CAD Strength - Fundamentals or Positioning?

- Canadian dollar has rallied nearly 2% since the beginning of June; what's driving it and is it sustainable?

- We think it's more of a positioning unwind; heavy shorts were built throughout 2019 - are they starting to unwind with more dovish Fed pricing?

- See attached charts for a deeper dive

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The Canadian dollar’s strong rally since the beginning of June looks to us to be more about position squaring than a significant change in the fundamentals that had driven CAD lower since the turn of the year.

While it’s tempting to explain lower USDCAD by pointing to the divergence in economic data (relative to expectations) between the two economies, we think this explanation is somewhat lacking.

The spread between Canadian and US economic data surprises is strongly in favor of the former; data in the US continue to weaken relative to expectations, while north of the border, the data have continued to be strong. Until recently, CAD had ignored this widening spread, so it’s tempting to conclude that it’s playing catch-up. However, even if this is behind the recent CAD rally, we note that the data surprise spread mean-reverts, and it is likely to narrow sooner or later.

Furthermore some major economic variables in Canada have weakened as well, namely the housing market (although there are some signs housing’s slide has at least taken a pause lately) and like most other developed economies, forward looking survey data.
Another tempting explanation is that with market pricing for the US betting heavily on rate cuts in H2 2019, carry as a factor favoring USD no longer exists. However, Bank of Canada rate expectations have also fallen, and there is virtually no policy expectation differential between the US and Canada. Carry hasn’t been a USDCAD driver for a while.

Nor is CAD trading on oil any longer. While it was closely aligned with crude prices for most of this year, CAD’s correlation with oil is now rather low.

Instead, we note that heavy shorts in CAD have been built up since the beginning of the year. This is evident both in IMM speculative positions as well as our cumulative iFlow (real money) data. It’s likely that the change in policy expectations for the Federal Reserve have provided the catalyst to unwind these positions.

When CAD does resume trading on fundamentals, we would expect it to stay under pressure, proving the current rally short-lived.

To see a deeper dive, please click here.

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