

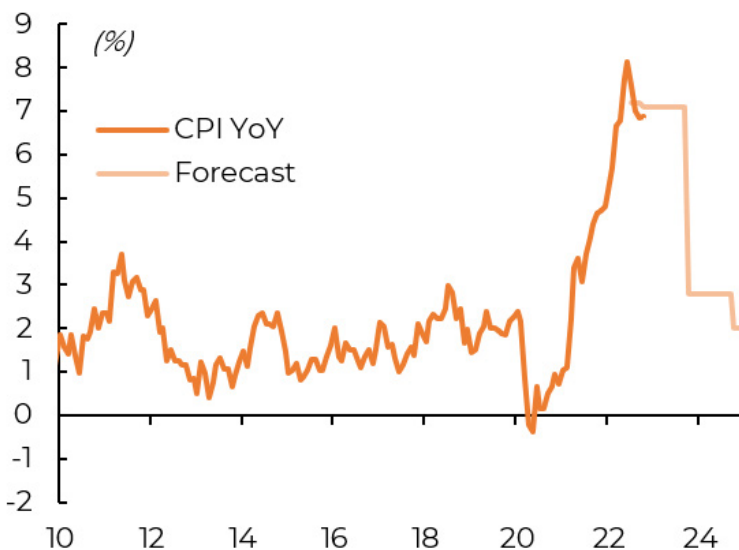
MONTREAL EXCHANGE

Canada FX Will Underperform the US

The Bank of Canada (the “BoC”) hiked the policy rate by 50bps to 3.75% at its October meeting, a smaller move than markets had expected. The BoC noted several reasons to slow the pace: headline inflation was lower than forecast, business price expectations are falling, and long-term inflation expectations remained anchored (Figures 1 and 2). At the next meeting in December, the BoC may hike by 25bps or 50bps¹, but they have been clear that future hikes will be limited as previous ones have yet to fully impact the economy.

One reason for the BoC’s caution around further hikes is household leverage. Canadians have much higher debt burdens than Americans (Figure 2). Therefore, as higher policy rates transmit to higher mortgage payments, Canadians will probably reduce spending more aggressively. The difference in household leverage suggests the Federal Reserve (the “Fed”) will hike rates higher than the BoC will.

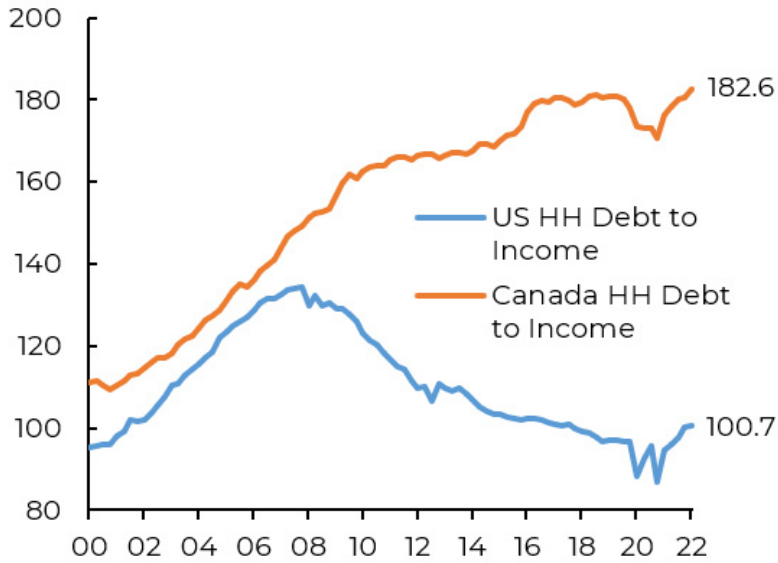
FIGURE 1
Canada CPI Undershooting Forecast



Source: Macro Hive, Macrobond

¹ This article was written prior to the announcement of the 50bps rate hike by the BoC on December 7th.

FIGURE 2
Canada Has High Household Leverage



Source: Macro Hive, Macrobond

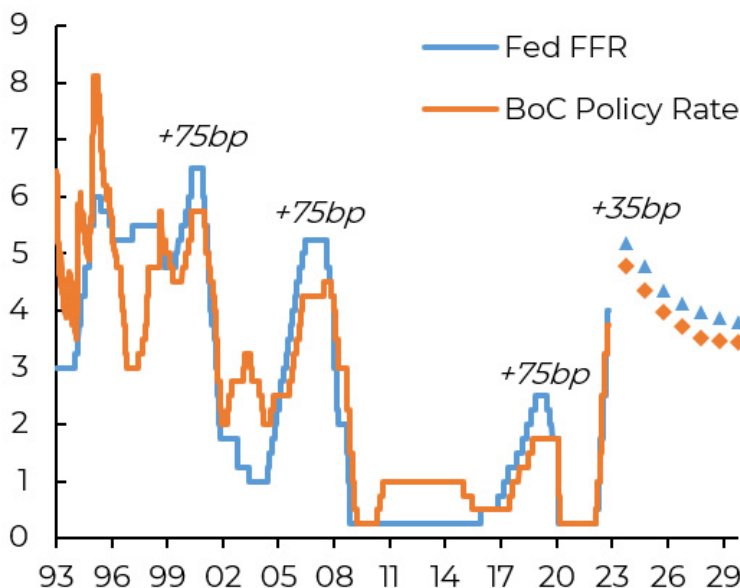


What Does This Mean for Canadian Bond Futures?

