MONEX

CAD OUTLOOK

October 2023

Turning bearish on CAD as recession odds mount

AUTHORS

SIMON HARVEY
Head of FX Analysis
+44 (0) 203 650 6472
Simon.Harvey@monexeurope.com

JAY ZHAO-MURRAY
FX Market Analyst
+1 647-480-1812
Jay.Zhao-Murray@monexcanada.com

INTRODUCTION

In the context of a shifting macroeconomic backdrop and growing geopolitical risks, we have opted to review our forecasts for the Canadian dollar. Over the near term, we no longer expect policy rate differentials to be a major driver of the loonie after this week's Q3 surveys and September's inflation data removed the risk the BoC will resume its hiking cycle in Q4, with risk sentiment and oil prices likely to dominate instead. While these forces compete against one another and have been amplified by the outbreak of war in the Middle East, we believe the risk channel will likely dominate price action in USDCAD and have revised up our one-month and three-month forecasts to reflect this. While near-term risks have increased on the whole, a considerable deterioration in the global geopolitical environment poses the largest risk to our near-term USDCAD forecast and could see the pair rise above 1.40 this year if this scenario materialises. In this event, we expect CAD's positive beta to oil will likely result in outperformance on crosses where the removal of the dollar's haven attributes makes the diverging terms-of-trade shock more explicit. We expect this to be most visible against the euro, CE-3 currencies, and the South African rand.

"Further out on the projection horizon, we expect Canada's domestic fundamentals and policy rate differentials to re-emerge as the loonie's primary drivers."

Downward revisions to growth data and evidence suggesting the slowdown in domestic demand is set to accelerate have led us to downgrade our view on the Canadian economy. We now expect the Canadian economy to continue to stagnate in Q4 before entering a recession in 2024 H1, leading the Bank of Canada to pivot to rate cuts sooner and more aggressively than markets are currently pricing. As a result, we have upgraded our 6-month USDCAD forecast to 1.38, and we believe that if the Middle East escalation scenario does not materialise, the pair could still intermittently break through 1.40 as early as Q1 of next year as recessionary conditions become more visible. We have retained a bullish bias on CAD in 2024 H2, based upon our expectation that the dollar will structurally depreciate as the Fed begins to ease policy and global growth conditions improve, but have raised our 12-month forecast to 1.34 to reflect the lower starting point for the Canadian economy. Our views are subject to considerable two-sided risks. Over the near term, the potential for a seasonal Q4 equity rally would be the primary downside risk to USDCAD, while a lack of confirmation of the latest soft CPI report would re-introduce the interest rate channel, lifting Canadian yields but at the expense of a deeper recession. In 2024, we view a soft landing scenario in which population growth, fiscal policy, and US demand for Canadian exports allow Canada to avoid a recession as being the main downside risk to USDCAD. At the other end, greater margin compression that results in employment losses and a severe recession in Canada would pose a major upside risk to the currency pair.

Monex's updated October USDCAD forecasts – previous forecasts are included in parentheses

	1-month	3-month	6-month	12-month
USDCAD	1.37 (1.35)	1.37 (1.33)	1.38 (1.30)	1.34 (1.28)

Revising up our year-end USDCAD forecasts even as concerns over $100 barrels of oil increase

From now until the end of 2023, we expect the Canadian dollar to be primarily driven by global risk appetite and crude oil, both of which are highly sensitive to the outbreak of war between Israel and Hamas. Unlike the past twelve months, the interest rate channel is likely to play a lesser role, as both the Bank of Canada and Federal Reserve are viewed as having reached, or nearly reached, their terminal rates. Interest rates will likely become the loonie's dominant driver in 2024 once again as the two central banks' rate profiles diverge in the months following the official end of hikes in North America, but we don't expect that to take place until the second quarter of 2024. Ahead of that, and up until year-end, we think the loonie is likely to remain under pressure as a deterioration in risk sentiment weighs on the high beta currency even as speculation over higher oil prices rise.

