MACRO MORNING BRIEFING

iFlow

January 10, 2025

Canadian Dollar Update

- With political uncertainty in Ottawa, CAD will come under renewed pressure as Trump rhetoric strengthens
- BoC policy divergence from the US will play a fundamental role in its further weakness
- Flows into the loonie picked up last week, but are unlikely to lead to material strengthening
- CAD weakness has much to do with USD strength; against a basket of non-dollar currencies, CAD remains solid

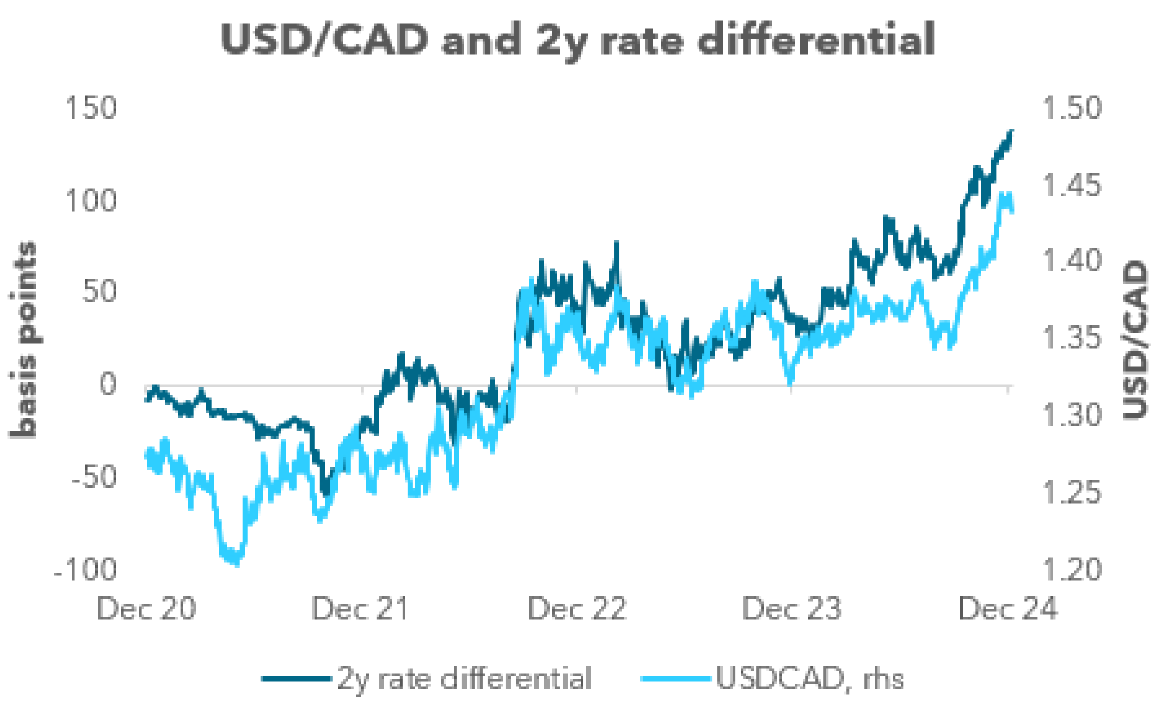
Electoral politics won't affect CAD that much

Since the new year, political developments in Canada have focused attention on the exchange rate. The reaction on Monday last week when PM Trudeau formally announced his resignation saw a brief but noticeable rally in the loonie, with USD/CAD down to 1.43, a cent lower than its close on Friday January 3. We don't think in the short to medium term that electoral developments will drive much CAD strength from here. Divergent central bank paths, a weaker fundamental setup in Canada than in the US, and positioning do not auger well for a stronger currency, and it's more likely to see further CAD weakness from here, unrelated to the political evolution of the country. In addition, political uncertainty in Ottawa right when Canada becomes the subject of strong rhetoric from President-elect Trump provides an additional source of currency uncertainty and volatility.

The rhetoric obviously comes at an unfortunate time, given the political stasis in Canada currently. Without a standard bearer to address Canadian economic and even sovereignty concerns, an opportunity to react strongly to the threats from Ottawa is being missed. Until the Liberal Party appoints a leader to succeed Trudeau, he will be a lame duck. Leadership contests cannot take place until Parliament reconvenes in March. Another 60 days must pass before the election is held, meaning May is the earliest we can expect a new government. The Conservative Party of Pierre Poilievre is heavily favored in the polls – at more than 40%, but below the 50% that would be required for the party to govern without being in a coalition. This sets up CAD for a period of uncertainty, emanating from both sides of the border. We see USD/CAD weakening to and possibly even through 1.46 in the near future.

