

OBSERVATION

TD Economics



January 30, 2014

THE CALL OF THE LOONIE

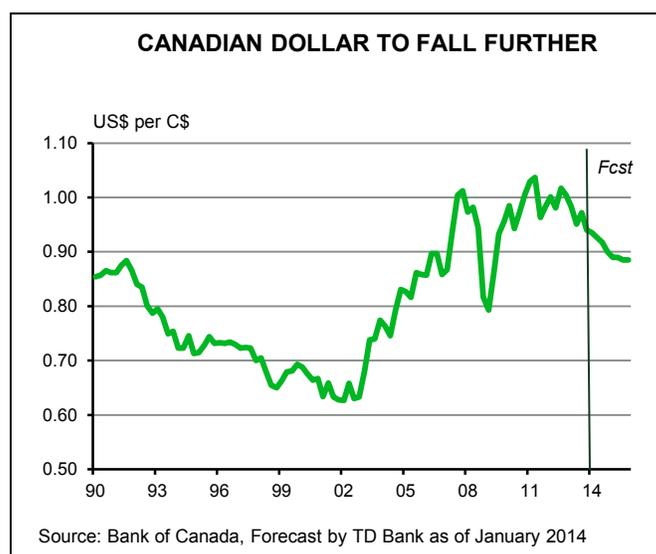
Highlights

- The Canadian dollar had been quietly depreciating for a while now, but its descent accelerated so far in 2014. The economic fundamentals have been flashing warning signs for the loonie, but more dovish messaging from the Bank of Canada gave markets a green light to take the currency to its lowest level in four years.
- We expect the loonie has a bit further to fall, likely to 85-cents U.S. by mid-year. However, as inflation picks up in Canada, and interest rate hikes become more imminent, the loonie is likely to return to around the 90-cent level by the middle of 2015.
- A weaker currency does have mixed effects on the Canadian economy. But, given the current economic realities; a very low level of inflation and competitiveness challenges facing the export sector, it is a desirable trend.

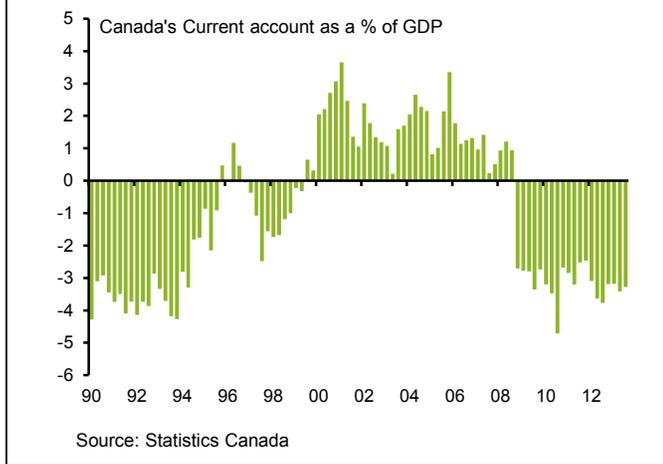
The rapid depreciation of the Canadian dollar has been a big story for financial markets so far this year. However, the loonie had actually been depreciating for a year or so, falling 6 cents versus the U.S. Dollar over the course of 2013 (from parity to 94 cents). This trend accelerated in January, with the Canadian dollar falling three cents in just a couple of weeks. Why have financial markets turned on the Canadian dollar? And where is it likely to go from here?

For starters, the weakness in the Canadian dollar is not unexpected. Many forecasts had warned that the fundamental drivers were pointing to a weaker currency for quite some time. Textbook macroeconomics tells us that the currency of a country with a current account deficit like that of Canada, which means we import more goods and services than we export, will tend to depreciate. Prior to the recession, Canada had a healthy current account surplus (see chart next page), which was a positive for the Canadian dollar. However, a relatively sharper drop off in exports than was experienced by imports during the downturn tipped Canada into a deficit position. Canada remained in a deficit position in the recovery as relatively healthy growth in the domestic economy kept imports stronger than exports. Canada's export growth has disappointed since the recession due to competitiveness challenges.

