WILL THE CANADIAN DOLLAR KEEP SURPRISING US?

Summary

Clearly, the Canadian dollar keeps coming up with surprises. In February, if anyone had asked us whether there was a chance the loonie could go above US$0.90 before summer, we would immediately have said: “Yes, but it’s very unlikely.” Well, you know what has happened. After having oscillated around US$0.85 from January to March, the loonie suddenly jumped over the US$0.93 bar at the end of May, for a gain of just over 9.0% in almost three months.

It should be said that the loonie’s dynamics have improved substantially, as shown by the currency’s climb. It remains to be seen whether the rising trend is here to stay or whether an imminent correction should be expected. In this Economic Viewpoint, we look at the Canadian exchange rate’s determinants. We show that the improvement in the terms of trade (ratio between export and import prices), due to the increase in raw materials prices, in particular, has favoured appreciation by the loonie. However, other factors—both local and international—have helped the loonie rebound against other “commodity currencies” such as the Australian and New Zealand dollars, as well as against European and Asian currencies.

For now, we expect the currency’s advance to be more limited. In the short term, movement by interest rates and raw materials prices will remain key variables. If easing inflation pressure allows the U.S. Federal Reserve to relax its monetary policy to offset the housing market’s difficulties, it is likely that the loonie will continue to soar, especially since Canada’s economy is in full swing and the Bank of Canada is prepared to ensure that inflation risks remain controlled.

The dollar’s current level broadly reflects interest rate expectations and, as a result, future exchange rate movements will primarily depend on how raw materials prices evolve. After getting 2007 off to a strong start, metals prices are undergoing a period of consolidation and even correction, and they will make a smaller contribution. Conversely, oil prices seem to be lagging behind metals prices and, on the eve of summer and the hurricane season, the risks are still to the upside. This catch-up would be good for the loonie, a currency that is increasingly focused on energy exports.

We remain optimistic for the long term. The overall trend for energy and non-energy commodity prices remains upward, if only because of the frenzied pace at which some emerging economies are developing. Under these circumstances, the idea of Canadian dollar parity with the greenback during the next few years is not in the least outlandish. The foreign exchange market is very enthusiastic about the currency, and will certainly want to test the loonie’s appreciation limits soon. Foreign exchange market adjustments can be severe, and it would not be surprising, given the current craze for the loonie, for it to confound the most optimistic projections once again. However, unless there is a lasting increase in oil prices, we do not believe we will see parity immediately. We estimate that linear monthly growth, bringing oil prices to US$82 and metals prices up by 20% by the end of 2008, would be required in order for the loonie to reach parity with the greenback before 2009.
The loonie’s correction period was short

After more than four years of almost continuous appreciation which took it from a historic low of less than US$0.62 on January 18, 2002 to a cyclical peak of just over US$0.91 on May 30, 2006, the Canadian dollar took a break (graph 1).

Over the months that followed, one after another, the global economic slowdown (which caused the price of oil to plummet by almost US$27 a barrel (graph 2) and led to a correction in some metals’ prices) and concerns about a Canadian economic soft patch resulting from the repercussions of the American housing market’s difficulties pushed the loonie down to a recent low close to US$0.84 on February 7.

At the time, everyone was expecting the loonie to vacillate for a while. After all, the impacts of the American residential real estate market’s adjustments had not yet been fully felt and Canada’s economy, which expanded by only 1.5% in Q4 of 2006, had just posted its worst growth in almost four years.

Change in dynamics for the loonie

However, the situation quickly took a different turn and the currency was back on the growth track. We were not the only ones to be surprised when, in just over two months, the exchange rate recouped all of the losses it had racked up in ten months, from May 2006 to March 2007.

It should be said that the loonie’s dynamics have improved substantially. Underlying this is the fact that international investors seem to have agreed that, in spite of the U.S. slowdown that is underway, global economic growth would remain robust for the next two years. The improved domestic economies of Euroland’s pillars helped the euro zone to take up some of the slack, but it was mainly ongoing frenzied growth by Asian economies ex-Japan, especially China and India (whose contribution to global economic growth was over 40% in 2006) that ensured the planet’s economy would maintain a solid pace (graph 3).

After a slacker period, demand for raw materials firmed up and metals and oil prices started moving up again. The subsequent improvement to the terms of trade (ratio of export prices to import prices) was broadly beneficial to the “commodity currencies”, including the loonie (graph 4 on the next page).
The Canadian dollar stands out from the pack

In addition to energy and non-energy commodity prices, other factors emerged to cause the Canadian dollar to rebound (graph 5). First, the American economy’s relative growth compared with Europe’s pillars generated some pessimism about the greenback. While many expect federal funds to ease slightly, everything suggests that Europe’s major central banks have not finished firming up their monetary policy.

Meanwhile, the Canadian economy’s fundamentals are very solid. Economic growth has made a strong comeback since December, and the overall trend for employment is very robust. With core inflation evolving upward, it is now certain that the Bank of Canada (BoC) is closer to raising its key rates than the U.S. Federal Reserve (Fed) is. As a result, the expected narrowing of the spread between Canadian and U.S. interest rates is providing our currency with good support. Simultaneously, we should also mention the many mergers and acquisitions taking place in Canada, particularly among mining and gold companies, generating substantial capital inflows despite the appetite for “Maple bonds”.

We will take a closer look at each of the Canadian exchange rate’s determinants in later sections to explain the loonie’s current strength and, in particular, to see whether the rising trend is going to continue or whether a sharper correction is on the horizon.

