



## Highlights

By Stéfane Marion/Kyle Dahms

- The trade-weighted U.S. dollar index continues its inexorable rise in the fourth quarter. Jerome Powell is certainly no stranger to this situation. Playing Icarus by keeping monetary policy and the exchange rate in the stratosphere, Mr. Powell could get burned. A Fed pivot may still be in sight, but for that to happen, inflation must fall. Based on empirical evidence, upcoming inflation reports should show a tangible deceleration for the price of consumer goods.
- The loonie continues to struggle as we enter the home stretch of the year. While much of this weakness reflects the strength of the USD, the Bank of Canada (BoC) helped clipped the loonie's wings by failing to meet market expectations with a smaller-than-expected 50 basis point increase in its policy rate on October 26. With inflation cooling faster in Canada than in the U.S. and the BoC unlikely to overtake the Fed in the coming months we do not see opportunities for a significant strengthening of the CAD against the USD until an FOMC pivot. Subsequently, we see the possibility of a significant appreciation of the CAD against the greenback to reflect Canada's improved economic growth profile driven by upgraded immigration targets.
- The euro ended the month of October a penny higher than a month ago. We continue to expect the currency to reflect the weak outlook over the next two quarters but do not discount the possibility of a Fed pivot before the second half of next year that could set the stage for a modest rise in EUR/USD.
- A swivel towards fiscal rectitude has stemmed the sell-off in the Pound which ended October trading within the range prior to Truss' proposals. That is not to say that the challenges facing Albion have subsided. Austerity and tax hikes by the new Prime Minister combined with tighter monetary policy and a slowing economy are not desirable traits for a significant appreciation of the GBP.

## NBF Currency Outlook

Currency		Current	Forward Estimates			PPP <sup>(1)</sup>	
		October 31, 2022	Q4 2022	Q1 2023	Q2 2023		Q3 2023
<b>Canadian Dollar</b>	<i>(USD / CAD)</i>	<b>1.36</b>	<b>1.39</b>	<b>1.36</b>	<b>1.30</b>	<b>1.25</b>	<b>1.25</b>
<i>United States Dollar</i>	<i>(CAD / USD)</i>	<i>0.73</i>	<i>0.72</i>	<i>0.74</i>	<i>0.77</i>	<i>0.80</i>	-
Euro	<i>(EUR / USD)</i>	0.99	0.97	0.99	1.03	1.05	1.45
Japanese Yen	<i>(USD / JPY)</i>	149	146	140	132	125	99
Australian Dollar	<i>(AUD / USD)</i>	0.64	0.64	0.67	0.71	0.74	0.67
Pound Sterling	<i>(GBP / USD)</i>	1.15	1.12	1.14	1.16	1.18	1.48
Chinese Yuan	<i>(USD / CNY)</i>	7.30	7.10	6.95	6.85	6.70	4.2
Mexican Peso	<i>(USD / MXN)</i>	19.8	20.5	20.0	19.5	19.5	9.7
<b>Broad United States Dollar <sup>(3)</sup></b>		<b>127.0</b>	<b>128.1</b>	<b>125.1</b>	<b>121.1</b>	<b>118.3</b>	-

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

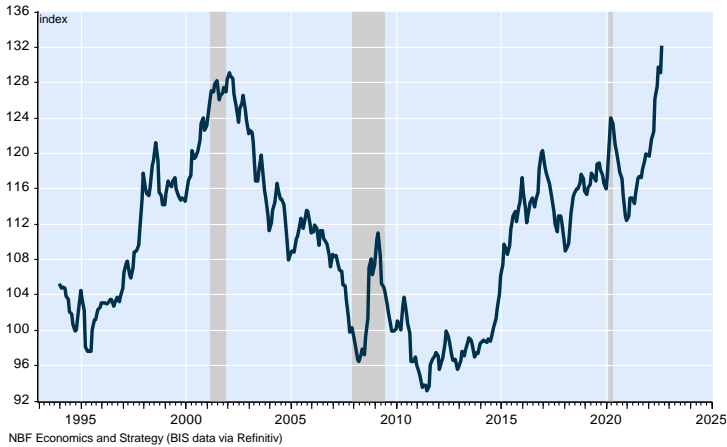
Currency		Current	Forward Estimates			
		October 31, 2022	Q4 2022	Q1 2023	Q2 2023	Q3 2023
Euro	<i>(EUR / CAD)</i>	1.35	1.35	1.35	1.34	1.31
Japanese Yen	<i>(CAD / JPY)</i>	109	105	103	102	100
Australian Dollar	<i>(AUD / CAD)</i>	0.87	0.89	0.91	0.92	0.93
Pound Sterling	<i>(GBP / CAD)</i>	1.57	1.56	1.55	1.51	1.48
Chinese Yuan	<i>(CAD / CNY)</i>	5.35	5.11	5.11	5.27	5.36
Mexican Peso	<i>(CAD / MXN)</i>	14.6	14.7	14.7	15.0	15.6

