QV UPDATE

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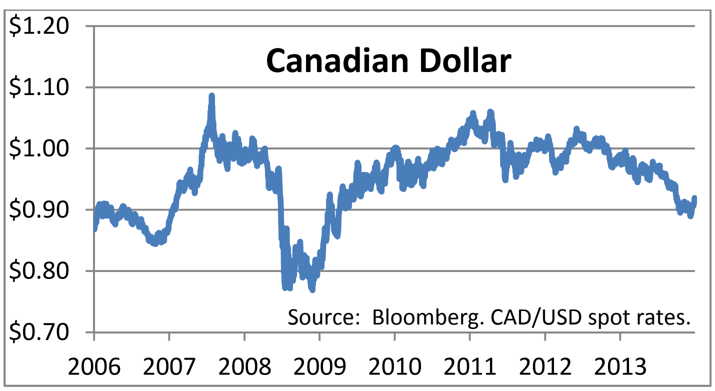
The Loonie: Are the glory days over?

As many returning snowbirds are keenly aware, the Canadian dollar has lost some of its lustre over the past year. The Loonie's decline began early in 2013 in conjunction with weaker commodity markets. The decline accelerated in the latter half of 2013 with the US Central Bank's tapering announcement, coinciding with Bank of Canada Governor Steven Poloz's more cautious outlook on the Canadian economy. As we write today, the Canadian dollar in US dollar terms is valued at $0.91, down from $0.94 in January, 2014, and $1.00 (parity) at the start of 2013.

Despite improving commodity prices of late, and a federalist Liberal majority win in Quebec, the Loonie continues to trade around the 90 cent level. Is this the level we should expect going forward? To answer that question, we must consider what drove our currency to parity (and beyond) both before and following the financial crisis in 2008.



The Canadian dollar's first brush with US dollar parity since 1976 occurred in late 2007 as frenzied commodity prices, and tighter Canadian monetary policy led investors to bid up the price of our currency. The rapid fall of the Canadian dollar in 2008 is linked to both the sharp reversal of commodity prices, and the global banking crisis that led to an unprecedented demand for liquidity in the form of US dollars.

The Loonie's climb back to parity in 2010 was fuelled again by surging commodity prices and interest rate differentials. US Central Bank's aggressive easing policies and the credit downgrade of the US further strengthened the Canadian dollar. In the midst of European default worries, Canada's coveted AAA status helped fuel significant foreign investment inflows into our bond market through to 2012, keeping the Loonie above parity.

Following a year of relative global financial market stability, foreign bond inflows into Canada have reversed. Economic improvements in the Euro region are providing more opportunities for bond investors, as evidenced by this week's successful Greek bond issue. This is the first time Greece has borrowed from the public debt markets since defaulting in 2012. Their 4.7%, 5-year bond yield compares to 1.7% for a 5-year Canada bond. In a "risk-on" world, suddenly we are not as attractive.

Barring another crisis of investor confidence, we expect the Canadian dollar to continue to trade in its current range. Our balance of trade and lower productivity measures do not necessarily warrant a permanent value above US dollar parity, much to the chagrin of Canadian travellers. At the same time, stable government finances and demand for Canadian resources should prevent the dollar from returning to a level below 70 cents, as we witnessed through most of the 1990s.

The Bank of Canada's push for a larger economic contribution from the manufacturing sector will be aided by a lower dollar. Their cautious outlook has had the desired effect of a lower currency. Thus, we expect the Bank of Canada may move more slowly on increasing their policy rates, keeping our dollar at the Bank's fair value range of 90 cents, and at the same time managing the debt servicing costs of highly indebted Canadians.

For our Canadian companies, many will benefit from translating their foreign sales back to Canadian dollars. Our retailers may also benefit from less cross border shopping. Though the "glory days" of the Loonie may be behind us, we must remind ourselves of the benefits to a more reasonably priced currency, namely a healthier manufacturing sector and greater economic diversity. Now, if we could only import the warm weather!