Economics

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Do we still oil up the Canadian dollar?

by **Avery Shenfeld** avery.shenfeld@cibc.com

Is the Canadian dollar still a petrocurrency, whose fate is steered by the price of oil? That's worth asking, since oil prices could be swinging wildly ahead, given the developments in Ukraine and US talks with Iran over its nuclear activities.

But a huge move in the past year hasn't shown up in the exchange rate. The loonie sits close to where it stood in early 2021, when WTI prices were running in the low $50 US per barrel range. The most recent spike on the outbreak of war created a flight to safety bid for US dollars at the expense of other currencies, but the loonie hadn't benefited from oil's gains prior to the threat of war showing up on markets' radar screens.

If the oil-CAD link is broken, that's of particular importance for our energy sector clients, as they typically take it into account in thinking about overall hedging strategies for both the commodities price and the exchange rate. It also means that Canada's inflation rate doesn't get the usual cushioning effect from a rise in the loonie's foreign purchasing power when gasoline is most expensive. Herein we provide evidence that oil's link to the Canadian dollar has in fact weakened, examine the reasons for that, and suggest that it's this looser relationship that is likely to continue.

Two roads from oil to the loonie

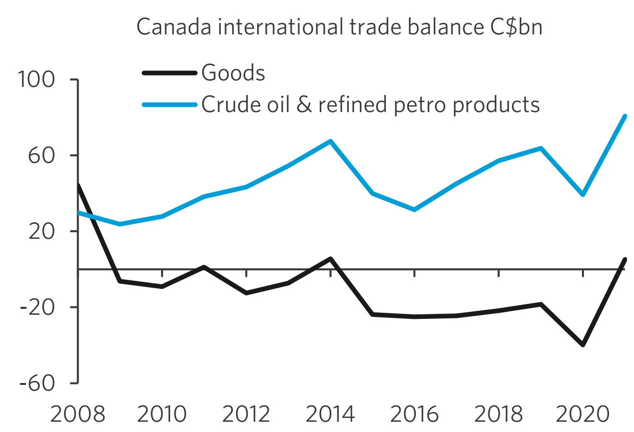
There are two ways that, in theory, a move to higher oil prices should help propel the Canadian dollar to firmer levels, and one of them may in fact no longer be as powerful as it was historically. The first, and most obvious, comes through the trade and current account balance. The higher the price per barrel, the greater is the lift to Canada's goods trade balance. In even simpler terms, when oil prices are higher, our oil exporters have more foreign currencies to convert into Canadian dollars to pay their taxes, workers and shareholders.

We're not Saudi Arabia, but oil exports still tell a lot of the story for our goods trade balance from year to year (Chart 1). If anything, that link has increased as the country's export volumes have expanded, and as Canada's performance in non-energy tradeable goods has lacked lustre.

But there's a second linkage to the loonie that operates on financial flows. When oil prices are stronger, overall it's a benefit for Canada's economy, or at least it has been in the decades since the country first became a significant net exporter. Models consistently show that beginning in the 1990s, the drag on growth from higher fuel costs was more than offset by the lift to export volumes and capital spending.

That meant that oil prices fed into Bank of Canada interest rate decisions, and importantly, did so to a greater degree than in the US. America has generally been a net oil importer, and as a

Chart 1: Goods balance swings with oil trade



Source: Statistics Canada, CIBC

result, rising oil prices, while lifting inflation, are a negative for growth. In Canada, with oil price gains lifting both growth and inflation, there's a stronger link between a rise or fall in crude and a decision to raise or lower interest rates.

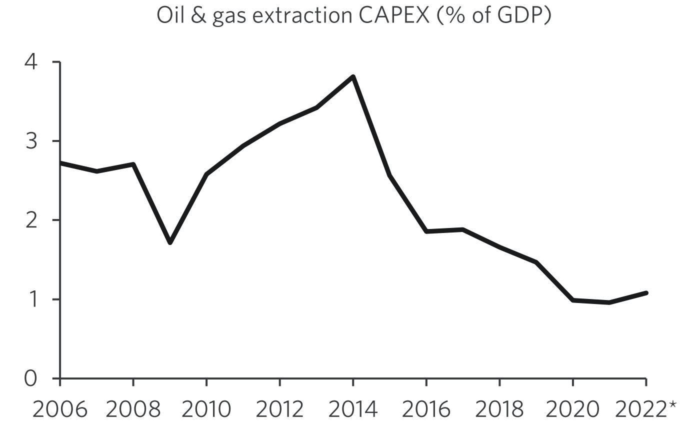
The last example of this was in 2015, when Governor Poloz cut overnight rates to provide additional stimulus after the outlook was hit by a sharp drop in oil prices. There was no corresponding move in US monetary policy (Chart 2). Since Canada-US interest rate spreads tend to widen when oil prices are higher, the financial flows stimulated by those spreads become a second avenue through which crude prices can oil up the Canadian dollar's ascent.