## USD: Up, up and away?

The trade-weighted U.S. dollar index continues its inexorable rise in the fourth quarter. After adjusting for inflation, the real effective exchange rate is stronger than ever – chart.

### U.S.: The greenback at a generation high

Real-effective USD index

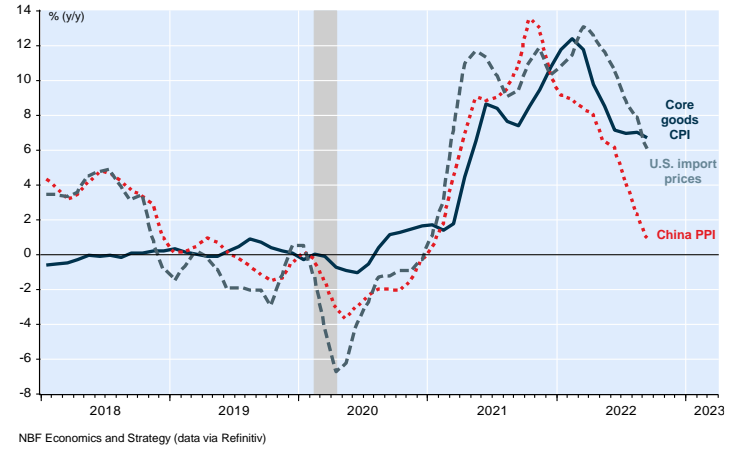


Jerome Powell is certainly no stranger to this situation. As expected, the U.S. Federal Reserve raised the federal funds rate by 75 basis points on November 2 to 4 percent. Although the rate statement apparently adopted a more pragmatic tone, markets were quickly disabused about a near-term policy pivot at Jerome Powell's press conference. Indeed, the Fed Chair said that "it's very premature to be thinking about pausing" the monetary tightening campaign. In fact, he even argued that the guidance the Fed gave last September might not be high enough. As **argued** by our rate strategists, it appears that the Fed is inclined to hike for longer and to a higher level in early-mid 2023. Playing Icarus by keeping monetary policy and the exchange rate in the stratosphere, Mr. Powell could get burned. A Fed pivot may still be in sight, but for that to happen, inflation must fall.

Based on empirical evidence, upcoming inflation reports should show a tangible deceleration for the price of consumer goods. China, which accounts for about 30 percent of global manufacturing output, recently reported that the price inflation achieved by its producers plunged from 14 percent at the end of last year to just 1 percent currently. In the past, this has been accompanied by a decline in U.S. import prices and in the CPI for basic goods – chart.

### U.S.: China will help lower CPI inflation

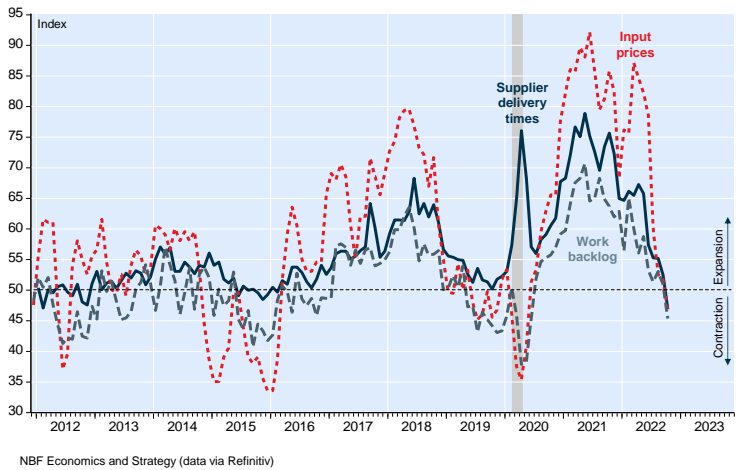
China PPI, U.S. import prices and U.S. core goods CPI



There is growing evidence that inflationary pressures in the U.S. manufacturing sector are easing. A majority of companies now report lower input prices, shorter supplier lead times and reduced backlogs – chart.

