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Market Ethos

The latest market insights from Richardson Wealth

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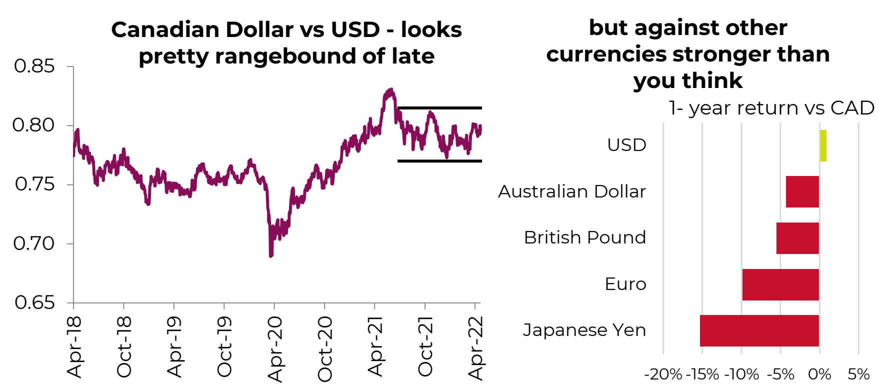
The Loonie: It's stronger than you think

For most Canadian investors, when thinking currency, it is all about the USD/CAD exchange rate. And on this topic, there really hasn't been much to talk about. The CAD has remained relatively rangebound from 78-81 cents over the past quarters. Against other measures, however, both the US dollar (USD) and the Canadian loonie (CAD) have been appreciating together, materially.

Both currencies are enjoying the fact that our respective central banks are, on the hawkish spectrum, near the top. 50 bps moves are being implemented and the expectations are for overnight rates to move higher pretty quickly this year. Other central banks are also becoming more hawkish, but not to the same degree.

The USD has also caught a strong bid as a safe-haven currency given heightened geopolitical risks. Greenbacks are historically a safe-haven currency and enjoy a large physical distance from the war in Ukraine. The CAD is not a safe-haven currency, in fact it is the opposite. But we do have the same kind of stuff in the ground as Ukraine and Russia. The uncertainty of their exports becomes a positive for the Canada and the companies selling those commodities.

Stepping outside our North American bubble, measured against the CAD, the euro is down 10% over the past year and yen down 15%. Keep that in mind when looking at poor returns on many international holdings—yes, the stock or fund prices are probably down, but the currency is increasing the magnitude of the drop.



Source: Bloomberg, Purpose Investments

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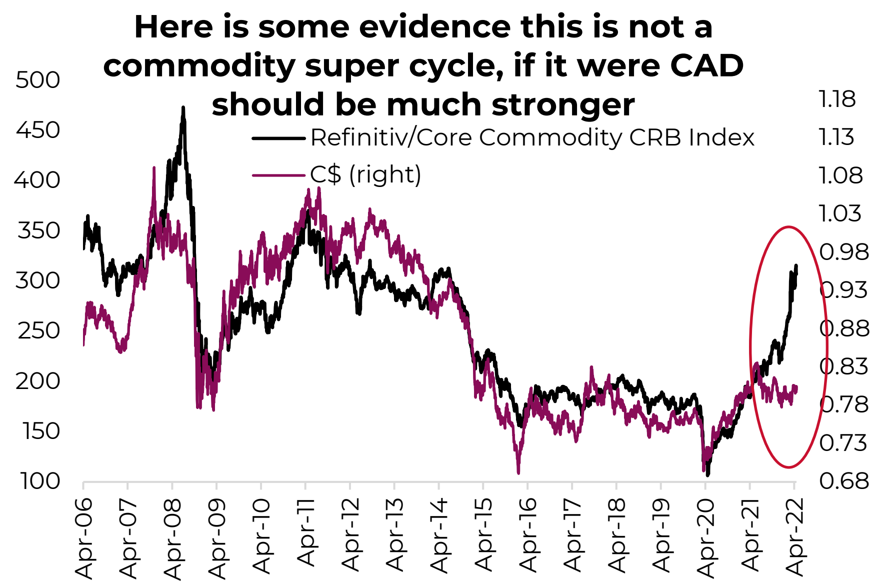
Side note – There has been a lot of talk of a commodity super cycle given the obvious rise in commodity prices. Depending on the commodity index of your choice, prices are up near or above the peaks reached at the tail end of the 2002-2008 super cycle (and 2011 echo).

