Forex

Economics and Strategy

NATIONAL BANK OF CANADA FINANCIAL MARKETS

July 2022

Highlights

By Stéfane Marion/Kyle Dahms

- The greenback continues to benefit from safe haven flows as global financial stress increases due to a more uncertain economic outlook. Many European economies are on the ropes and U.S. recession fears are rising as the Federal Reserve continues to guide towards restrictive monetary policy to reduce inflation. Something will have to give.

- Despite signs of a cooling economy south of the border, Canada remains resilient. Notwithstanding a significant decline in residential home sales, real GDP is still expected to grow robustly in the second quarter, amid surging terms of trade and a very tight labour market. our fixed income strategists expect the BoC's governing council to increase the overnight target by 75 basis points on July 13

- The euro has slipped from 1.14 at the end of 2021 to nearly parity as of this writing. The normalization of monetary policy which normally accompanies economic vigor arrives at a pivotal time for Europe. The next half of 2022 is unlikely to foster conditions for euro appreciation as the European economy could be in a technical recession. As such, we expect the euro to remain low in the near term and will require improvements for energy prices and supply to catch a bid.

NBF Currency Outlook

Currency		Current July 8, 2022	Forward Estimates Q3 2022	Q4 2022	Q1 2023	Q2 2023	PPP [1]
Canadian Dollar	***(USD / CAD)***	**1.29**	**1.32**	**1.28**	**1.25**	**1.22**	**1.25**
United States Dollar	*(CAD / USD)*	*0.77*	*0.76*	*0.78*	*0.80*	*0.82*	-
Euro	*(EUR / USD)*	1.02	0.98	1.02	1.03	1.05	1.45
Japanese Yen	*(USD / JPY)*	136	138	134	132	128	99
Australian Dollar	*(AUD / USD)*	0.69	0.69	0.71	0.72	0.72	0.67
Pound Sterling	*(GBP / USD)*	1.20	1.19	1.21	1.22	1.22	1.48
Chinese Yuan	*(USD / CNY)*	6.70	6.68	6.65	6.60	6.55	4.2
Mexican Peso	*(USD / MXN)*	20.4	21.0	20.5	20.0	20.5	9.7
Broad United States Dollar [3]		**122.0**	**124.4**	**121.3**	**119.5**	**118.5**	-

1) PPP data from OECD, based in Local Currency per USD
2) Current Account Balance data from IMF, as a % of GDP (2020 & 2021 IMF estimates)
3) Federal Reserve Broad Index (26 currencies)

Canadian Dollar Cross Currencies

Currency		Current July 8, 2022	Forward Estimates Q3 2022	Q4 2022	Q1 2023	Q2 2023
Euro	*(EUR / CAD)*	1.32	1.29	1.31	1.29	1.28
Japanese Yen	*(CAD / JPY)*	105	105	105	106	105
Australian Dollar	*(AUD / CAD)*	0.89	0.91	0.91	0.90	0.88
Pound Sterling	*(GBP / CAD)*	1.56	1.57	1.55	1.53	1.49
Chinese Yuan	*(CAD / CNY)*	5.18	5.06	5.20	5.28	5.37
Mexican Peso	*(CAD / MXN)*	15.8	15.9	16.0	16.0	16.8

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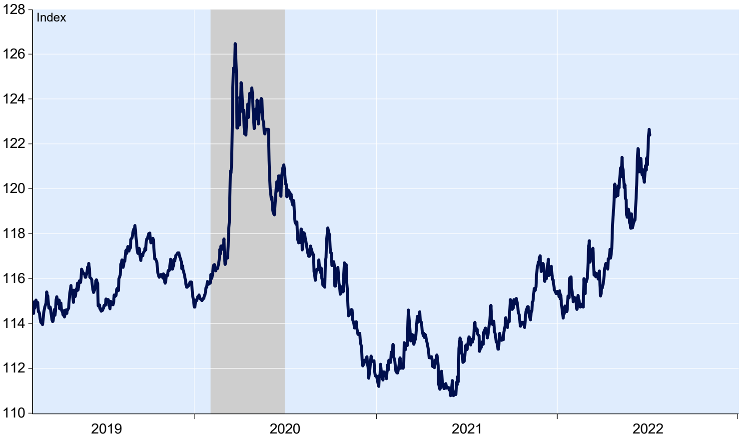
USD: Surging again

The trade-weighted U.S. dollar has regained all the ground lost in May and is currently at a new post-recession high against a basket of 26 currencies (chart).