### U.S.: Inflationary pressures are receding

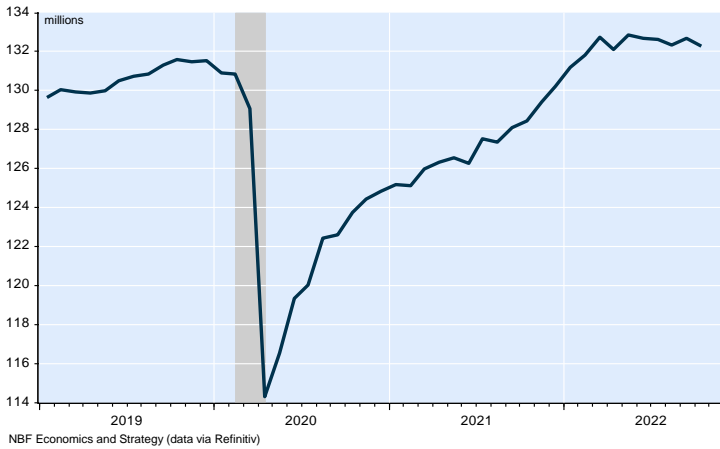
ISM Manufacturing PMI



Of course, inflation will not cool on a sustainable basis if labour markets remain tight. Here too, developments are encouraging. Even though payroll jobs rose a robust 261K in October, the household survey showed a significant decline in full-time employment during the month. As corporations grow wary about their profit outlook, full-time jobs have stalled in recent months – chart.

**U.S.: Full-time jobs are stalling**

Full-time employment



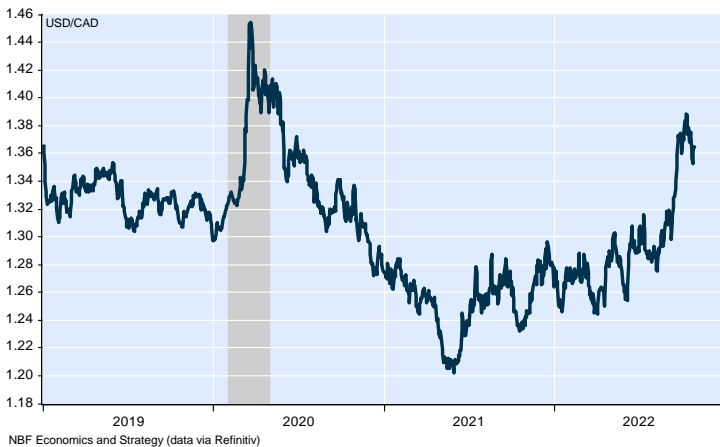
The above developments suggest below-trend growth and slower inflation in the months ahead. If we are correct, we can expect a policy change from the FOMC in the first quarter of 2023, which would set the stage for a weaker U.S. dollar in 2023.

**CAD: BoC surprises markets**

The loonie continues to struggle as we enter the home stretch of the year with USD/CAD hovering near 1.36, the worst performance since the COVID recession – chart.

**USD/CAD: Worst performance in over two years**

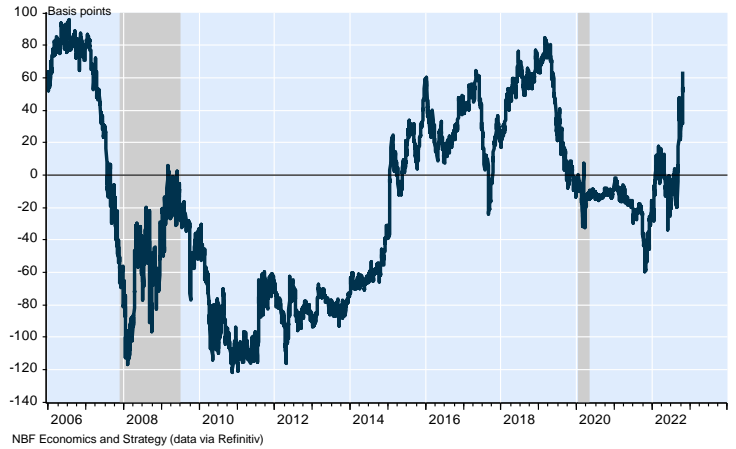
Canada-U.S. exchange rate (as of Nov 1, 2022)



While much of this weakness reflects the strength of the USD, the Bank of Canada (BoC) helped clipped the loonie's wings by failing to meet market expectations with a smaller-than-expected 50 basis point increase in its policy rate on October 26. The move triggered a rally in the Canadian Treasury market, with U.S.-Canada interest rate spreads (a key determinant of the exchange rate) reaching their highest levels since 2018 – chart.

