Market Perspectives

PRIVATE CLIENT SOLUTIONS

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Making 'Cents' of Currency Markets

The global foreign exchange (FX) market sees roughly US$6.6 trillion in daily trading activity, yet as an asset class it is often spared thorough analysis by portfolio managers. As Canadian investors in an increasingly global economy, the movement in the Canadian dollar, aka the Loonie, has considerable impact on the value of our investments from our foreign denominated stocks. FX revenue generated by domestic companies also impacts their bottom lines. So what has been happening in FX markets given recent events?

- Since the beginning of the year, G10 Central Banks have collectively slashed overnight lending rates by 615 basis points (bps) while simultaneously injecting trillions of dollars into public markets, with a combination of primary and secondary market operations, in order to keep the liquidity wheel well-oiled. In the shorter term, we expect FX markets to be hyper-focused on changes to the tone of central bank messaging and how that will spillover to risk assets. Further out past the pandemic, the size of Central Bank balance sheets will be sharply scrutinized.
- As the world's reserve currency, the USD has been utilized by many global investors as an asset to turn to in periods of deteriorating risk sentiment. As such, the market's perception of macroeconomic risk has by and large been the primary driver of USDCAD performance since mid-March (as well as performance of the other majors). We gauge risk sentiment by looking to the S&P500 Index, which bottomed on March 23 when concerns regarding COVID-19's impact were at their highest.
- Given the massive amount of USD liquidity injected into the system courtesy of the Fed, it ought to have a negative effect on the USD. After rising 8.80% back in mid-March, the DXY US Dollar Index is now down +6% at the time of writing and effectively right back at January 2020 levels.
- So where do we go from here? Our view is that the abundance of global USD liquidity will eventually weigh on the USD and halt its momentum. However, as the situation stands right now, the high correlation between NA equities and USDCAD will be the single-most significant driver. Forget (for now) the days when oil, yields and economic data played a significant factor in direction. In the current environment, CAD will continue to be a slave to broader risk sentiment.

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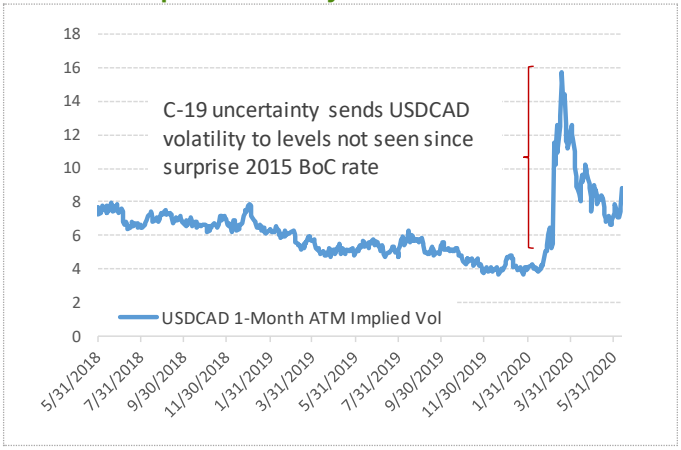
Year-to-date, the Swiss Franc (CHF) and Japanese Yen (JPY) have been the strongest performing G10 currencies against the US Dollar (USD), reflecting their safe-haven demand during the mid-March market panic. Indeed, the scramble to safety ensuing from the rapid spread of COVID-19 impacted currency markets in ways that even our most seasoned peers across the Street had not seen. For example, the US Dollar Index (DYX), which tracks the USD against a basket of global peers, saw average daily movements that were roughly three times as large as those seen in the past 20 years. The USDCAD pair similarly saw daily price swings nearly four times as high as the 20 year average. As volatility peaked, we saw spreads widen exponentially and intra-second moves were swinging by more than a few pips on occasion. Since then, markets have calmed on a relative basis, though it has not made it easier to gauge medium-term direction given the swath of risks that lay ahead of us. In this report we will attempt to parse through what has happened in global currency markets over the past few weeks, with emphasis on the Loonie, by answering some of the more prevailing questions we have received on the FX Desk.

