CAD Risk Into BoC Wednesday — Key Scenarios

CAD is testing fresh 10 month highs (USDCAD lows) heading into this week's Bank of Canada policy decision and MPR forecast update, with markets almost fully pricing in a 25bps hike and implying 46 bps of tightening over the next 12 months. A lot of good news appears to be priced into the CAD at the moment, with yield spreads at their narrowest since October, pushing toward 20bpts at the 2Y horizon. We consider three scenarios heading into Wednesday and outline our expectations for CAD (and USDCAD) in response to each. These scenarios include 1) no move; 2) one 25bpt hike; 3) a 50bpt hike.

CAD risk is elevated heading into this week's Bank of Canada policy decision and MPR forecast update. The currency is currently trading just below Friday's fresh 10 month high and the balance of risk appears to favor additional near-term CAD strength on the basis of relative central bank policy as a result of the BoC's hawkish bias and the Fed's increasingly tentative tone. BoC policymakers have been clear in expressing their desire to withdraw the 50bps of 2015 stimulus delivered in response to the oil price shock.

The MPR forecast update is critical as we look to the BoC's latest projections for growth as well as their assessment of the closing of the output gap. The April MPR had seen the output gap closing in the first half of 2018. This assessment is crucial as we consider the outlook for rate hikes beyond the desired normalization of the policy rate to 1.00%. For reference, Scotiabank's forecast profile includes three 25bpts hikes—in Q3 and Q4 2017 as well as Q1 2018.

In terms of vulnerabilities, we highlight the CFTC data showing a still-sizeable bearish CAD position. The $3.0bn net short CAD position is the second largest among the reporting currencies, despite a six week run of short covering from mid-May. Meanwhile, options markets are suggestive of a shift in the balance of risk with short-term risk reversals once again attributing a premium for protection against CAD weakness.

The scenarios below include 1) no move (CAD negative, USDCAD higher); 2) 25bpt hike (CAD neutral, USDCAD steady); 3) 50bpt hike (CAD positive, USDCAD lower).

Scenario 1—no move, low risk—CAD negative (USDCAD higher)

Markets are implying a slight (sub-10%) probability of a policy hold at this Wednesday's decision. However, the consensus among Bloomberg survey respondents appears much less unanimous with 8 of the 27 contributors looking to a policy hold. Such a move would go against the clear, consistently hawkish messaging delivered since Sr. Dep. Gov. Wilkins' June 12 speech. Neither Gov. Poloz nor Dep. Gov. Patterson saw any need to check the shift in expectations driven by Wilkins, and a decision to hold would call into question the BoC's credibility in terms of its communication. The CAD reaction would likely be negative and push USDCAD higher toward the 1.3100-1.3200 area.

Scenario 2—25bpt hike, highest risk—CAD neutral (USDCAD steady)

The balance of risk favors a 25bps hike on Wednesday. Markets are implying a near-certain likelihood of a hike (90%+ probability) along with 19 of the 27 Bloomberg survey respondents. The hike would put the BoC on the path toward normalization and withdrawal of the 50bpts of stimulus delivered in 2015. The statement/press conference tone will be crucial in determining how quickly the Governing Council wants to bring the policy rate back to 1.00%. The CAD reaction would likely be neutral. For USDCAD we would anticipate a potential knee-jerk drop to the upper 1.27 area ahead of a return back to the 1.2800-1.2900 area. A "dovish hike" - meaning a 25bps tightening an no guidance on subsequent policy action, suggesting

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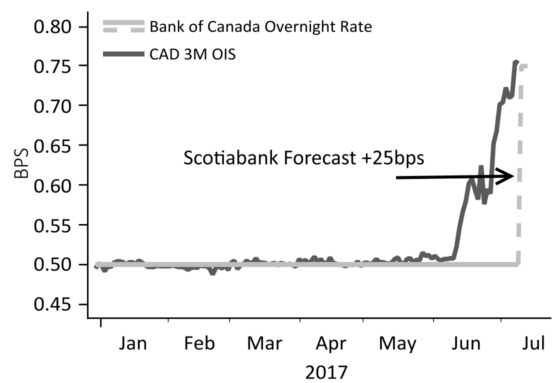
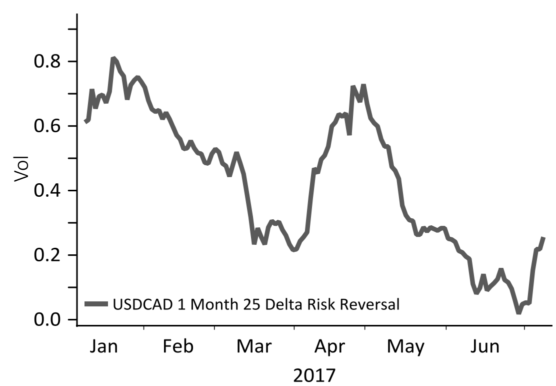
Expectations "Fully Priced" for BoC Hike



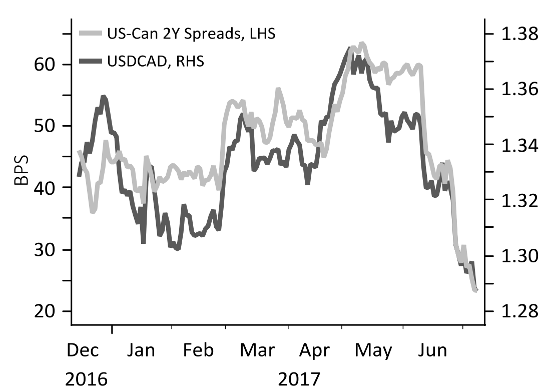
Source: Macrobond, Scotiabank FICC Strategy

USDCAD Riskies Price in N/T Upside Potential



Source: Macrobond, Scotiabank FICC Strategy

How Much More Can Spreads Compress?



Source: Macrobond, Scotiabank FICC Strategy no rush to follow up, would tilt the balance of corrective risks more obviously against the CAD.

Scenario 3—50bpt hike, lowest risk—CAD positive (USDCAD lower short-term, then fade)

A 50bps hike is seen as the least likely by both financial markets (0%) and Bloomberg survey respondents (0/27). But we see this is the most underappreciated possible outcome and would assign it a slightly greater (though still miniscule) risk. Tightening 50bps in one go delivers fully on removing emergency accommodation and would blunt speculation regarding how quickly additional moves would come. We think the only reason to go 50bps in one go would be to choke off speculative upward pressure on the CAD and would likely be delivered with a neutral-sounding policy statement that made it clear that no further rate increases were likely for some time. While the initial response would be to drive the CAD higher (USDCAD to 1.26/1.27), we think the markets would quickly move to book profits and drive the CAD lower again (pushing USDCAD back towards the 1.30/1.31 area).

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