The missing ingredient, in our view, is demand growth. We have seen demand growth following the 2020 recession, but this is similar to the echo of 2011. Now the spike in commodity prices is driven largely by supply issues as demand is starting to slow. **We don't think that is the environment for a commodity super cycle**, even acknowledging the underinvestment in capacity over the past few years.

The Canadian dollar is also not reacting as if this is a commodity super cycle. Plus, how can you reconcile that a commodity super cycle is ahead at the same time there is slowing economic growth, and even talk of recession. It does not compute. Now back to currency.



Source: Bloomberg, Purpose Investments

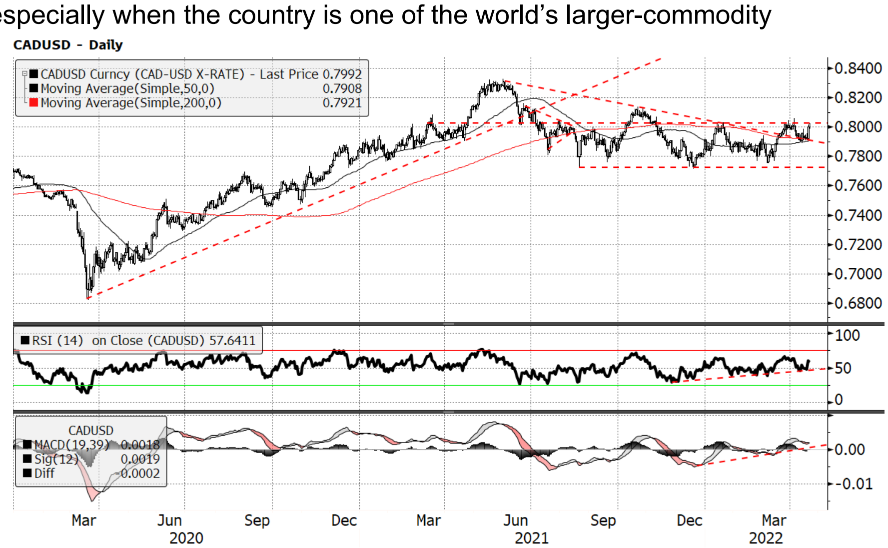
Where to from here?

Near term – Fundamentally, we don't have a near-term high-conviction view on the USD/CAD exchange rate and expect it to remain in the current range. If the demand for a safe-haven currency keeps a bid on the USD, it's safe bet that's because the situation continues to look dire between Ukraine and Russia. That keeps the CAD high too.

If a resolution appears, USD falls as demand for a safe haven diminishes and the CAD falls too as uncertainty around the global commodity supply lessens. Plus given the economic data, it's unlikely that either central bank backs off their tightening path, which has just gotten started.

Being a high beta FX cross has its benefits, especially when the country is one of the world's larger-commodity producers. We're in an environment of persistently positive risk sentiment for the Canadian dollar, yet it has failed to achieve what we would characterize as a meaningful technical breakout.

Looking at technical - Overhead resistance remains firmly entrenched. The frontline would be the March and January highs around $0.8030, with the next levels of resistance staggered above and below $0.8200. As we write, the CAD/USD rate is roughly in the middle of its year-long rangebound trading action.

