Global Asset Management

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The Lowdown on the Loonie

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The Canadian dollar (CAD) has appreciated 10% since early May. That pace of appreciation has happened three times in the past decade: the fall of 2007, the spring of 2009 and the spring of 2016. The first two of these three rallies occurred during the U.S. dollar (USD) bear market. The last one occurred during a USD bull market, and was preceded by an equally rapid CAD depreciation, forming an almost perfect “V” on the charts. To put it in context, a 10% CAD move within a three month timeframe is massive considering that one year option volatility averaged 8.25% over the last 200 days.

The Bank of Canada (BoC) provided fuel for the move with its abrupt turn on June 12 when Deputy Governor Carolyn Wilkins talked about stronger growth ahead for the Canadian economy and the need for anticipatory monetary policy. That took the market by surprise as the BoC jumped from the back of the tightening queue to the front of the line. Almost at the same time, the U.S. Federal Reserve (Fed) started focusing more on the reduction of the balance sheet, implicitly delaying the additional hikes. While we have debated what caused the BoC turn, the market’s reaction to this change in tone led U.S.-Canada two-year interest rate differentials to tighten from 64bps to 2bps by the end of July, reflecting increased expectations of BoC rate hikes.

The currency markets took notice, switching attention almost exclusively to this new information and abandoning the previous focus on oil prices. To illustrate, the short term correlation of oil to CAD dropped from 56% to 25% while the correlation of two-year interest rate differentials to CAD took over, rising from 30% to 72%. The scenario painted by BoC assumes that the consumer contribution to growth will slow down with exports and corporate investment taking over.

The BoC turn came at a time when short positions on CAD were at extremely high levels. Foreign speculative CAD shorts built-up on concerns around Canada’s housing market and newsflow surrounding Home Capital Group. These were then reinforced by trades with an eye for a higher USD based on oil weakness. These shorts have now been unwound, long CAD positions are back on, but probably not excessive enough to topple under their own weight. Usually a trigger is needed to move sentiment the other way, conditions are certainly ripe for it.

Our medium term views don’t align with that of the Bank of Canada. A number of headwinds exist for the Canadian economy:

- Excessive consumer debt which will make future contribution to growth problematic
- Heightened risk of real estate prices dropping following a long streak of regulatory measures targeting excessive real estate risk-taking, higher interest rates and lower affordability for foreign buyers who have just seen Toronto housing go up by an additional 25% (15% tax + 10% currency appreciation)
- While the market focuses on interest rates differentials, for now it ignores the soon-to-come central bank balance sheet reduction in the U.S., which should be supportive for the USD
- Large current account deficit that still requires funding from foreign inflows
- Stronger CAD and new interprovincial trade agreements will be disinflationary, and BoC may be disappointed in their expectations of inflation reaching 2% over the next few years
- Canadian competitiveness challenges such as trade-related risks as well as tax, labour and environmental differences relative to the U.S.

Against this backdrop, we have been taking advantage of the recent CAD strength and tactically adding to our foreign currency exposures across a number of our fixed income mandates. One of the asset classes that looks particularly attractive is emerging markets currencies (EMFX). As we have pointed out in the past, the worst performance of this asset class (the best opportunities to add to positions) comes during periods of idiosyncratic CAD strength like we are facing today.

While we can't know for sure that this is the end of CAD strength in the short term, we believe it already provides good medium and long term opportunities.

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