



Theme #7: CAD dumps ugly krone – buy CAD/NOK

- We see modest upside in USD/CAD to 1.45 but can't get excited. We like buying CAD/NOK which isolates the oil factor and takes a constructive view on Canada's adjustment to the oil shock so far as well its ability to benefit from US growth.

Both the Canadian dollar and Norwegian krone are being hit by an oil shock. Norway is likely to cut rates first, however, and does not benefit from economic links with the United States. Expectations regarding Canadian growth are at almost historical lows while there is still plenty of scope for deterioration in Norway.

Monetary easing may come belatedly

With the oil and mining sector providing directly or indirectly up to twenty percent of Canada's economy, lower oil prices will dampen potential growth and exports. Capital spending is dropping as projects are shelved. Oil extraction should continue to decline with oil below the twenty five dollars extraction costs and sixty dollar total costs. This will intensify as oil hedges roll-off. The resultant drop in production in Canada is for now easily matched by rising production abroad.

Faced with an intensification of the oil shock, the Bank of Canada expressed some willingness to accept higher imported inflation and potentially the use of non-conventional monetary policy. Inflation remains very sticky with pressure in the production pipeline courtesy of a weak currency. This would delay any Bank of Canada easing while over time US demand should support Canadian exports.

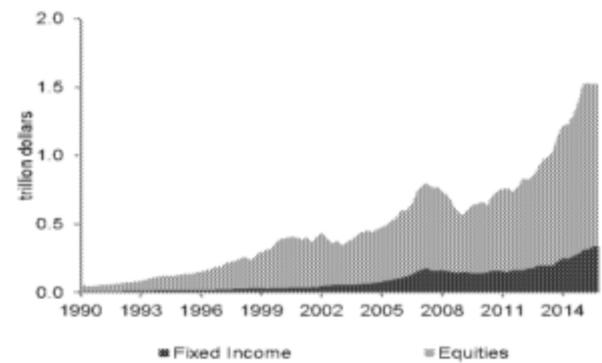
Theoretically, the Bank of Canada could ease another fifty basis points to drive rates to zero and USDCAD somewhat above 1.47. We find that a one percent move in the two year sovereign rate differential pushes USDCAD from 1.40 to 1.51. The model is of average quality and methodology as another key driver is missing by necessity. Oil moves almost in synch with interest rate differentials leading to misleading results irrespective of the data frequency.

Portfolio and positioning

Canadians are long one and half trillion in foreign securities almost half of which is managed by Canada's giant pension funds (Figure 1). Eighty percent of Canada's assets are in equities - an amount that is declining as they reduce their risks. Foreigners hold a slightly larger amount of assets, seventy percent of which is in fixed income. This amount is rising and presumably fully hedged against currency movements.

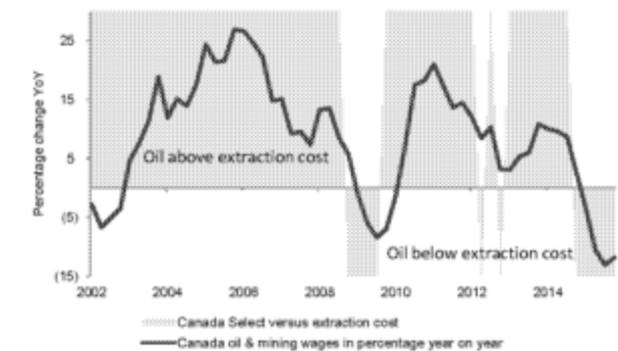
From a portfolio point of view, the key is therefore the hedging ratio of the pension funds, half of which are in dollars and ten percent in the Eurozone. Based on a detailed analysis of their balance sheets, the currency hedging ratio is between forty and fifty percent - much higher for fixed income and much lower for equities

Figure 1: Canada's portfolio of assets is dominated by equities



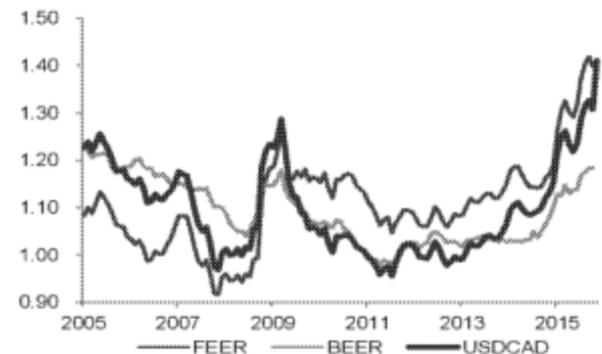
Source: Deutsche Bank, Bloomberg Finance LP.

Figure 2: Canadian wages drop sharply as oil moves below production costs.



Source: Bank of Canada, July 2015 Monetary Policy Report

Figure 3: USDCAD rarely exceeds its FEER value for long



Source: Deutsche Bank, Bloomberg Finance LP.