June 2024

Highlights

By Stéfane Marion and Kyle Dahms

- The USD's recent weakness has been exacerbated by a series of negative economic surprises. However, despite this development, the language of Federal Reserve officials has actually become more hawkish in recent weeks. So what is going on? Inflation, that's what's going on. For the fourth month in a row, the annualized change in the core PCE deflator has been well above the Fed's 2% target. So for now, the FOMC can't let its guard down and we don't expect to see a lower Fed Funds rate before the autumn. We therefore continue to expect the USD to strengthen in the coming months.
- After a spike above 1.38 in mid-April, the USD/CAD has been on a slight uptrend. As some of the extreme bearish speculative positions on the CAD are being unwound, we don't rule out the possibility of the Loonie strengthening, but we doubt that the strength will be sustained. Our model still sees the USD/CAD exchange rate rising above 1.40 in the second half of 2024. Our forecast reflects the divergence in economic performance between Canada and the US, as the impact of restrictive monetary policy argues for imminent summer rate cuts on this side of the border.
- After hitting fresh lows in April, the euro returned in May closer to the range it was previously trading within in the first quarter of this year. Although current levels cannot be portrayed as strong for the common currency, they are perhaps artificially elevated considering the backdrop of upcoming changes in monetary policy. The ECB has telegraphed that it will start easing rates as soon as June, in the process making it the first major central bank to cut in the current cycle. With the growth outlook for the eurozone lukewarm and the possibility of a still restrictive Fed, the question remains if the euro can stave off further deterioration.

NBF Currency Outlook

Currency		Current May 31, 2024	Forward Estimates Q2 2024	Q3 2024	Q4 2024	Q1 2025
Canadian Dollar	***(USD / CAD)***	**1.36**	**1.38**	**1.40**	**1.42**	**1.39**
United States Dollar	*(CAD / USD)*	*0.73*	*0.72*	*0.71*	*0.70*	*0.72*
Euro	*(EUR / USD)*	1.09	1.07	1.06	1.04	1.06
Japanese Yen	*(USD / JPY)*	157	153	148	145	142
Australian Dollar	*(AUD / USD)*	0.66	0.65	0.64	0.64	0.65
Pound Sterling	*(GBP / USD)*	1.27	1.26	1.24	1.22	1.24
Chinese Yuan	*(USD / CNY)*	7.24	7.24	7.22	7.20	7.20
Mexican Peso	*(USD / MXN)*	17.1	17.7	18.3	19.0	19.5
Broad United States Dollar [(1)]		**121.5**	**122.9**	**124.1**	**125.7**	**124.8**

1) Federal Reserve Broad Index (26 currencies)

Canadian Dollar Cross Currencies

Currency		Current May 31, 2024	Forward Estimates Q2 2024	Q3 2024	Q4 2024	Q1 2025
Euro	*(EUR / CAD)*	1.48	1.48	1.48	1.48	1.47
Japanese Yen	*(CAD / JPY)*	115	111	106	102	102
Australian Dollar	*(AUD / CAD)*	0.91	0.90	0.90	0.91	0.90
Pound Sterling	*(GBP / CAD)*	1.74	1.74	1.74	1.73	1.72
Chinese Yuan	*(CAD / CNY)*	5.31	5.25	5.16	5.07	5.18
Mexican Peso	*(CAD / MXN)*	12.5	12.8	13.1	13.4	14.0

USD: Will the bullish trend stop?

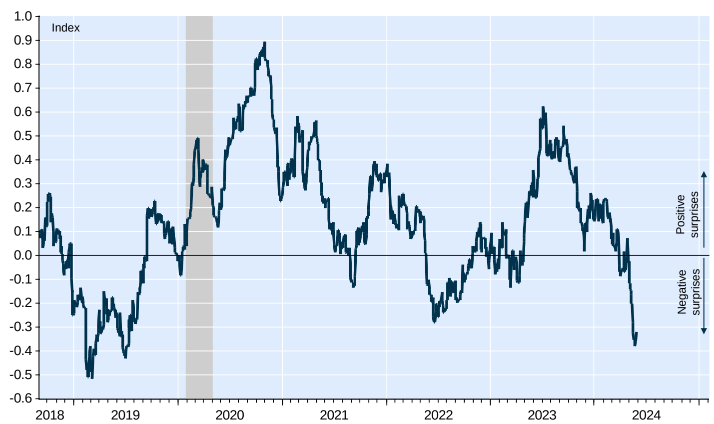
The trade-weighted USD fell to a 10-week low in late May before regaining some strength in early June (chart). For now, the bullish trend seen since the start of 2024 is holding, but there are certainly a number of factors weighing on the greenback. So where do we go from here?

