FALL 2017

CURRENCY MARKETS

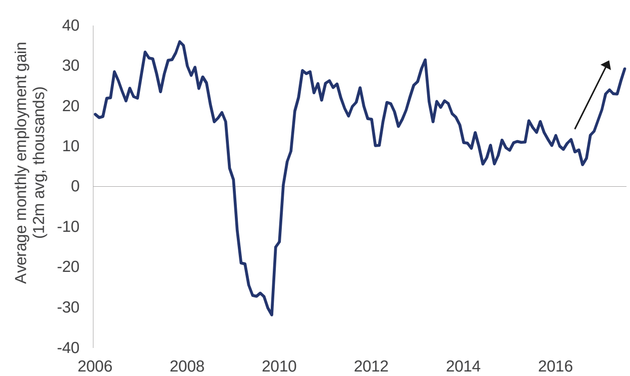
Canadian dollar

Dagmara Fijalkowski, MBA, CFA
Head, Global Fixed Income and Currencies (Toronto & London),
RBC Global Asset Management

Three cheers for the Canadian economy. It had been the underdog among developed economies since oil prices peaked in 2014. Growth expectations were reduced based on the downturn in energy prices, and then reduced some more after the U.S. election, when President Trump barged in on the international scene with his declaration to tear up NAFTA. Yet the Canadian economy has turned out to be the "little engine that could." Stronger global growth has helped and is reflected in a stronger domestic expansion in the first half of 2017. Canada, with a growth potential estimated at 1.4%, grew 3.6% in the first quarter and 4.5% in the second. Jobs have been added at an average rate of 32,000 in the 12 months ending July, a much faster pace than the 13,900 jobs added in 2016 and the 9,500 in 2015 (Exhibit 1). Export volumes have risen in the energy, merchandise and industrial-machinery sectors. Canada's blistering housing market, a perpetual source of worry, withstood a slew of macroprudential measures aimed at cooling it down, but with mortgage rates still low, household debts remain affordable. By 2017, Alberta oil companies had succeeded in reducing their operating and capital costs, and as a result break-even production prices have fallen by over 25% since 2014.

These positive developments fell onto the parched ground of expectations, which at the end of May were very, very low. The Bank of Canada (BOC) was paying attention and decided to take advantage of the window of opportunity to undo the interest-rate cuts taken as insurance in 2015. Deputy Governor Carolyn Wilkins's comments on June 12th hinting that this insurance would no longer be required sent shocks through the investor community, especially foreigners, who became quite weary of the Canadian housing market and the Canadian currency after Home Capital grabbed the headlines. The reversal of the market's short positioning helped fuel the loonie's appreciation. Between early May and end of July, the Canadian dollar rose 10% (Exhibit 2). It was only the fourth move of such a magnitude in the past decade, following the ones in the fall of 2007, the spring of 2009 and the spring of 2016.

Exhibit 1: Canadian employment data shows continued strength



Source: Bloomberg, RBC GAM

To put the move in context, the options markets assumed on average annual volatility of 8.25% over the past year. Canadian-dollar positioning swung from long U$2 billion in February to a massive short of US$7.3 billion after Home Capital and now sits at long US$4.1 billion, the most bullish stance in several years (Exhibit 3). So we ask ourselves, knowing what drove the currency's gain and its extraordinary magnitude, is it wise to buy the loonie now? Is a "hawkish" BOC a good enough reason? We believe that buying the Canadian dollar at current levels because BOC is hiking is like driving a car looking only in the rearview mirror.

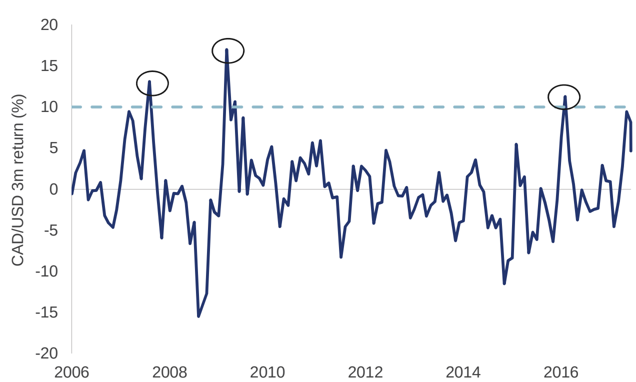
What we should ask is: What's ahead given that economic data surprises have been ratcheted up, the currency has strengthened and the Trump administration has disappointed? How likely is it that current expectations can be further exceeded? Is it likely that an economy that has surprised by growing 2% above potential can do so again?

