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RICHARDSON GMP

Market Ethos

The latest market insights from the Richardson GMP team

Which way will the Loonie fly this winter?

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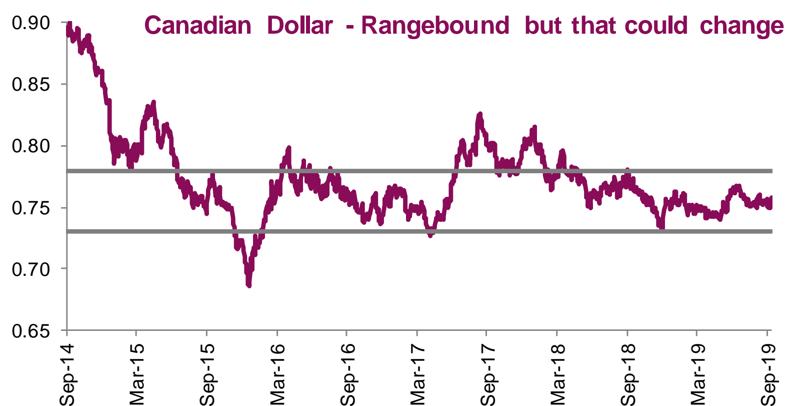
The Canadian dollar is currently trading a little over 75 cents/USD and has largely remained in a range of 73-78 cents over the past five years. This range has actually been even more narrow over the past year, implying a calm currency market. Well, that is likely no longer the case given slowing global economic growth, U.S.-driven protectionism, rising relative deficits and divergent paths by central bankers. Maybe these divergent factors have been offsetting each other to create such a calm exchange rate but, if that is the case, chances are it will end.

In this Ethos, we provide an update on our currency view, present a bull/bear case and explain how this filters down to our portfolio management process. Let's start by saying Canadian investors have benefited over the past decade from U.S. currency exposure, not just from a performance enhancement perspective but also as a great volatility management tool. Generally speaking, when the global markets turn risk-off, due to whatever the problem de jour, equity markets would fall but the U.S. dollar would rise. The U.S. dollar has been viewed over the past decade as a safe-haven currency, so when markets are falling, the U.S. dollar appreciates – just the kind of diversification tool that all portfolios would like. And don't forget that the U.S. dollar has appreciated by an average annualized rate of 2.5% over the past decade. This boost, while not constant, has helped portfolio performance when translated back into Canadian dollars.

We have been long-term fans of U.S. exposure in our North American portfolios and asset allocation services. However, we have started to temper this view for a number of reasons. In the next sections, we provide reasons to be both bullish and bearish on the Canadian dollar, so you can come to your own conclusion. But don't worry, we will share our conclusion as well.



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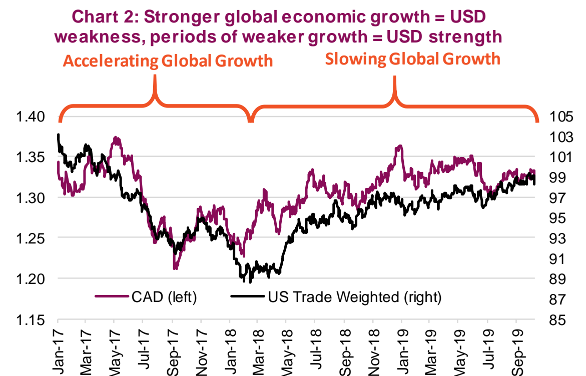
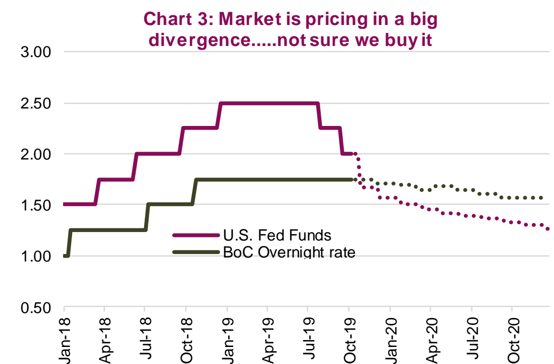
Reasons to be bearish the C$ over the USD

