24 January 2025

FX Viewpoint

Currencies
Global

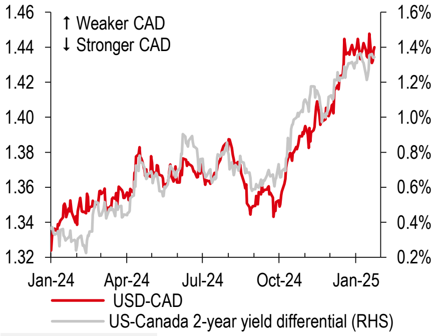
CAD: Assume the best but…

- Like consensus economic forecasts and rates markets, we are assuming the best in terms of the tariff path…
- …and so, we expect USD-CAD to move sideways in 2025, but with upside risks if trade tensions prove more acute
- Over the near term, risk-reward favours CAD weakness, given the looming tariff threat on 1 February

USD-CAD has been tracking in line with its yield differential and broader USD moves for now

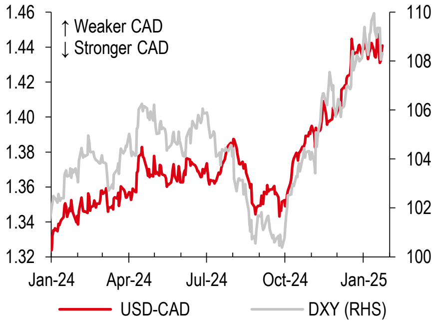
Typically, we look to two main drivers of USD-CAD, namely Canadian interest rate differentials against the US (Chart 1), and the outlook for the broad USD (Chart 2). USD-CAD is tracking in line with both drivers for now, but **some of the rise in US yields and the associated strength in broader USD is built on expectations of a material shift in US policies.** In other words, both drivers could change alongside US policy steps.

1. USD-CAD is following its yield differential



Source: Bloomberg, HSBC

2. USD-CAD is also aligned with broader USD moves



Source: Bloomberg, HSBC

Consensus economic forecasts appear to be assuming the best, with little change in Canadian GDP and inflation expectations since the US election

The recent choppiness in USD-CAD has captured the dilemma for the CAD around the US tariff risks. This means **USD-CAD has to weave in a third driver – the outlook for trade relations with the US – for 2025 and beyond.** It is unclear what is priced into the CAD for the looming possibility of US tariffs on imports from Canada. That being said, consensus economic forecasts appear to be assuming the best, with little change in Canadian GDP and inflation expectations since the US election. The Canadian economy is still expected to expand by 1.8% and inflation is forecast at 2.1% in 2025, matching pre-US election expectations (Bloomberg, 20 January 2025). But **a 25% import tariff levied by the US could bring a 1.8% hit to the Canadian economy, and the hit could be as high as 2.6% if Canada retaliated in full** (Canadian Chamber of Commerce, 28 November 2024).

Rates markets also seem to be hoping for the best in terms of the tariff path

There are reportedly plans in place for Canada to impose tariffs on USD150bn of imports from the US (Dow Jones, 16 January 2025). The Bank of Canada (BoC) is likely to respond with much lower rates, although higher inflation through a weaker CAD and tariff effects would be part of the policy mix. But here too, **rates markets seem to be hoping for the best**, with the implied rate for one-year ahead at c2.7%, not far from where it was at the start of November (Bloomberg, 24 January 2025).

But the risks are skewed towards a weaker CAD given the looming tariff threat

Assuming that no meaningful tariffs are imposed, we expect **USD-CAD to move largely sideways in 2025.** However, as markets assume the best, **risk-reward favours CAD weakness over the near term**, given the looming tariff threat on 1 February.

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