The weakened cap-ex channel

Remember, however, that the reason that Poloz cut interest rates in 2015, and thereby added to loonie weakness, wasn't that Canada's oil production was expected to see a steep slide. It was energy sector capital spending that was at risk. Just prior to the late 2014 crude price crash, energy sector cap-ex accounted for roughly a third of all business capital spending in Canada. And the Bank of Canada correctly anticipated that a sharp pull back in new projects would represent a big dent in Canadian GDP, putting the economy into two quarters of negative growth to start 2015.

Since 2015, while oil sector capital spending has recovered, it is far from returning to its former glory or its share of Canadian GDP (Chart 3). The latest survey of spending intentions for 2022 could be an underestimate, given that the March upswing in oil prices came after the survey date, but we're likely to remain well below the mega-project days seen earlier in this century. That could reflect several forces, including environmental policies that are seen as increasing hurdles for mega-project approvals, investor reluctance to back energy sector projects, expectations that lofty oil prices could prove temporary, and a generally more cautious approach to capital spending across the sector.

Chart 3: Energy capital spending in Canada



Source: Statistics Canada, CIBC. *spending intentions

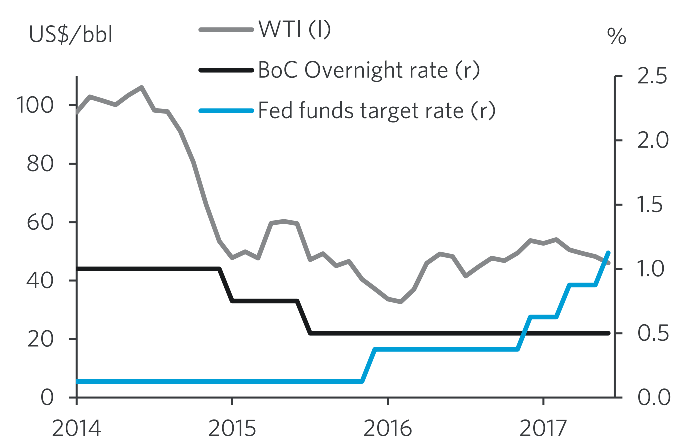
Whatever the cause, the result is that an upswing in oil prices won't prove as beneficial to Canadian economic growth as it did in the past, while a retreat in crude oil to even half its current level doesn't have room to cancel projects that haven't yet been put on the drawing board. So oil prices should no longer be as meaningful for Canada-US interest rate differentials as was the case in the last cycle.

The evidence

Beyond what we've seen with our naked eyes in the steadiness of the C$ amidst volatile crude prices, there is indeed statistical evidence to support the weakening of the linkage between oil and Canada-US interest differentials, and the corresponding softening of the oil-C$ tie (Chart 4).

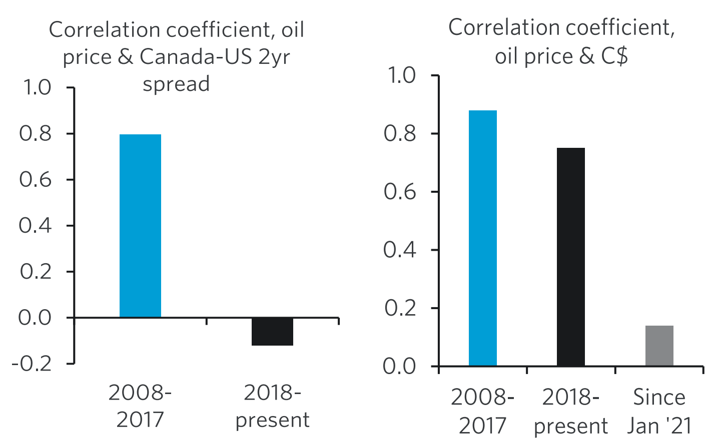
Looking at monthly average levels in the decade before 2018 to smooth out some of the noise in daily or weekly moves, there was a 0.80 positive correlation between the level of oil prices and the level of the Canada-US two-year bond spread. The two-

Chart 2: BoC cut rates after last oil plunge



Source: BoC, Fed, EIA, CIBC

Chart 4: C$ and rate spreads less sensitive to oil



Source: Bloomberg, CIBC

year spread picks up both actual moves by the central banks in overnight rate decisions, but also the market's anticipation of those decisions over the following two years. So higher oil prices have been generally seen by markets as a reason to expect a relative tightening of monetary policy north of the border, providing a lift to the loonie as a consequence.