It isn't just political and trade policy uncertainty that should cause the currency some jitters. We think the Bank of Canada will persist in its rate cutting cycle, including a 25bp cut at the end of this month. Presently, interest rate differentials are the dominant driver of CAD weakness, as Exhibit #1 below shows. The spread between the US 2y yield (a simple proxy for monetary policy expectations) and that of Canada is as high (approx. 135bp) as it's been since early 2007, and the currency pair is closely following the evolution of this spread.

Exhibit #1: Monetary Policy Divergence Is Main USD/CAD Driver



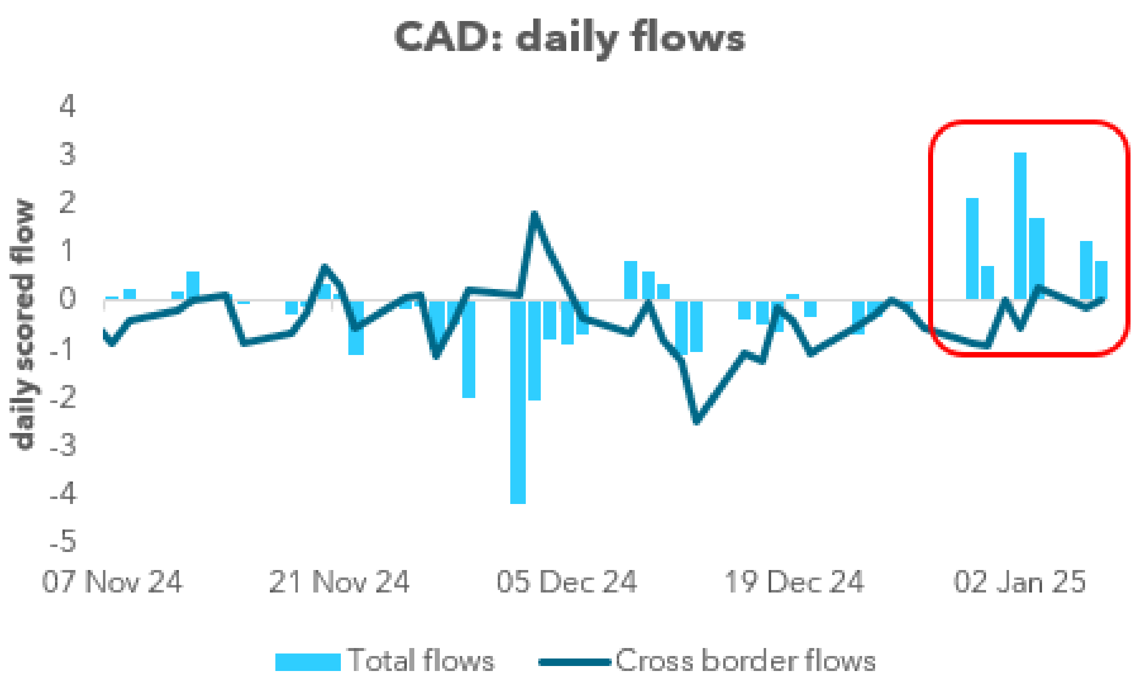
Source: BNY Markets, Bloomberg

Nevertheless, iFlow observed seven straight days of CAD buying commencing on New Year's Day and persisting though the end of last week, although this trend looks to have peaked a few days prior as the Trudeau decision became imminent. More notably, these flows largely reflect domestic buying, rather than cross-border inflows, suggesting that locals onshore in

Canada are putting on CAD hedges rather than expressing an overtly bullish view on the currency. See Exhibit #2.

