

CHART 1
PARITY PATH
(US\$/C\$: daily close)

Canadian Dollar

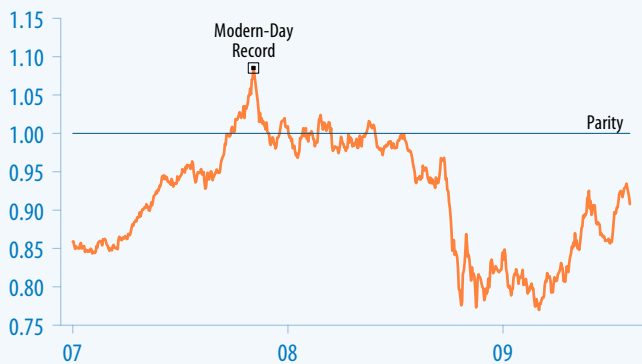


CHART 2
VOLATILE TIMES
(US\$/C\$: m/m % chng)

Canadian Dollar

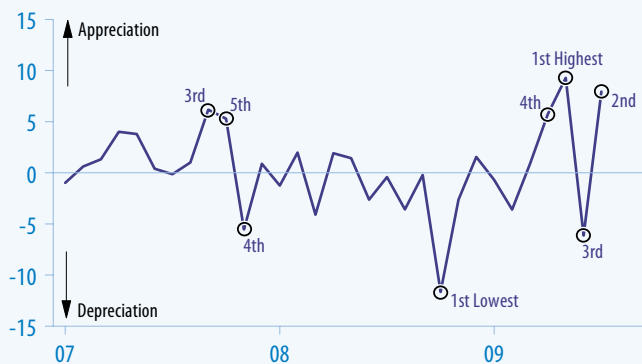


CHART 3
GREENBACK BLUES
Broad Trade-weighted US\$



Loonie Tunes

Michael Gregory, CFA, Senior Economist

A strong Canadian dollar is again rousing concern among policymakers, businesses and politicians, with markets buzzing about a potential return to parity. Earlier this month, the loonie hit its highest level in more than 10 months (above 94.3 U.S. cents) (Chart 1), prompting Finance Minister Flaherty to join the chorus of concerned voices. In early June, the Bank of Canada first served notice that it was concerned, with Governor Carney reiterating recently that “the higher Canadian dollar... is significantly moderating the pace of overall growth” and, going forward, “a stronger and more volatile Canadian dollar represents an important downside risk to output and inflation.”

As Mr. Carney noted, the volatile fashion of the current C\$ surge is what differs from the one that lifted the loonie above parity during September 2007—for the first time in 31 years. Sharp currency moves make it more difficult for businesses to adjust. For example, the loonie soared 9.3% in May, the most for any month in the modern period (since 1950) (Chart 2). This was followed by the third weakest month on record (it depreciated 6.1% in June), only to be followed by the second largest monthly appreciation on record (7.9% in July). The increased volatility reflects both the legacy of the global credit crisis, and the inconsistent signs of global economic recovery. Presumably, as these signs become more consistent and the credit crisis fades further into market memory, volatility should decrease. However, underlying strength in the Canadian dollar should linger, owing to a lower U.S. dollar, higher commodity prices and stronger Canadian economic performance.

Lower U.S. dollar... We look for the greenback to depreciate steadily against the broad basket of currencies for the next 12 to 16 months (Chart 3), reflecting the following four factors:

- 1) Investor risk appetite, already whetted by the prospects for global economic recovery, should get increasingly roused by confirmation of this scenario, thus further reducing safe-haven demand for U.S. dollars and Treasuries. While most currencies should benefit, particular strength will probably be exhibited

