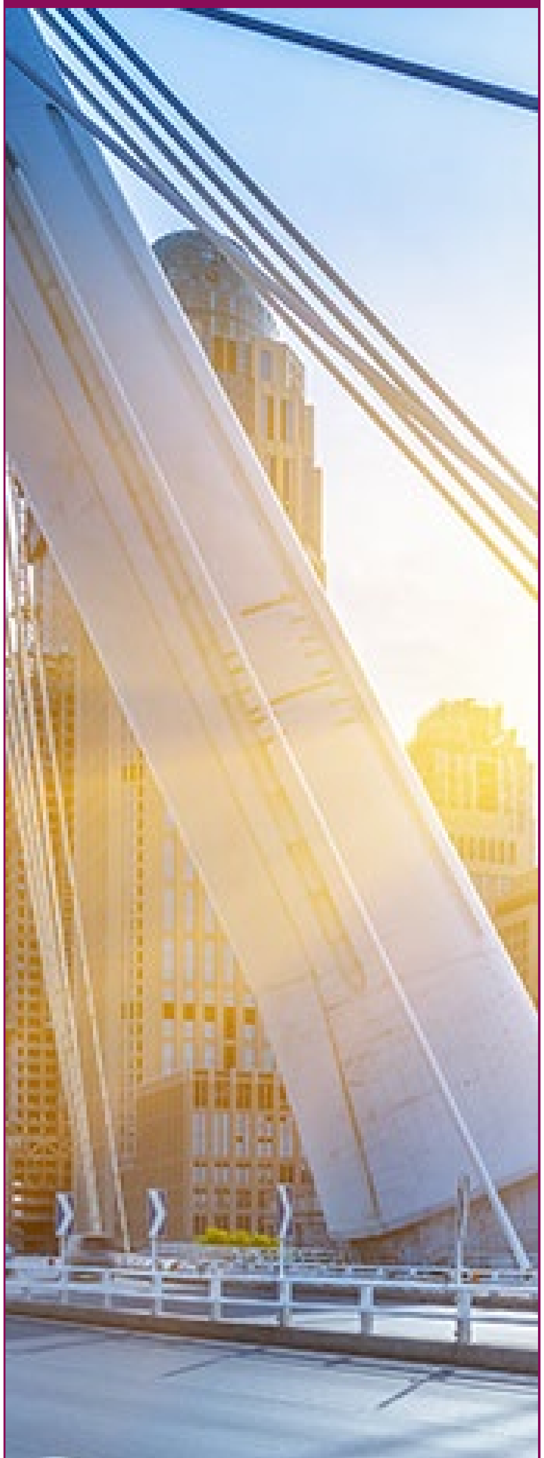
July 11, 2022

Market Ethos

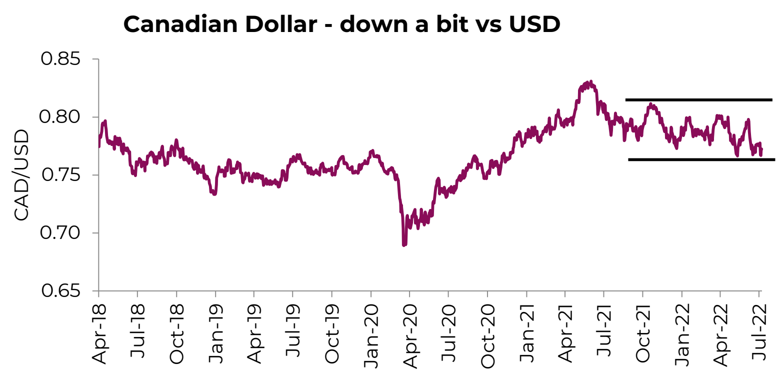
The latest market insights from Richardson Wealth



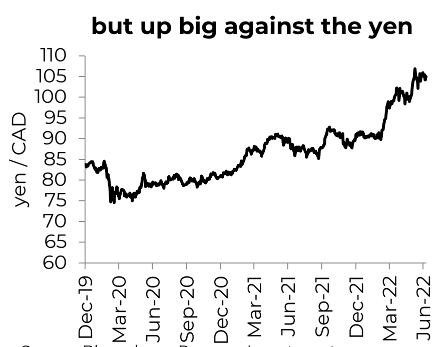
Currency in the spotlight

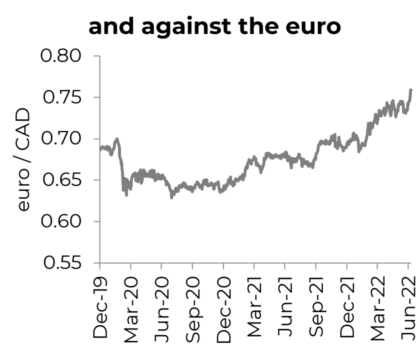
These are troubled times for the markets with equities down, yields up, inflation, lost luggage, and now recession grumblings. Yet the most recurring question during client events remains the Canadian dollar. While these questions are predominantly aimed at the CAD/USD exchange rate, currency has become increasingly impactful at the portfolio level over the past year. Not to be outdone by the volatility in equities and bonds, currency volatility has also been right up there this year.

There is no denying the USD has been the star as the greenback has reached multi-decade highs against many of the major currencies, including the yen and euro. So, while the CAD may be a bit softer at 77-78 cents, that drop is marginal compared with many other currencies. As the following chart illustrates, the CAD has appreciated by 10% this year in comparison with many international currencies.