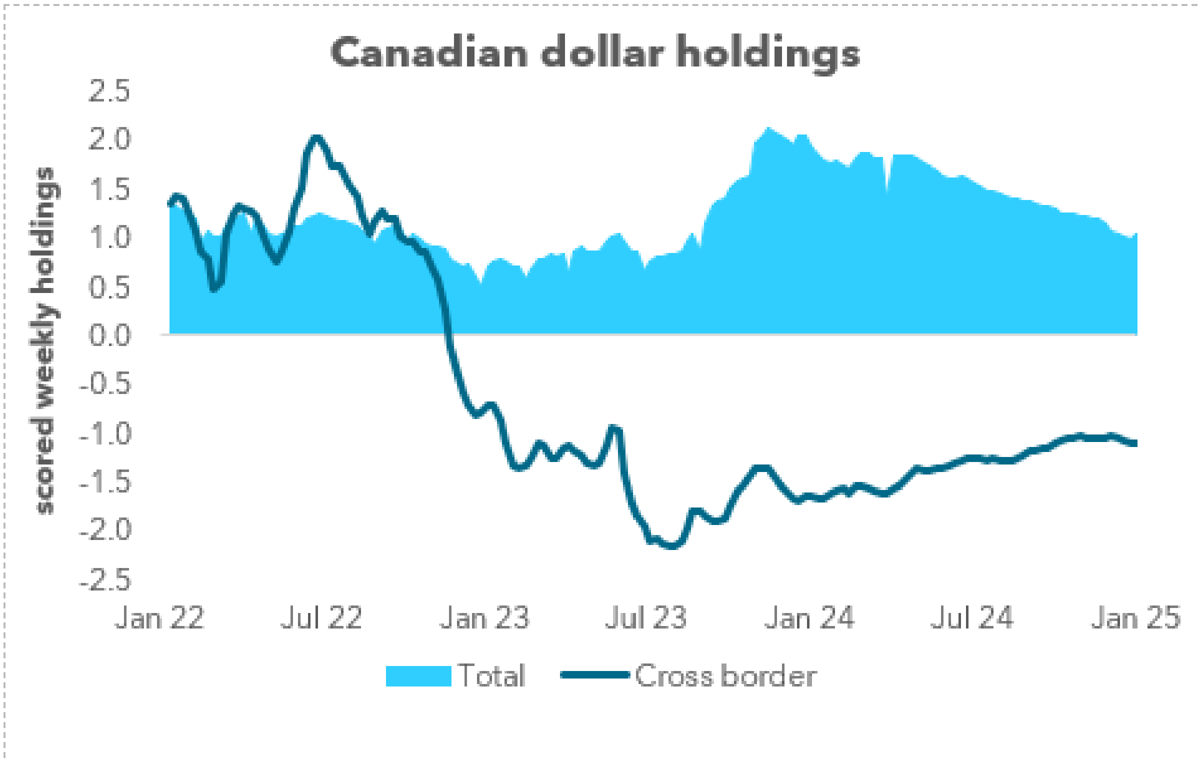
Positioning is relatively unmoved. As we have frequently discussed, holdings of CAD have remained elevated, but again reflect mostly domestic money hedging overseas asset exposure back into loonies. Cross-border (mostly US-based) investors remain well short the currency, as can be seen in Exhibit #3. This suggests no major sentiment change for CAD, and therefore we think the weakening trend is not in danger of any unwind in cross-border shorts or adding to locally held positions.

Exhibit #2: Recent Pick-up in CAD Flows...