USDCAD Implied Volatility

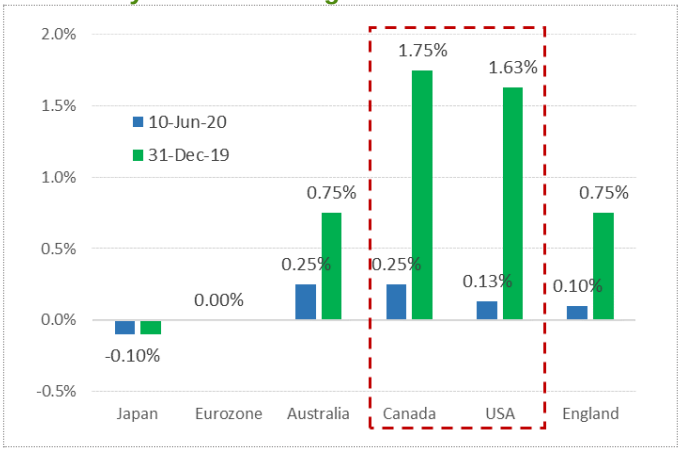


Source: FactSet, Raymond James Ltd.

What Role Have Central Banks Played in Foreign Exchange Markets?

- In an effort to combat the inevitable economic calamity spurred by physical distancing and lockdown measures, monetary policy easing across the globe has come at a time where Central Banks have already been quite accommodating. Since the beginning of the year, G10 Central Banks have collectively slashed overnight lending rates by 615 basis points (bps) while simultaneously injecting trillions of dollars into public markets, with a combination of primary and secondary market operations, in order to keep the liquidity wheel well-oiled (more on this in a later section).
- The result of converging policy rates among developed markets means the carry trade (i.e. strategy of borrowing in low interest rate currency to investing in higher interest rate currency) among G10 currency pairs has all but disappeared; a theme we expect to continue for the next couple years.
- The result of bloated central bank balance sheets has been huge outperformance in risk assets, as investors remain assured that central banks will do whatever it takes to keep the market afloat. Printing presses switching to

G10 Policy Rates Converge

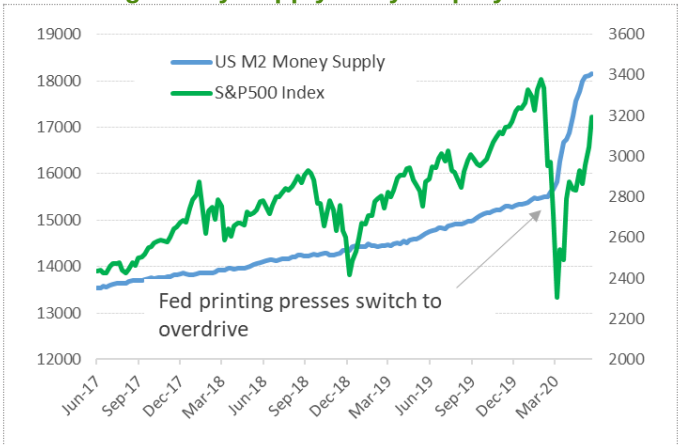


Source: FactSet

overdrive have ensured that corporate bankruptcies remain subdued and declining top-line growth has been offset by lower discount rates.

- Looking forward, we expect the Fed and BoC to keep asset purchase programs in place for the foreseeable future. While not all facilities have been utilized by the markets, the fact is that the Central Banks have ensured liquidity will not dry up across the alphabet soup of debt markets, including: money market, commercial paper, provincial/municipal bonds, MBS and even high yield. Interest rates should also remain weighed down as overnight lending rates in the US and Canada are expected to be maintained near current lows for the next couple of years; in fact, this week the Fed's dot plot showed almost all members foresee current rates remaining in place until 2022.
- In terms of further possible action, markets believe some variation of yield curve control, like that currently utilized in Japan, will be next. Both the Fed and BoC have expressed doubts regarding the efficacy of negative rate policy and it is a view shared among many private sector economists.
- In the shorter term, we expect FX markets to be hyper-focused on changes to the tone of central bank messaging and how that will spillover to risk assets. Further out past the pandemic, the size of Central Bank balance sheets will be sharply scrutinized; bloated Central Bank and government balance sheets should weigh heavily on the ability to increase rates in the future.

Increasing Money Supply Buoys Equity Markets



Source: FactSet, Raymond James Ltd.

What Factors Have Been Driving the Loonie's Direction?