CHART 4
ROCKS, TREES & LOONIES
Canada

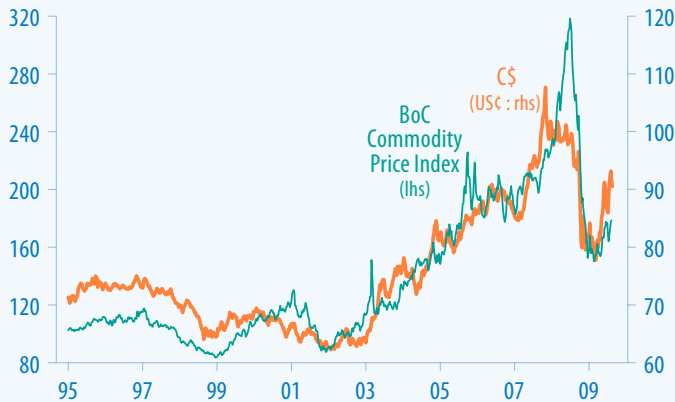


CHART 5
CANADIAN ECONOMY POISED TO OUTPERFORM

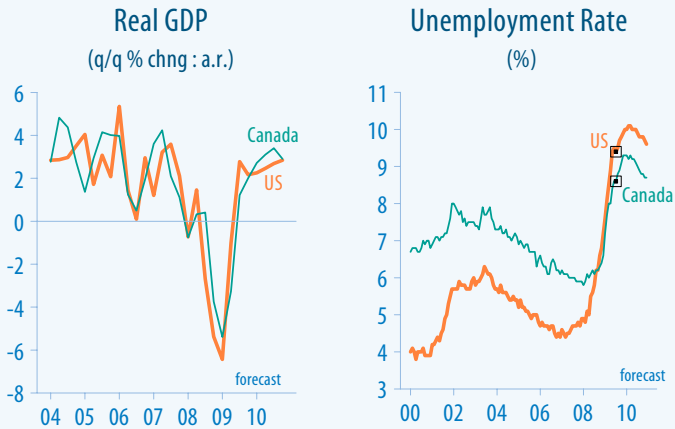
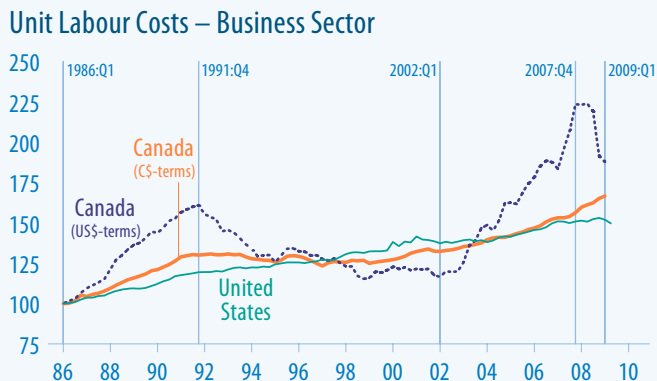


CHART 6
CANADA'S COMPETITIVENESS STUNG BY STRONG C\$
(1986:Q1 = 100)

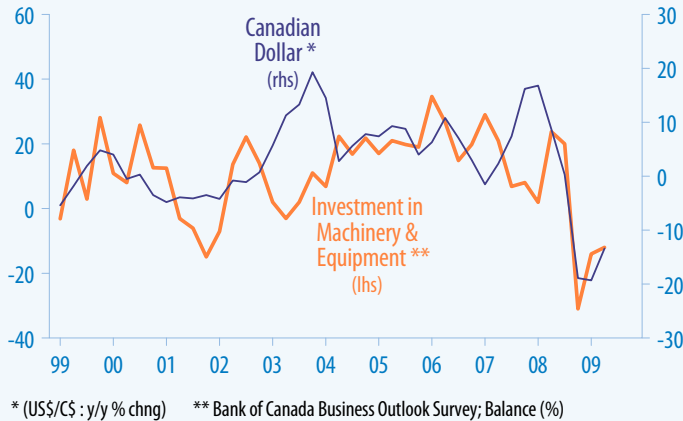


by emerging market currencies, high-yielding currencies and commodity-linked currencies.