**CAD: Interest rate spreads surge**

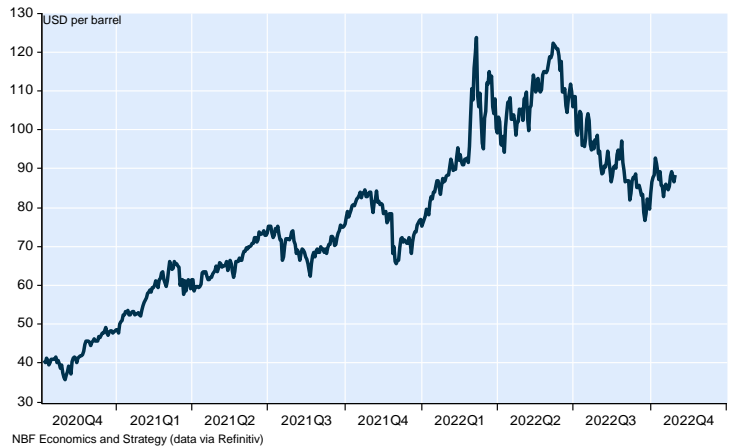
U.S.-Canada interest rate spread on 2-year Treasuries (as of Nov 1, 2022)



As our rate strategists [explain](#), the BoC's decision make clear that monetary policy is now willing to weigh the risks of over- vs. under-tightening after unveiling new forecasts for much weaker growth (but no recession). Despite the smaller move relative to consensus expectations and market pricing, the Bank limited the damage to the CAD by stating that some further tightening will be necessary. Commodity prices also helped limit the loonie's decline, with a rebound in WTI – chart.

**Canada: Oil prices have rebounded**

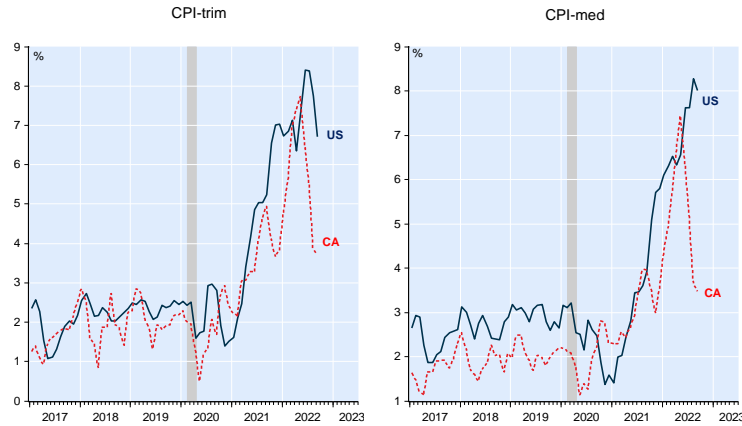
Price of WTI (as of Nov 1, 2022)



With inflation cooling faster in Canada than in the U.S. and the BoC unlikely to overtake the Fed in the coming months we do not see opportunities for a significant strengthening of the CAD against the USD until an FOMC pivot, which we expect in H1 2023.

### Canada: Core inflation softer this side of border

3-month annualized change in core inflation measures

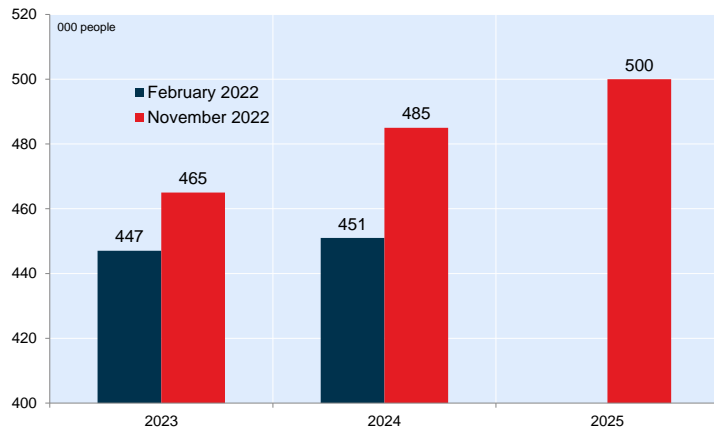


NBF Economics and Strategy (data via Statistics Canada, Fred)

