CAD - A Shift in Focus

• Oil's uptrend is failing to impress the CAD
• The focus has shifted to growth
• The odds appear to favor the bears

That the CAD has ceded 1.5% to the USD since its January high is something of a surprise, given a simultaneous 17% rise in NYMEX and an 87% daily correlation between the two since the turn of the millennium. Clearly, the market has its eye trained elsewhere.

An examination of one-month correlations confirms that the CAD’s typically healthy relationship with oil prices broke down almost entirely early last month: correlations dropped from a near 60% daily average through February to negative correlations in its aftermath.

The apparent catalyst for this breakdown was Canada’s Q4 GDP data released on March 1: an annualized growth rate of 0.4% fell well short of expectations and constituted the weakest figure since Q2 2016. The figure contributed to the CAD’s 0.9% daily loss - the fourth largest since the start of 2018.

It is yield, therefore, that has taken the baton from oil

Neil Mellor
Senior Currency Strategist,
BNY Mellon

Newswatch

1. German industry orders for February slump by largest margin in more than two years

2. Kudlow assures that US/China talks on trade have made "good headway"
After all, the figure appeared to corroborate BOC Governor Stephen Poloz’s warning 10 days earlier that the path back to more neutral rates had become “highly uncertain”. Certainly, five days after the report, it could be inferred from the BOC’s March 6 policy statement that rate hikes would now be put on the back burner.

It is yield, therefore, that has taken the baton from oil: the rolling one-month correlation between daily movements in USD/CAD and US/Canadian 10-year yields has yet to fall below 77% since early March, and through the latter half of last month, the CAD’s relationship with the two-year spread averaged well over 85%. Of course, which way the spread takes the CAD from here is another matter.

Indeed, putting a halt to a five-month trend, yield spreads have moved back in favor of the CAD since mid-March, in part due to rather better economic news. GDP rose by 0.3% m/m in January, thereby erasing all losses from November/December and as rising oil prices were a factor, their continued uptrend bolsters hope that the current soft patch in growth will prove to be temporary. Indeed, this is the BOC central case.

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Then again, a central bank which has raised interest rates five times since the summer of 2017 will be understandably reluctant to capitulate to the doves at the first sign of pressure – a point that could be readily inferred from Mr Poloz on Monday.

Yet, irrespective of this stoicism, one proxy for expected policy tightening - the spread between the overnight rate and two-year/two-year swap rates – clearly suggests that dovish thinking is in the ascendancy.

The data certainly favor the doves despite January’s GDP. Indeed, more timely lead indicators point to stagnation: retail sales have fallen for three months in a row, and the current ‘soft patch’ will do little to alleviate downward pressure on the BOC’s three core inflation rates, all of which remain defiantly at the lower end of the bank’s 1-3% target range.
Given that the BOC is not alone in facing such a backdrop, perhaps the most important consideration of all is that under such circumstances, even a central bank as reticent on currency matters as the BOC will be conspicuously wary of having its guidance translate into a stronger currency.

Please direct questions or comments to:

AerialView@BNYMellon.com