OBSERVATION

TD Economics

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THE LOONIE SET TO FLY SOUTH

Highlights

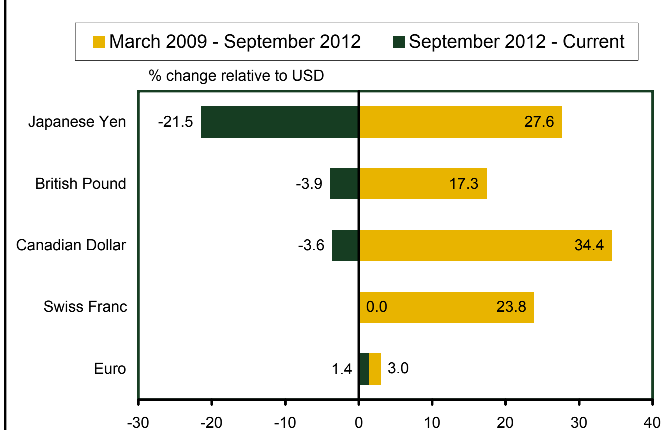
- The recent bout of weakness faced by the Canadian dollar over the last 6 months is set to persist over the next year. We anticipate the Loonie to drop towards the US$0.90-0.92 range by late 2013 and early 2014, before renewed stability sets in by the second half of next year.
- Several factors underpin this change in view: chief among them are concerns regarding Canada's medium-term economic fortunes, a pullback in commodity prices, and a strengthening outlook for the U.S. dollar.
- The transition within the Canadian economy towards more business investment and export-led growth has not been smooth thus far. A depreciation in the Loonie to a level more consistent with fair value estimates (pegged around US$0.80-0.90) should help facilitate that transition.

After a glowing performance during the global economic recovery, the Canadian dollar has more recently lost some of its shine. Since last September, the currency has fallen from above US$1.03 to as low as US$0.97 and has underperformed many of its international counterparts. Several factors have contributed to the pullback. Chief among them are a pullback in commodity prices, growing worries surrounding Canada's medium-term economic fortunes and the strengthening outlook of the U.S. dollar. Although the currency will be buffeted by various factors in the coming months, TD Economics believes that the currency will trend lower against the U.S. dollar and lose much of its current overvaluation as it drops towards the US$0.90-0.92 range in late 2013 and early 2014 before reversing course as Bank of Canada rate hikes become more imminent.

The lure of the Canadian dollar since the recession

The Canadian dollar's depreciation since last fall has halted a sharp upward move since the global economic recovery began in 2009 – from a low of US$0.77 to a peak of US$1.06 in July 2011. Throughout most of 2012, the currency continued to hover in a tight range around parity. As shown in chart 1, the Loonie was among the top performers vis-à-vis the U.S. dollar between 2009 until it began to head lower in the autumn of last year.

CHART 1: RELATIVE CURRENCY PERFORMANCE



Source: Wall Street Journal

Several factors lay behind this prior strength. Canada outpaced many of its international peers in job growth and housing activity, helped in part by a post-recession rebound in commodity prices and low interest rates. The country's banking system, which has been widely recognized as being one of the world's safest, provided economic stability. Investors have also earned a premium on investing in Canadian short-term debt. More specifically, the

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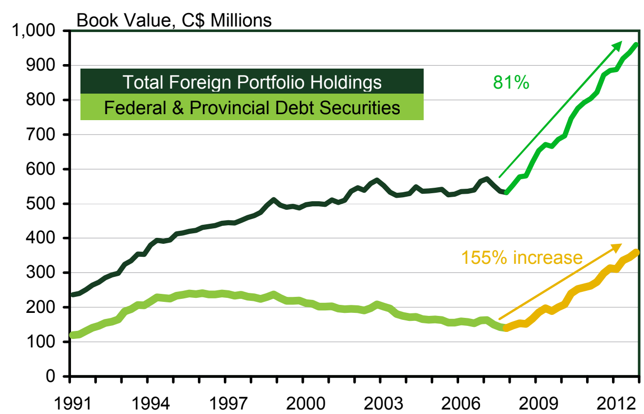
Bank of Canada avoided the use of unconventional monetary policy tools like quantitative easing and was one of the first major central banks to raise interest rates in late-2010. And while the federal and provincial governments have fiscal challenges, most have adopted credible medium-term plans to balance their budgets, which have provided both rating agencies and international investors comfort. This contrasts with many other countries, who have had their debt downgraded since the financial crisis. Indeed, the triple-A credit rating of the Canadian federal government has become an increasingly rare commodity.