Subsequently, we see the possibility of a significant appreciation of the CAD against the greenback to reflect Canada's improved economic growth profile. On November 1, Ottawa announced that it was raising its immigration target to 500,000 per year by 2025 (chart).

### Canada: Sharp revisions to (already elevated) immigration targets

Permanent resident admissions target released in February and November 2022



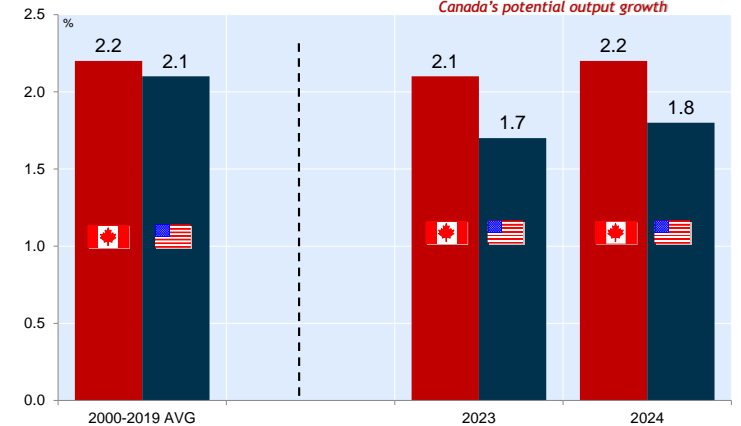
NBF Economics and Strategy (data via Government of Canada)

Since the vast majority of these newcomers will be economic immigrants, the impact on potential GDP growth is notable. According to the latest BoC projections, potential output growth in Canada is expected to exceed that of the United States by about ½ percentage point over the forecast horizon (chart).

### Canada: Potential GDP growth to exceed that in the U.S.

Potential real GDP growth: Canada vs. the U.S.

*Net immigration to account for over two-thirds of Canada's potential output growth*



NBF Economics and Strategy (data from Bank of Canada October 2022 Monetary Policy Report)

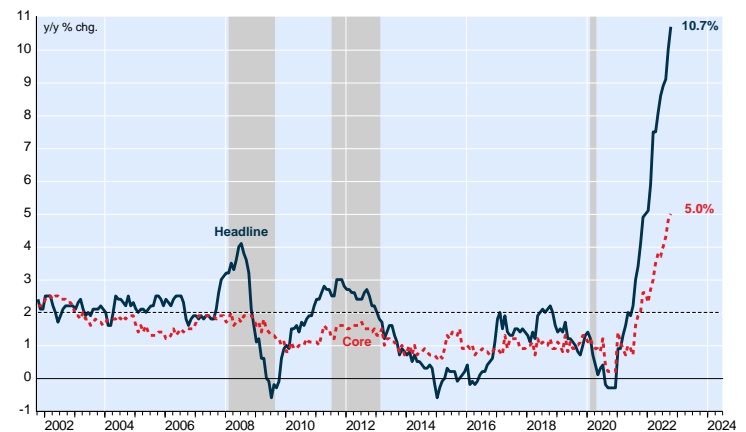
Stronger potential growth in Canada would also argue for a higher policy rate than in the U.S. once we overcome the current economic downturn. If, as we expect, material progress on inflation is secured in the coming months and U.S. monetary policy can be made less restrictive before too much damage to the global economy is done, the outlook for CAD may prove far less problematic than some now fear. We still see USD/CAD at 1.39 at the end of Q4 22 and at 1.30 at the end of Q2 23.

## EUR: Double-digit inflation!

The euro ended the month of October a penny higher than a month ago. That is not to say there was no action on the currency. The common area currency approached September lows only to bounce back above parity for a brief period. These variations and depreciated level reflect not only a deteriorating internal outlook but are also inflected by U.S. monetary policy. Prices pressures have yet to abate in Europe with each subsequent inflation print bringing with it new all-time highs (chart).