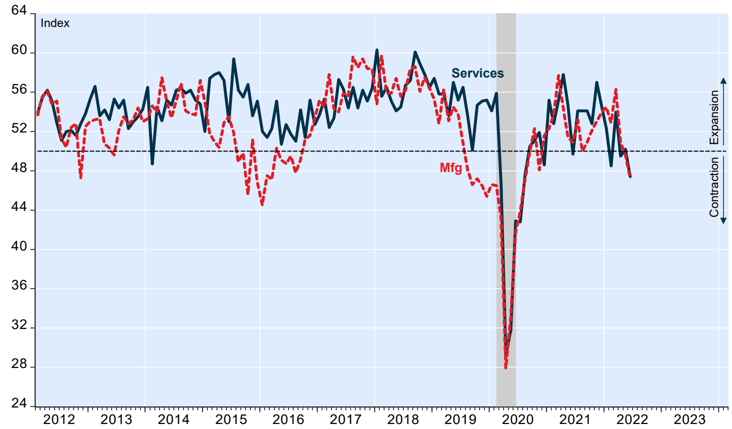
U.S.: The greenback at a post-recession high
Trade-weighted USD against a basket of 26 currencies



NBF Economics and Strategy (data via Refinitiv)

The greenback continues to benefit from safe haven flows as global financial stress increases due to a more uncertain economic outlook. Many European economies are on the ropes and U.S. recession fears are rising as the Federal Reserve continues to guide towards restrictive monetary policy to reduce inflation. Something will have to give. In our view, although real GDP growth is expected to be positive in the second half of 2022, it is unlikely to be above potential. If we are right, the pace of hiring should soon decelerate and set the stage for moderating inflation and a less hawkish Fed. Despite the creation of a stronger-than-expected 370K payroll jobs in June, we see impending signs of weakness. For one, the household survey (similar in methodology to Canada's LFS) painted a much less upbeat picture with a reported 315K drop in employment in June (the second decline in three months). Also, the ISM PMI reports showed employment contracting in both the manufacturing and services sector in June (chart).

U.S.: Impeding slowdown in hiring
ISM PMIs, employment component



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A slowdown in the pace of hiring as companies seek to preserve profit margins would certainly help mitigate wage inflation and reduce the need for outsized rate hikes. At this writing, we remain comfortable with our below-consensus call for the Fed to end its rate hiking cycle in the fourth quarter at a rate of just 3% and avoid pushing the U.S. economy to the brink. The next Fed meeting is slated for July 26-27.

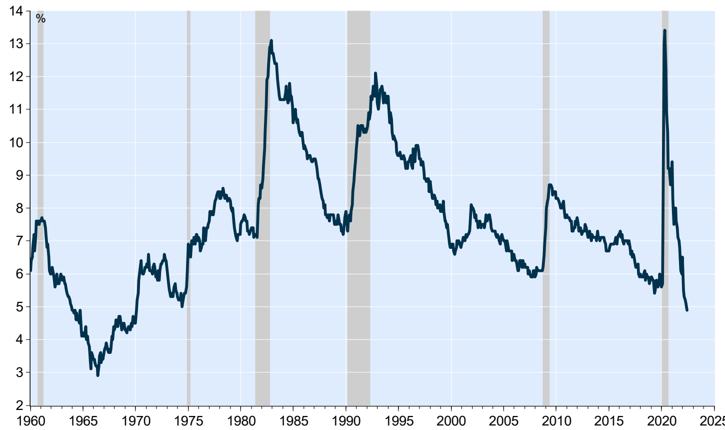
We mentioned last month that a way for Washington to quickly reduce consumer goods inflation would be to lift tariffs on products made in China. Encouragingly, the U.S. Treasury Secretary Janet Yellen met with the Chinese Vice Premier Liu He on July 5 to discuss tariffs. According to the Wall Street Journal, taxes on about $50 billion of Chinese exports are set to expire in July and August.[1]