But looking at the period since 2018, after capital spending in Canada's energy sector had completed its retrenchment, the correlation completely vanishes (in fact, it's slightly negative). The market no longer looks at oil prices as a factor in relative interest rates between the US and Canada.

Oil prices in that period since 2018 still had a linkage to the exchange rate, likely capturing the impact of crude oil on Canada's trade balance. But the correlation was weaker, dropping from 0.88 in the prior decade to 0.75 since 2018.

Looking only at the last year, it's essentially disappeared, but we would argue that's too short a window to conclude that oil will no longer matter at all for the loonie, particularly since the past year has entailed major swings in expectations for central bank policy for reasons that were much broader than what was happening to oil. A dramatic shift in the Fed's view of the world was clearly the major mover for currency markets in that period, since the US central bank went from projecting no rate hikes before 2024 to talking about an aggressive tightening in 2022.

The implications and some forecast adjustments

If the CAD-crude link is weaker, for Canada's oil producers, it implies that the FX moves will no longer be as strong a buffering force for their earnings when US dollar crude prices move in either direction. They can enjoy more of a climb in crude without seeing an offsetting appreciation of the Canadian dollar, but conversely, should crude oil retreat from recent heights, it won't promote as much of a softening in the loonie as we would have seen in the past.

We continue to expect a modest weakening in the Canadian dollar over upcoming quarters, but that has less to do with oil's likely slippage than with monetary policy. Neither the Ukraine conflict nor some upside surprises in inflation have seen us alter the 100 basis points we expect from both the Fed and the Bank of Canada this year, with a further leg in store for the subsequent two years. The degree of monetary tightening shouldn't be that sensitive to where the peak in CPI sits this year, as it will have a greater tie to what is needed to moderate growth, and therefore inflation, come 2023. But the greater need to demonstrate resolve against inflation during this sharper upswing, to prevent it from impacting longer term expectations, had us eliminate any pauses on this year's spate of quarter point hikes until rates are up by 100 bps in both countries (Table 1).

That's of less importance for the loonie, however, than the fact that we also see investors adjusting their assumed terminal rate for the US to higher levels that are more consistent with both our forecast, and the Fed's view of the longer term neutral rate. We see the US neutral rate as likely to be somewhat higher than that for Canada, given the Canadian household sector's higher debt burden and exposure to resets on mortgage rates over time. We're waiting until there's a bit more clarity on the war to post new FX forecasts, so the table shows where our thinking was on overseas major currencies prior to the flight to safety bid for the US greenback.

With the Ukraine events being part of an upward adjustment to our oil price forecast, and absent a disinflationary climb in the Canadian dollar, we've significantly raised our inflation projections for both Canada and the US through the first half of 2022 (Table 2). The higher base level for gasoline this year will, however, put some downward pressure on year-on-year inflation in 2023 if oil has cooled by that point as we expect.

We've also adjusted our growth projections in the wake of Q4 GDP for Canada, and recent US monthly reports. Russia's invasion will have downside implications for European growth, and by extension global growth, but as a commodities exporter, Canada will see some offset from at least a risk premium lingering for a while in prices for fossil fuels, grains, fertilizers and some metals. Our Canadian growth forecast for 2022 overall hasn't changed. A better Q4 last year, and a surprise monthly gain in GDP in January despite public health measures tightening, got us off to a firmer start that will offset a downward revision to our projection for the middle two quarters.

On the US side, firmer inflation in the next two quarters from a higher profile for gasoline will be a negative for growth, by squeezing real disposable incomes. Our 2022 annual growth projection will benefit from an upward revision to our Q1 projection, but that's more than offset by a weaker profile for the spring and summer. We nudged down our 2022 growth rate by 0.2% as a result, while adding nearly 2% to our CPI average for the year as a whole.