### Eurozone: Inflation hits new all-time high

Harmonized index of consumer prices

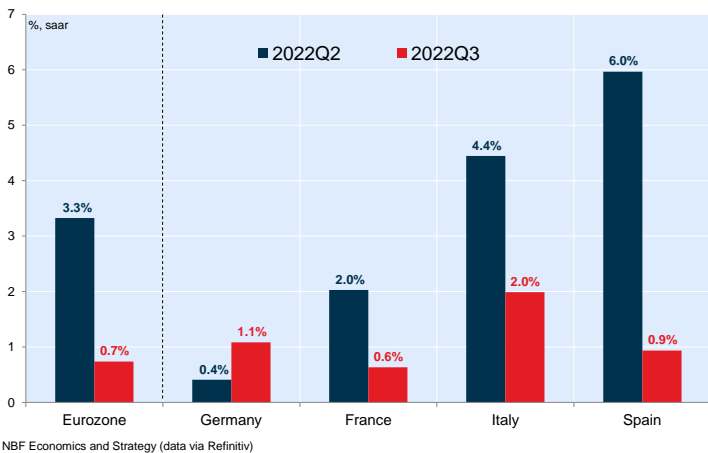


NBF Economics and Strategy (data via Bloomberg)

Unsurprisingly, the European Central Bank opted for another jumbo 75bps rate hike in the last week of October. Rates in the eurozone are now at their highest since 2009. Still, the announcement and ensuing press conference were not hawkish and provided little lift to the flailing currency. Indeed, the statement reiterated that inflation was “far too high”, but it also indicated that the Governing Council had made “substantial progress in withdrawing monetary policy accommodation”. Moreover, the text no longer mentioned that rates would have to rise “at the next several meetings” but stated instead that borrowing costs would have to be increased “further”. At the press conference, ECB president Christine Lagarde sounded rather dovish, stating that economic activity in the Eurozone was “likely to have slowed significantly in the third quarter” and the possibility of a recession had grown. She did not completely discard additional hikes by saying that they still had “more ground to cover” in terms of monetary tightening.

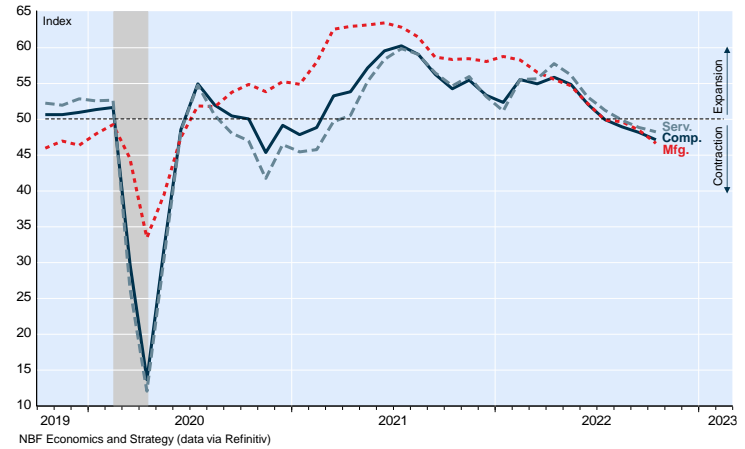
But that ground is starting to look like a minefield. As alluded to in the ECB press conference, Eurozone growth in the third quarter has slowed significantly, registering at 0.7% annualized following a 3.3% print in the second quarter. Although Germany saw a slight improvement in the latest data, the manufacturing sector will surely be weighed down by energy costs and potential rationing in the coming months (chart).

**Eurozone: Sharp slowdown in growth in Q3... worse yet to come**  
Change in real GDP



The latest GDP figures are consistent with Markit PMI data that we have been tracking over the last few months. The latter showed that private sector activity is contracting for both the services and manufacturing subsectors. With households seeing buying power dwindle, a declining wealth effect and increasing interest payments, the worse is yet to come. As such, the outlook for consumption and the broader economy are negative.

**Eurozone: Private sector downturn accelerates**  
Markit Flash PMI. Last observation: October 2022



Where does this leave the forecast? We continue to expect the currency to reflect the weak outlook over the next two quarters but do not discount the possibility of a Fed pivot before the second half of next year. Assuming some improvements on inflation and the geopolitical front, that could leave some room for Euro appreciation later in our forecast horizon.