At this current juncture, risk sentiment scans as extremely bearish and there are only a few reasons to suggest it will improve. The deterioration has recently been driven by the bear-steepening in yields, weaker global activity data, rising energy prices, and the threat that the Israel-Hamas conflict could spread throughout the Middle East. Looking at the world's largest stock markets, spanning the Americas, Europe, and Asia, all except the UK's FTSE 100 have all fallen over the past three months, with the S&P 500 down -3.9% over this period. While there are reasons to believe cyclical optimism could improve—seasonality points higher through year-end, CNN's Fear and Greed index suggested sentiment reached an extreme low earlier this month, and Chinese stimulus supports global demand and risk assets—crosswinds including a probable US growth slowdown, increased geopolitical risk, and structurally higher yields make it challenging to determine whether the usual Q4 risk rally will play out.

The outlook for crude oil in Q4 isn't clear cut either. While global supply has tightened following production cuts from Saudi Arabia, Russia, and other OPEC+ producers, leading WTI prices to briefly crack above $95/bbl in late September, downgrades to the demand outlook have led oil benchmarks to retrace, with WTI trading below $90/bbl at the start of the fourth quarter. We expect these conflicting forces to persist up until year-end, with an expected slowdown in the US economy and continued uncertainty over Chinese growth to cast doubt over projections for a global supply deficit.

If not for the latest developments in the Middle East, we would have been willing to call $95/bbl the top in WTI for 2023 due to these factors and assumed a range of $80 to $90 to hold through year-end. Now, however, there is a serious threat that Iran—the world's eighth-largest producer of crude—could be dragged into a broader regional conflict, which would likely produce a more pronounced global energy supply shock. Media reports have given conflicting information on the degree of Iran's involvement in the latest Hamas attack on Israel, and Antony Blinken, the US Secretary of State, recently said that the US had no "direct evidence" the country was behind the attack. Since then, Iran has called for an embargo on crude exports to Israel, leading WTI prices to take another run at $90/bbl.

"The highest-impact tail risk would be if Iran retaliated to any potential tightening in Western sanctions by blocking the Strait of Hormuz, the world's most important oil transit choke point whose daily flows account for one fifth of global energy demand."

In this scenario the outlook for USDCAD is mired in uncertainty due to the opposing crosscurrents, with higher oil prices providing a tailwind for the loonie as Canada's terms of trade improve, while heightened risk aversion is set to have the opposite effect. Nevertheless, we expect the risk channel to dominate USDCAD price action in this scenario, likely leading the pair above the 1.40 handle as markets flock back into the dollar. The loonie's positive correlation with crude is likely to be more visible on CAD crosses, where the removal of broad USD dynamics isolates the diverging terms of trade. In that scenario, we would expect a $100 barrel of oil to lead to CAD outperformance against oil-importing economies' currencies, particularly EUR, CE-3 FX and ZAR.

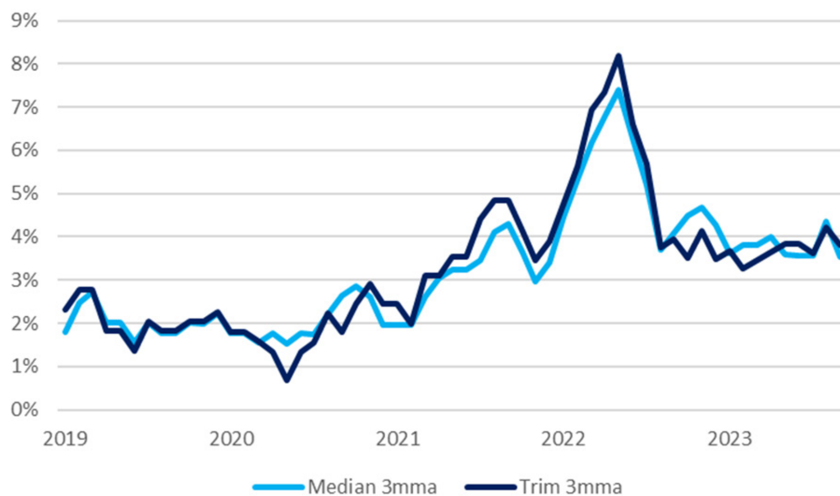
Overall, given the tentative outlook for risk assets into year-end and our view that the Bank of Canada will continue to monitor whether weak growth is sufficiently dampening underlying inflation, we have revised up both our 1-month and 3-month USDCAD forecasts to 1.37, reflecting a more bearish view than earlier this month on the loonie's prospects, but a relatively neutral view on the currency pair over the near term from current spot pricing. We note that two-sided risks to our view are plentiful, given the loonie's sensitivity to cyclical factors, commodities, and overall risk appetite in the context of a precarious global macro environment. While risks are two-sided, the most prominent risk stems from a substantial escalation in geopolitical conflicts, which in our view hold a limited probability but will likely have a profound impact, potentially taking USDCAD above 1.40 in the near-term.

