

Bank of Canada Decision – Will It Mean Parity For The USD/CAD?

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 Published: July 9, 2007

With the Canadian dollar gaining an impressive 1300 pips, or 12 percent, against the US dollar in the first half of the year, many are wondering how much further the pair can decline. Some have noted that the USDCAD currency pair move has been overextended for sometime, calling for a retracement all the way back up to C\$1.0800 in the short term. While others are looking for further gains to the downside, forcing expectations of C\$1.0300. Either way, the directional bias in the near term will likely hinge on the upcoming Bank of Canada decision. Although expectations are for a rate hike of 25 basis points, there are factors that may lead central bankers of the world's ninth largest economy to pass aside the rate hike for a future date. Should the latter occur, this would definitely have implications for the Canadian dollar pair in the near term.



The Canadian Dollar has gained 12 percent against the US greenback on economic speculation
 Source: FX Trek Intellicharts

It's Not Only Oil

In the first half of the year the relationship with crude oil and the Canadian dollar has visibly surfaced. No one can deny the fact that the Canadian economy continues to benefit from soaring oil prices as the commodity has been bid higher by almost 42 percent since the end of January and above \$70 a barrel as per recent trading. Incidentally, the Canadian dollar has moved in tandem, heading higher against the US dollar in roughly the same time. As such, the correlation (which currently runs above +85 percent) has helped to support a stronger Canadian currency and its subsequent gain against the US dollar.

Although the correlation between the Canadian dollar and crude oil still remains prevalent, the recent runup in the Canadian currency has also been widely due to speculation on the economy. Before the year started out, traders and investors disregarded the CAD as anything but an active currency. However, recent economic developments have boosted the attractiveness of the currency. According to recently released reports, consumer price inflation has continued to be on the upside. Core prices, or prices excluding volatile items like energy, have trended higher since the middle of 2006 and remained higher above the 2 percent central bank benchmark. The latter warranting higher interest rates. Attributed to the increase in prices has been the housing sector which has been ramped up due to improved employment prospects and wage earnings gains. For the record, according to Statistics Canada, average hourly wages have risen by a whopping 3.5 percent in the past year, allowing consumers to afford higher home prices. Additionally, the increases have allowed more spending by domestic consumers as witnessed through rather strong retail sales figures in recent months. Ultimately, the writings on the wall as speculators continue to hype up the fact that rates will likely be increased to 4.50 percent with further rate hikes



to go in the near term. The idea should boost the Canadian dollar trade against the carry trade favorite Japanese yen, supportive of a CADJPY cross pair that has gained almost 21 percent since the end of February.

Is The Market Overpricing?

However, is the runup justified considering the fact that some sectors like growth continue to remain weak? According to the most recent estimates for monthly gross domestic product, expansion in the economy is expected to stall after inching higher in the previous month's report. As a result, this sets the expected expansion for the country at just below 2 percent, hardly a number that would warrant rampant inflationary pressures. Moreover, growth prospects are even dimmer when considering the negative effects that an appreciated currency is likely to have on export producers in the short term. Weakness has already begun to be witnessed as wholesale sales dropped a rigid 3.1 percent in the past month, coupled with manufacturing shipments that contracted by 0.6 percent in the same time frame. If weakness persists in the sector, the mainstay of the Canadian economy, it would lend to emerging softness in the country and quickly curb the necessity for higher interest rates by the Bank of Canada. Ultimately the notion would help support a pullback in the USDCAD pair as previously short positions would be exited en masse.

What Can Markets Expect From The Bank Of Canada And For USDCAD

Given all the fundamental data, it is difficult to definitively say whether or not central bankers will side with a rate hike or not. However, the scenarios play pretty close to what has been previously witnessed in the currency markets.

- **A “no change” decision** – Unexpected by the market consensus, the decision would more than likely help to push the pair in the US dollar's favor, supporting a touch of the C\$1.0800 figure
- **A rate hike decision** – Expected by the consensus, the decision would likely support further appreciation in the underlying Canadian dollar, setting up a formidable test of the C\$1.04-C\$1.03 area. Subsequently, market speculation is looking for accompanying dovish statements that will help to minimize appreciation in the Canadian dollar. Here, policy makers will likely note that although price increases exist in the economy, stabilization is on the horizon as commodity valuations are likely to pull back.
- **A rate hike decision with hawkish rhetoric** – Completely unexpected by the market, should central bankers release hawkish rhetoric following the decision to hike rates, market sentiment would be completely overhauled. The notion would mean that inflationary expectations are higher than expected and call for greater tightening bias in the near term. This scenario would more than likely mean a formidable push below C\$1.0300 and a faster attempt at parity.

One thing is for certain, however, and that is the importance of the current figure. It remains pivotal in the fact that should a break lower occur in the underlying pair, attention on the possibility of parity with the US dollar would heighten exponentially. Notably, policy makers have stated that although appreciation in the Canadian dollar is likely, pain thresholds will be triggered around the C\$1.04 figure, likely sparking rumors of possible intervention by central banks. As a result, participants in the markets should be in for a significantly different itinerary compared to previous notions of smooth sailing in the beginning of the year.

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