OBSERVATION
TD Economics

February 24, 2012

STRONG CANADIAN DOLLAR AHEAD, BUT MIND THE POTHOLES

Highlights

- Firm commodity prices, Canada's relatively strong fiscal position and widening interest rate spreads should support a Canadian dollar above parity with the U.S. over the medium term.
- However, we do expect the volatility of recent years to persist, with the loonie vulnerable to any potential deterioration in market risk sentiment over the next few months.
- Our base case is for the Canadian dollar to fluctuate between 94 and 105 U.S. cents over the next couple of years.

The Canadian dollar's steady climb since the end of the last recession has put to bed any notion of a return to the days of a 65-75 U.S. cent exchange rate. Indeed, foreign exchange investors have taken heed of the relatively strong mix of domestic fundamentals underpinning the currency. Despite significant market volatility, 2011 saw the loonie average above parity with the U.S. dollar for the first time since 1976. Over the next few months, we see the loonie at risk for a moderate pull-back to about 94 U.S. cents. But, this period of relative weakness is not likely to have staying power.

TD Economics expects the macroeconomic fundamentals will likely support continued strength in the Canadian dollar over the next couple of years. Robust commodity prices, widening interest rate spreads with the U.S., and Canada's relatively sound fiscal situation should underpin another leg up for the Canadian dollar to 105 U.S. cents by the end of 2013. That is not as high as its peak prior to the financial crisis, but it is near the top of its post-financial crisis range.

Commodities are king for Canada

There are several macroeconomic factors that influence exchange rates (summarized in in Table 1), but for the Canadian dollar, some matter more than others. Commodity prices continue to be king when it comes to idiosyncratic moves in the Canadian dollar. Simply put, commodity prices matter because the resource sector is a major source of income and investment from abroad, increasing money flowing into Canada, and pushing the loonie higher. Bank of Canada research[1] shows that

TABLE 1. OUTLOOK FOR THE CANADIAN DOLLAR

MACROECONOMIC FACTORS	EXPECTED IMPACT: SHORT TERM*	EXPECTED IMPACT: LONGER TERM
Commodity prices**	-	+
Government debt-to-GDP**	+	+
Growth & Productivity	-	-
Current Account Deficit	-	+
Short-term capital flows	+	na
Interest rate differentials	+	++
Inflation	neutral	neutral
Domestic political uncertainty	+	+

Source: Adapted from the Bank of Canada Backgrounder "The Exchange Rate", May 2010
*Within 3-6 months
**Bank of Canada research identifies these two factors as explaining the majority of bilateral exchange rate moves versus the U.S. dollar

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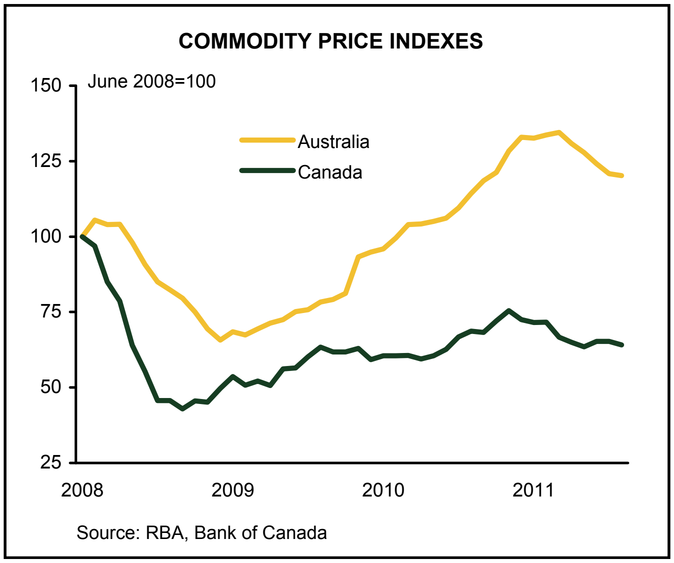


commodity prices have become even more important for Canada since 1993[2]. And among commodities, energy prices now rule, carrying a 60% weight in the Bank of Canada's commodity price index. Our more energy-laden commodity basket goes some way to explaining our underperformance relative to our commodity cousin, the Australian dollar, since the financial crisis (see chart). Crude oil's heavy weighting in Canada's commodity basket (one third of the index) also helps explain why the Canadian dollar continues to display a close correlation with oil prices.

Research from the Bank of Canada focusing on the drivers of exchange rates versus the U.S. dollar[3] since 1980, concluded that the relative U.S. debt position explained a substantial share of long-term movements in the currencies studied – more so than productivity differentials. Commodity prices played a significant role for Canada, Australia and New Zealand, and interest rate differentials also mattered in the short-run. The empirical results suggest that it was the deterioration in the relative U.S. fiscal position which can best explain the long-run U.S. dollar depreciation from 2002-2007, and that commodity prices also played a leading role in the performance of resource-oriented countries. For Canada, from 2002-2007 our relative fiscal position and commodity prices can account for over 60% of the loonie's appreciation.