Economic fundamentals will play a more crucial role in 2024, driving a monetary policy divergence that will likely lead USDCAD to break through 1.40 as early as Q1

Over the medium term, Canada's domestic fundamentals will play a greater role as the market focus returns to monetary policy and central banks' ability to guide inflation back to target. Canada's fundamentals, however, are not entirely clear. The state of the Canadian economy was put into question ever since GDP growth for Q2 came in slightly negative, significantly undershooting expectations. Following downward revisions from Statistics Canada, monthly GDP by industry now suggests that the economy has completely stagnated over the last 6 months of data. Weaker growth is generally accompanied by a softer labour market and declining inflation pressures, and while we are seeing this to some extent in Canada, labour and price dynamics have shown much greater resilience than the economy as a whole. The labour market has loosened somewhat since last year, but as the latest jobs numbers show, firms are still hiring enough workers to keep the unemployment rate at 5.5%, which is not far from its all-time low of 4.9%. Solid labour demand has also translated to strong wage growth, which is tracking between 4% and 5% year-on-year depending on the indicator. In the meantime, inflation pressures have stayed elevated with relatively little progress since last summer. A recent uptick in energy prices and core pressures saw the headline rate return to 4% in August after bottoming out at 2.8% in June, fuelling worries about stagflation. That uptick proved to be short-lived, however, with the prices of food, energy, and core goods

declining outright in September, bringing the headline rate of inflation back down to 3.8%. More importantly, the Bank of Canada's preferred measures of underlying inflation both fell sharply in September and are tracking below 4%, although the recent progress has merely returned these metrics to the range that they were stuck in for much of this year, a key factor behind the Bank of Canada's decision to resume hiking rates in June. While the progress in abating inflation has been minimal this year, the lack of breadth in September's report was a signal that inflation pressures may have hit an inflection point. Nevertheless, this must be confirmed by subsequent reports, and the lack of synchronisation between weak economic growth, high inflation, and a tight labour market has resulted in considerable volatility for both Canadian interest rate expectations and the loonie.

August's surprise uptick in the BoC's preferred measures of core inflation was a false alarm



Several structural factors have contributed to these discrepancies, most notably the adjustments made in response to the global pandemic. But another key factor has been a sizable demographic shift. Canada is in a per capita recession, but the strongest population growth in decades has prevented the economy as a whole from rolling over. From 2000 to 2015, Canada's annual population growth was fairly stable, averaging 1% per year. Under Trudeau, however, more aggressive immigration policies led annual population growth to rise to 1.6% by 2020 Q1, right before the pandemic caused a severe drop in migration. Strong population growth resumed once again in 2021 before accelerating to 3% YoY in 2023 Q3, the highest growth rate since the late 1950s. Based on official statistics, Canada is now home to over 40 million people, an increase of nearly 2.3 million since the end of 2019, and estimates from CIBC suggest that the true population may be undercounted by another 1 million people. The impact cannot be understated: without migration, Canada's population would have grown by less than 200k over the last three years, a tiny sliver of the actual growth in the country's headcount.

"Underlying this demographic change has been the government's new approach to Canada's temporary foreign worker program."