In light of these positives, foreign investors have flocked to Canadian assets since the global recovery took hold (Chart 2). Since 2008, foreign portfolio holdings of Canadian assets doubled to $960 billion. While portfolio holdings of federal and provincial government money market instruments and bonds led the charge, rising by 155%, all sectors experienced increased foreign investment interest. Corporate debt and equity holdings also rose by between 50-60%, while a wealth of anecdotal evidence suggests that Canada's real estate sector, both residential and commercial, has been a hotspot of foreign investment activity.

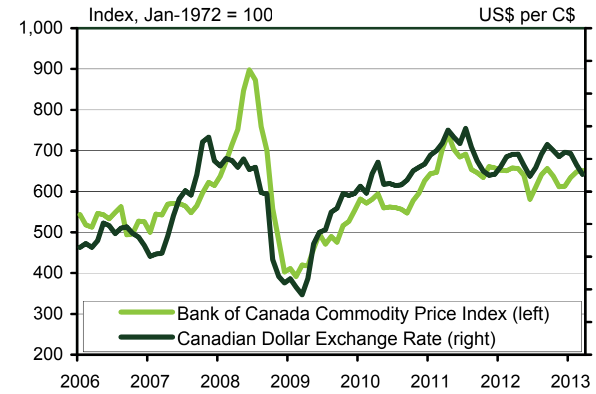
One negative fundamental for the currency since the recession has been a large and growing international current account deficit. A combination of strong domestic spending and relatively weak U.S. demand for Canadian exports have been contributing factors. Text book economics would indicate that the need to sell Canadian dollar assets to finance this external shortfall should weigh on a currency's value.

CHART 2: FOREIGN PORTFOLIO HOLDINGS OF CANADIAN ASSETS



Source: Statistics Canada

CHART 3: CANADIAN DOLLAR AND GLOBAL COMMODITY PRICES



Source: Standard & Poor's, Bank of Canada

However, the loonie appreciated by roughly one-third even as the current account deficit swelled, highlighting the attractiveness of Canadian assets over the 2009-12 period.

Drivers of the currency have become less supportive

While the longer-term positive influences on the Loonie have not evaporated, a number of them have become less supportive in recent months, transforming the Canadian dollar from an outperforming currency to an underperformer. That being said, as Chart 1 shows, the extent of the currency's depreciation since the autumn of 2012 is nowhere near that of the Japanese Yen, which has been sideswiped by the central bank's commitment to inject massive liquidity.

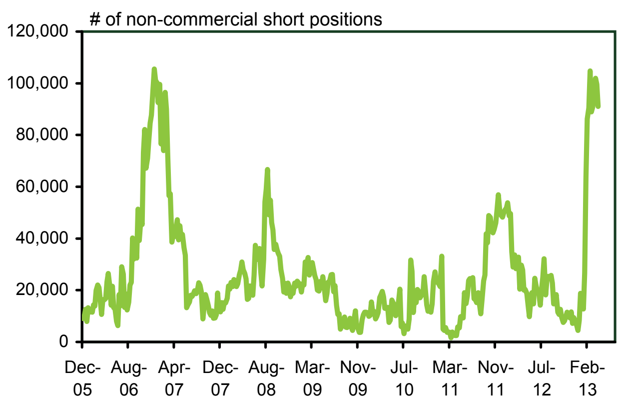
A summary of the recent turn of events dogging the Loonie:

- *Canada has lost its growth advantage* – reflecting a lack of pent-up demand among highly indebted households and slowing housing markets, Canadian real GDP growth has virtually ground to a halt in the second half of last year. While Canada's economy should improve as this year goes on, it is still expected to trail the U.S. for the second-straight year.
- *Commodity prices have softened* – prices for several of Canada's key commodities have pulled back substantially in recent months, in part, on the reemergence of global growth concerns. The Bank of Canada's commodity price index is off roughly 13% since its peak in the spring of 2011 (Chart 3). West Texas Intermediate crude oil has managed to stay relatively steady. However, Brent

crude is down by nearly $15/bbl (-12%) since February. Both precious and base metals have also sunk since last fall – gold and copper have lost roughly 20% and 15% of their respective values since the September-October period. In light of this pull back, a number of forecasters – including TD – have reduced their near-term projections for prices.