While acknowledging a likely slowdown in consumer spending, the BOC is counting on increased exports and corporate investment to take over as drivers of the economy. That would require a large dose of luck in the face of severe headwinds to Canadian competitiveness that should become evident over the next year. These are[1]:

1. **Protectionism** – NAFTA objectives for the U.S. include revising the rules of origin, potentially increasing minimum U.S. content requirements. The re-negotiation schedule is unrealistically short in that the agreement is supposed to be redrawn by the end of the first quarter of 2018.
2. **Tax changes** – while corporate and personal taxes in the U.S. are likely to fall over the next year, Canadian personal taxes have been increasing, with the top combined federal and provincial rate in Ontario now at 53.53% for income above C$220,000. Even in the highest taxed states, like California, the combined federal and state tax rate reaches 52.70%, the highest federal bracket kicks in at US$418,000 and the highest state tax takes effect beyond US$1 million.
3. **Tougher provincial labour laws** – Alberta and Ontario are gradually increasing their minimum wages, Alberta by 47% and Ontario by 32% over the next two years.
4. **Stricter environmental standards** – the U.S. has withdrawn from its environmental obligations, while Canada is moving enthusiastically forward with a national minimum carbon tax, ensuring that all provinces are moving in the same direction.
5. **Electricity prices skyrocket** – electricity prices in Ontario climbed so high earlier this year that the Liberal government had to come up with a relief plan for voters ahead of next year's election. Even with the reductions, the competitiveness of Ontario's manufacturers has been severely hurt versus many manufacturing states in Mexico.
6. **Oil prices** – the rise of U.S. shale-oil production, which gives producers the ability to turn wells on and off with ease, is just the beginning of Canada's energy challenges. The promise of alternative energy such as wind power, as well as electric and automated vehicles, pose longer-term threats to the use of oil as a source of energy.

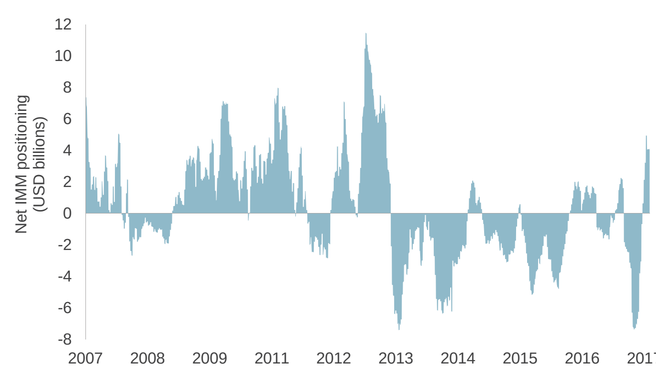
[1] Lascelles, Eric. *RBC GAM Weekly Economic Bullets*, June 19, 2017

Exhibit 2: Magnitude of recent CAD rally seen only three other times in the past decade