In the three years preceding the pandemic, Canada saw an average net inflow of 400k people per year, with two thirds being immigrants and one third being temporary residents. Breaking down the net inflow, Canada used to see roughly 300k new immigrants and 135k temporary residents, offset by 35k leaving the country. Over the last year, however, this pattern has been flipped on its head. The annual inflow of immigrants increased by nearly 60% since the pre-pandemic period, to 470k people. This is already a sizable increase, but it pales in comparison to the exponential growth in temporary residents, whose inflow has quintupled to a monumental 700k per year. The change in Canada's migration policies hasn't just been in terms of numbers, but in the types of people that Canada brings in. For decades, Canada used to focus on attracting highly skilled and educated economic immigrants. Now, however, with lower-paying industries generally seeing the worst labour shortages, policymakers have shifted gears, approving visas for lower-skilled workers to plug those gaps. This has resulted in lower-paying industries generally seeing stronger job growth and proportionally larger wage increases when compared to higher-paying industries.

Although the inflow of workers has raised the economy's productive capacity and supported aggregate demand, the outlook for growth is poor. According to the Bank of Canada's Business Outlook Survey, a growing proportion of firms have reported declines in sales volumes over the past 12 months (32% in 23Q3 vs. 6% in 21Q4), and indicators of future sales growth suggest this trend will only worsen from here. Indicators such as order books, advanced bookings, and sales inquiries are tracking at their most pessimistic readings ever recorded outside of a recession, and the downward trend has been robust. While most firms generally tend to report positive growth signals, in Q3 the exact same share of firms (37%) reported improving and deteriorating indicators. Both of these have been trending the wrong way, with the share of optimistic firms down from a peak of 81% in 21Q2, at which time the pessimistic share also troughed at 0%. Softer demand conditions were reportedly broad based, although weakness was especially concentrated in domestic consumer spending and real estate. The Canadian Survey of Consumer Expectations echoes the idea that demand has softened, with nearly 6 in 10 (58.1%) of Canadians saying that they have cut back on spending to protect themselves against inflation. Firms see the weakness

in domestic demand as being partially offset by public sector and foreign demand. The public sector may continue to be a genuine offset, considering the federal government has repeatedly overshot its budget projections, but while the US economy has been strong, its current strength will likely fade and induce a pullback in demand for Canadian exports.

The survey data also support the notion that considerable lagged effects of monetary policy are set to come. Roughly half of firms (46.7%) say that they have barely begun to feel the impact of higher interest rates, while another third (31.6%) said they have only seen about half of the total impact they expect. The results of the consumer survey were similar, especially since many mortgage-holders have yet to refinance at higher rates. In addition, firms report lessened hiring intentions over the coming year, as labour shortages are easing. As firms' demand for labour will decline once vacancies get filled, the number of work visas issued should fall in tandem, leading the population growth slowdown to restrain the growth in Canada's productive capacity and intensify the decline in domestic aggregate demand. We therefore expect the Canadian economy to tip into a mild recession next year, which should see the 3-month annualised rates of core inflation finally break below 3%. The downside risk of a more severe recession will likely be averted so long as firms retain their workforces. Currently, only 12% of firms plan to reduce their headcounts, which is in line with historical norms, while 39% are still looking to hire. These plans appear feasible, considering that margins are high enough to let firms hoard labour even in the face of a weak sales outlook.

"To illustrate this point, the average profit margin for TSX-listed companies has declined to 11.6%, which is still higher than the range of 7.5% to 11% that held in the five years preceding the pandemic."

Canada's growth outlook is particularly poor when compared to the United States. On an annualised basis, quarterly US GDP growth has exceeded 2% since 2022 Q3, and most recently came in at 2.1% for Q2. For Q3, even more pessimistic forecasts anticipate growth to accelerate further. The New York Fed's nowcast is tracking at 2.5%, the Bloomberg consensus forecast is at 4.1%, and the Atlanta Fed's GDPNow model points even higher at 5.4%. In other words, as Canada stagnates and faces a looming recession, the US economy looks set to strengthen further from an already-solid pace of growth. The implications for monetary policy are considerable, since the market-implied policy paths for the Bank of Canada and Federal Reserve are similar over the near term but see the former as more hawkish in 2024. Given the divergent growth outlooks between the two economies, we view this as being seriously mispriced. It is true that rhetorically the BoC has been marginally more hawkish of late, with Governor Macklem dismissing the idea that higher market yields could substitute for policy tightening even as multiple Fed officials suggested otherwise. It is also true that year-to-date progress on cooling underlying inflation measures in Canada has generally lagged the US.