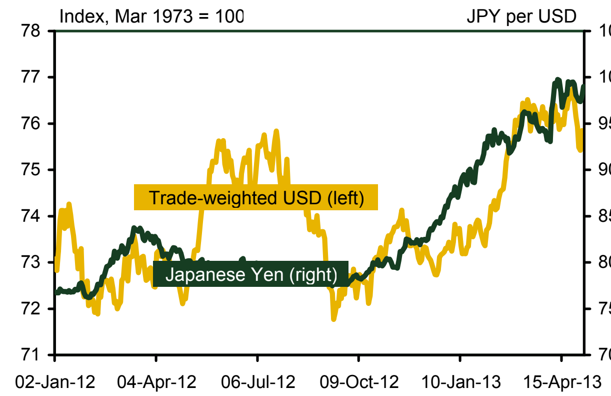
- *Interest rate increases have been pushed back further* – Owing to the unexpectedly soft pace of growth and inflation, the Bank of Canada softened the upward bias in its forward-looking language, implying that the overnight rate could stay at current levels for longer than financial markets were previously anticipating.
- *Growing external financing needs* – all of the developments noted above have occurred at a time when Canada's external financing needs have continued to grow. Notably, in 2012, the international current account deficit rose to a new 20-year high of 3.7% per cent of GDP. With U.S. equity markets looking increasingly attractive to global investors and with the S&P TSX underperforming, Canada has seen a modest slowdown in capital inflows. Recent data on international securities transactions confirmed net foreign outflows from Canadian equities so far this year, while Canadian-dollar net short positions have also increased in recent weeks (Chart 4).
- *U.S. dollar strength part of the story* - the outperformance of U.S. equity markets highlights another key factor that has weighed on the Canadian dollar of late: U.S. dollar strength. Other international developments have increased the lure of the greenback. In particular, Japan's latest salvo of monetary stimulus has the Bank of Japan doubling the country's monetary base by purchasing a laundry list of assets, from Japanese government bonds to ETFs and REITs. This move has pushed the dollar-yen exchange rate from 77.5 Yen per U.S. dollar to nearly 100 Yen since September. Alongside more modest appreciations against the Pound and the Euro, the trade-weighted U.S. dollar has risen by nearly 6% since the autumn (Chart 5).

CHART 4: SHORT BETS AGAINST CANADIAN DOLLAR



Source: Commodities & Futures Trading Commission

CHART 5: TRADE-WEIGHTED U.S. DOLLAR & JAPANESE YEN



Source: Wall Street Journal, Federal Reserve Board

Loonie likely to fall further

With these influences unlikely to change significantly in the coming months, the currency's recent descent is expected to continue. Canada's economy is going through a transition in the primary sources of economic growth – away from domestic sources of growth such as consumers, real estate and government, towards exports and business investment. This transition has not been smooth, and Canada's economy is likely to continue to underperform the United States. Although world economic prospects should improve in the second half of the year, the overall pace of global economic growth is not expected to support a strong rebound in commodity prices. And, the U.S. dollar should continue to get support from actions of other governments to weaken their currencies (i.e. Japan) and should benefit when the Federal Reserve eventually scales back its bond buying program and then ultimately ends it. We anticipate the trade-weighted US dollar to appreciate by an additional 4-5% from current levels between now and the end of 2014.

As a consequence, the Canadian dollar is likely to head lower into the US$0.90-0.92 range later this year and into early 2014, before encountering some renewed stability in the second half of next year. Gradual interest rate hikes by the Bank of Canada beginning in the fourth quarter of next year are likely to increase demand for the currency.

From a longer-term perspective, a move down in the value of Loonie into this lower range would bring it more in line with economic fundamentals. Despite trading above parity, estimates of the equilibrium value of currency in recent years have generally continued to land in the US$0.80-0.90 range. A depreciation in the currency towards its equilibrium value would help the competitiveness of Canada's exporters. For several years, observers have stressed that given record levels of household debt and a move towards fiscal restraint, the economy must increasingly be driven by exports and business investment. A lower Loonie should help facilitate that shift.

Bottom Line

Over the past few quarters, the ground underneath the Canadian dollar has shifted, owing to both deteriorating domestic fundamentals and strengthening prospects for the U.S. dollar. We anticipate that another significant leg of depreciation is in store for the loonie over the next 6-12 months, before some renewed stability sets in.

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