**CAD To Remain Well Supported Into Next Week’s BoC**

We expect the CAD to remain well supported into next Wednesday’s Bank of Canada policy decision. A hold is widely anticipated however the statement tone is likely to see a significant re-write and offer a much more constructive message relative to the one conveyed at the last meeting in late April. The recent run of stronger than expected domestic data releases has been impressive, and North American trade policy uncertainty has moderated following the lifting of steel and aluminum tariffs. Gov. Poloz reintroduced a bias to higher rates last week, and we suspect that the May 29 statement tone and May 30 Economic Progress Report (Wilkins) speech will confirm the Governor’s shift in messaging. Markets have nearly faded their bias to BoC easing however they have yet to fully reflect the Governor’s expectations for a shift toward a higher neutral policy rate.

Speculative CAD shorts look increasingly vulnerable to a squeeze as we approach next Wednesday’s Bank of Canada policy decision as well as Senior Deputy Governor Wilkins’ Economic Progress Report speech the following day. Stronger domestic releases and constructive North American trade policy developments will warrant a significant shift in messaging.

The recent run of domestic releases has been impressive, with upside surprises across key housing, trade, employment, and consumer spending data. The Canadian data surprise index is nearing its multi-year high from 2017, a high reached just ahead of Wilkins’ hawkish pivot that powered much of the near-15% rally in the CAD from May to September of that year.

On trade policy, the lifting of steel and aluminum tariffs should bolster policymakers’ confidence in the economic outlook, and specifically business investment, given the implications for USMCA/CUSMA ratification.

BoC Gov. Poloz had already reintroduced a hawkish bias in last week’s Bloomberg interview that was recorded ahead of the tariff announcement. We suspect that next week’s statement and Wilkins’ Economic Progress Report speech will confirm the Governor’s renewed optimism.

Domestic rate expectations have seen a significant adjustment over the past two months. Market participants had priced as much as 30bpts in BoC easing (over 12 months) as recently as March 27, and had been pricing about 20bpts of easing into the last policy decision and MPR forecast update. The easing bias has almost been completely eliminated however Gov. Poloz’ latest comments suggest that markets may need to reprice for modest tightening.

A reminder that the April MPR determined a neutral policy rate estimate ranging between 2.25 and 3.25%. At minimum, the BoC will need to deliver two additional rate hikes to get to their estimate of ‘neutral’. Scotiabank Economics’ forecast anticipates to additional BoC rate hikes into the end of our forecast horizon, including one in Q4 2019 and one in Q2 2020.

Price action following the release of the robust Retail Sales data earlier has been disappointing, with the CAD unable to sustain early gains and reversing quickly from the dip through technical support in the upper 1.33 zone. That might leave the CAD prone of a little more softness in the very short term but scope for weakness should be limited.

By our estimate, the CAD remains significantly undervalued relative to key fundamental variables. We think this can be partially explained at least by ongoing trade tensions between the US and China. But the spot market’s discount to our estimated equilibrium (assessed using 2Y and 5Y U.S.-Canada yield spreads as well as WTI) is nearing two standard deviations. We currently assess FV for USDCAD at 1.3064.
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