"But fundamentally, Canada is both more sensitive to interest rates due to its reliance on shorter mortgage terms and faces a considerably more pessimistic growth outlook, indicating that inflation will likely break lower in Canada at a quicker pace than markets are discounting, while US inflation could ultimately prove more persistent."

We currently expect the Federal Reserve to begin gradually easing monetary policy in the middle months of 2024, and if the drag on Canadian growth proves sufficiently disinflationary, the Bank of Canada will likely be forced to cut rates earlier and more aggressively than the Fed. Once interest rate differentials widen to reflect this, we expect considerable downward pressure on the Canadian dollar to follow. In our view, this could see USDCAD break back above the 1.40 level, and this is more likely to occur in the early parts of 2024 as structural pressures are set to weigh on the US dollar from Q2 onwards, as per our latest forecasts.

Low-paying industries generally faced more severe labour shortages and have seen stronger job and wage growth this year

	Share of GDP	Relative wage level	Vacancy rate (January)	Vacancy rate (July)	GDP growth (Jan. to Jul.)	Job growth (Jan. to Jul.)	Wage growth (Jan. to Jul.)
All industries	**100.0**	**1.0x**	**4.8**	**3.9**	**0.0**	**2.9**	**1.8**
Goods sector	**27.9**	**1.2x**	**4.1**	**3.5**	**-0.8**	**9.4**	**0.6**
Agriculture, forestry, fishing and hunting	1.9	1.1x	5.0	4.1	-7.3	26.6	-7.8
Mining, quarrying, and oil and gas	7.7	1.8x	3.7	3.5	2.4	5.3	-6.3
Utilities	2.0	1.8x	2.1	2.2	-1.1	5.3	0.9
Construction	7.1	1.2x	5.7	5.0	-2.4	16.8	2.6
Manufacturing	9.4	1.1x	4.1	3.3	-0.2	4.9	0.8
Services sector	**71.8**	**1.0x**	**4.2**	**3.3**	**0.4**	**1.6**	**1.7**
Wholesale trade	5.1	1.2x	3.5	3.3	-2.4	2.4	2.9
Retail trade	5.1	0.6x	4.6	6.5	-2.7	2.9	5.4
Transportation and warehousing	4.1	1.1x	5.2	4.4	0.1	0.1	4.5
Information and culture	3.5	1.4x	4.1	2.5	0.2	-0.8	1.7
Finance and insurance	7.4	1.3x	3.7	2.5	0.2	1.0	-3.3
Real estate, and rental and leasing	13.1	1.0x	3.9	3.2	1.8	3.8	-8.0
Professional, scientific and technical services	6.6	1.4x	4.2	3.3	0.6	2.2	2.5
Management of companies and enterprises	0.1	1.4x	3.1	1.7	-13.6	0.7	6.8
Administrative and support services	2.4	0.9x	5.8	4.9	-0.3	5.2	6.1
Educational services	5.4	1.0x	1.6	1.3	1.3	-19.5	5.0
Health care and social assistance	7.4	0.9x	6.3	5.7	1.0	3.2	1.5
Arts, entertainment and recreation	0.7	0.6x	5.0	3.6	1.5	31.9	1.8
Accommodation and food services	2.0	0.4x	8.5	5.7	-1.2	10.3	7.5
Other services	1.9	0.9x	6.5	5.4	0.7	4.6	4.7
Public administration	7.1	1.3x	2.7	2.8	1.5	6.6	-0.5

General disclosure

This material, including, any statistical information, is provided for informational purposes only. It does not constitute advice and you should seek independent advice if necessary.

The material is based upon information which we consider reliable, but may not be accurate or complete, and therefore should not be relied upon. Any estimates and forward-looking statements, or forecasts do not represent a guarantee of future performance. The opinions expressed are as of January 2023 and subject to change. Reliance upon information in this material is at the sole discretion of the reader. No permission is granted to reprint, sell, copy, distribute, or modify this material, in any form or by any means except with the written permission of Monex Europe Limited.