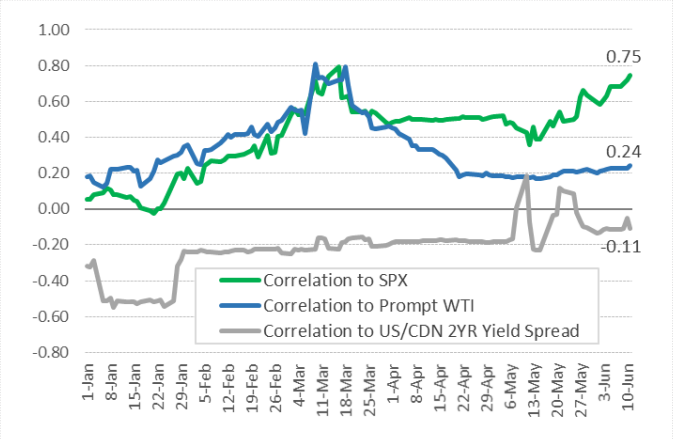
As with many asset classes during the pandemic, we have seen a breakdown in fundamentals in FX markets and price action has instead been driven by broader risk sentiment. Historically, two of the most meaningful fundamental factors for USDCAD movement have been crude oil prices and front-end interest rate spreads but, as we can see quite evidently, this is not the case right now and risk sentiment is becoming a much more important driver.

Crude Oil

- There is no questioning the importance of crude oil to the Canadian economy with the energy sector representing roughly 8% of GDP and 20% of business fixed investment.
- Developments in the global crude oil space this year have been nothing short of spectacular - it seems as if the escalation of US-Saudi Arabia tensions in January was years ago. Negative interest rates have been a topic of discussion over the past few years but no one would have predicted that we would see negative pricing in crude oil contracts, but nonetheless COVID-19 helped make that a reality (for more on that click here). That said, as manufacturing and construction activity have begun to pick up, we are seeing West Texas Intermediate (WTI) crude oil prices back to early-March levels in the US$35-40/bbl range.

- Despite the tumultuous moves in crude pricing, we have actually seen correlation between the Loonie and crude oil deteriorate to its lowest levels in more than two years. Shorter-term, this trend should continue as broader risk sentiment remains in focus among investors. However, looking further out, weak dynamics in crude pricing could weigh significantly on the Canadian economy. The Canadian government has pumped vast sums of money into our energy patch but this can only act as a crutch until global dynamics improve. Most domestic producers have breakeven production pricing near US$40/bbl, so while many can stay in business at current levels, we question the long-term sustainability.

USDCAD (Inverse) Correlations



Source: FactSet, Raymond James Ltd.

Front-End Spreads

- Interest rate differentials are a chief component of determining the value of any currency pair, particularly 2-year Treasury spreads. Taking a broad look across the G10 space, interest rate differentials are now working against the USD, which has historically enjoyed a definitive yield advantage relative to its peers. With G10 policy rates all close to 0% at this point and no expectations for policy normalization in the near term, the USD can be expected to lose some ground in this area as interest rates spreads will not be a material factor in the USD's outlook going forward.
- Looking at USDCAD, upside policy revisions by either the Fed or BoC would be a catalyst for front-end spreads to be a more meaningful factor once again. This means that while Central Banks may not take any meaningful action in the near term, their commentary will be closely scrutinized by FX traders for signs of future policy decisions to come.