Often, in countries like Canada or Australia – which both have long-standing current account deficits – the currency is prevented from depreciating by very strong financial flows into the country, which offset the current account deficit. That is, as long as they continue to be a magnet for foreign investment. As Canada's experience earlier in the economic recovery shows, the loonie remained strong despite a current account deficit, since it had very healthy financial inflows.



NO NARROWING IN CANADA'S CURRENT ACCOUNT DEFICIT



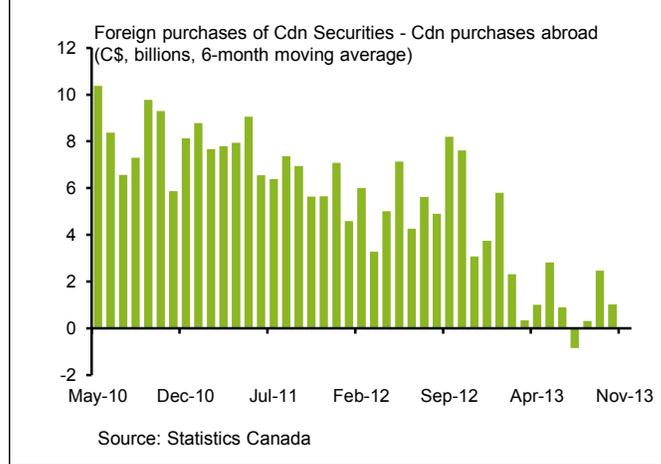
Early in the recovery, investing in Canada was very attractive. Commodity prices were rising, which helped lift Canada's resource-dominated equity markets. Interest rates were higher than the U.S. and the Canadian government's strong credit rating was a magnet for investors seeking safety. Financial flows into Canada were strong enough to offset the current account deficit, and the Canadian dollar was driven above parity with the U.S. dollar. It remained in a relatively tight range around parity for much of 2011 and 2012.

But, the tide started to turn early in 2013. Growth in Canada's economy had slowed to a crawl, commodity prices were going nowhere, and the Bank of Canada started talking about interest rate increases being less "imminent". Canada's economy was underperforming the U.S. and Canadian equity markets similarly trailed many of their international counterparts. All of these factors made Canada less attractive for investors and net portfolio flows into Canada ebbed. At the same time, Canada's export sector struggled, leaving Canada's current account deficit as wide as ever. So over the course of 2013 the combination of a trade deficit with lower level of financial flows into Canada was a recipe for a weaker loonie.

It's not all about Canada

A depreciating currency was not unique to Canada. Part of the story of a weaker Canadian dollar is a stronger U.S. Dollar. All exchange rates are relative prices. When Canadians talk about the Canadian dollar, what they really mean is the value of a Canadian dollar relative to a U.S. dollar, so even if nothing changes in Canada's fundamentals, a strengthening U.S. dollar will see the loonie fall. This has

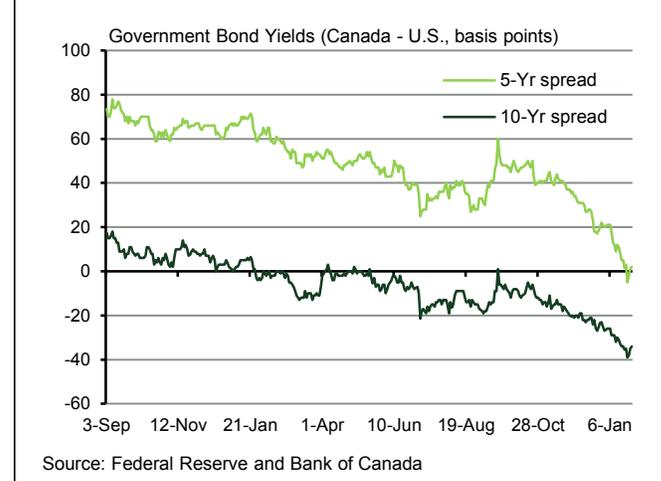
NET FLOW OF PORTFOLIO SECURITIES INTO CANADA



also been the case for the past couple of years. In fact, over the past year many world currencies have also depreciated versus the U.S. Dollar. Among major world currencies, the Australian dollar, Japanese yen, Brazilian real and South African rand have all seen their currencies depreciate further versus the greenback than Canada over the past year.

