Loonie Pizza 1

The Canadian Dollar is sharply up this last couple of months. Currency is one of the very most difficult things to forecast. Here are some thoughts on what we might expect in the months ahead.

We had houseguests, a couple of teenage nephews of mine, and we were all very hungry, having missed two meals already that day. The pizza was in the oven, its aroma permeating our basement newlywed apartment, which was as sparsely furnished as our fridge was stocked.

Finally, the timer beeped on the oven, and I raced to retrieve our thick and delicious dinner. Oven mitts on, I lifted the pizza out of the top shelf and smiled to myself as I saw the crusted, melted cheese and meat teasing me. Sometimes a small bubbling puddle of salty grease is actually pretty appealing.

I one-handed the pizza sheet while I held the oven door with the other hand. My 14-year-old nephew was right behind me, large-eyed and visibly drooling. If he was a puppy, his wagging tail could have fanned in the apartment with an impressive breeze.

As I stood and turned to place the piping hot package down, with apparently a little too much enthusiasm, the pizza slid off the sheet and hit the wall with remarkably full force, face first. Sticking there for a brief second, it then slid slowly down the wall onto the floor, competing for floor space with a trail of ants who had been relentlessly milling about there.

Mouths open, aghast, and still starving, we just stood there for a few seconds in disbelief. I tried resuscitation, but it had landed in that trail of ants, not far from the kitchen garbage. All the king's horses and all the king's men would have given up. Dog food.

A few moments later we were chewing sadly on celery sticks and peanut butter, lined with dried-up raisons. A few slices of stale bread with cheap imitation margarine, and a half-eaten bag of pretzel sticks dipped in honey for dessert.

Markets are all about anticipation, but like that unfortunate Sunday afternoon meal, sometimes they over-react, and outguess themselves. Such, according to RBC economists, is the case with the recent trajectory of the Canadian dollar against the US Greenback. Currency is perhaps the very most challenging thing to forecast, due to the multiplicity of international transactions at play, nevertheless, here are some things to consider.

Recent Moves:

The Canadian dollar currently sits at a nearly 2-year high, hovering around US$0.80, following a 9% rally since early May as the market adjusted to an evolving message from the Bank of Canada. In a matter of six months, the central bank has shifted from having a rate cut 'on the table' in January, to implementing a 25 basis point (bps) rate hike in July. This shift in policy prompted a radical adjustment in market expectations and the Canadian dollar has been the best-performing currency amongst its G10 peers since May. There's that word. "*Expectations.*"

The market is pricing in a second 25 bps rate hike coming from the Bank of Canada in October, and the overnight rate reaching approximately 1.5% by mid-2019. As recently as early June, consensus among both market participants and forecasters was that the Bank of Canada would not begin hiking rates until mid-2018. We believe the Bank of Canada will need to not only raise rates, but also convince the market we are getting more rate hikes than are currently priced in for there to be a continuation of the recent moves higher in short-term yields which have translated into a stronger Canadian dollar.

Markets are pricing in more hikes in Canada than the U.S. over the next 12 and 24 months. This stands in stark contrast with RBC Capital Markets' most recent forecast which calls for three rate hikes from the Bank of Canada over the next 18 months, but five hikes from the Fed over the same time period. If the RBC Capital Markets view plays out, that would likely result in a weaker Canadian dollar over the next 18 months.

Economies Juxtaposed:
Despite the recent string of softer U.S. economic data compared to improved readings in Canada, RBC economists believe that the U.S. economy is better equipped to handle higher short-term interest rates than the Canadian economy as its labour market boasts lower unemployment and higher wage growth, which filters through to a higher inflation profile for the broader economy. RBC Capital Markets is forecasting 2.8% GDP growth in the U.S. in 2018 versus 2% in Canada in 2018.

NAFTA renegotiations: A wild card
The Trump administration recently laid out plans to renegotiate NAFTA and meetings could start as soon as this month. Canada has a more balanced trade relationship with the U.S. than Mexico so these negotiations appear to present a higher risk profile to Mexico relative to Canada. Nevertheless, these negotiations represent a source of event risk to the Canadian dollar that could resolve itself in either direction depending on the outcome of the negotiations. RBC Capital Markets views these negotiations as a source of downside risk to the Canadian dollar.

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