CAD: BoC set to deliver a large hike

Despite signs of a cooling economy south of the border, Canada remains resilient. Notwithstanding a significant decline in residential home sales, real GDP is still expected to grow robustly in the second quarter, amid surging terms of trade and a very tight labour market. The unemployment rate fell to 4.9 percent in July, the lowest rate since 1970 (chart).

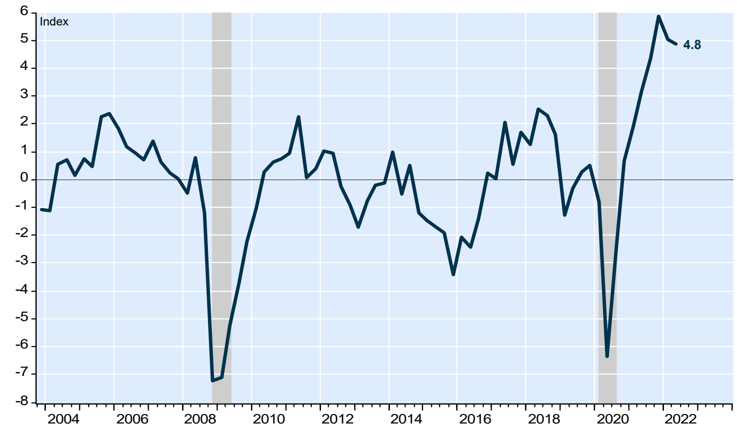
[1] https://www.wsj.com/articles/janet-yellen-and-chinas-top-trade-negotiator-discuss-tariffs-on-call-11657015225

Canada: The lowest jobless rate since 1970
Unemployment rate



NBF Economics and Strategy (data via FRED)

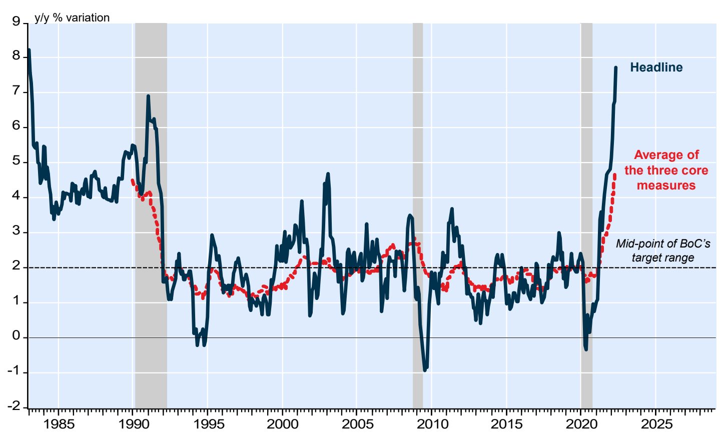
Canada: Business sentiment remains high
Business Outlook Survey Indicator



NBF Economics and Strategy (data via Bank of Canada)

With tight labour markets, inflation has been rising. In June, total CPI inflation was just under 8%, the highest rate since 1983. The average of the three core measures monitored by the Bank of Canada showed annual inflation of just under 5% (chart).

Canada: Highest annual inflation since 1983
Consumer price index, headline and average of the three core measures, annual change (%)



NBF Economics and Strategy (data via Statistics Canada)

What's more, there is scant evidence of a widespread cooling in economic activity. According to the Bank of Canada's (BoC) Business Outlook Survey, business confidence remained near peak levels at the end of May (chart).

