



Canadian Dollar: Back to Reality

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The Canadian dollar's long run around parity came to a stop in early 2014, and a return to parity isn't likely anytime soon.

The Bank of Canada's (BoC) increasingly dovish tone might have been the dollar's biggest driver over the past few months. Since Governor Poloz took the helm at the BoC, each statement has become more dovish. The Bank was also more vocal-than-normal about the Canadian dollar in the January Monetary Policy Report, stating that "despite depreciating in recent months, the Canadian dollar remains strong..."

The Bank's shifting tone has also driven Canadian bond yields lower which, coupled with generally rising U.S. yields due to Fed tapering, has weighed heavily on the C\$. Since the start of 2012, the spread between Canada-U.S. 5-year government bonds has been highly correlated with the loonie and the narrowing yield advantage makes Canada less attractive. We don't anticipate this spread to narrow in the next few months. But, as long as there are rate cut expectations, which is probably through at least the first half of the year, the spread isn't likely to move meaningfully in Canada's favour either. As inflation and growth pick up in the second half of 2014, spreads should widen and provide some support for the loonie.

Current commodity prices also point to the C\$ hovering near fair value. The BoC's commodity price index and Canada's terms of trade both flag fair value around C\$1.11 (or 90 US cents). While we look for prices to hold steady, there are plenty of downside risks. Rising concerns about a potential crisis in emerging markets and slowing growth in China do not bode well for commodities and, thus, the loonie.

Commodities are an important driver for the C\$, but the currency can become disconnected from those fundamentals for long periods. The loonie was conspicuously overvalued from 2009 to 2013, with capital flows the major culprit.

Following the global financial crisis, Canada emerged as an important diversification outlet for sovereign wealth funds and foreign exchange reserve managers. Foreign buying of Canadian securities surged to over \$100 bln annually from 2009 to 2011. That inflow has slowed sharply while Canadian investment abroad has accelerated. Foreign reserve diversification flow into C\$ assets will likely continue over the long run. But in the near term, with many emerging markets under pressure, we may be in a temporary period of falling reserves which will limit C\$ asset buying.

Moreover, U.S. assets are looking more attractive, lessening the allure of Canadian securities. Through the first half of 2014, the BoC's dovish tone, opposite Fed tapering, will be the primary C\$ driver. Look for the loonie to weaken to C\$1.15 (87 US cents) around mid-year. However, if we make it to the second half without any low-inflation-induced rate cuts, sentiment is likely to shift in favour of the C\$. By then, inflation should perk up (though it will still be low) and growth will gain momentum on the back of the weaker dollar and a better U.S. economy. Rate cut expectations should fade and the conversation will shift to whether the BoC raises rates ahead of the Fed. We anticipate the BoC hikes first (2015Q3 vs. 2015Q4 for the Fed), which will be C\$ supportive as we move into 2015.

Fundamentals suggest the Canadian dollar is currently hovering around fair value. However, as evidenced over the past five years, currencies can deviate from fair value for long periods. Until expectations for commodity prices turn higher or the BoC becomes more hawkish, the risk is tilted toward more weakness. That should help exporters and some domestic retailers, but will markedly raise the price of travelling outside Canada and put a serious dampener on cross-border shopping enthusiasts.



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