aggressively while the Fed can afford to keep rates higher for longer. In this case, US-CA rate differential would widen to a sufficiently large level that the FX market can no longer ignore. Current one standard deviation of carry returns across major G10 currencies vs the USD is 2.2%. With an annualized 3m carry of just 0.5% for USD/CAD, rate differential would not be a major driver for USD/CAD for now.

- **Geopolitical shock**: The global economy has experienced two consecutive years of geopolitical shocks (2022 Ukraine shock and 2023 Middle East shock). Global financial stress indicator currently hovers around a 2-year low (Exhibit 9) with market pricing little risk premium into 2024. The rise of another geopolitical shock in 2024 could lead to a sharp deterioration in risk sentiment with USD/CAD surging higher on the back of "flight-to-quality" demand for USD.

Exhibit 8: US-Canada growth differential in Q3 2023 was at a historically wide level
US-Canada GDP differential (QoQ saar)



Source: BofA Global Research, Bloomberg

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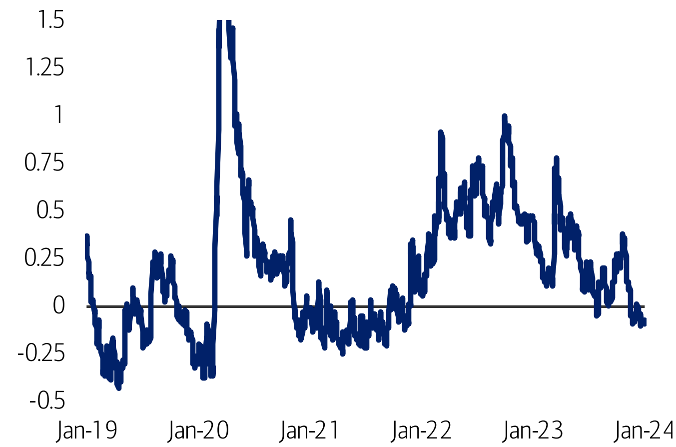
Exhibit 9: Global financial stress indicator has fallen to a 2y low
Global financial stress indicator (GFSI)



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- **Worsening balance of payments:** Investors have not paid too much attention to the deteriorating balance of payments for Canada in 2023, but the risk is brewing. Current account surplus from 2022 dropped back to negative territory in 2023 on lower oil price. Net foreign direct investment (FDI) has been negative for 10 consecutive quarters. Lack of net FDI amid record inflow of new immigrants would pose some risk to long-term growth outlook. More importantly, portfolio investment, which has been positive in the past to offset the negative current account and FDI, also saw record outflow in Q3 2023 (Exhibit 10), mainly driven by equity flow from Canada to the US due to TSX underperformance vs SPX (Exhibit 11). Our baseline forecast of rebounding TSX and higher oil price in 2024 should alleviate some of the balance of payments weakness from 2023. A continuation of weak balance of payments for Canada in 2024 would pose risk to our bearish USD/CAD outlook.

Exhibit 10: Balance of payments dropped back to negative in 2023, with record portfolio outflow in Q3 2023
Canada quarterly balance of payment (NSA)

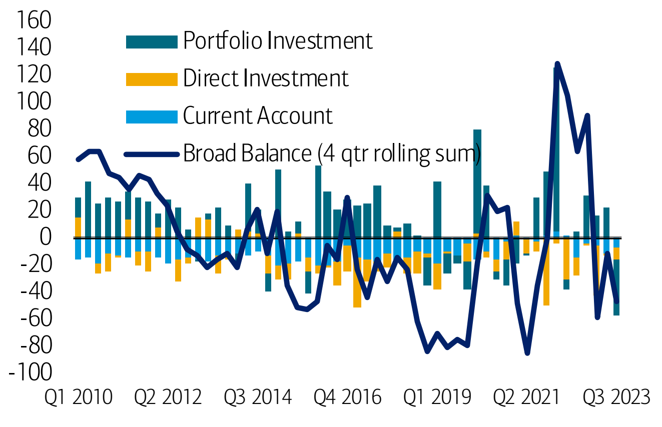

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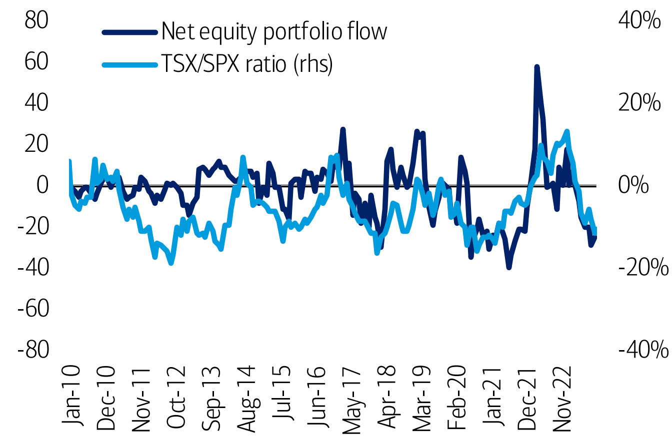
Exhibit 11: TSX underperformance vs SPX drove equity portfolio outflow from Canada into US
Net monthly equity portfolio flow vs TSX/SPX ratio



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