FX: Surely not another surprise from the Bank of Canada

Why Canada will raise rates today, the dollar is shaking off US politics and ECB policymakers are playing 'good cop/bad cop'

Source: Bank of Canada

USD: Just when the dollar was looking for some respite, US politics strikes again

The already beaten-down dollar may have shaken off news that Steve Bannon has been issued with a subpoena by Special Counsel Robert Mueller, but this is yet another example of why the unpredictability of US politics is weighing on the currency.

EUR: ECB policymakers playing the ‘good cop/bad cop’ routine for euro bulls

After rallying to a fresh three-year high – and holding the burden of a currency that is ‘hot right now’ – we see the EUR as being highly sensitive to three factors in the near term: (1) EZ economic data surprises – namely inflation readings (we get the final release of December CPI today); (2) adverse political developments, with the immediate focus on the German coalition deal and a key vote this weekend; (3) ECB policy noise ahead of next week’s meeting (25 Jan). Officials have been playing ‘good cop, bad cop’ for EUR bulls – with Francois Villeroy citing FX moves as a source of uncertainty, while Jens Weidmann noted that expectations for a mid-2019 ECB depo rate hike are realistic. While the latter holds the key to further EUR upside, Villeroy’s cautious take is probably the ECB consensus and this may limit the EUR’s rally for now.

CAD: Data warrants a Bank of Canada rate hike today, NAFTA risks may not

With markets all but pricing in a 25bp Bank of Canada rate hike today (1500 GMT), we see the key driver for the Candian dollar as being the propensity for further tightening amid rising NAFTA break-up risks. A hawkish hold today is a non-trivial risk, though with net exports not an integral part of the BoC’s positive outlook – and other areas of the economy firing on all cylinders – a 25bp hike today is the most likely outcome. Governor Stephen Poloz may keep a non-committal and laissez-faire tone – and the risks are that investors view this as a dovish hike, with the CAD rate curve flattening slightly as sentiment for further BoC tightening eases a bit.

With the Fed on a pre-set course, BoC policy dynamics hold the key to USD/CAD over the coming months. Based on our scenario model simulations, the risk-reward implies not chasing the BoC rate hike story today; with a 100bps worth of tightening priced in over a two-year horizon, it's hard to imagine much further upside and at best USD/CAD runs down to 1.2350 in a hawkish hike scenario. Yet, the tail risk of a hawkish hold could see a widening of US-Canadian interest rate differentials and initiate a CAD sell-off to 1.2650. We still think USD/CAD is on a path to 1.20; getting there may be a post-NAFTA-resolution story (2H18).