USD: Uptrend still intact
Trade-weighted USD* vs. a basket of 26 currencies

NBF Economics and Strategy (data via Refinitiv)

The USD's recent weakness has been exacerbated by a series of negative economic surprises. According to Bloomberg, it has been five years since the US economy disappointed as much as it is now (chart).

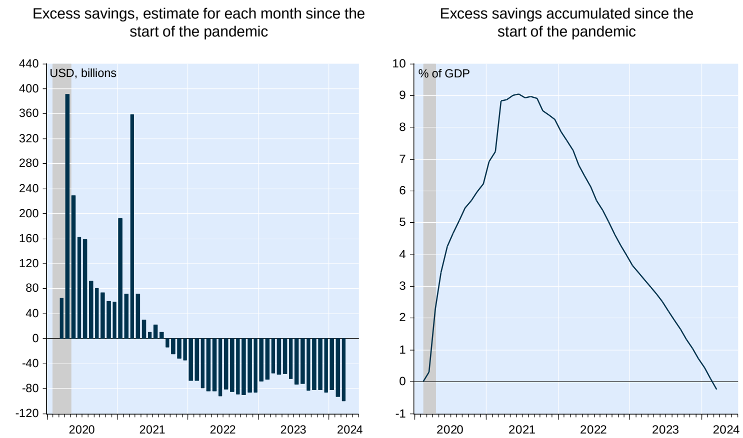
U.S.: Economic data has been disappointing lately
Bloomberg Economic Surprise Index



NBF Economics and Strategy (data via Bloomberg)

The underwhelming growth can be attributed to American consumers, whose excess savings accumulated during the covid pandemic through generous government transfers are now being depleted (chart).

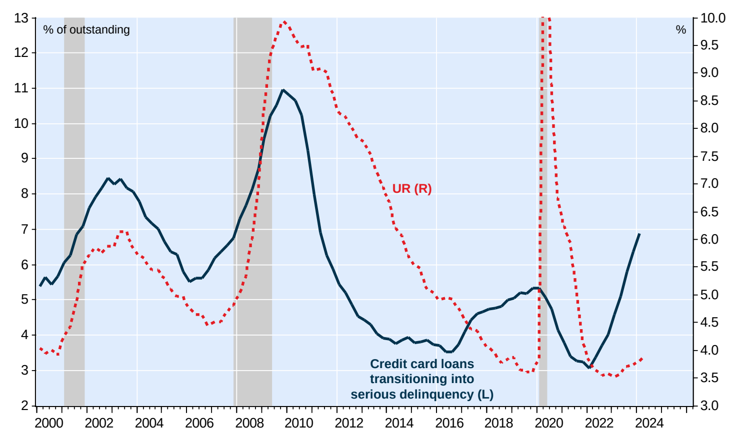
U.S. : Excess savings are now depleted



NBF Economics and Strategy (data via the San Francisco Fed)

The lack of savings in the context of a restrictive monetary policy has led to an increase in consumer credit delinquencies. The percentage of credit card loans that are seriously delinquent is now at 7%, the highest level since 2010. This is unusually high given that the US unemployment rate is still below 4% (chart).

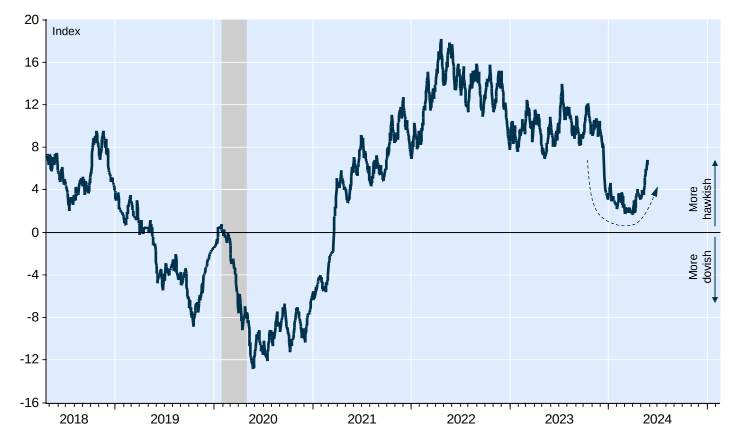
U.S.: Defaults rising despite strong labour market
Percentage of credit card loans transitioning into serious delinquency (90+ days) vs. unemployment rate



NBF Economics and Strategy (data via Bloomberg and Refinitiv)

However, despite this development, the language of Federal Reserve officials has actually become more hawkish in recent weeks (chart).

