Theme #8: Niagara falls – buy USD/CAD

There should be no doubting the paradigm. Estimates of the Fed minus the Bank of Canada terminal rate (both using the 1yr swap rate in 3 years) explains over 90% of the variation in USD/CAD over the past year. In predicting future USD/CAD movements, that is the logical starting point. Currently the terminal rate spread is close to zero, having oscillated between -25bps (Fed rate < BoC rate) to +25bps (Fed rates.> Boc rates) as USD/CAD marked out a range of 1.21 – 1.29. 25bps on the 'terminal rate' spread is worth 4 big figures on USD/CAD.

Besides the terminal rate, in terms of near-term meetings, the market has 64bps of Bank of Canada tightening priced in through July, which is substantially more than the 52bps the market has priced for the Fed for the entire year! Both the market estimates of the relative terminal rate, and the markets expectations of relative Fed and BOC tightening in H1 2018, are likely to err significantly in favour of more relative Fed tightening when compared with BOC, that skews the risks on USD/CAD to the upside over the medium-term.

Firstly on the terminal rate, Fed tightening has yet to tighten US financial conditions, while US mortgage rates have barely budged. A mix of all of household leverage rates, the current stage of the housing market, and the structure of the mortgage market, all suggest Canadian housing and related consumption will be far more sensitive to tightening than the US real economy will be to Fed tightening. The BOC Governor has bluntly made the same point, noting "related to indebtedness—we expect that high levels of debt will make the economy as a whole more sensitive to higher interest rates today than in the past." In Poloz's honest treatise on what keeps him awake at night, he noted, "It is not just the amount of debt; it is also its composition and distribution. More than 80 per cent of household debt is composed of mortgages and home equity lines of credit (HELOCs). Increasingly, mortgages are being combined with HELOCs, to the point where about 40 per cent of all housing-backed loans are blended with a HELOC component." There are then very good reasons, why the BOC has tapped its foot on the brake, but will approach tightening much more gingerly than the Fed, watching and waiting to see where and when higher rates bite. It is very easy to imagine a world where in this cycle, the Fed terminal rate is as much as 100bps above BOC terminal rate. As the second chart suggests that would be consistent with USD/CAD back above 1.40.

Of course so far the Canadian economy has shown no real signs of slowing so a BoC hike in January seems reasonable. However, after the December employment report this is 84% priced in. We also see the CAD supported by the latest rise in oil prices, but expect that this rotation of supply fears from the UK to Libya and now on to Iran will calm, as will the cold N.American winter. From here, there is a downside bias because commercial crude inventories remain elevated, and we are still facing a reawakening US tight oil sector following its 2016 decline. US oil and gas executives surveyed by the Dallas Fed cite USD 61-65/bbl as the range likely to trigger a substantial increase in drilling activity. In addition, the inflation repercussions of higher oil prices will likely have a quicker impact on Fed and ECB expectations than they will on the Bank of Canada. Lastly, there is politics to consider, with the NAFTA negotiations likely to have almost no impact on Fed policy but a more plausible consideration for the BOC.

On USD/CAD there are then two approaches. After the Canadian employment data we edged into the lower half of the last 4 months range- a range that we