## GBP: Who wants to be PM?

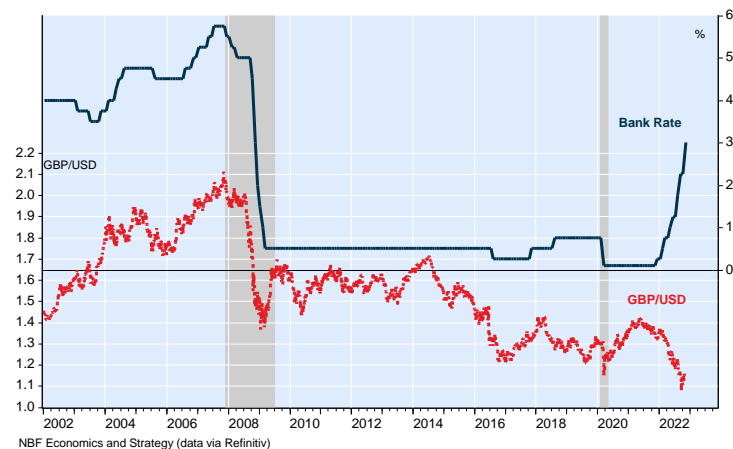
The political trials and tribulations of the island nation are now the thing of record books. Liz Truss has managed to snag the unwanted trophy of shortest tenure of Premiership. Looking beyond produce comparisons, the U.K. now finds itself in the hands of Rishi Sunak ex-Chancellor of the Exchequer (finance minister). A swivel towards fiscal rectitude has stemmed the sell-off in the Pound which ended October trading within the range prior to Truss' proposals.

That is not to say that the challenges facing Albion have subsided. The backdrop of elevated inflation and declining growth are themes that are and will continue to be critical. The latest meeting by the Bank of England reflected the difficulty in treading those waters. The announcement marked the largest interest rate hike in 33 years and brought the bank rate to 3.0%, the highest level in 14 years (chart).



**U.K.: Pound remains subdued despite jumbo hike**

BOE Bank Rate and GBP/USD Last observation: November 2022



Still, the central bank cautioned markets that the path for future tightening would likely fall below expectations. The BOE was forthright in regard to market anticipations, relaying that reaching the peak forecasted by the latter would push GDP down 3% and bring inflation to zero. An approach closer to the current rate level would allow for a briefer and less intense recession with inflation eventually moderating over the next 24 months. In a press conference, BOE Governor Andrew Bailey framed this with the intention of easing pressure on mortgage interest rates which have significantly surged.

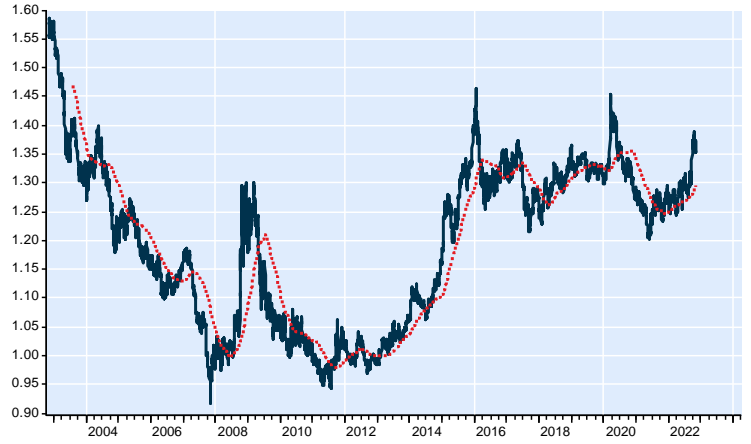
As of the meeting, the Pound is trading lower with interest rates paring down. Still, the UK central bank must certainly be lauded for its transparency in this latest announcement. They have provided clear communication to markets while remaining grounded in a realistic if somewhat gloomy framework. With the rate hike path for the BOE now lower, we expect the currency to remain depressed until we get a blink from the Fed. Even then, austerity and tax hikes by the new Prime Minister combined with tighter monetary policy and a slowing economy are not desirable traits for an appreciation.

