



Until such point as oil prices start to rebound, pension funds have little incentive to change their hedging ratios. When they eventually do shift their policy, the positive impact on the CAD should be considerable.

Valuation

As the Canadian dollar is driven lower by falling oil prices, its external and internal position deteriorated. Demand for external goods remains sticky while oil exports collapse driving fair value lower. Over time, a weak CAD should help Canada export more non-energy products to the US helping the FEER to improve with a lag. USD/CAD has rarely exceeded its FEER fair value for long suggesting that ex ante a greater collapse in oil prices, it is already at stretched levels.

Buy CADNOK

One way to express a moderately constructive view on CAD is via CADNOK. The cross has historically tracked the broad USD index closely, which suggests it is cheap (Figure 4). Given the more diversified nature of the Canadian economy, and its close ties to the US cycle, there is much more potential for policy to remain on hold in Canada than in Norway, where the Norges is likely to cut at least once in the first half of this year. Finally, the lower oil breakeven rate in Norway (at 38 versus 49 for Canada tar sands) should mean that further falls in oil or stable prices hurt the NOK more on a marginal basis.

Sell USDCAD 1.50 strike

There is only a 5% probability of USD/CAD exceeding 1.50 based on the past history of monetary divergence between the US and Canada (Figure 6). Using the past history of the two year sovereign rate divergence and a valuation model we can calculate this probability. The parameters as always will prove unstable in line with the Lucas critique of Keynesian econometric models. This is in addition to model error with CAD somewhat of a dicey currency to work with. Option prices attach by definition a higher risk neutral probability to crossing the rubicon of 1.50.

The risk is that getting the 1.50 level wrong could prove exceedingly expensive. Tail events are brutal and history shows 1.60 as the top level.

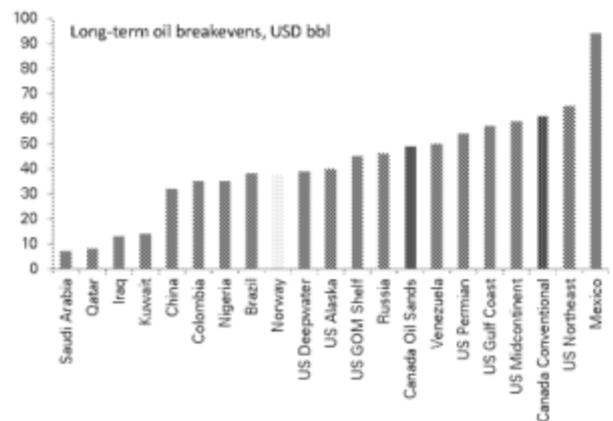
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Figure 4: CADNOK should follow the US hiking cycle higher



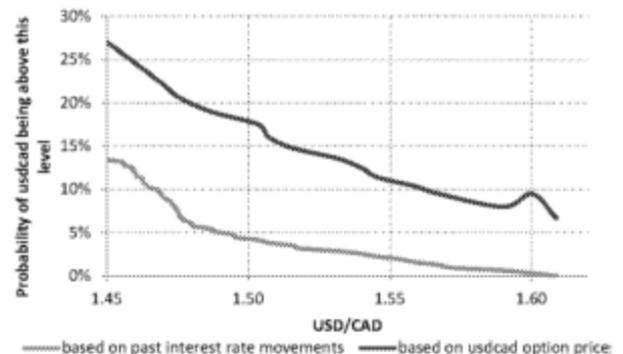
Source: Deutsche Bank, Bloomberg Finance LP

Figure 5: CAD may be more poised to benefit from a bounce-back in oil than Norway



Source: Deutsche Bank, Bloomberg Finance LP

Figure 6: Probability of USDCAD exceeding 1.50



Source: Deutsche Bank