- 2) To entice foreign investors to finance a hefty share of the ballooning U.S. budget deficit, lower Treasury prices in foreign currency terms will be required. But with increased domestic demand for Treasuries by households (reflecting rising savings rates and more conservative investment practices) and banks (part of the multi-year healing process from the credit crisis) providing some offsetting support for Treasuries, the greenback will likely have to play a larger role in cheapening prices for foreign investors. On top of this, you have perceptions of rising U.S. sovereign credit risk.
- 3) As the US\$ continues to depreciate, market rumblings about the greenback's reserve currency status will no doubt persist. The pre-credit crisis trends of sovereign wealth fund and international FX reserve diversification (from USDs and Treasuries) should persist.
- 4) Eventually, we look for the Chinese authorities to resume a moderate appreciation pace for the yuan against the dollar, which should tow other emerging currencies in the Asian FX space also stronger against the greenback.

Higher commodity prices... Commodity prices are a key driver of the Canadian dollar (*Chart 4*). After a peak-to-trough decline of 53% between July 2008 and March 2009, commodity prices have rebounded 19%, led by oil and base metals (i.e. copper, aluminum, nickel). As the global economic recovery unfolds, prices should find further support as rising production stimulates raw materials demand, augmenting the increased demand generated by a build-up of raw material inventories (the latter has been a key factor fuelling the recent rebound in prices). Once inventory levels are deemed adequate, commodity price gains should slow and perhaps see some correction (the proverbial mid-cycle correction), but this is still a long way off. On balance, we look for the basket of commodity prices to increase another 15% to 25% from current levels through next year, with recent laggards such as natural gas prices picking up.

CHART 7
FX & CAPEX
Canada



Stronger Canadian economic growth... The automakers announced increased production for the remainder of this year due to inventory restocking following the recent shutdowns and the U.S. “cash-for-clunkers” program. The rebounding auto sector should ensure positive GDP growth in Q3 on both sides of the border. Initially, U.S. growth should outpace Canadian growth, reflecting the “cash-for-clunkers” positive impact along with inventory restocking (Canada only gets that latter benefit). However, as this impact fades, Canada’s economic recovery is destined to outpace its U.S. counterpart.

Ultimately, the pace of recovery will be dictated by the willingness of consumers and businesses to unleash their pent-up demand (Canada has an edge owing to stronger balance sheets), and the ability of the banking system to finance the unleashing (again, Canada has an edge owing

to its sounder system). Add in the boost to incomes from rising commodity prices and you have a case for Canadian domestic demand eventually driving stronger GDP growth than south of the border. This, in turn, will begin reducing Canada’s output gap and unemployment rate sooner and by greater amounts than in the U.S., suggesting the Bank of Canada could begin renormalizing policy sooner than the Fed (which is a C\$ supportive scenario).

Unfortunately, the strengthening loonie is re-establishing a deteriorating trend in Canadian competitiveness (*Chart 6*). The multiyear appreciation of the Canadian dollar from 2002 to 2007 resulted in unit labour costs surging 70% in US\$-terms, much higher than the comparable 9% in the U.S. (in C\$ terms, Canadian costs rose 16% over the interval). For many businesspeople, the push through parity in 2007 marked the first time in their lives that the loonie traded above the greenback, a rude awakening for those always expecting the currency to provide a competitive hand. Revisiting parity should reinforce the growing belief that one should no longer count on the currency as a competitive crutch. Instead, we suspect growing numbers of businesses will do what many did after the first parity flight: reorganise their operations and investment in machinery and equipment to become more efficient (*Chart 7*). Not only does this reflect a sense of urgency from a competitiveness standpoint, but imported capital goods also become less expensive as the loonie strengthens.

Bottom Line: We look for the loonie to take another run at parity within the next year or so, owing to a lower U.S. dollar, higher commodity prices and stronger Canadian economic performance. While this will be painful in the short run from a competitiveness perspective, Canadian businesses will probably respond with higher capital spending and other efficiency-seeking activities. In the end, this will provide Canada with a higher level of competitiveness and one that is no longer tied to the vagaries of exchange rates.

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