However, the decline in the loonie in 2014 has been notable. At every opportunity, Bank of Canada Governor, Stephen Poloz, has emphasized how low inflation is in Canada, and lowered its forecast for inflation in its latest Monetary Policy report. He has also described a weaker Canadian dollar as "the icing on the cake" for an improving outlook for Canadian exporters. This messaging has lead markets to believe that the Bank of Canada will not be raising interest rates for quite some time, and that the Bank is very comfortable with a weaker loonie. This gave currency

CANADA - US SPREADS HAVE SHRUNK

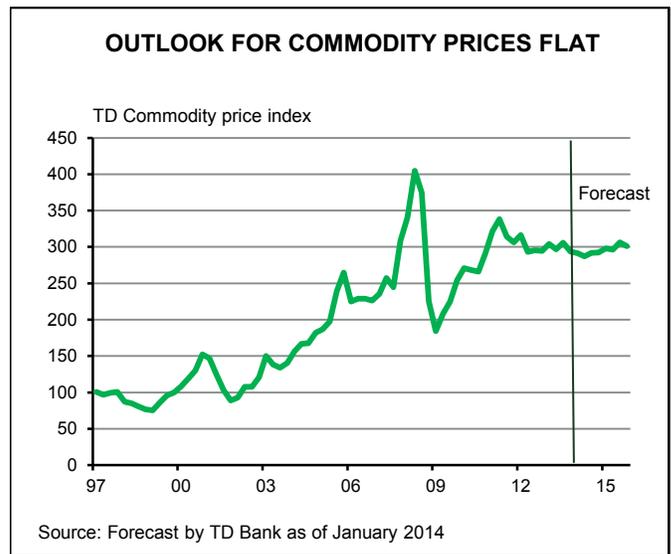


markets a green light to take the loonie to the lowest level in more than four years in January.

More dovish messaging from the Bank of Canada has led to a re-calibration of interest rate expectations. This has had a notable impact on interest rate spreads versus U.S. Treasuries. Early in 2013, the 5-year Government of Canada Bond had yielded about 60 basis-points more than the U.S., but that spread shrank steadily as inflation in Canada declined, and economic growth underperformed the United States. Then in October the Bank of Canada removed any reference to an eventual increase in interest rates from its communications, and the spread narrowed dramatically. By late January, it was essentially non-existent. This is strong evidence of why investors are less drawn to Canadian bonds than they were earlier in the recovery, the yield advantage has been drastically reduced, and this has coincided almost exactly with the turn in sentiment on the Canadian dollar.

What’s ahead for the Canadian dollar?

TD Economics expects that the factors which have taken the Canadian dollar lower are unlikely to shift over the next year or so. Canada’s economy is forecast to underperform the United States, interest rate hikes remain quite a ways off and the outlook for commodity prices is pretty flat, on average. In the near-term, the loonie is forecast to fall as low as 85 cents U.S by mid-year. However, it is then expected to appreciate slightly as inflation in Canada starts increas-



ing and the Bank of Canada gets closer to raising interest rates. TD expects the Canadian dollar to return to the 90 cent level in the second half of 2015, coinciding with the next rate hike by the Bank.

To put this in perspective, a 90-cent Canadian dollar is lower than earlier in the economic recovery, when Canadian travelers and cross-border shoppers enjoyed a currency at par with the U.S. dollar. But, it is worth remembering that it is still a far cry stronger than the decade from 1993-2003 that the loonie spent below 80-cents U.S. – at its worst reaching a low of 62 cents in 2002. A weaker Canadian dollar does create winners and losers. Broadly speaking it benefits exporters, but reduces Canada’s purchasing power abroad and will likely lead to higher inflation. However, given Canada’s current reality, where stronger export growth is the missing piece in Canada’s economic growth and inflation is at a very low level, it is an economic boon.

CANADIAN DOLLAR FORECAST								
Exchange rate	2014				2015			
	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
C\$ per US\$	1.12	1.18	1.15	1.15	1.15	1.14	1.11	1.11
US\$ per C\$	0.89	0.85	0.87	0.87	0.87	0.88	0.90	0.90

Source: Forecast by TD Economics as of January 2014.

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