## Appendix: Spot rates with their 200d MA

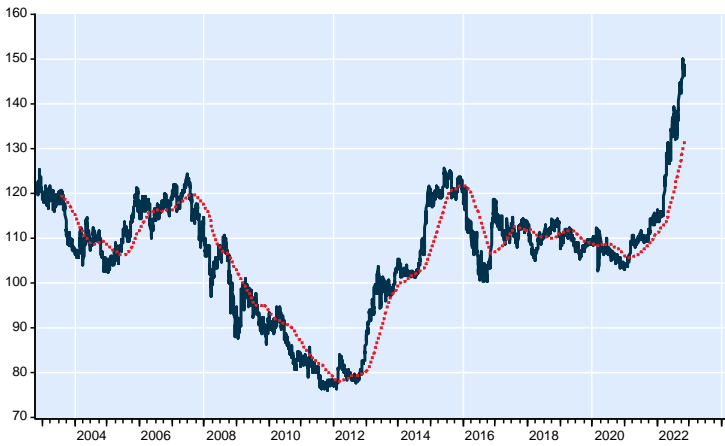
### EUR / USD



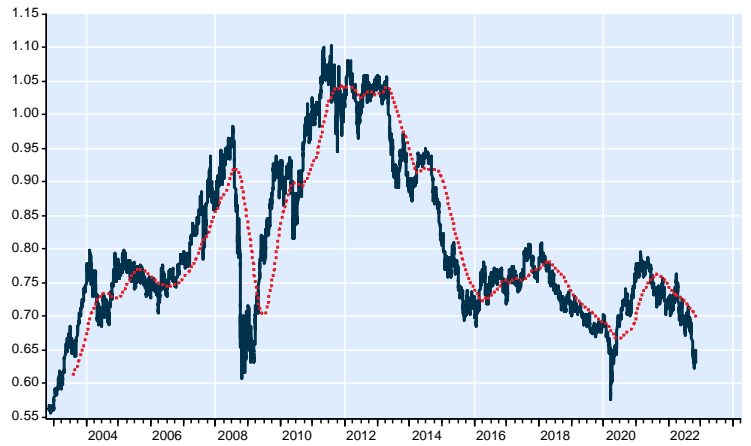
### USD / CAD



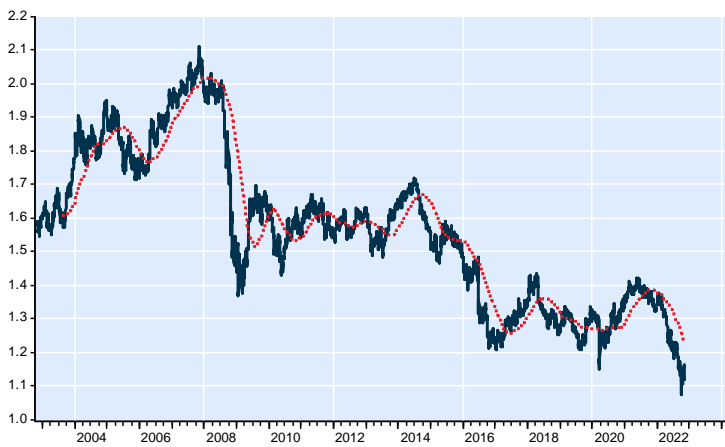
### USD / JPY



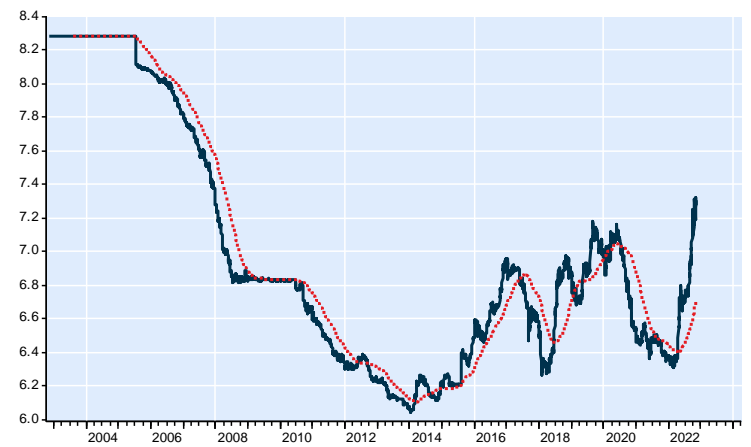
### AUD / USD



### GBP / USD



### USD / CNY



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