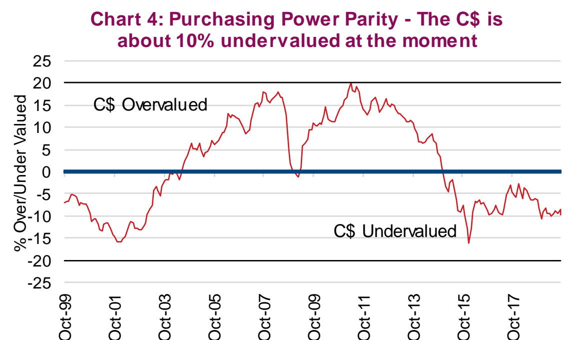
Slowing global growth – In 2018, global economic growth appears to have come in around 3.7% after accelerating for a few years. The consensus has global growth slowing in 2019 to 3.2%, down from expectations six months ago of 3.4%. 2020 is now forecast at 3.1% growth. While not falling off a cliff, the trend appears to be a deceleration from above trend-line growth back down to trend line. Normally, when global growth is slowing, the U.S. dollar appreciates versus the Canadian dollar. Weaker global growth leads to slowing global trade and that weighs more heavily on Canada's export/resource-tilted economy compared to the more insulated consumer-tilted U.S. economy (Chart 2).



Along the same lines, if you believe the current economic expansion is nearing its final innings and a recession is approaching, it would be difficult to be bullish on the loonie. If or when we enter the next recession, the U.S. consumer is in much better health to weather the contraction. Debt-to-disposable income is now below 100% for Americans and near all-time highs of 170% for the Canadian consumer. Plus, the Canadian economy is much less diversified now, as energy and manufacturing have declined in importance while housing is now the big driver. Most would expect, in a recession, for the U.S. dollar to rise relative to the loonie.



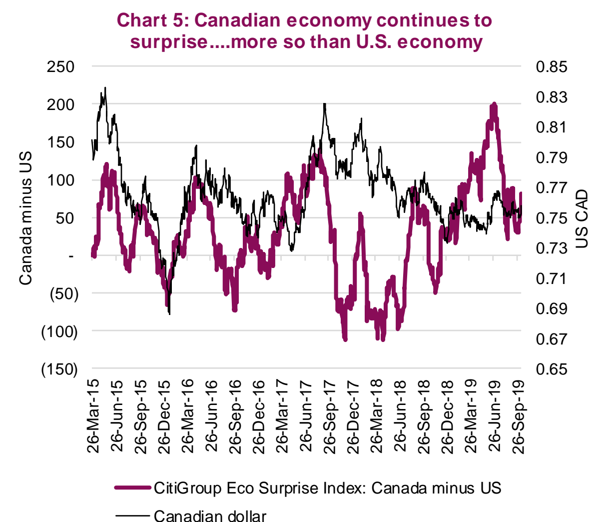
Central banks – We have seen a divergence in monetary policies of late. The U.S. Federal Reserve (Fed) has cut rates twice while the Bank of Canada (BoC) has remained steadfast. Plus, expectations at the moment have the markets pricing in 75 basis points (bps) in rate cuts by the end of 2020 for the Fed and only about 16 bps for Canada (Chart 3). This divergence, the U.S. cutting while Canada remains stable, has helped support the Canadian dollar in the past months. However, if you believe the economic data gets bad enough to see the Fed cutting twice, it would be a safe bet that the BoC would pivot to cut as well.



