Canadian Dollar

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1 – 3 Month Outlook – Upside potential to USD/CAD

We are maintaining our near-term bullish USD/CAD view on continued concerns that riskier asset classes, especially equities, might be too aggressively priced for a perfect global economic recovery. A further downward correction in equity and commodity prices should drive USD/CAD toward our target of 1.14 as global forces continue to overshadow FX trends. Local developments are slowly starting to reassert themselves as potential CAD drivers. Although Chinese stocks underwent a major correction in August – at one stage down 24% from the 2009 peak – global stocks are still trading close to their 2009 highs. The MSCI world index is down only 5% from its Aug 28, 2009 peak after rallying 60% during the prior six months. Base metal and crude oil prices exhibit a broadly similar trend – ie strong increase, very mild correction. Given the risk of an erratic global recovery as opposed to a smooth V-shaped trend, further downside corrections can be expected in riskier asset classes within the next few months, weighing on commodity currencies.

Locally, the economy is expected to show increasing signs of the recovery. Retail sales are once again increasing. The economy is also expected to start showing the positive impact from the fiscal stimulus announced in January. Also, the increase in US manufacturing ISM data and the US "cash for clunkers" program bode well for Canada's manufacturing sector in H2 09. These developments set the stage for a more sustainable CAD rally in 2010. Although political uncertainty could temporarily weigh on CAD, we expect any politically-induced moves to be moderate and fleeting irrespective of whether the government is toppled or survives into 2010.

6 – 12 Month Outlook – CAD closer to parity

The BoC is unlikely to soon drop its conditional commitment to keep rates unchanged till June 2010. However, as the economy recovers, the market will either start pricing in earlier rate hikes or more aggressive rate hikes once the normalization process starts. Either outcome should support CAD strength; and together with a global economic recovery, CAD is expected to embark on a renewed path of appreciation, albeit at a slower pace than seen between March and July 09. Dips toward parity remains a clear possibility in 2010.

Indicators

	Current (Previous) *
Official cash rate	**0.25% (0.25%)**
Trend interest rates 10y average	4.00%
Bias in interest rate market	Stable
Core CPI Inflation %Y/Y Jul (Jun)	**1.8% (1.9%)**
CPI Inflation target range %Y/Y	1-3%
Budget balance % GDP FY09 (FY08)	**-0.1% (+0.6%)**
Budget balance target % GDP	Balanced over the business cycle
GDP Growth %Y/Y Q2 (Q1)	**-3.3% (-2.3%)**
Trend GDP %Y/Y	3.0%
Purchasing Power Parity Value Jul	**1.2912**
Spot end-Aug	1.0937
PPP Valuation	USD/CAD is undervalued
Current account balance % GDP Q2 (Q1)	**-3.0% (-2.0%)**
Trend current account balance % GDP	2.00%
Moody's Foreign Currency Rating	**Aaa**
Outlook	Stable

** Current is latest month, quarter or year*

1. Market still believing BoC's rate commitment

Source: RBC Capital Markets, Bloomberg, BoC

2. Improving US manufacturing bodes well for Canada

Source: RBC Capital Markets, Bloomberg

Forecasts

	2009				2010			
	Q1f	Q2f	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/CAD	1.260	1.162	1.140	1.090	1.080	1.070	1.050	1.050