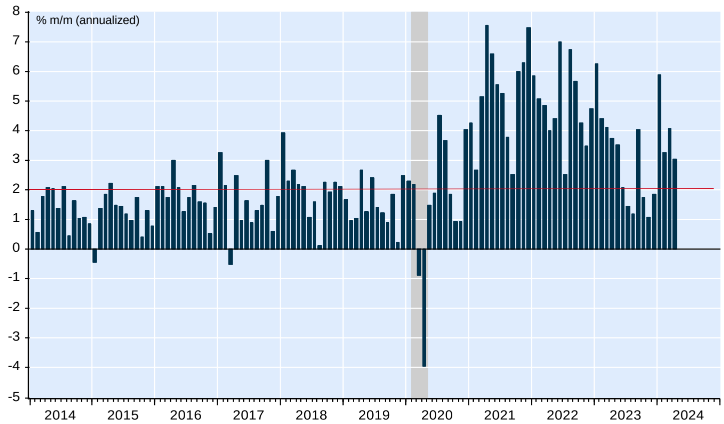
U.S.: Fed language has turned more hawkish lately
Bloomberg Federal Reserve Language Sentiment Index



NBF Economics and Strategy (data via Bloomberg)

So what is going on? Inflation, that's what's going on. For the fourth month in a row, the annualized change in the core PCE deflator has been well above the Fed's 2% target, with April's reading above 3% (chart).

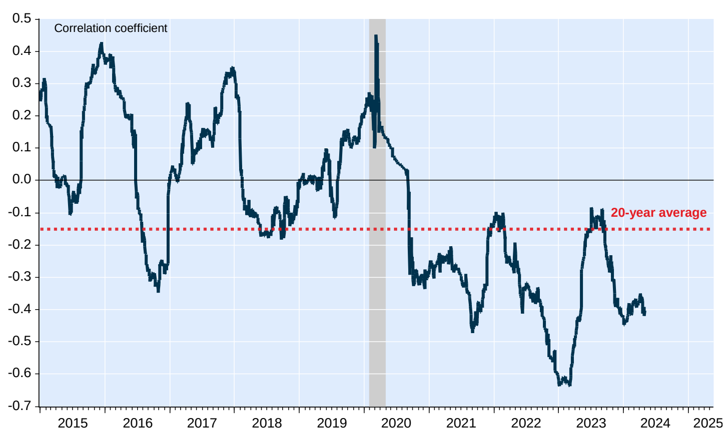
U.S.: Inflation is still above 3%
Core PCE deflator



NBF Economics and Strategy (data via Fred)

This does not bode well for an imminent easing of interest rates. If anything, the US inflation outlook has been complicated by Washington's decision to introduce tariffs on a number of Chinese imports. So for now, the FOMC can't let its guard down and we don't expect to see a lower Fed Funds rate before the autumn. As we have argued before, the longer monetary policy remains restrictive, the greater the likelihood of negative growth and earnings surprises in the second half of the year. Given the unusually strong negative correlation between the S&P 500 and the USD index, we expect weaker equity markets to lead to greenback appreciation (chart).

USD: Strong correlation with the S&P 500
26-week moving correlation between daily changes in the S&P 500 and USD dollar index (DXY)



NBF Economics and Strategy (data via Bloomberg)

CAD: Summer rate cuts are coming

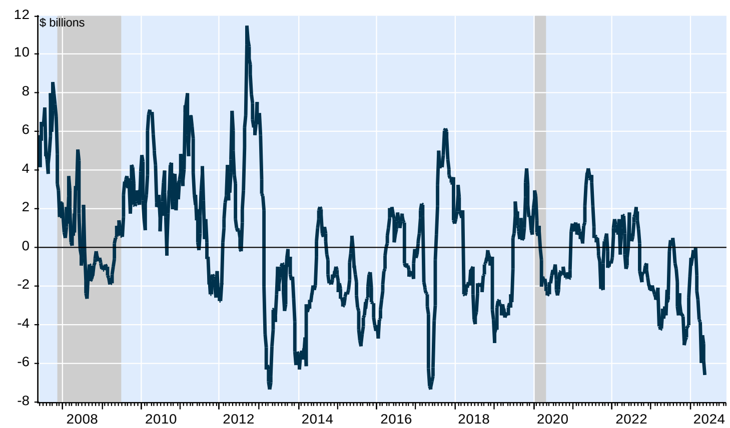
After a spike above 1.38 in mid-April, the USD/CAD has been on a slight uptrend, before falling back to 1.37 (chart).

CAD: Resistance at 1.38 continues to hold
Canada-US exchange rate

NBF Economics and Strategy (data via Refinitiv)

We still expect 1.38 resistance to be breached in the coming months, but not before a potential retracement due to extreme speculative bearishness on the Loonie. In fact, non-commercial traders are the most short on the CAD since 2017 (chart).