As a result, our fixed income strategists expect the BoC's governing council to increase the overnight target by 75 basis points on July 13 and to note that they will continue to 'act forcefully' to bring down inflation (see here).

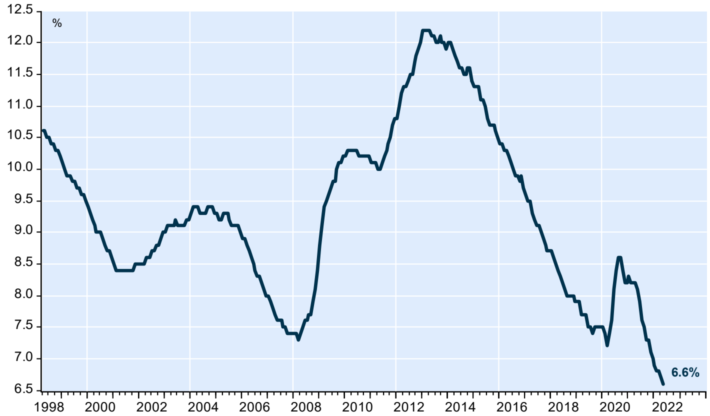
EUR: Parity and recession

The first half of 2022 can only be described as eventful for the Eurozone. The common currency area has faced spiking energy prices, a war on its borders and surging inflation. The aforementioned factors have given no traction to the euro, the latter having slipped from 1.14 at the end of 2021 to nearly parity (1.01) as of this writing. The next half of 2022 is unlikely to foster conditions for euro appreciation as the European economy could be in a technical recession.

Some of the recent euro weakness can be retraced to the ECB emergency meeting on the 15th of June. The spread between an Italian and German 10y bond had reached 240 basis points, prompting serious discussions. The central bank promised an anti-fragmentation tool to help alleviate supposedly unjustified interest-rate spreads. The ECB has now given a name to its "secret" tool. The Transmission Protection Mechanism, although specifics could change between now and subsequent meetings. While there is no certainty the mechanism will be announced at the July meeting this month, its purpose will be to keep yields contained for periphery Eurozone economies. The central bank felt pressured to have an instrument at its disposal for when it would start normalizing monetary policy. That said, this measure which would involve asset purchases is likely to be detrimental for the common-area currency.

The normalization of monetary policy which normally accompanies economic vigor arrives at a pivotal time for the European economy. Sure, the unemployment rate reached a new all-time low in May registering at 6.6%.

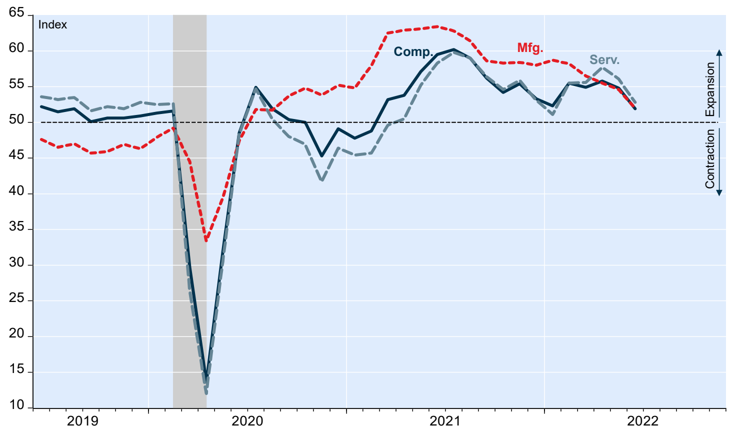
Euro zone: Unemployment rate to an all-time low
Unemployment rate



NBF Economics and Strategy (data via Bloomberg)

But June inflation also clocked in at an all-time high, surging 8.6% over the last year. The latest Markit Flash PMI showed private sector activity on the verge of entering contractionary territory.