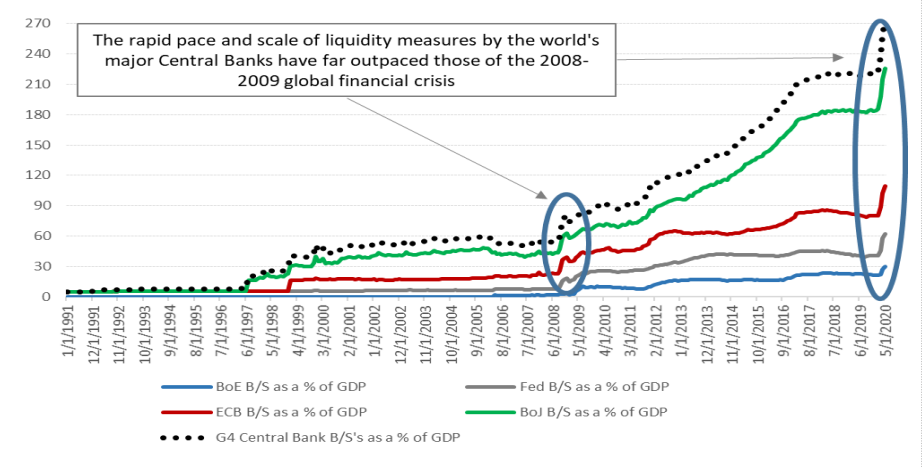
Risk Sentiment

- As the world's reserve currency, the USD has been utilized by many global investors as an asset to turn to in periods of deteriorating risk sentiment. As such, the market's perception of macroeconomic risk has by and large been the primary driver of USDCAD performance since mid-March (as well as performance of the other majors). We gauge risk sentiment by looking to the S&P500 Index, which bottomed on March 23 when concerns regarding COVID-19's impact were at their highest.
- Although uncertainty surrounding the global post-COVID-19 economic recovery should continue to support the USD as it continues to live up to its safe-haven status, broad risk sentiment will be by far the most influential factor going forward.

Coordinated Effort to Ease a Global Dollar-Funding Crunch

- Given the Fed's expanded/uncapped overnight repo operations, unlimited asset purchases and a myriad of new credit and liquidity facilities that it had hidden up its sleeves to fulfill the market's seemingly unquenchable thirst for liquidity, the Fed's balance sheet has exploded from +US$4trln at the beginning of March to an astonishing +US$7trln as of June 3. As of May 31, 2020, the Fed's balance sheet as a percentage of GDP has reached an all-time high of 32.7%.

G4 Central Bank Balance Sheets (% of GDP)



Source: FactSet, Raymond James Ltd.

- During March, the deterioration in global US dollar funding conditions, where offshore market participants scrambled for USD liquidity in order to roll over their short-term funding obligations, reminded everyone of how dependent global Central Banks are on short-term unsecured funding in US money markets. Remember, the USD continues to be the lifeblood of international trade and the world's reserve currency.

- The Fed wasted no time in addressing the global dollar shortage and immediately launched an unprecedented amount of liquidity programs to help ease global funding pressures and support the economy. At their March 15th meeting, the Fed announced a coordinated action among major Central Banks to provide liquidity via standing US dollar liquidity swap line arrangements. Over the next 2 months, the Fed expanded swap lines to other central banks and even opened up the facility to those in emerging markets.

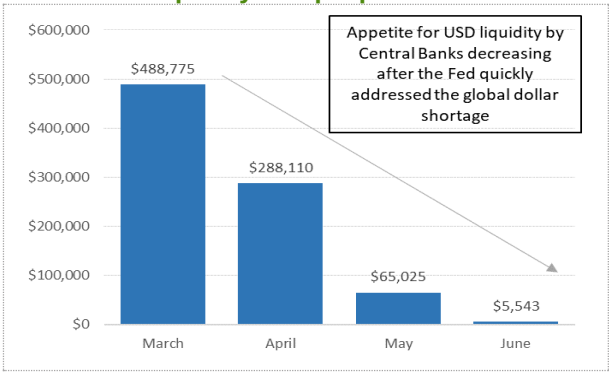
- From March 3 to June 3, the Fed's USD liquidity swap operation provided nearly $850bln in liquidity to global central banks. From March onwards, the size and scope of the Fed's swap line operations have been dwindling, signaling that the Fed's rapid move to flood markets with USD funding has done the trick and eased fears of a potential financing crunch.

USD Liquidity Swap Operation Results (March 3 - June 3)	*In millions USD*
Bank of Japan	$405,249
European Central Bank	$259,104
Bank of England	$90,895
Swiss National Bank	$32,278
Bank of Korea	$19,872
Monetary Authority of Singapore	$19,579
Danmarks Nationalbank	$7,315
Banco de Mexico	$6,590
Norges Bank	$5,400
Reserve Bank of Australia	$1,170
Grand Total	**$847,452**

Source: Federal Reserve Bank of New York

- Given the massive amount of USD liquidity injected into the system courtesy of the Fed, it ought to have a negative effect on the USD. After rising 8.80% back in mid-March, the DXY US Dollar Index is now down +6% at the time of writing and effectively right back at January 2020 levels.