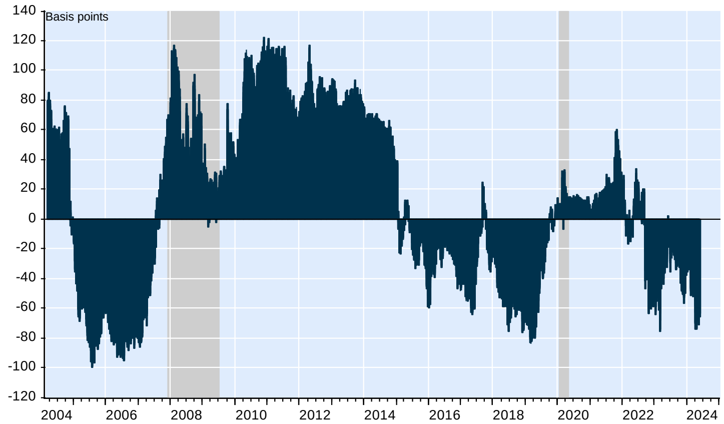
CAD: Speculators don't like the loonie
Net speculative positions of non-commercial traders on the CAD



NBF Economics and Strategy (data via Bloomberg)

As some of these positions are being unwound, we don't rule out the possibility that the CAD will appreciate, but we doubt that the strength will be sustained. Indeed, we expect the two-year Treasury yield differential between Canada and the US (a key determinant in our CAD valuation model) to widen from 70bp currently to 100bp in the coming months (chart).

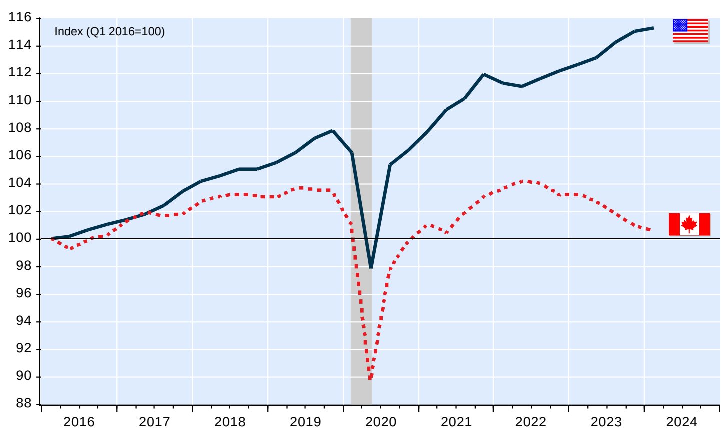
CAD: Negative interest rate differentials could get worse
Two-year Treasury spread: Canada minus the U.S.



NBF Economics and Strategy (data via Bloomberg)

Our forecast reflects the divergence in economic performance between Canada and the US, as the impact of restrictive monetary policy argues for imminent interest rate cuts on this side of the border. The Q1 GDP data was a case in point. The economy expanded at an annualized rate of 1.7%, lower than consensus estimate calling for a 2.2% increase and more than a full percentage point below the Bank of Canada's forecast in its Monetary Policy Report last April. The previous quarter's result, meanwhile, was revised down from 1.0% to 0.1%. Importantly, GDP growth remains well below population growth. To illustrate the counter-performance GDP per capita is now 3.5% below the peak recorded at the beginning of the rate hikes. A decline of this magnitude has never been seen outside a recession and is very different from the US (chart).

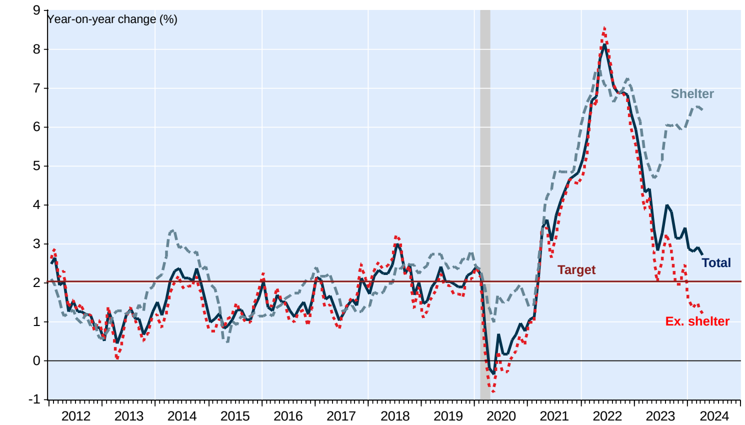
Canada: GDP per capita diverges from the United States
Real GDP per capita



NBF Economics and Strategy (data via Statistics Canada and Refinitiv)

Inflation trends are also more supportive of a summer rate cut in Canada. Annual CPI inflation has now been within the Bank of Canada's target range of 1% to 3% in each of the past four months. Excluding shelter, CPI inflation was 1.2% in April, a multi-year low (chart).