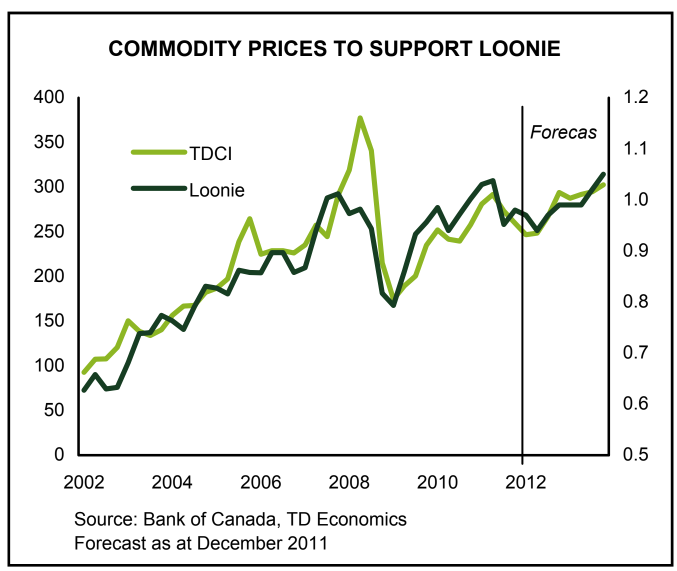
Outlook for the Canadian Dollar

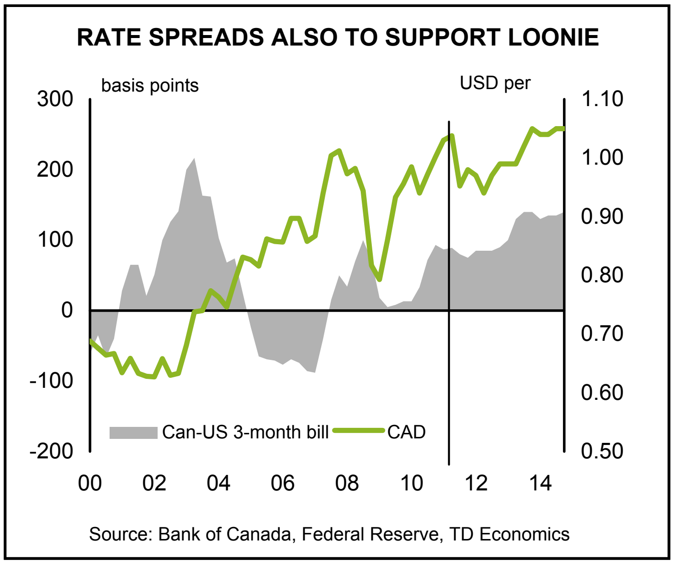
In terms of the general macroeconomic backdrop for the loonie, our outlook for the next couple of years essentially has two phases. In ther neart term, financial contagion risks have eased since the European central bank injected substantial liquidity into the banking system, and Greece has secured a second bailout agreement, but Europe still has a difficult road ahead to work through its debt mess. We are less pessimistic than late last year, but bouts of risk aversion on financial markets are still likely. However, once the way forward in Europe is clearer we expect the uncertainty to diminish, boosting the global economy and market sentiment in the second half of 2012 and 2013.

So what does this mean for the Canadian dollar? Canada's relatively smaller currency market is not a safe haven for international investors in times of turmoil. So when fear grips markets, "flight-to-safety" flows hurt the Canadian dollar. Consequently, the Canadian dollar has had a close correlation with the trend in equity markets in recent months. We expect the potential for financial market volatility in the next few months, and a possible pull-back in oil prices from their current levels, which have been elevated by tensions surrounding Iran, could take the Canadian dollar lower at mid-year, to around 94 U.S. cents. That is slightly below its lowest close in 2011.

Another, but related, near-term risk is if the Chinese economy has a more material slowdown. That would impact prices for many of Canada's commodities, and could lower the value of the Canadian dollar. This is not in our base case outlook, but if matters in Europe produce greater global contagion than we are expecting, China would take a hit.

In the medium term, we expect overall strong growth from emerging markets to keep commodity prices firm over the next couple of years as a whole, providing support to the Canadian dollar (see chart). Interest rate differentials versus the US are also supportive, and we expect that to become a





