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MONTRÉAL EXCHANGE

December 2022

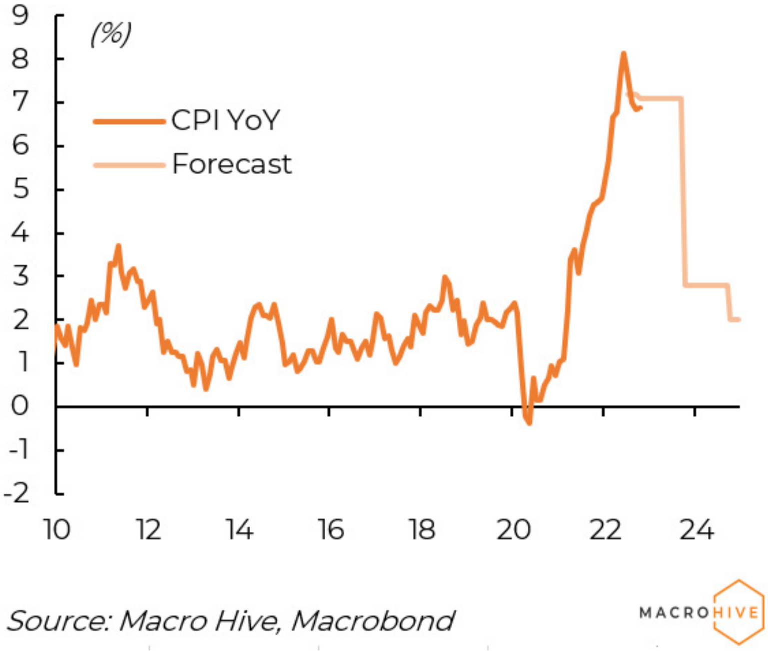
Canada FX Will Underperform the US

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 50bps[1], 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

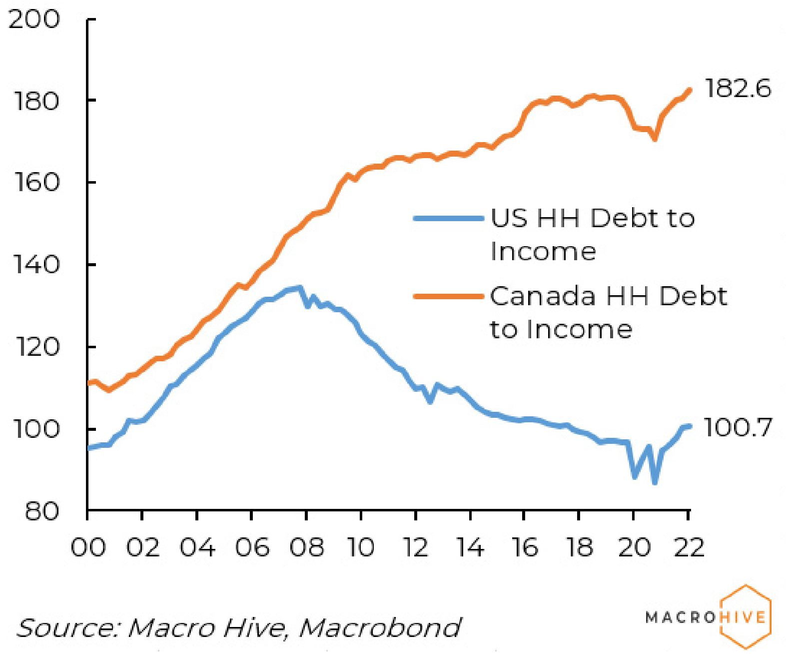


Source: Macro Hive, Macrobond

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



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

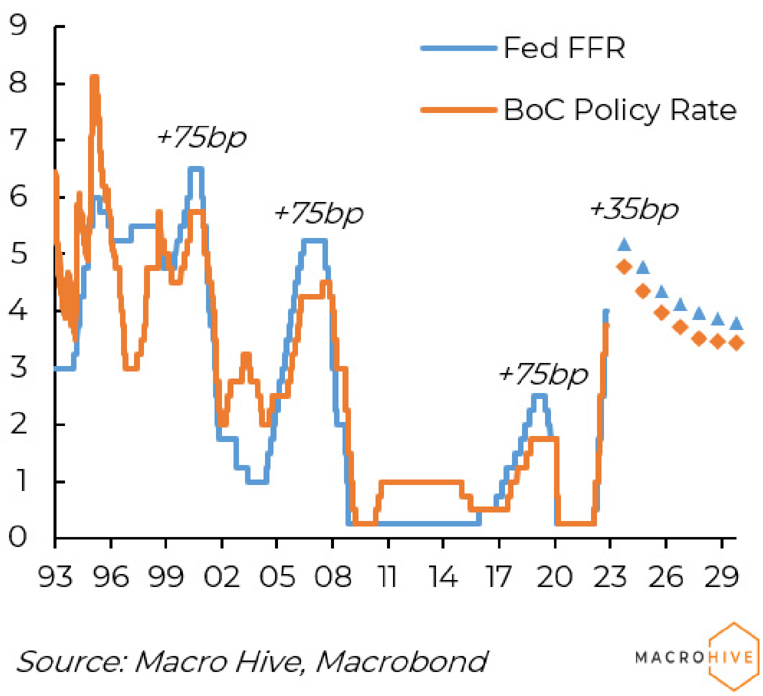


FIGURE 4

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

Bilal Hafeez is the Founder and CEO of Macro Hive – a leading independent research firm. Prior to Macro Hive, Bilal was Global Head of International Fixed Income Strategy at Nomura between 2016 and 2019. Before that, Bilal held various senior roles at Deutsche Bank between 2002 and 2015, including Head of Multi-Asset Research, Advisor to the CEO, Head of Asia Research in Singapore and Global Head of Foreign Exchange Research. Bilal started his career at J.P. Morgan in 1998. During his sell-side career, Bilal was rated #1 market strategist by Euromoney and Institutional Investor for most years between 2004 and 2013. He also pioneered FX investment and smart beta benchmarks. Academically, Bilal was an Honorary Visiting Professor of Finance at Cass Business School. He studied Economics at St John's College, Cambridge.

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