CAD and the BOC

• Canadian fundamentals have weakened
• Hence CAD bears are rubbing their hands
• But the BOC could well have other ideas

For a currency pair that has borne out an 87% daily (inverse) correlation against NYMEX since the start of the millennium, USD/CAD’s disinterest in surging oil prices has been nothing short of impressive.

NYMEX oil futures have risen by $20 (or circa 50%) since Christmas Eve - during which time the CAD has risen only 1.1%.

In fact, since the start of last month, NYMEX has risen $9 while the CAD has fallen 1.2% - and just as NYMEX was heading north through $66 yesterday, the CAD was heading in the opposite direction.

Since the release of a weaker than expected Q4 GDP data in early March, economic fundamentals and, by extension, expectations surrounding the Bank of Canada’s policy position, have proven a formidable distraction.

As we suggested earlier this month, there is clearly a bearish case to be made for the CAD on these grounds over the medium term.

Certainly, the BOC’s central case remains that the recent soft patch in growth will prove to be temporary; but like
many of its peers, the Bank is likely to acknowledge the growing risks to this view.

And although there have been one or two bright spots among recent data, the Bank’s own business survey for Q1 (published last week) made for particularly downbeat reading.

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As such, a cautious tone from Mr Poloz - in conjunction, perhaps, with modest downward revisions to the Bank’s forecasts - will certainly be seen as an endorsement by a market that has not only dismissed the prospects of a hike this year but has now placed a circa 35% chance on a quarter point rate cut by year end (according to OIS).

The bearish case has certainly proved to be the more appealing of late. As one measure of this, the ratio of CAD losses to unfavorable basis point movements in (the 10 year US/Canadian) spread have exceeded gains (to favorable movements) by a 30% margin since early March.

Nevertheless, as strong as the doves' case would appear to be, that the BOC will inevitably take to the fence on policy should not be taken for granted.

Credibility and the need for ammunition aside, a central bank that has raised interest rates five times since the summer of 2017 will be understandably reluctant to reverse course at the first sign of pressure.

This may explain why, in recent speeches, the BOC Governor has pointedly looked to convey as balanced a take on the outlook as possible despite growing evidence of slowing growth.

**A market shorn of some of its doubts on fundamentals could feasibly see the CAD as an**
Evidently, the point here is that something approaching the policy status quo would almost certainly catch the market off guard.

CFTC data show that net short speculative positions in the CAD have risen for two weeks in succession, to levels not seen since January. In fact, the current net position has only been exceeded on a few brief periods in the past twenty years.

And in keeping with our recent series of articles, we would note that a low volatility environment leaves investors as susceptible to sharp movements in the CAD as any other currency.

Indeed, despite its recent rebound, one-month historical vol has spent only 294 out of 5,956 days below current levels since 2003 and three quarters of them can be accounted for by just three years (2012-14).

So the immediate upside risk to the CAD is clear and who knows, if presented with an unexpectedly stoical take on the policy outlook, a market shorn of some of its doubts on fundamentals could feasibly see the CAD as an entirely different proposition when the stellar rally in oil prices is thrown into the mix.

Please direct questions or comments to:

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