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MARKET ETHOS

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New NAFTA

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It would appear the bark was worse than the bite. After months and months of tough talk, name calling and threats of walking away from any trade deal, the U.S. and Canada (plus Mexico) have agreed to a new NAFTA deal called the United States-Mexico-Canada Agreement (USMCA). We would say this resolution is a positive surprise for Canada. Yes, concessions were given on the Dairy front, opening up more of our market to the U.S. but most other key friction points went our way.

The USMCA is set to last for 16 years, which is a good thing. That helps remove uncertainty and allow businesses to make longer term decision. Canada won again on keeping the dispute settlement mechanism. The new terms on autos and auto parts appear largely positive for Canada. Online shoppers should welcome the move to allow purchases below $150 to be duty free, which may hurt some Canadian retailers. As mentioned the biggest concession was allowing access to 3.5% of Canada's dairy market, slightly higher than the 3.25% Trans-Pacific Partnership level. Perhaps the price of cheese will fall, but the government plans to compensate dairy farmers, so higher taxes may offset the consumer gain.

There was much speculation that the hard line talk taken by the U.S. was largely policitally motivated. Lots of tough talk sound bites for politicians ahead of the mid-term elections, and a win in the form of a better deal ahead of going to the polls. We would expect this new deal to be marketed as a win by U.S. congress members vying for re-election.

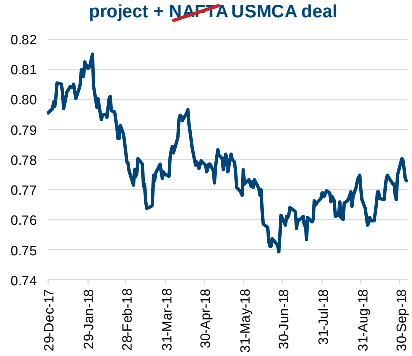
Implications

This is good news for the **Canadian economy**. A big harsh overhang has been removed, that while it had a low probability of occurrence, would certainly have caused a big economic hit. We would not be surprised to see the consensus of 2.0% GDP growth for next year to move marginally higher.

This deal also makes rate hikes by the **Bank of Canada** more likely. In their latest statement, the BoC specifically highlighted trade uncertainty as a contributing factor to their decisions. Now with this removed, it is more about the economic data and the data has been good.

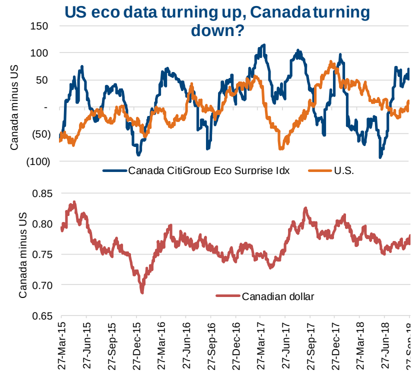
This bring us to the **loonie**. The trade deal obviously removes a big overhang from the loonie and there was a move higher. However this move has not impressed most and we were left wondering, can it get any better for the loonie?

Perfect Storm for C$ - better data, LNG project + ~~NAFTA~~ USMCA deal

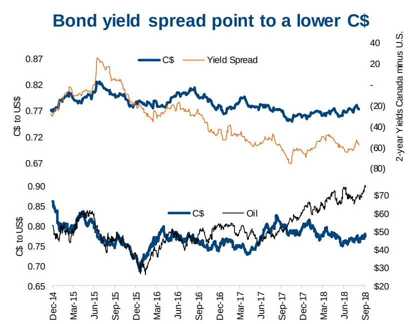


C$ - where to from here

Ok, one would have thought that, given the strong Canadian economic GDP print on September 28, oil trading into the mid $70s, the good news of a multi billion dollar investment into LNG capacity **AND** the USMCA deal the loonie would have rallied more. The C$ strengthened by 1% on Friday, thanks to the economic data and 0.73% on Monday with all the other good news. But since then it has given back about half those gains with the market moving into more of a risk-off environment.

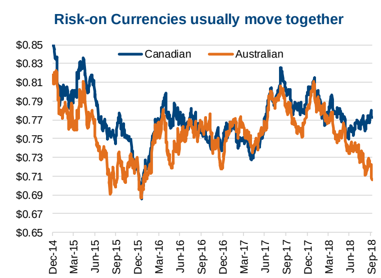


This brings us to the economic data. The U.S. data has been failing to impress expectations since the beginning of the year as made evident in the declining yellow line in Chart 1. The yellow line is the Citigroup Economic Surprise Index for the U.S. with the blue line the same for Canada. We would note the C$ (bottom panel) failed to rally much when the Canadian data was surprising to the upside. However now, the U.S. data appears to be turning more positive. This has been a seasonal trend evident over the past seven years that has seen soft U.S. data in the first half of the year and stronger data in the back half. Meanwhile Canada appears to be starting to soften. Today's employment data from Canada was very strong but the vast majority of new jobs were part time with full time actually shedding jobs.

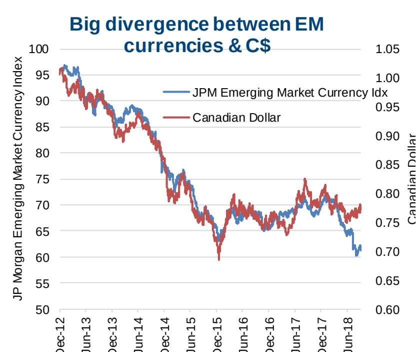


If these reverse course and we transition to a market with better U.S. data and softer Canadian, we would bet the C$ would soften.

Care for some more support that the C$ should weaken? Yield spreads, based on 2-year maturities certainly favour a lower C$ relative to the U.S. (Chart 2 top panel). Yields in the U.S. continue to be much more attractive than in Canada, plus they appear to have inflation and an economy firing on more cylinders than ours. Risk-on currencies, which includes the C$ and Australian dollar (AUD) usually trade together. But not recently as the AUD has been declining while ours has held up (Chart 3). While we could argue the AUD is more levered to China which is in a bear market and their housing industry appears to be in some trouble, if this relationship reasserts, there is an airpocket under the C$.



There is also an airpocket under the C$ if you look at emerging market currencies. Now we are not saying the C$ is an emerging market currency, but there has been a long strong relationship over the years and currently there is a big divergence (Chart 4).



There are some counterarguments to a weaker C$. Oil in the mid $70s is certainly a strong one. Plus from a valuation perspective the C$ is about 5% undervalued vs. the US$. US$ may also be starting to top out as global yields rise, playing some catch up to the U.S. Still, when a big pile of bullish C$ news hits and the result is tepid, the market is telling you something. Likely the path of least resistance for the C$ may be to the downside for now.

Charts are sourced to Bloomberg unless otherwise noted.