But it is not just one side…

Reasons to be bullish the C$ over the USD

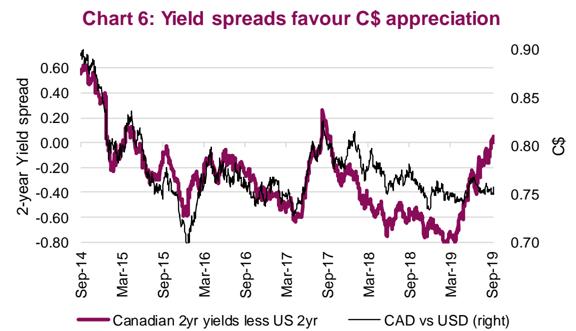
Valuations – A currency isn't like a company that we can apply a discounted cash flow valuation or price-to-earnings multiple to compare relative value. Instead, there is purchasing power parity (PPP), which attempts to determine that an exchange rate should be based on the relative price of goods between countries. (Here's a fun two-minute video explaining PPP). PPP can be used to demonstrate if a currency is over or undervalued relative to another. And while it can remain far from equilibrium for a long time, it tends to move towards mean reversion for investors with patience. The Canadian dollar is about 10% undervalued compared to the U.S. dollar based on PPP (Chart 4).



No respect - The Canadian dollar has been getting no respect despite strong fundamentals and relative outperformance of the Canadian economy. Canadian data continues to hold up and in fact the data has decisively beaten expectations. Chart 5 shows the spread between the Citigroup Economic Surprise Indicator for both Canada and the U.S. Historically, when Canadian economic surprises have been positive and stronger than the U.S. for such an extended period of time, the Canadian dollar shows strength.

This dislocation between strong economic fundamentals and the currency market is difficult to reconcile with, but it is being priced into the bond market. Two-year Canadian/U.S. bond yield differentials have historically been a significant driver of the exchange rates. The spread heavily favoured U.S at the beginning of the year, but has been trending lower since March and in early October flipped into negative territory. Two-year Canadian bonds now yield more than their U.S. counterparts. As you can see from Chart 6, the last time differentials were at this level, the C$ was above 80 cents.

Chart 6: Yield spreads favour C$ appreciation



Portfolio Implications

We still believe there is a strong diversification benefit in a decent amount of U.S.-dollar exposure for Canadian investors, especially if there is a recession on the horizon in the coming year or two. However, given current valuations and expectations baked into the market, we do not expect a return bump from currency over the coming years. In fact, if you look out over 5+ years, we would expect to see a currency drag for U.S.-currency investments. Let's not forget, in 2011 nobody wanted U.S. exposure and many clamoured for hedged investment strategies, which was not the time to be doing so as the U.S. dollar was undervalued versus most major currencies (Chart 7). Today it is the opposite – nobody wants to hedge, and the U.S. dollar is now overvalued against most (Chart 8).

Based on this view, we believe investors should be more open to considering hedged investment strategies on a go-forward basis.

Chart 7: In 2011 USD was undervalued vs most currencies

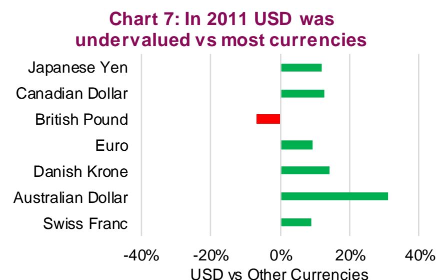
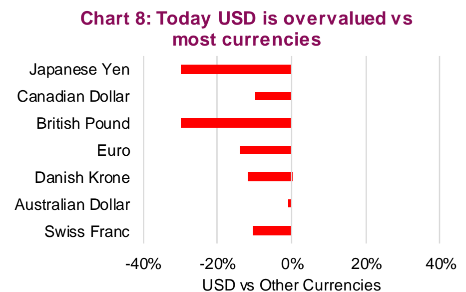


Chart 8: Today USD is overvalued vs most currencies



Source: All charts are sourced to Bloomberg L.P. and Richardson GMP unless otherwise stated.

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