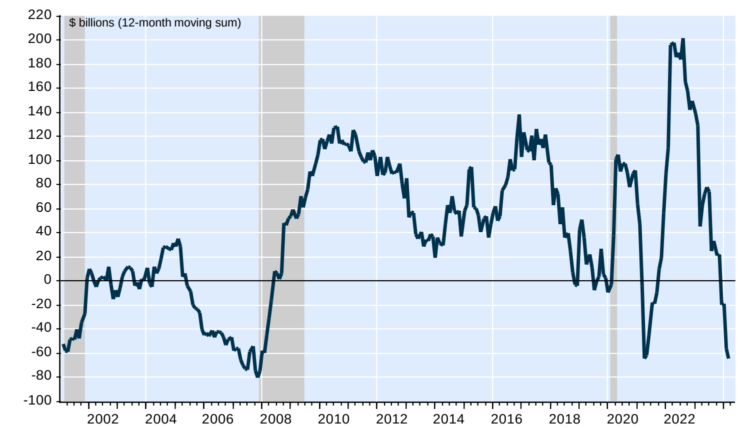
Canada: Outside shelter, inflation is well below target
CPI inflation: Total, shelter and ex-shelter



NBF Economics and Strategy (data via Statistics Canada)

In fact, the most recent report on Canada's international securities transactions showed a net outflow of more than $60 billion over the past twelve months (chart).

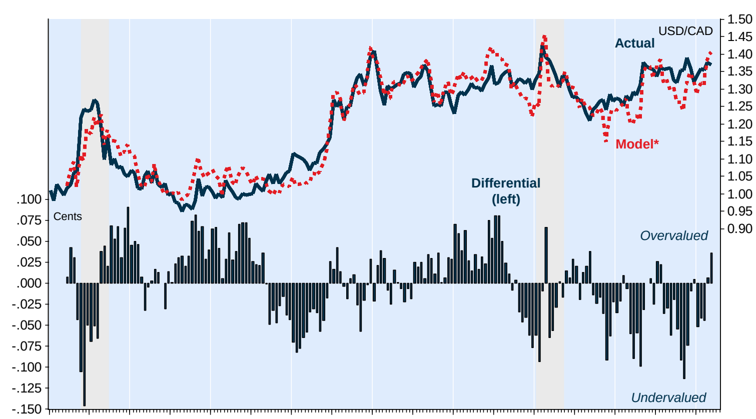
Canada: Not very popular with investors recently
Canada international transactions in securities (net flows)



NBF Economics and Strategy (data via Bloomberg)

In light of the above, our model still sees the USD/CAD exchange rate rising above 1.40 in the second half of 2024 (chart).

USD/CAD: Divergence between the model and actual
Actual exchange rate against USD, NBF short-term fair-value estimate* against USD, and differential



** Model estimated from 2008 to 2022:*
log(USDCAD) = c+ β1(US2Y yield − CA2Y yield) + β2 log(WTI oil price) + β3 WCS differential + β4 log(metal price index)

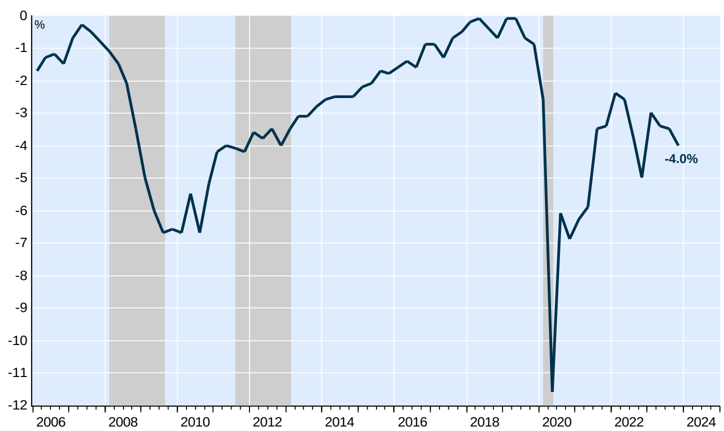
NBF Economics & Strategy (data via Refinitiv & Bloomberg)

EUR : Certainty of uncertainty

After hitting fresh lows in April, the euro returned in May closer to the range it was previously trading within in the first quarter of this year. Although current levels cannot be portrayed as strong for the common currency, they are perhaps artificially elevated considering the backdrop of upcoming changes in monetary policy. The ECB has telegraphed that it will start easing rates as soon as June, in the process making it the first major central bank to cut in the current cycle. With the growth outlook for the eurozone lukewarm and the possibility of a still restrictive Fed, the question remains if the euro can stave off further deterioration.