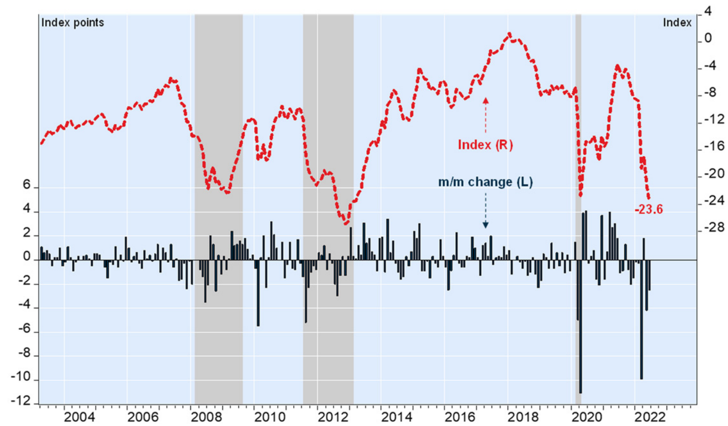
Eurozone: Slumping demand weighs on activity in the private sector
Markit Flash PMI. Last observation: June 2022



NBF Economics and Strategy (Source: Markit via Refinitiv)

Consumer confidence has collapsed past the COVID low and was approaching levels last seen during the 2012 European debt crisis.

Eurozone: Confidence hit hard by rising prices and interest rates
European Commission's Consumer Confidence Index. Last observation: June 2022



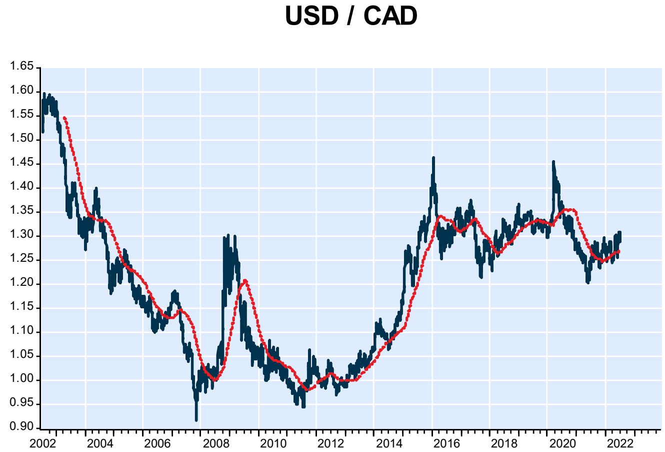
NBF Economics and Strategy (data via Bloomberg)

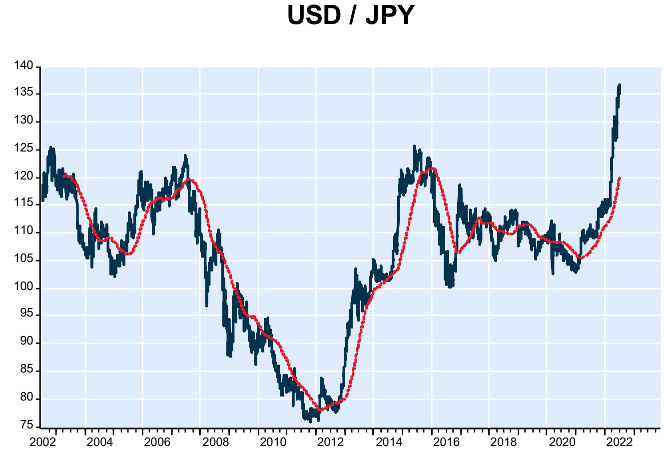
Germany recorded its first trade deficit since 1991 as import prices goosed up that side of the equation. Altogether, the picture for the European economy is far from rosy and it may already be in the throes of a technical recession. As such, we expect euro to remain low in the near term and will require improvements for energy prices and supply in order to catch a bid.

