Canada and the loonie: Oiling up the engine

The slump in oil prices has already hit the Canadian economy and left a question mark over its ability to recover. Despite that, we think USD/CAD will be able to trend lower in the second half of the year as oil prices and global risk appetite recover, with the Bank of Canada unlikely to stand in its way. We forecast 1.31 in 4Q20

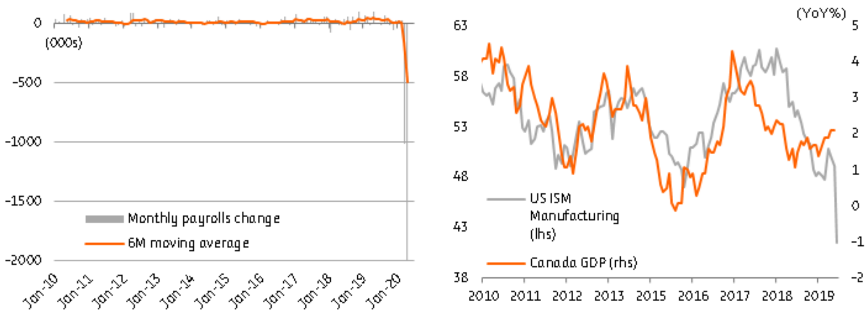
Source: pexels

The Bank of Canada expects GDP to plunge between 15 and 30% in 2Q with Senior Deputy Governor Carolyn Wilkins stating recently that “even in a good scenario, lost output will be made up only gradually as containment measures are lifted, people return to work and production ramps up”. We certainly agree with this prognosis and think it will take until at least mid-2023 before all of the lost output is recouped.

Widespread impact of low oil prices

Canada is particularly exposed given its high dependence on commodities, which have seen prices plunge in the wake of the collapse in global demand, and the importance of global trade to overall economic activity. The oil and gas rig count numbers published by Baker Hughes have collapsed from 257 in February to just 26 today as oil prices plummeted. There has been a partial recovery in recent weeks, but the continuing oil supply glut means that the scope for a full price rebound that will entice renewed drilling is some way off.

Canadian jobs market and GDP



Source: ING, Bloomberg

In the meantime, Canada has lost three million jobs through March and April, pushing the unemployment rate to 13%. It will break well above this level in May with the clear risk it hits 20%. Average hourly earnings have picked up, but this is misleading – job losses have been concentrated in lower income households, boosting the "average" wage of those still in employment. There are no pay rises happening in the Canadian economy right now, which in the absence of demand, will further limit any price pressures.

Given this backdrop and the Bank of Canada's clear reluctance, like the Federal Reserve and Bank of England, to go down the route of negative interest rates, we expect the policy rate to be left at the "effective lower bound" of 25 basis points. In any case, as Federal Reserve Chair Jerome Powell alluded on Wednesday – central banks can't generate demand out of thin air when there has been a shock such as we are currently experiencing. That is the task of fiscal policy. The BoC can merely ensure financial markets continue to function well, credit is flowing and there is enough liquidity.

Oil still holds key to CAD recovery

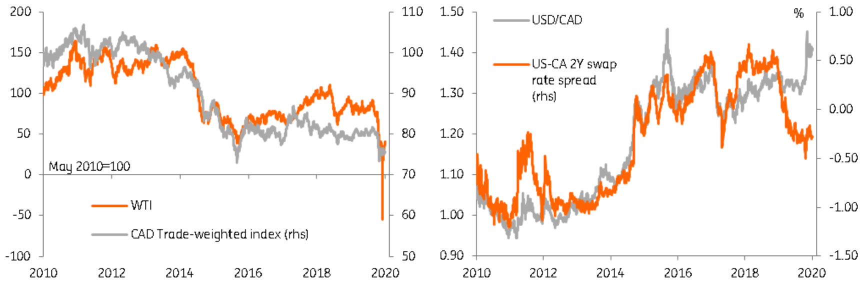
In a 30 April publication, we looked at what currencies were best positioned to benefit from a recovery in risk sentiment. The Canadian dollar was lagging some pro-cyclical G10 peers like the Australian dollar and the Swedish krona in our FX scorecard, mostly because of its exposure to the troubles in the oil market.

With the energy sector accounting for some 10% of GDP and crude oil being the main export, the fate of the loonie is inevitably interconnected with that of oil price dynamics, in particular WTI. However, the historic slump in oil prices failed to push USD/CAD to the 1.45 area we had initially forecasted. Similarly, the recent recovery in prices failed to provide significant pressure to the pair. The 120-day correlation of WTI with the CAD trade-weighted-index is at 0.18, its lowest since 2014. The five-year average correlation is 0.45.

However, as oil volatility decreases, the correlation should pick up again, and as we expect a sustained recovery in oil prices in the second half of the year , we also see USD/CAD entering a sustained downward trend in that same period.

Our view on the loonie's outperformance in 2H not only stems from our optimistic stance on oil but more broadly from our expectation for a recovery in risk sentiment as the market, which is currently pricing in a severe depression, starts to price in an economic recovery.

CAD - Oil and rate spread



Source: Bloomberg, ING

The BoC is unlikely to curb CAD appreciation....

How will the BoC fit into the equation? We don't think the central bank will be a hindrance to a recovery in the currency. This is mostly because the Bank has simply aligned its policy with the global easing trends, so it does not stand out as an ultra-dovish outlier in the global picture. Looking specifically at USD/CAD, the US-Canada 2Y swap spread is likely to remain in negative (CAD-positive) territory mostly on the back the Fed's larger quantitative easing: the Fed's balance sheet is around 30% of GDP vs the BoC's 19%.

To be sure, there is still an open question on whether the new BoC Governor, Tiff Macklem, will deviate from the path that Stephen Poloz has set the bank on. We think the risk of this happening is quite limited, and Macklem may aim at a smooth transition by sticking with the current commitment to provide stimulus to the economy but without putting new monetary tools (for example, negative rates) into the equation. In other words, a smooth transition. Macklem will take over as BoC Governor on 3 June, when the Bank announces monetary policy.

... but a gloomy outlook could

The major risks to our bullish expectations for CAD in 2H20 are related to the possibility of a deeper recession in Canada compared to other countries. As discussed above, we have already started to see the impact of the oil slump on the economy, and as it may take a while before prices are back to pre-pandemic levels, the recovery in Canada may be slower.

The BoC's effort to close provincial spreads to the national bonds should help the single provinces in providing fiscal stimulus, and the national government has already been active in providing a backstop to job losses. At the same time, it must be noted that the fiscal response in Canada has not been as strong as in other countries (such as the US or other exporting economies like Australia) so far.

This may prove to be a factor that will slow the recovery in CAD, which should however be mostly reflected in some weakness versus other procyclical peers, while the rebounding global risk appetite and oil prices should allow the CAD to outperform the safe-haven dollar quite sustainably in the second half of the year.

ING Forecasts - CAD

ING Forecast	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21
USD/CAD	1.40	1.35	1.31	1.28	1.27	1.27	1.26

Source: ING

In the short term, lingering uncertainty around the length and depth of the global economic recession, and around the ability of oil prices to fully recover, should leave USD/CAD around the 1.40 mark.

We expect most CAD gains to be concentrated in 3Q and extend into 4Q, where we see USD/CAD at 1.31. Looking further ahead, we still expect the pair to stabilise in the 1.25/1.30 region through 2021.

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