At first glance, it would appear that the worst is behind for the euroland as growth picked back up in the first quarter of 2024. True, GDP rose above consensus expectations but merely indicated that activity was 0.5% above where it was a year ago. Moreover, the prior quarter was negatively revised which meant the European economy was actually in technical recession in the second half of 2023. The recent gain can likely be attributed to both somewhat resilient consumers and fiscal stimulus (chart).

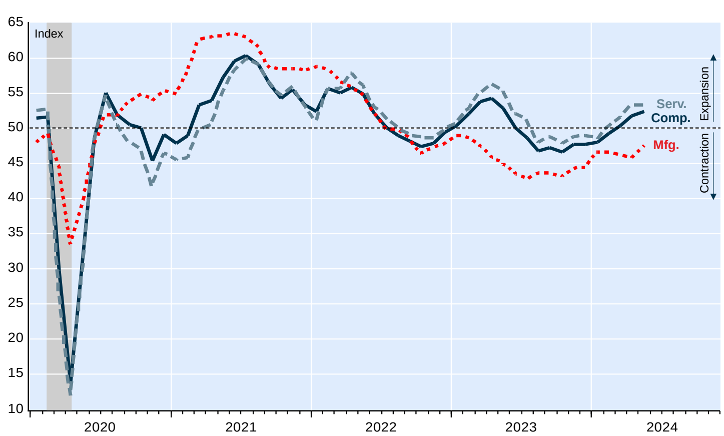
Eurozone: Governments have contributed to growth lately
General government fiscal balance as a percentage of GDP



NBF Economics and Strategy (data via Eurostat)

The outlook for Q2 remains mixed, the latest PMI data for the common euro area showing that the services sector remains nestled in expansion territory. The same can be said for the composite, although it is being dragged down by a manufacturing segment which is still in contraction (chart).

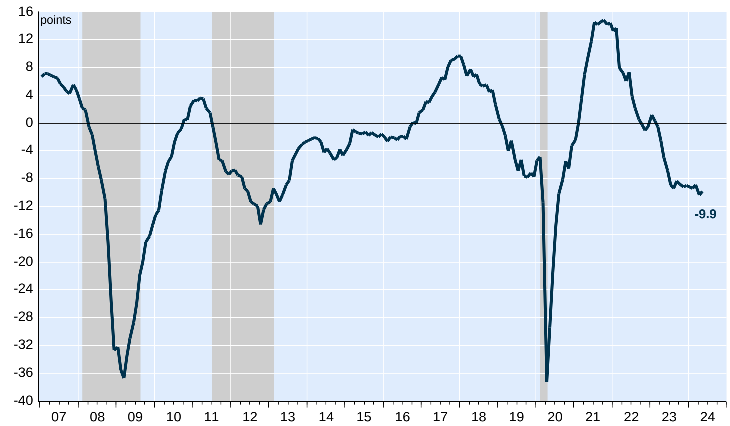
Eurozone: Private sector growth is accelerating
HCOB Flash PMI. Last observation: May 2024



NBF Economics and Strategy (data via Refinitiv)

And while the contraction in manufacturing has slowed down, industrial sentiment remains quite low and consistent with a recessionary environment (chart).

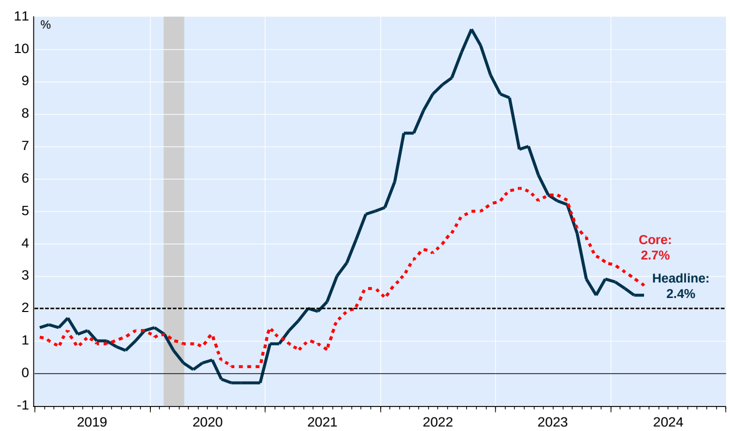
Eurozone: Industry confidence is at recessionary levels
Euro Area Industrial Sentiment



NBF Economics and Strategy (data via European Commission)

Given a relatively slow pace of growth, arguments have been mounting for the European central bank to cut interest rates. Nominally, it has largely achieved its goal of bringing inflation down towards target with headline prices registering at 2.4% year-over-year and core prices not far off (chart).