Source: Bloomberg, Purpose Investments





Source: Bloomberg, Purpose Investments

There are many moving parts to these currency gyrations. We highlight a few of the bigger ones to help put things into perspective as we look back:

US Dollar – The USD has benefitted from several tailwinds over the past few quarters. The U.S. economy has emerged from the pandemic with relatively greater strength than many other major developed economies. This has also translated into more aggressive inflation and a central bank (the Fed) on a more aggressive rate hiking path. It is also worth noting that in a world wrestling with food/energy prices and reliability of supply, America is largely self-sufficient on both. The USD enjoys a safe haven premium in the market during periods of uncertainty, and 2022 is clearly a year of great uncertainty.

Canadian Dollar – While maybe not with as much gusto, our economy has done well coming out of the pandemic. Inflation is clearly a problem in Canada as well, which has the Bank of Canada (BOC) on a similar rate hike path for now. Obviously, the big plus for the CAD has been energy and other commodities, as sizeable portions of our economy and with stability of supply. This helps explain why the CAD has kept pace with the higher move in the USD, with a bit of slippage.

Euro – The economic outlook for Europe is not as positive, given a greater reliance on global trade and proximity to the war in Ukraine. Energy supply and continued disruptions are big risks to the economy and currency. The euro is also a risk-on currency with 2022 being a risk-off year so far. Inflation is a problem in Europe as well but not as much as the U.S., and with slower economic growth the European Central Bank (ECB) is raising rates at a more tepid path.

Japanese Yen – With most major central banks increasing rates, the Bank of Japan (BOJ) is the exception. Having wrestled with disinflationary pressures for decades, the central bank policy remains rather dovish — very dovish if you consider relative central bank policies.

What does this mean for portfolio construction?

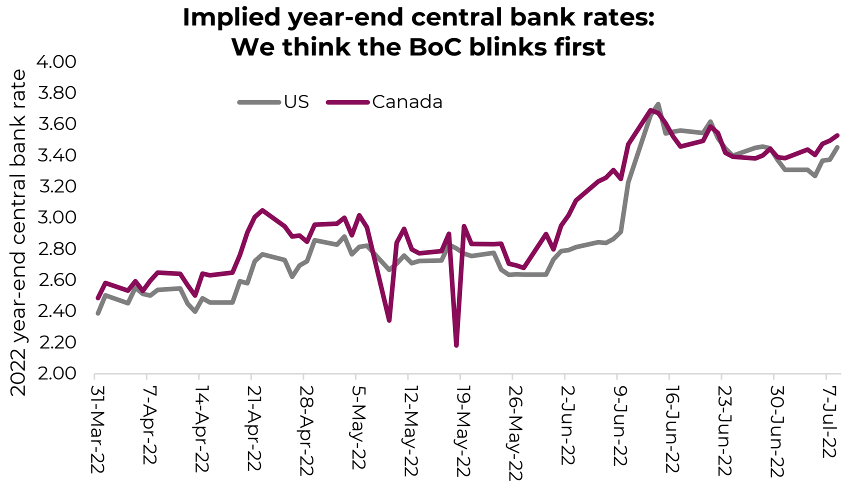
The weakness you may have noticed with international holdings has been amplified once converted back to CAD (assuming not hedged). These are not trivial percentages — over the past year, the yen has fallen 17% and the euro by 11% against the Canadian dollar. **Clearly hedging a year ago would have been the better strategy. But going forward, we would certainly lean the other way.**

For Canadian portfolios, U.S. dollar exposure has been a great diversification tool for decades. This stems from the simple fact that Canada is a more pro-global growth country and currency. So, when growth is great, the Canadian market does well, as does the CAD vs USD. When growth slows the opposite happens, creating a useful diversification factor for Canadian portfolios.

We also think that among central bankers, the BOC will respond first. The Canadian economy has a consumer that has too much leverage and a very high reliance on the housing industry. This is very noticeable relative to the U.S. economy, which means these **rate hikes will likely have a bigger impact on slowing economic activity in Canada compared with the U.S**. In fact, we may already be starting to see this. In the employment reports out on July 8, the U.S. added 372k net new jobs while Canada shed -43k jobs. This makes us feel more positive toward the USD than the CAD.

The counter argument is also compelling

If global inflation cools and we don't have a near-term recession, the safe haven premium in the USD may soften, providing a lift for CAD. In this case, hedging U.S. exposure would be a benefit. However, recession risk is rising, if not this year, then next, and Canada's domestic issues may also increase in the coming months. We think the BOC will blink first.



Source: Bloomberg, Implied central bank rates, Purpose Investments

This is an easier portfolio construction question for international equity holdings. We think it is too late to hedge and would prefer no hedge going forward. The drop in euro and yen has made the CAD the expensive currency. Plus, with the BOC at the high end of the hawkishness spectrum, ECB in the middle, and BOJ on the dovish side, the next change is likely that spread narrowing. Either the BOC will become less hawkish because of a slowing Canadian economy, or the other central banks will move up the hawkish scale.

Impact on portfolios

Over the very long term, developed market currencies tend to be a zero-sum game. But over periods of months, quarters and even years, there are moves that can hurt or help a portfolio. Considering not just the currency moves over the past while but also how things fit into a portfolio, We are increasingly in the 'unhedged' camp. For the U.S., our view is based more on the diversification benefits of the USD. For international developed currencies, we think they have fallen too far versus the CAD and there could be a reversion lift for being unhedged.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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*This report is authored by Craig Basinger, Chief Market Strategist, Purpose Investments Inc. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.

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