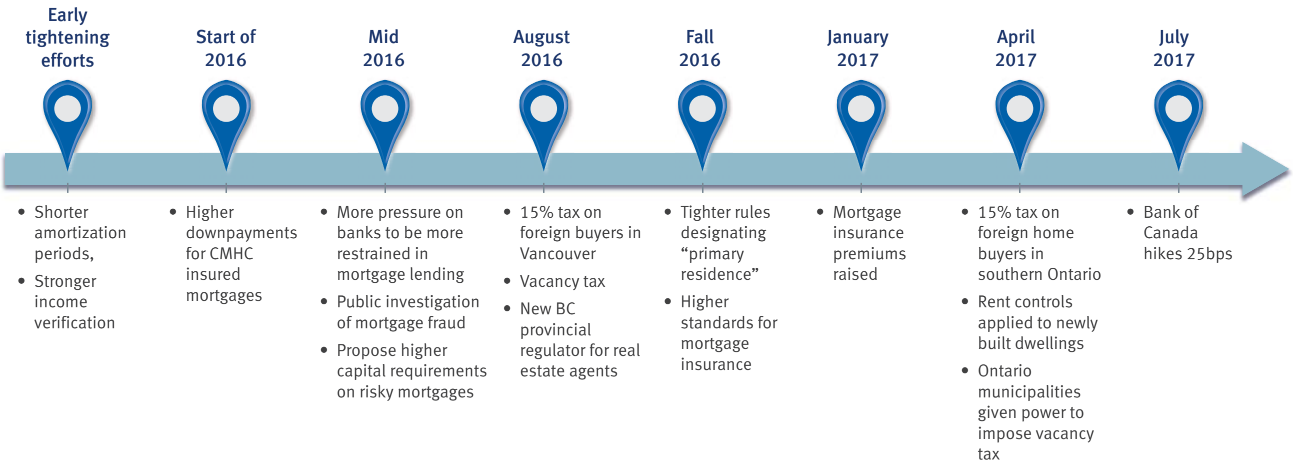
Source: Bloomberg, RBC GAM

Exhibit 3: CAD has seen large swings in positioning



Source: Bloomberg, CFTC, RBC GAM

Exhibit 4: Measures to slow Canadian housing excess

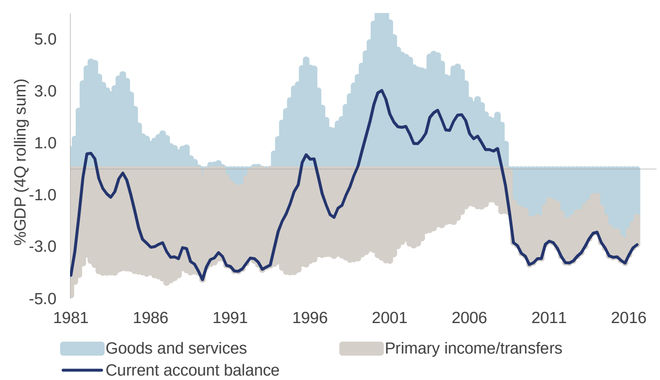


Source: RBC GAM

The BOC is counting on stronger exports and higher corporate investments, yet the headwinds above reduce the odds of success there. In addition, China's property bubble and problems in the country's overleveraged financial system are a risk down the road beyond the all-important National Congress of the Communist Party in mid-October. Slowing Chinese growth and excess capacity are likely to put downward pressure on Australia, Latin America and Canada. As for the cooling of consumer spending, the BOC acknowledges that the consumer will probably not be the engine of future growth, but its base case is for spending to level off rather than decline. Cumulative measures taken over the past couple of years to limit excessive risk-taking in the Canadian housing market, combined with higher interest rates, are much more likely to cool household spending (Exhibit 4). The marginal domestic home buyer is stretched. The measures targeted at foreign buyers (15% tax in Vancouver and Toronto) had been bolstered by the 10% appreciation of the loonie. Those that expect foreign buyers to return after a quarter or two may be underestimating the impact that the combined 25% increase in costs could have on foreign demand.

With a current-account deficit of 3%, the Canadian economy remains as dependent as ever on foreign funding (Exhibit 5). A cheaper Canadian dollar is one lure for foreign investors wanting to make direct investments and buy real estate. When it comes to balancing the imbalances, it's not just the degree of weakness the currency reaches, but the length of time it spends at the weaker side of valuations that has

Exhibit 5: Canada's current-account deficit



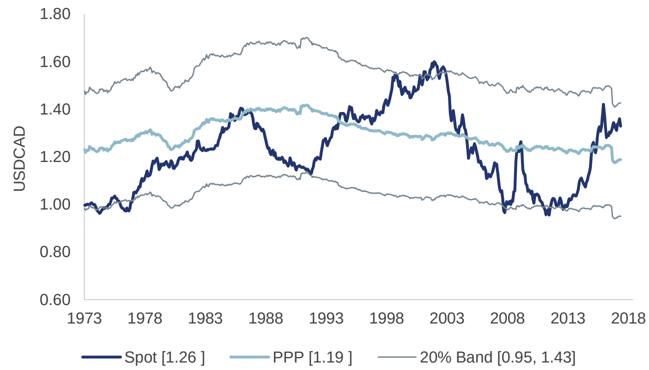
Source: Bloomberg, RBC GAM

> *The current backdrop leads us to believe the Canadian dollar will fall back to levels that compensate for Canada's lack of competitiveness, and that the currency will have to remain weak for some time.*

to be considered (Exhibit 6). It requires time to make the business decisions that would lead to sustainable fuel for future currency strength. For example, in the previous cycle it took 10 years of an undervalued currency to facilitate economic adjustment. The current backdrop leads us to believe the Canadian dollar will fall back to levels that compensate for Canada's lack of competitiveness, and that the currency will have to remain weak for some time. Our 12-month forecast for the loonie is C$1.37.

This discussion brings us to our longer-term view on the direction of the Canadian dollar. We can imagine the development of quite a few positives. Weaker energy prices and restrictive environmental policies may accelerate efforts in Canada to develop alternative energy sources that are cleaner and cheaper than fossil fuels. Moreover, anti-immigration sentiment in the U.S. may result in an immigration dividend for Canadian cities. That's the positive long-term scenario and we hope it will be the one to unfold.

Exhibit 6: USDCAD vs. PPP



Source: Bloomberg, RBC GAM

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