According to futures markets, the Fed will hike policy rates to a peak of 35bps higher than the BoC. However, over the past three hiking cycles (2000, 2008 and 2018), the Fed’s policy rate has ended 75bps higher than the BoC (Figure 3). History, therefore, suggests markets are either underpricing Fed hikes or overpricing BoC hikes.

Were history to repeat, the spread between US two-year bond yields and Canada two-year bond yields should widen to at least 85bps (Figure 4). A trade such as buying MX’s Canada Two-Year Government of Canada Bond Futures (Exchange symbol: CGZ™, Bloomberg: CV) and selling CME’s Two-Year T-Note (Exch: ZT, BBG: TY) would perform well in this scenario.

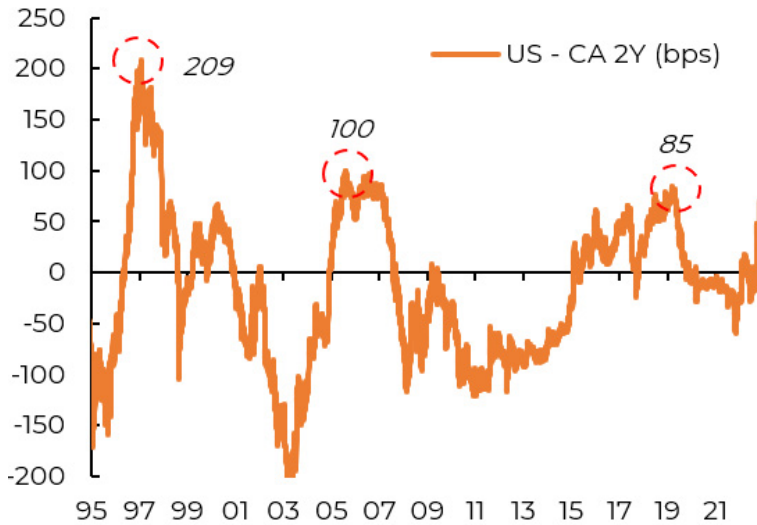
FIGURE 3
Fed Historically Hikes 75bp More Than BoC



Source: Macro Hive, Macrobond



FIGURE 4
US to CA 2Y Spread Could Exceed 100bp



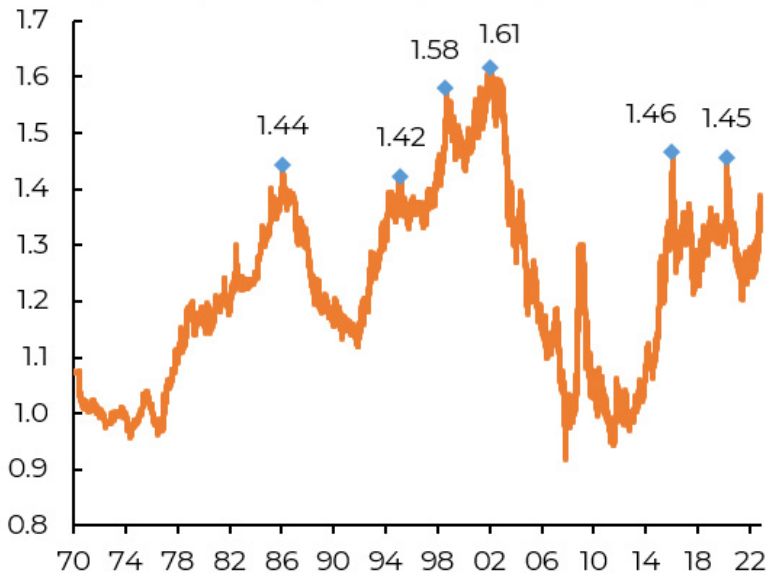
Source: Macro Hive, Macrobond



USD/CAD to Re-Test 1.45

Rates markets are not alone in pricing a relatively optimistic outlook for Canada. In FX, the US dollar is up 10.5% this year on average against other G10 FX. However, the US dollar is only up 6.7% against the Canadian dollar. Consequently, USD/CAD has not reached its previous highs (Figure 5). But if rates markets start to price a less hawkish BoC, we could see USD/CAD moving to earlier highs of 1.42 or even 1.45.

FIGURE 5
USD/CAD Could Re-Test 1.45



Source: Macro Hive, Macrobond





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