CAD 'Insurance' Cheap Despite Escalating Risks

The options market appears to be mispricing CAD risk on both a relative and absolute basis. Measures of implied CAD volatility are low relative to both major and emerging market currencies, offering a very low cost of protection against CAD weakness. The options market appears somewhat at odds with the recent fundamental developments and the CAD's vulnerable technical setup. Trade policy uncertainty is weighing on the outlook for the Bank of Canada and shifting correlations suggest a renewed focus on interest rate differentials—at the expense of commodities and terms of trade. The low cost of CAD 'insurance' may reflect a willingness to look beyond the near-term risks to trade but anyone looking to protect against CAD weakness will find it very cheap to do so.

The CAD gapped lower at Monday's Asian open as market participants returned from a weekend laden with headline risk related to trade. Tensions between Canada and the U.S. appear to have escalated considerably over the past week, posing a material risk to the outlook for relative central bank policy in the context of a cautious Bank of Canada and an increasingly confident Fed.

Renewed trade policy uncertainty is weighing on the CAD as market participants reassess the outlook for BoC tightening. BoC rate hike probabilities are softening, fading the near-certain prospect of a July hike and reducing the likelihood of an additional 25bpt hike by year end. Interest rate differentials are widening in a CAD-negative manner, and the 2Y US-Canada spread has pushed to a fresh one year high above 60bpts.

Commodity prices continue to provide an important offset to the deterioration in the outlook for relative central bank policy but renewed weakness in the price of Western Canada Select may deliver an erosion in this critical pillar of CAD support. Lumber prices are also softening from their recent record levels and indices incorporating a broad range of CAD-relevant commodities are drifting lower.

Our FV model for USDCAD, incorporating benchmark oil prices and 5Y spreads has climbed materially over the past three weeks, rising from the lower 1.24s in late May to 1.2700 as of this morning. Current spot levels are roughly one standard deviation above the FV estimate.

Looking at the charts, the CAD's technical setup appears finely balanced just above a pair of critical support (USDCAD resistance) levels. In USDCAD terms, we highlight the importance of the descending trend line drawn from the 2016-2017 highs and the ascending trend channel drawn from the September 2017 lows. The 1.3050-1.3120 area is critical and additional resistance appears limited ahead of the 1.3380-1.3400 area.

The options market appears remarkably sanguine in the context of the CAD's deteriorating fundamentals and increasingly vulnerable technical picture. Measures of implied CAD volatility are low relative to other G10 currencies and even lower relative to measures of EM FX volatility. Implied CAD vols are also priced close to or below realized vols across most tenors. Relatively lower CAD vols (versus its peers) is not that unusual a circumstance historically. But the persistence of low volatility in the face of what appears to be a significant deterioration in Canada's relationship with the US, the recent uncertainty over the Bank of Canada policy outlook and the rally in commodity prices is a little surprising.

Broader measures of market volatility (outside of the lift in bond market vol recently) remain quite low considering shorter-term factors (significant event risk recently) and longer term considerations (central banks' policy normalization process). It may be the time of the year, or it may have something to do with the impending start of the World Cup in Russia (a cursory glance at vol trends through mid-year does tend to

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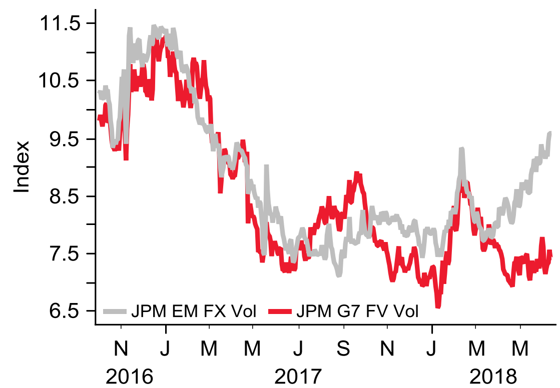
Shaun Osborne
Chief FX Strategist
461.945.4538
shaun.osborne@scotiabank.com

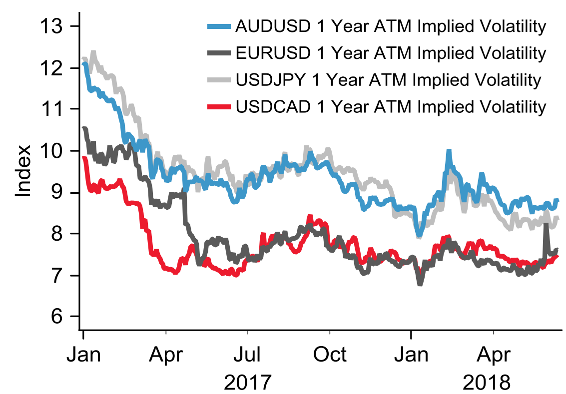
Eric Theoret, CFA, CMT
FX Strategist
416.863.7030
eric.theoret@scotiabank.com

EM FX Vol Elevated, G7 Lags



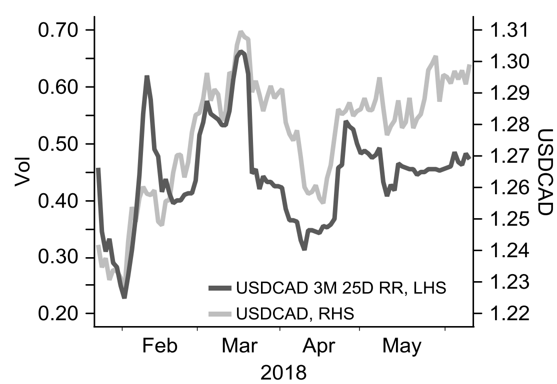
Source: Macrobond, Scotiabank FICC Strategy

1Y CAD Vol Low Vs. Peers



Source: Macrobond, Scotiabank FICC Strategy

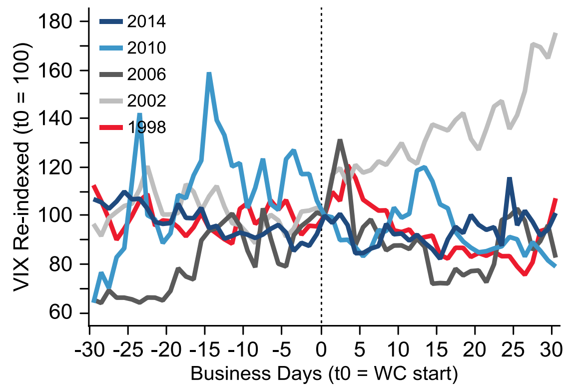
USDCAD vs. 3M Risk Reversals



Source: Macrobond, Scotiabank FICC Strategy suggest that the summertime slump in market volatility/activity is a little more pronounced in World Cup years since the late 1990s).

Vol-depressing option structures perhaps have a hand in keeping risk-reversal pricing subdued relative to the shift in USDCAD recently and the disconnect may also perhaps reflect some confidence in the CAD's longer-term prospects and a willingness to discount near-term uncertainty relating to trade. In any event, we view the cost of protection against CAD weakness as being incredibly cheap.

World Cup Volatility Red Card?



Source: Macrobond, Scotiabank FICC Strategy