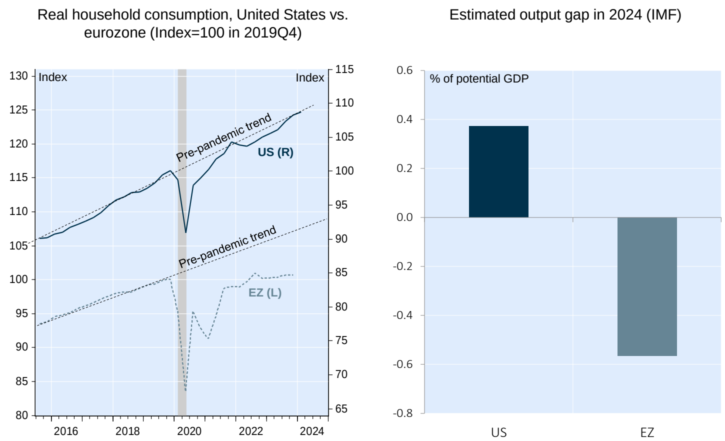
Eurozone: Significant progress has been made on inflation
Headline inflation and inflation less food/energy/alcohol/tobacco



NBF Economics and Strategy (data via Refinitiv)

Compounding on that data, ECB staff forecasts expect further moderation for both growth and inflation. Still, market participants have questioned whether President Lagarde would allow a divergence in policy with the US Federal Reserve. When asked on this matter, Lagarde has categorically stated that they (the ECB) "are not Fed-dependent". If data-dependence is their guiding light, the difference in economic fortunes between the US and the Eurozone would signal that policy deviation is warranted.

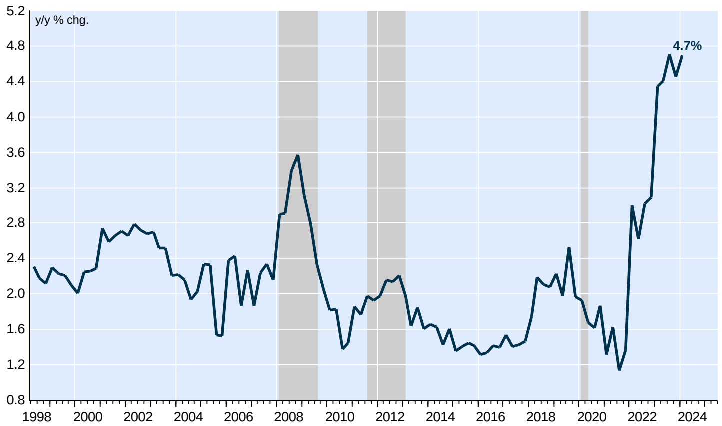
Diverging economic backdrops mean ECB can diverge from Fed



NBF Economics and Strategy (data via Refinitiv and the IMF)

So far markets have priced in more easing on the eastern side of the Atlantic this year but there are some elements which have kept a larger easing at bay. The unemployment rate in the Eurozone remains at record lows and as such, wage growth remains well above the comfort zone (chart). The ECB may be willing to allow real wages to regain some of the lost ground in past couple of years, but they will be seeking confirmation of reasonableness.

Eurozone: Wage growth remains too high
Negotiated wage



NBF Economics and Strategy (data via the ECB)

All in all, the only certainty we have for the common currency union is that there will be uncertainty in the next few quarters. Monetary policy should ease on the back of tepid growth but will somewhat be limited by a tight labour market and elevated wages. We are keeping our penchant for euro weakness in the context of a Fed which could keep rates higher for a bit longer.