Table 1: Canada forecast detail (real % change, SAAR, unless otherwise noted)

Variable	22Q1F	22Q2F	22Q3F	22Q4F	23Q1F	23Q2F	23Q3F	23Q4	2021F	2022F	2023F
Real GDP Growth (AR)	2.4	4.2	2.3	3.7	1.6	3.6	2.8	2.1	4.6	3.6	2.8
Real Final Domestic Demand (AR)	1.8	1.7	3.3	3.3	1.8	3.1	1.9	2.2	5.5	2.7	2.5
Household Consumption (AR)	0.7	2.0	3.2	4.1	2.1	4.5	2.3	2.4	5.2	3.7	3.1
All Items CPI Inflation (Y/Y)	5.6	5.2	4.0	3.2	2.0	1.6	1.9	2.0	3.4	4.5	1.9
Unemployment Rate (%)	6.3	5.8	5.6	5.6	5.5	5.6	5.6	5.6	7.4	5.8	5.6

Table 2: US forecast detail (real % change, SAAR, unless otherwise noted)

Variable	22Q1F	22Q2F	22Q3F	22Q4F	23Q1F	23Q2F	23Q3F	23Q4	2021A	2022F	2023F
Real GDP Growth (AR)	2.7	3.2	3.0	2.9	2.8	2.6	2.4	2.3	5.7	3.8	2.8
Real Final Sales (AR)	3.9	3.1	2.8	2.2	3.0	3.5	2.7	2.5	5.4	2.9	2.9
All Items CPI Inflation (Y/Y)	7.7	6.9	5.9	4.6	3.1	2.2	2.1	2.2	4.7	6.3	2.4
Core CPI Inflation (Y/Y)	6.4	5.7	4.9	3.9	2.8	2.2	2.3	2.5	3.6	5.2	2.5
Unemployment Rate (%)	3.8	3.6	3.5	3.5	3.5	3.5	3.5	3.5	5.4	3.6	3.5

Table 3: Canadian interest rates (end of period)

Variable	2022 7-Mar	2022 Jun	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
Overnight target rate	0.50	1.00	1.25	1.25	1.50	1.75	1.75	1.75
98-Day Treasury Bills	0.59	0.75	1.00	1.20	1.70	1.75	1.75	1.75
2-Year Government Bond	1.40	1.70	1.85	1.90	2.15	2.20	2.25	2.30
10-Year Government Bond	1.70	2.15	2.25	2.30	2.40	2.45	2.50	2.55
30-Year Government Bond	2.00	2.35	2.40	2.40	2.40	2.45	2.50	2.55
Canada - US T-Bill Spread	0.24	-0.15	-0.15	-0.15	0.10	-0.10	-0.05	-0.10
Canada - US 10-Year Bond Spread	-0.08	0.00	0.05	0.05	0.10	0.05	0.05	0.05
Canada Yield Curve (10-year — 2-year)	0.30	0.45	0.40	0.40	0.25	0.25	0.25	0.25

Table 4: US Interest rates (end of period)

Variable	2022 7-Mar	2022 Jun	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
Federal funds rate	0.125	0.875	1.125	1.125	1.375	1.625	1.875	1.875
91-Day Treasury Bills	0.34	0.90	1.15	1.35	1.60	1.80	1.80	1.85
2-Year Government Note	1.54	1.60	1.80	1.85	2.15	2.30	2.40	2.50
10-Year Government Note	1.78	2.15	2.20	2.25	2.30	2.35	2.40	2.50
30-Year Government Bond	2.19	2.40	2.50	2.55	2.60	2.65	2.70	2.70
US Yield curve (10-year — 2-year)	0.24	0.55	0.40	0.40	0.15	0.05	0.00	0.00

Table 5: Foreign exchange rates

Exchange rate	2022 7-Mar	2022 Jun	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
CAD-USD	0.79	0.77	0.76	0.76	0.76	0.76	0.77	0.78
USD-CAD	1.27	1.30	1.32	1.31	1.31	1.31	1.30	1.29
USD-JPY	115	116	115	114	113	112	111	110
EUR-USD	1.09	1.11	1.10	1.10	1.11	1.12	1.13	1.15
GBP-USD	1.32	1.33	1.33	1.33	1.33	1.33	1.35	1.36
AUD-USD	0.74	0.74	0.75	0.76	0.76	0.77	0.77	0.78
USD-CNY	6.32	6.25	6.20	6.15	6.10	6.05	6.00	5.95
USD-BRL	5.04	5.70	6.00	5.70	5.90	5.70	5.50	5.30
USD-MXN	21.1	21.5	22.0	21.5	21.0	21.5	21.3	21.5

Contacts:

Avery Shenfeld
416 594-7356
avery.shenfeld@cibc.com

Benjamin Tal
416 956-3698
benjamin.tal@cibc.com

Andrew Grantham
416 956-3219
andrew.grantham@cibc.com

Karyne Charbonneau

karyne.charbonneau@cibc.com

Katherine Judge
416 956-6527
katherine.judge@cibc.com

FICC Strategy
Ian Pollick
416 594-7057
ian.pollick@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
Bloomberg @ CIBC

economics.cibccm.com