Poloz Spreads the Word On Data Dependence, CAD Softer

CAD is down roughly 0.8% vs. the USD in the aftermath of BoC Governor Poloz's speech. The governor specifically singled out the currency in terms of its impact on inflation and the timing for reaching the 2% target, echoing recent comments from Deputy Gov. Lane. Policy is not on a predetermined path and considerable uncertainty clouds the economic outlook, the governor indicated. The comments leave the door open to further rate increases but near-term risks will shift more decisively to the Dec policy meeting (from Oct). The CAD is under pressure and we will have to allow for the risk of the USD gaining a little more near-term. USDCAD sellers should consider hedging receivables on USD gains towards 1.25/1.26 and we think USD buyers should hedge payables now. We remain bearish on the USD from a longer-term point of view, however, and think Canadian institutional investors should remain underweight the USD relative to benchmarks.

Bank of Canada rate hike expectations have softened in response to Governor Poloz's speech on data dependence. The Governor expanded on themes communicated in the September 6 policy statement and built on the message delivered in the most recent speech from Deputy Governor Lane. Policy is not on a predetermined path and the Bank of Canada is not going to take a mechanical approach to monetary policy.

The Bank's cautious approach is deemed appropriate as a result of the significant uncertainties clouding the outlook for inflation. These uncertainties include the evolution of economic capacity, the disinflationary impact of technology, subdued wage growth and the economy's heightened sensitivity to interest rate increases in an environment of elevated household debt.

The Governor's overall tone remained constructive as he focused on the completion of the economy's adjustment to the oil price shock and the closure of the output gap. However his caution appeared to reflect a desire to moderate the aggressive tightening path reflected in market pricing of the policy risks.

OIS had been pricing roughly one hike into year-end and another by early March. Year-end pricing has since softened to roughly 20bpts with 44bpts for March. Yield spreads have also adjusted, in a CAD-negative manner, narrowing just over 7bpts at the 2Y horizon. This is in addition to the significant spread compression that resulted from Governor Lane's remarks earlier in the month.

We attribute a good portion of today's response to a position adjustment. Speculative bullish CAD positioning was extended heading into the speech, with CFTC gross longs at five year highs. The options market was also remarkably sanguine, with short-term risk reversals showing no premium for protection against CAD weakness.

The bottom line for us here is that USDCAD moving above 1.2450 lifts near-term prospects at least for the USD even if we feel the market has overshot somewhat relative to the move in yield spreads (spot is about 1 standard deviation above our equilibrium estimate). The USD is gaining some traction on strengthening expectations for a Dec rate hike from the Fed and hopes the Trump administration can make progress on tax reform. Typically USD-positive seasonal factors may count for something in Q4, having failed to find much rhythm with the overall move in USDCAD so far this year.

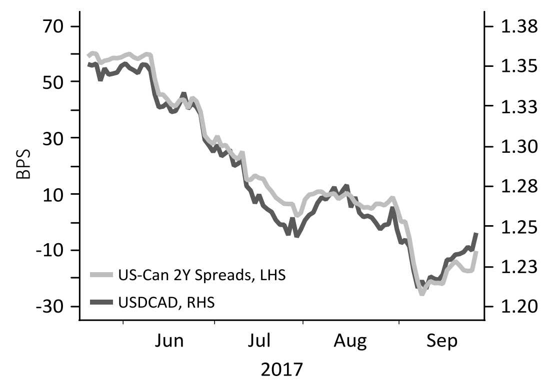
To reiterate, however, we are maintaining our call for the BoC to tighten 25bps in Dec. The BoC's last MPR forecast Q3 GDP growth of 2.0% and recent Canadian data (housing, wholesale and retail trade, for example) suggest the economy may be tracking a little stronger than that at the moment. Jul industry level GDP is released Friday and expected to show a 0.1% rise in the month—which would be a ninth consecutive monthly gain for 3.9% growth in the year (from Jun's robust 4.3%). In

FOLLOW US ON TWITTER @SCOTIABANKFX

Shaun Osborne
Chief FX Strategist
461.945.4538
shaun.osborne@scotiabank.com

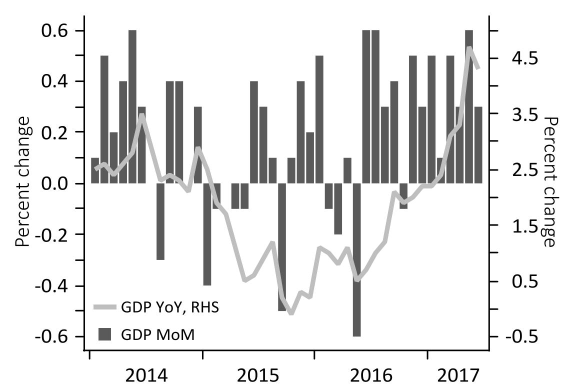
Eric Theoret, CFA, CMT
FX Strategist
416.863.7030
eric.theoret@scotiabank.com

USCAD tracks Short-Term Spreads



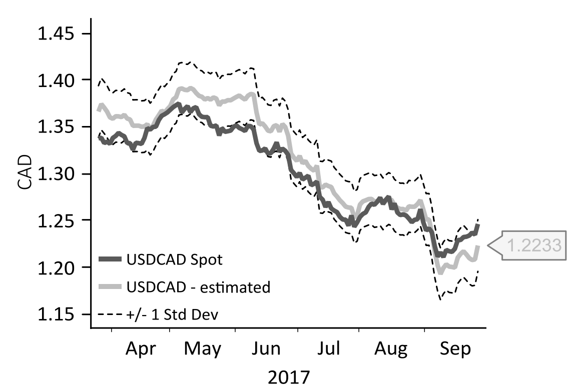
Source: Macrobond, Scotiabank FICC Strategy

Canadian GDP Rebound Extends



Source: Macrobond, Scotiabank FICC Strategy

USDCAD Firmer but Overshoots FV



Source: Macrobond, Scotiabank FICC Strategy addition, we also expect a pair of rate hikes in 2018, in Q1 and Q3. As such, we expect USDCAD to end this year nearer 1.20 than 1.30 and feel that USD gains in the next few weeks should be faded. Our FX forecast targets 1.15 for USDCAD into Q4 2018—which also reflects a generally negative view on the outlook for the USD.

CONTACTS - GLOBAL FX STRATEGY

Shaun Osborne
Chief FX Strategist
T +1 416 945 4538
Shaun.Osborne@scotiabank.com

Qi Gao
FX Strategist (Asia), Associate Director
T +852 2861 4770
qi.gao@scotiabank.com

Eric Theoret, CFA, CMT
FX Strategist (G10), Director
T +1 416 863 7030
eric.theoret@scotiabank.com