Total USD Liquidity Swap Operations MoM

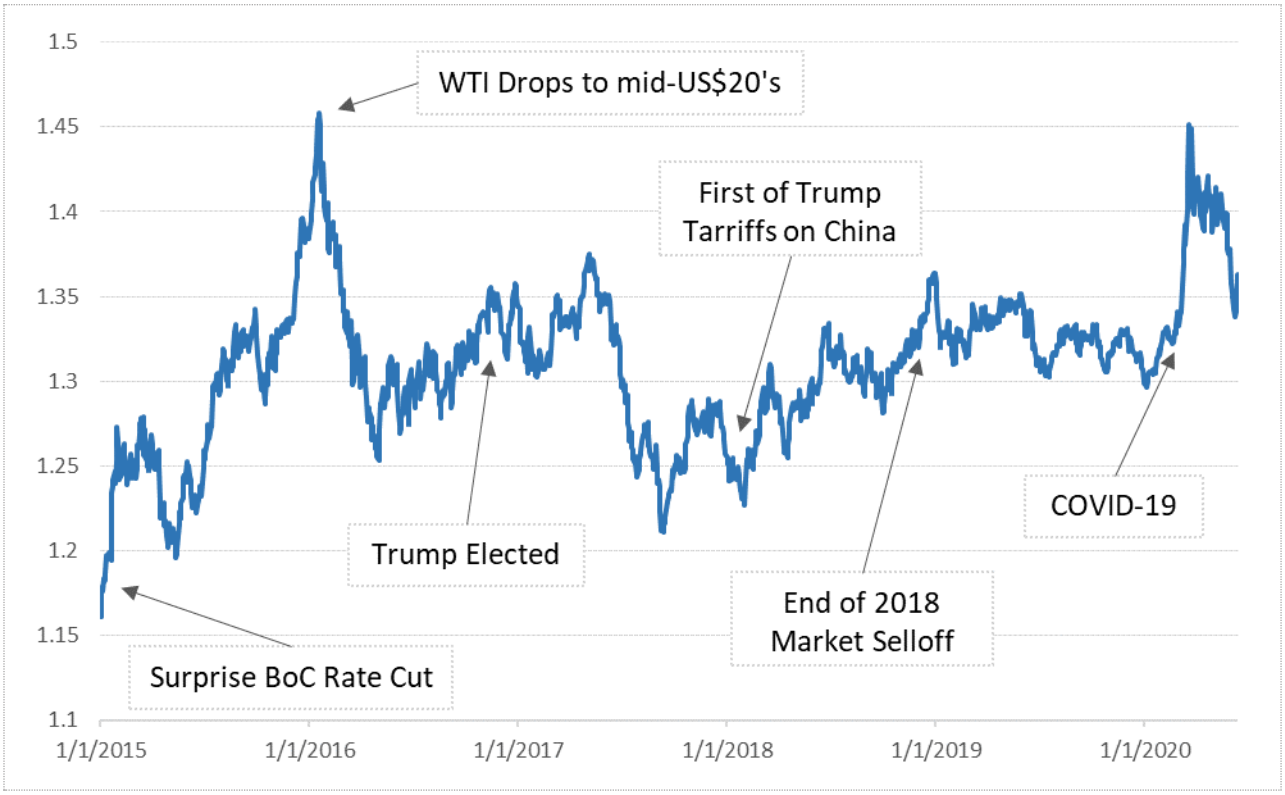


Source: FactSet, Raymond James Ltd.

What Does All This Mean for USDCAD Going Forward?

- When the pair was trading near the 1.39 handle in mid-April, we called an eventual target of 1.3500-1.3550, which coincided with the area the pair broke out of its ascending wedge pattern at the onset of the COVID-19 pandemic and Saudi/Russia oil price war.
- We also stated that in the interim, the pair would re-test the mid-1.41/1.42 range, which it did in late April, before drifting lower and eventually bottoming out at a low of 1.3316 in early June.
- So where do we go from here? Our view is that the abundance of global USD liquidity will eventually weigh on the USD and halt its momentum. However, as the situation stands right now, the high correlation between NA equities and USDCAD will be the single-most significant driver. Forget (for now) the days when oil, yields and economic data played a significant factor in direction. In the current environment, CAD will continue to be a slave to broader risk sentiment.

Roller Coaster Ride for USDCAD To Be Continued



Source: FactSet, Raymond James Ltd.

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