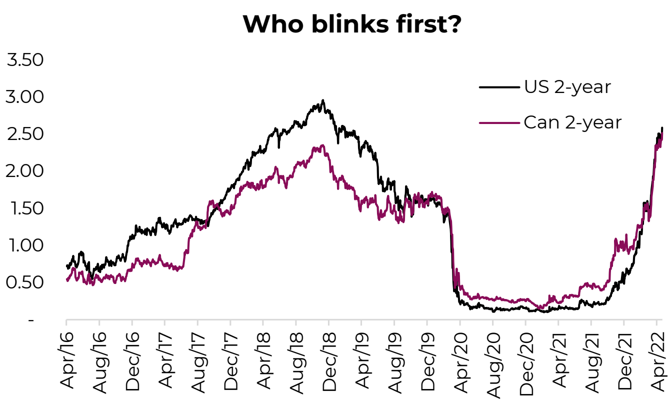


Near-term momentum has been improving, with the RSI steadily trending higher and the latest jump higher this week bringing the loonie close to upper resistance level. In doing so, it has also steadily rejected a retest of the falling trendline connecting the highs of June, October, and January. This is a noteworthy positive development. Coinciding with the breakout above the falling trendline was a move above the 200-day moving average. This too has held the retest, and we're closing in on a likely positive crossover of the 50-day over the 200-day moving average. Another positive development. A breakout above the previous highs this year would be required to confirm a resumption of a new trend. For now, the loonie remains locked in a countertrend consolidation range, which without any clear impetus will likely continue to constrain volatility.

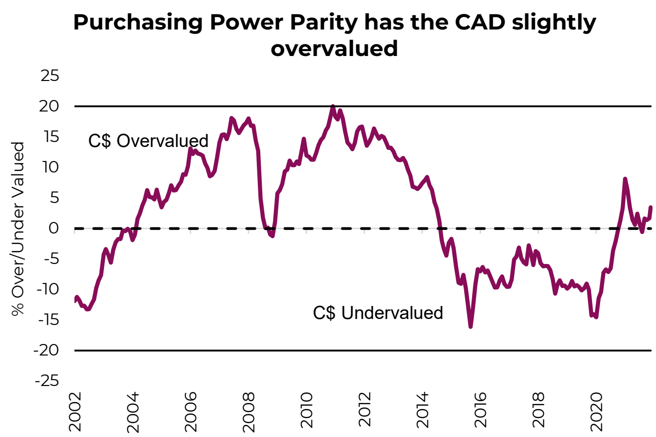
Medium term – Heavy household debt loads and a relatively narrow economy so dependent on real estate make Canada's economy more sensitive to higher interest rates and bond yields. We are more reliant on housing and our consumers are more indebted compared to the U.S. This may cause the Bank of Canada (BOC) to "blink first" on relative rate hiking paths. Doing so would be negative for the loonie. We believe the Bank of Canada may have to choose between the loonie and the economy.

Looking at the 2-year yields between Canadian Government bonds and U.S. Treasuries, we capture a simplified version of what the bond market is pricing in for rate hikes. At the moment, both 2-year yields are about equal, or both are pricing in similar paths for the respective central banks. The futures markets are also confirming this, with 2022 projected to end around 3% overnight rates. Clearly, very aggressive hiking for both.

Later this year, as growth begins to slow, we believe the Bank of Canada softens its path before the Fed. That is likely a negative for the CAD. Furthermore, periods of slower economic growth also favour USD over CAD as global demand for our exports would slow. Add to this, the CAD is a bit overvalued currently based on Purchasing Power Parity (PPP), though that's a condition that can persist for years.



Source: Bloomberg



Source: Bloomberg

Investment Implications

From a CAD/USD perspective, we believe range bound is the most likely path over the coming months. However, later this year and into next, we believe the USD has the advantage. **This means from an investment perspective, adding to U.S. exposure –or at least not hedging as much— may be prudent.** Longer term, who knows? We will weigh the fundamentals as we see how this cycle progresses.

The strong CAD relative to global currencies offers a current opportunity. **For those with limited investments outside North America, this may be a good time to consider adding some.** Maybe even taking some profit from Canada. The TSX will not fare as well as it has should global growth slow or higher rates start taking a bite out of Canadian housing.

Lastly, outside of the cost of flights, this may be the best time in a decade to travel to anywhere but the USA. Loonies are buying more stuff in Europe, South America, and Asia than they have in years!

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 Marke t Strategist, Purpose Investments Inc. and James Price, SVP Investment Strategies, Richardson Wealth Ltd. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.

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