Monex Europe Limited ("Monex Europe") is part of the wider financial services group, Monex S.A.P.I. de C.V. (formerly Monex S.A.B. de C.V.) ("Monex"), a global investment-grade financial services institution.

Part of the Monex group, Monex Europe Limited is headquartered in London (UK) and is an independent subsidiary of Monex Europe Holdings Limited. Monex Europe Holdings Limited operates various other subsidiaries in the FX industry; in the UK, Monex Europe Markets Limited; Monex Europe S.A. in Luxembourg, Spain and The Netherlands; Monex Canada Inc. in Toronto; and MonFX Pte Ltd in Singapore.

Not all products and services are available in all jurisdictions. Details of the different entities can be found at www.monexeurope.com/contact-us. Further information on the respective entities' regulated status and available products and services can then be found on the relevant links to the individual jurisdictions' website.

Market specific disclosures

United Kingdom: This document is distributed in the U.K. by Monex Europe Limited ("Monex Europe") and Monex Europe Markets Limited ("Monex Europe Markets"). Monex Europe Limited is authorised and regulated by the Financial Conduct Authority (FCA) under the Payment Services Directive (PSD) as an Authorised Payment Institution – firm registration number 463951. Monex Europe Markets Limited is an authorised and regulated investment firm, FCA reference number 596146. Monex Europe Markets only transacts business with clients who have been categorised as Professional or Eligible Counterparties. Foreign exchange options and other derivative products are not suitable for everyone and may present a high level of risk to your capital. You should seek independent advice if necessary. This communication has not been reviewed by the Financial Conduct Authority. It is for information only and does not constitute investment advice, or an offer to sell, or a solicitation of an offer to buy any investment product or service.

European Economic Area (EEA): This document is distributed in the EEA by Monex Europe S.A., a company registered in Luxembourg with registration number B230160 and has its registered office at 35 Avenue Monterey, L-2163 Luxembourg. Monex Europe S.A. is authorised and regulated by the Commission de Surveillance du Secteur Financier as a payment institution. Licence number 16/20 and regulatory identification number Z00000023. The entity delivers services to clients across Europe. This communication has not been reviewed by the CSSF. It is for information only and does not constitute investment advice, or an offer to sell, or a solicitation of an offer to buy any investment product or service.

Canada: This document is distributed in Canada by Monex Canada Inc. ("Monex Canada"). Monex Canada is a registered extra-provincial company under the Canada Business Corporations Act. Corporation number: 884479-8. Registered address: 199 Bay Street, Suite 4000, Toronto, Ontario, M5L 1A9. Monex Canada is registered with the Financial Transactions and Reports Canada is registered with both the Financial Transactions and Reports Analysis Centre of Canada ("FINTRAC") and the Revenu Quebec. In Toronto, Ontario, Monex Canada is registered as a MSB with FINTRAC and holds registration number M17698932. Additionally, Monex Canada holds a license from Revenu Quebec with license number 11642. This communication has not been reviewed by FINTRAC. It is for information only and does not constitute investment advice, or an offer to sell, or a solicitation of an offer to buy any investment product or service.

Singapore: This document is distributed in Singapore by MonFX Pte Ltd ("MonFX"). MonFX Pte Ltd is licensed and regulated by the Monetary Authority of Singapore as a Major Payment Institution under the Payment Services Act 2019 and as a Capital Markets Services Licence holder under the Securities and Futures Act 2001. MonFX Pte Ltd is a company registered in Singapore with registration number 201611101E and has its trading address as Asia Square Tower 2, #23-01, 12 Marina View, Singapore 018961. The entity delivers services to clients across Singapore and other APAC countries. This communication has not been reviewed by the Monetary Authority of Singapore. It is for information only and does not constitute investment advice, or an offer to sell, or a solicitation of an offer to buy any investment product or service.

Copyright © 2023 Monex Europe Holdings Limited/or its affiliates. All rights reserved.