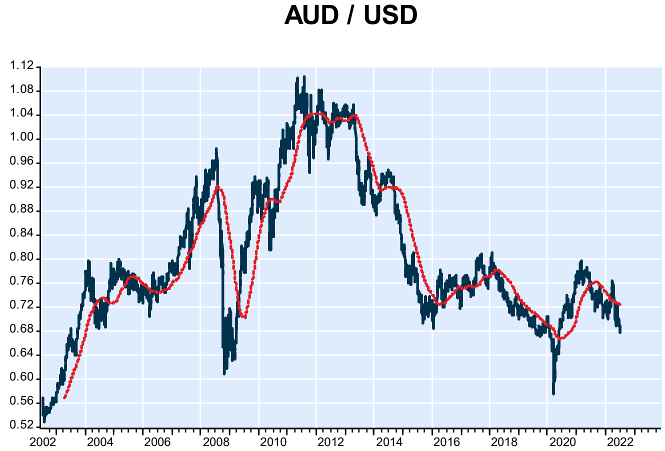
GBP: Political shuffle

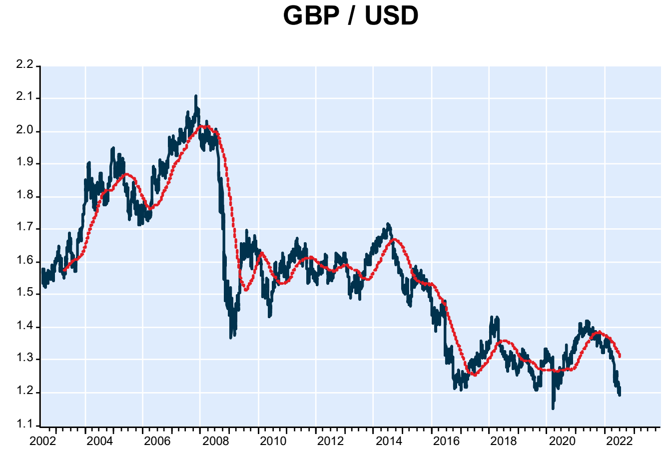
The British pound has weakened in the past month as mounting economic pressures are furrowing the outlook. The British economy is facing similar challenges as the rest of Europe as inflation runs rampant. While the BOE has been active in normalizing policy, it has admitted in its latest Financial Stability Report that conditions for the UK and the rest of the world had "materially deteriorated". While it appears set to continue restricting monetary policy to tame inflation and avoid further depreciation of the currency, challenges arise from other spheres. In somewhat of a historic move, the Prime Minister Boris Johnson resigned from his role following a spate of abandonment from party members. While his dismissal will usher in new management, it is to be seen how government policy may differ from the avid Brexiteer. All-in-all, we expect the pound to remain relatively contained in the near-term as growth likely moderated.

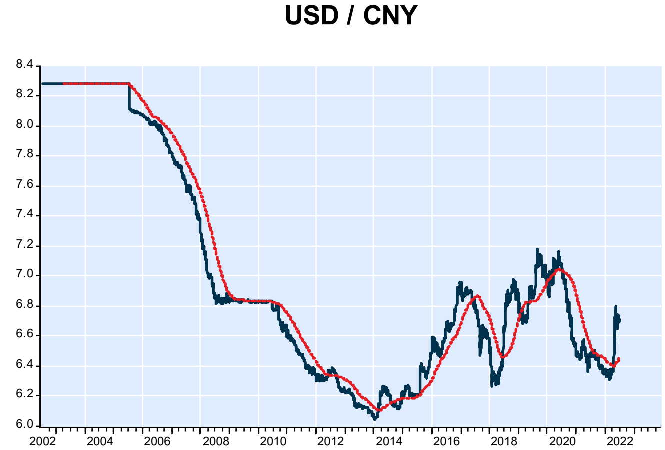
Appendix: Spot rates











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Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Daren King
Economist
daren.king@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Alexandra Ducharme
Economist
alexandra.ducharme@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
Chief Rates and Public Sector Strategist
warren.lovely@nbc.ca

Taylor Schleich
Rates Strategist
taylor.Schleich@nbc.ca

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