Source: BNY Markets, iFlow

Exhibit #3: ...Betrays Significant Cross-border Shorts



Source: BNY Markets, iFlow

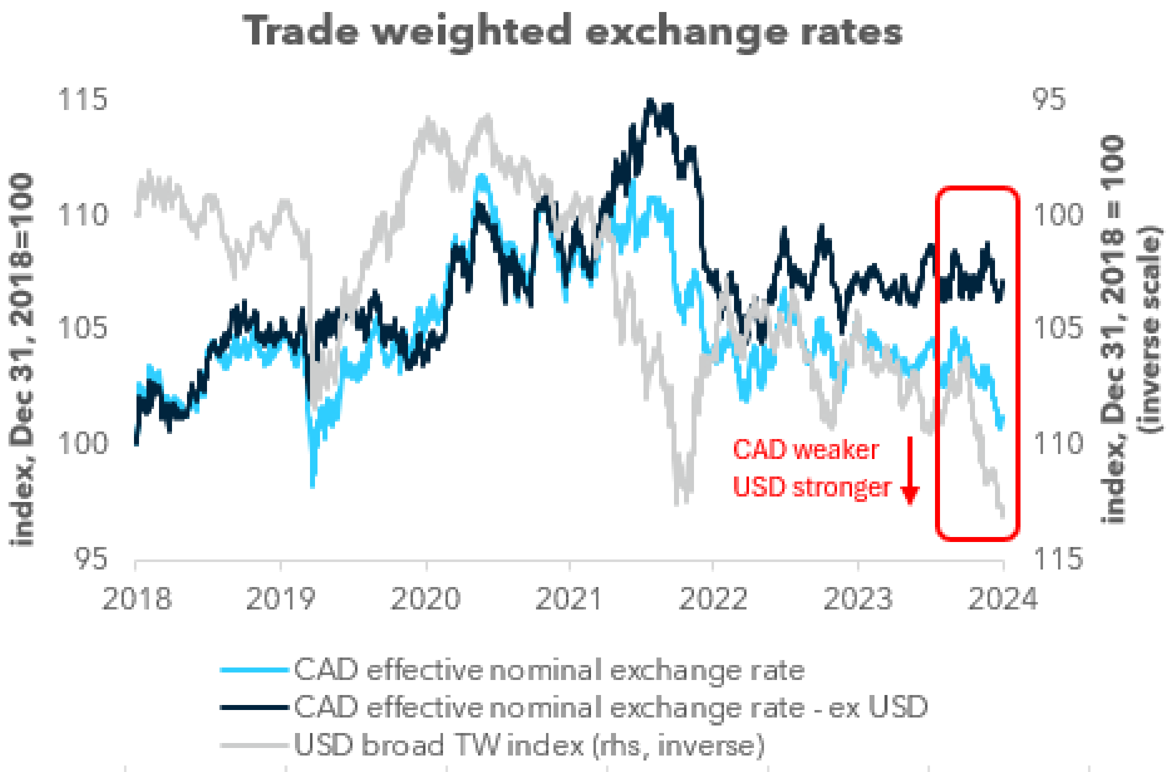
CAD not so weak against non-USD crosses

What's interesting in our mind, is that the Canadian dollar isn't particularly weak against non-dollar currencies (see Exhibit #4). We're loathe to put so many series on one diagram, but we think the information is revealing. We plot two BoC measures of the effective (i.e., trade-weighted) exchange rate, one including the USD in its calculation – the light blue line, and one ex-USD – the dark line. Ex-USD, the loonie is much stronger than it is if we were to look at the broader measure with the US dollar in its basket. This suggests that versus non-dollar crosses CAD has held up quite well over the past two years. When the USD is in the equation, the Bank's effective exchange rate has clearly depreciated much further since the end of 2022. CAD weakness is very much USD strength.

Finally, in the chart look at the gray line, which is the Bank for International Settlements' broad nominal exchange rate for the US dollar – again a trade-weighted measure, this time produced out of Basel. The extent of dollar appreciation is remarkable. Note that we have inverted this time series, so that it aligns directionally with the BoC's indices. A lower gray line indicates a stronger greenback, and a lower blue or black line indicates a weaker CAD. The point here is that the USD is obviously at an impressively strong level, stronger than the broad Canadian dollar is weak.

In conclusion, while we do understand the short-term reaction in both the USD/CAD exchange rate and in onshore flows, we don't think this is indicative of a change in direction in CAD, but rather just a short-term interruption in a broad weakening trend. Canadian politics per se will have less of an effect on CAD than troubling US rhetoric will, and less of an effect than divergent monetary policies and economic prospects.

Exhibit #4: Take the USD Away, and You Have a Solid Currency



Source: BNY Markets, Bank of Canada, Bank for International Settlements

Please direct questions or comments to: iFlow@bny.com

Disclaimer & Disclosures

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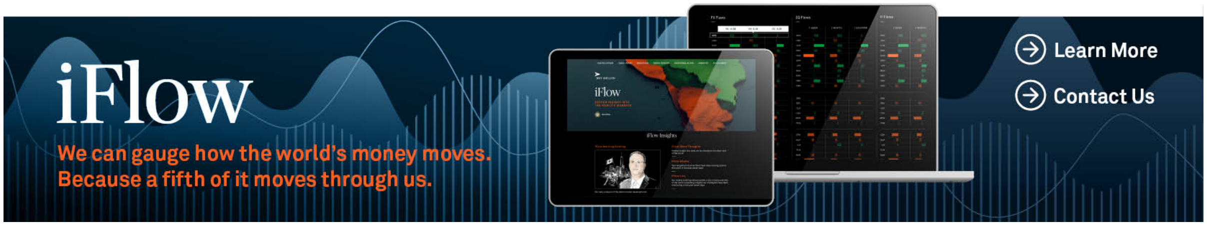

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