Regional Overview

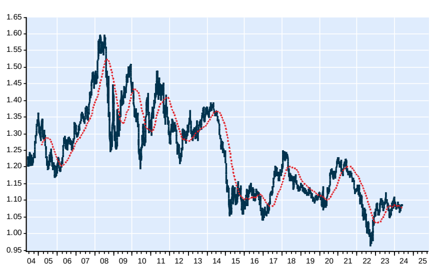
Region	Currency	$		Current USD FX	1M Prior USD FX	% Change 1-Month Performance	Current 2Y Yield	Relative to UST 2Y Spread	Current Policy Rate	Upcoming Next MP Meeting
Canada	**Canadian Dollar**	**CAD**	***(USD/CAD)***	**1.36**	**1.37**	**-0.42%**	**4.18**	**-69.4**	**5.00**	**2024-06-05**
United States	*United States Dollar*	*USD*	*-*	*-*	*-*		*4.88*	*-*	*5.50*	*2024-06-12*
Eurozone	Euro	EUR	*(EUR/USD)*	1.08	1.08	0.81%	3.10	-177.8	4.50	2024-06-06
Japan	Japanese Yen	JPY	*(USD/JPY)*	157	153	2.78%	0.41	-447.0	-0.10	2024-06-14
Australia	Australian Dollar	AUD	*(AUD/USD)*	0.67	0.66	0.65%	4.13	-75.0	4.35	2024-06-18
United Kingdom	Pound Sterling	GBP	*(GBP/USD)*	1.27	1.25	1.55%	4.41	-46.8	5.25	2024-06-20
China	Chinese Yuan	CNY	*(USD/CNY)*	7.24	7.24	0.01%	1.78	-309.9	2.00	2024-06-13
Mexico	Mexican Peso	MXN	*(USD/MXN)*	17.0	17.0	0.22%	10.66	578.6	11.00	2024-06-27

Country Central Bank	United States Federal Reserve			Canada Bank of Canada			Eurozone European Central Bank		
Current Policy Rate	6/3/2024	5.33	▲ current level	6/3/2024	5	▲ current level	6/3/2024	4	▲ current level
Next meeting	6/12/2024	5.328	-0.002	6/5/2024	4.799	-0.201	6/6/2024	3.671	-0.329
Subsequent meeting	7/31/2024	5.292	-0.038	7/24/2024	4.703	-0.297	7/18/2024	3.625	-0.376
Subsequent meeting	9/18/2024	5.162	-0.168	9/4/2024	4.571	-0.430	9/12/2024	3.513	-0.487
Subsequent meeting	11/7/2024	5.084	-0.246	10/23/2024	4.475	-0.525	10/17/2024	3.422	-0.578
Subsequent meeting	12/18/2024	4.913	-0.417	12/11/2024	4.360	-0.641	12/12/2024	3.320	-0.680
Subsequent meeting							1/30/2025	3.232	-0.768

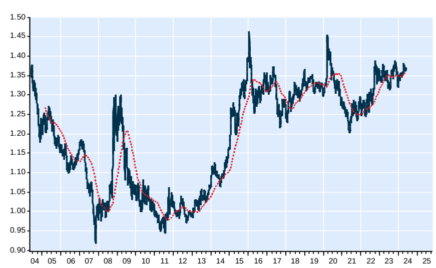
Country Central Bank	Japan Bank of Japan			United Kingdom Bank of England		
Current Policy Rate	6/3/2024	0.1	▲ current level	6/3/2024	5.25	▲ current level
Next meeting	6/14/2024	0.104	0.004	6/20/2024	5.180	0.180
Subsequent meeting	7/31/2024	0.176	0.076	8/1/2024	5.066	0.066
Subsequent meeting	9/20/2024	0.224	0.124	11/7/2024	4.912	-0.088
Subsequent meeting	10/31/2024	0.305	0.205	12/19/2024	4.833	-0.167
Subsequent meeting	12/19/2024	0.360	0.260	2/6/2025	4.734	-0.266
Subsequent meeting				3/20/2025	4.641	-0.359

Appendix: Spot rates with their 200d MA

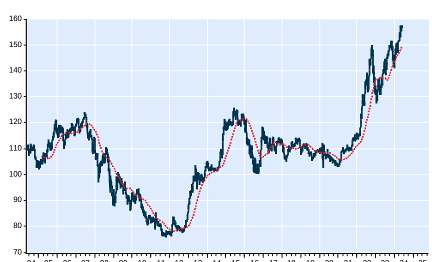
EUR / USD



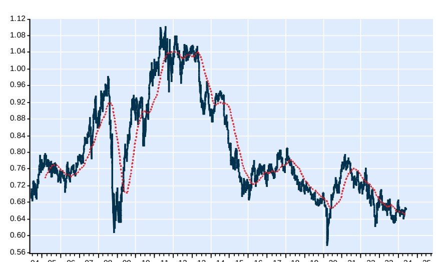
USD / CAD



USD / JPY

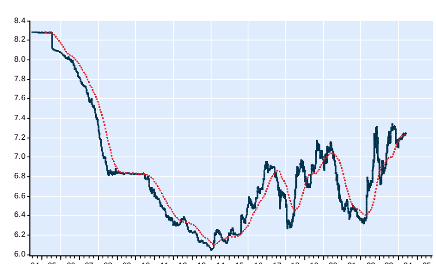


AUD / USD



GBP / USD

USD / CNY



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