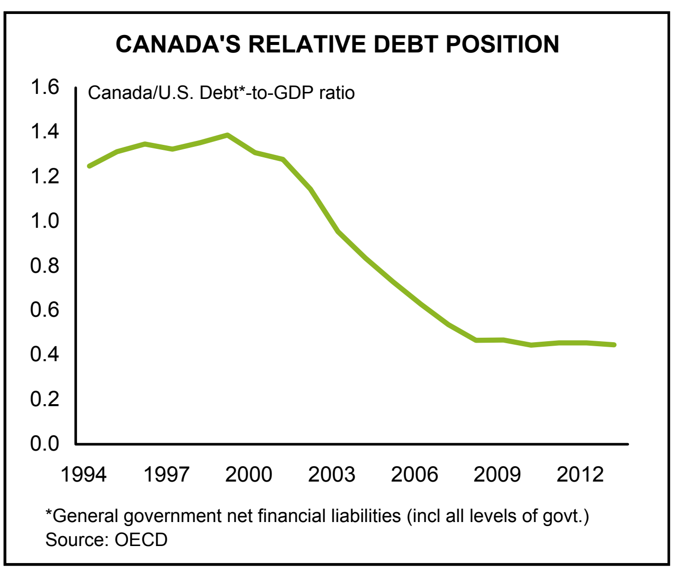
bigger positive in the second half of next year as the Bank of Canada raises interest rates ahead of the Federal Reserve (see chart). That said, the Bank is cognizant of fuelling a rally in the Canadian dollar that would further erode our export competitiveness. This circularity places both limits on how high the Canadian rates can diverge from U.S. rates, and any appreciation in the currency, contributing to limit our expected loonie appreciation to 105 U.S. cents by the end of 2013.

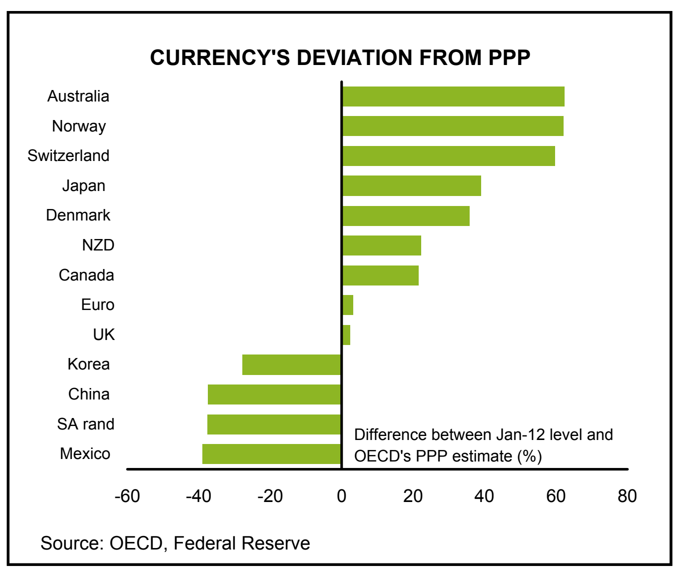
Canada's relative fiscal position (and debt-to-GDP ratio) versus the U.S. looks slightly positive over the next couple years. Both the U.S. and Canada are facing deficits, particularly in many provinces, but Canada has a credible plan to return to black. The U.S. is mired in political deadlock – at least until the presidential election – making its road back to budget balance longer and Canada look slightly better in relative terms, but nowhere near the improvement that helped the loonie take flight in 2002-2007. And as for politics, Quebec sovereignty is on the back burner for the foreseeable future.

Canada does have a current account deficit, reflecting relatively stronger domestic demand. The U.S. also has a current account deficit, but we expect Canada's to shrink relatively further, a positive for the currency. Moreover, a current account deficit on its own doesn't mean a currency will weaken in the short or even medium term, but it does require healthy capital inflows to stave off depreciation. (Note that Australia has had a current account deficit for 35 years, and has still managed a massive appreciation since 2002.) Canada has enjoyed very healthy net portfolio inflows since the financial crisis, representing investors diversifying into Canadian dollar assets in Canada's relatively stronger economy.

With Canadian growth set to lag the United States over the next couple of years we will be relatively less of a magnet for investment, and these portfolio flows show nascent signs of ebbing. Although against a backdrop of a shrinking current account deficit somewhat lower capital inflows could still forestall a depreciating currency.

The bottom line is the range on our outlook for the Canadian dollar is between 94-105 U.S. cents – well within recent swings, but above the typical ranges for the dollar prior to 2002. Since the financial crisis market volatility has remained above historical norms, and the Canadian dollar has too. We don't foresee this changing over the next couple of years.





Is the Loonie overvalued?

Canadians unaccustomed to a dollar on par with the U.S. may wonder whether the currency is currently overvalued. An exchange rate's long-run value is a nebulous concept, but looking at the concept of purchasing power parity – the level of the exchange rate that would equate price levels in two countries – the loonie is roughly 20% higher than the 83-cents U.S. PPP cited by the IMF (see chart previous page). However, as you can see it is by no means alone, and looks a bargain compared to some.

Moreover, as anyone who remembers the weak loonie of the 1990s knows, a currency can deviate from its supposed "long-run" fundamental value for a long time. But given our macroeconomic outlook, a Canadian dollar in a 5-cent range above or below parity with the U.S. dollar is a highly probable reality over the medium term.

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Endnotes

1 Cayen et al. 2010. "What drives exchange rates? New evidence from a panel of U.S> Dollar Bilateral exchange rates" Bank of Canada Working paper 2010-5.

2 The free trade agreement, liberalization of energy policy in the 90s (including deregulation of natural gas market) all affected the relationship between the Canadian dollar and commodity prices.

3 Currencies included were the Canadian dollar, British pound, Euro (a synthetic euro used prior to 1999), Japanese yen, and the Australian and New Zealand dollars over period 1980-2007.