Greenback pessimism

The general trend for the American dollar is downward. Housing market adjustments are ongoing and the economy has not yet felt their full impact. Real GDP advanced by only 0.6% in the first quarter, and the latest data suggest that the softness will have continued at least until spring. With home prices continuing to slide and gas prices that have recently gone to over US$3 a gallon, it will be hard for the economy to beat 2.0% in Q2 of 2007. Under the circumstances, and after four quarters of growth below potential, it seems increasingly clear that inflationary pressure will continue to fade slowly. Already, the annual variation in the consumer price index (CPI) excluding food and energy dropped to 2.3% in February and pressure from rents, which provided the primary upward contribution in recent quarters, should continue to ease over the months to come (graph 6 on the next page).

For now, the Fed is maintaining its slight restrictive bias due to inflation pressures, which has encouraged market players to lower their expectations regarding rate cuts.

1 “Maple bonds” are debt instruments issued by foreign companies in Canada denominated in Canadian dollars. Canada’s major financial institutions are fond of using these to diversify their bond portfolio. Usually funds borrowed in Canada are repatriated to the economy that issued the bonds.

2 For more details about the factors that govern exchange rates, see the Economic Viewpoint of January 25, 2006, “Loonie on Par with the Greenback? Maybe—But Not Tomorrow”.

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2. Greenback restrictions
   - The Fed is maintaining its slight restrictive bias due to inflation pressures.
   - Market players have lowered their expectations regarding rate cuts.
This allowed the trade-weighted U.S. dollar index to bounce back from the historic low, reached April 30 (graph 7), but pessimism about the greenback continues.

The euro zone still has the wind in its sails...

In contrast, Europe’s economic pillars are showing surprising strength. The euro’s appreciation, tax measures levied in Germany and Italy, and monetary firming by the European Central Bank (ECB) will, of course, curb Euroland’s economic advance. However, the confidence indexes continue to point to sustained growth (graph 8).

With the strong base effect provided by the final quarter of 2006, it is now clear that economic growth will be in the neighbourhood of 2.6% in 2007, a pace that is similar to 2006’s and above the consensus forecast for the United States (graph 9).

We expect inflation to remain contained until the end of the year, but increased production capacity utilization, further oil price increases, strong credit growth and the potential for larger wage increases than forecast are helping keep inflation risks to the upside. Under the circumstances, we believe the ECB will tighten its monetary policy from the current 3.75% to 4.25% by the end of the summer.

… as does the United Kingdom

Parallel to this, the British economy is not flagging. Real GDP growth has been above (or equal to) the economy’s potential pace for the last six quarters. With annual inflation over 3% in March, the Bank of England (BoE) brought its key rate up to 5.50% at its May meeting.

For now, there is nothing to show that May’s increase is the last one. Although inflation is expected to approach

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Graph 6 – Inflation pressures from housing prices should dwindle

Graph 8 – Euro zone growth remains robust

Graph 7 – The U.S. dollar index has recovered, but the trend is still downward

Graph 9 – The U.S. economy will see weak growth in 2007

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Sources: Bureau of Labor Statistics, Census Bureau, Office of Federal Housing Enterprise Oversight and Desjardins, Economic Studies

Sources: Datastream and Desjardins, Economic Studies

Sources: Consensus Forecasts and Desjardins, Economic Studies

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the 2% target by the end of the year, inflation risks are still to the upside. Note that house prices continue to rise quickly and the employment market is quite healthy. As a result, the odds are that the BoE will increase the cost of money again this summer, probably in August (graph 10).

The Canadian economy has very strong foundations

Make no mistake, the greenback’s downward movement will benefit the loonie. The fact is that, relatively speaking, Canada’s economy is clearly outperforming the American economy. In addition to Canada’s enviable position—a current account surplus and a budget surplus—lively domestic demand continues to indicate that growth will firm up. In April, the job market took a break, losing almost 5,000 jobs, but this followed average job creation of approximately 50,000 jobs in each of the six months prior to that, for a total of 280,000 new jobs since October of 2006. What’s more, at 6.1%, the jobless rate is the lowest it has been since 1974 (graph 11).

The economy has bounced back since December and, after seeming to hit a trough in the final quarter of 2006, real GDP will evolve at a stronger pace for the rest of this year and next year. With underlying inflation oscillating in the upper part (from 2% to 3%) of the BoC’s target range (graph 12), these developments have prodded the monetary authorities to change their stance to take the increased inflation risk into consideration.

The contribution by non-energy raw materials prices will be more limited

Even though, in the short term, anticipations of interest rate fluctuations will largely dictate the evolution of the Canadian exchange rate, any sustained increase or major correction will come from developments in energy and non-energy commodity prices, which are the main drivers of the loonie.

Raw materials prices have risen to dizzying heights in recent years, generating a net appreciation of the loonie. While the increase in oil prices has been making itself felt since the beginning of 2004, it was not until the second half of 2005 that industrial metals prices started to rise sharply. From May 2005 to May 2007, base metals prices (+118%) have more than doubled (graph 13 on the next page).
That being said, future trends in metals prices are uncertain. Since raw materials prices are very cyclical,
the dizzying rise in metals prices does not seem sustainable (graph 14). Although we remain confident
that the industrialization of China and India will ensure that prices stay high, the slower pace that is anticipated
for the world economy, combined with increased supply, mean that price growth will moderate.

Moreover, there is a potential risk of a correction. In the past, actual prices have generally headed downwards,
and the few episodes of strong growth have always been followed by periods of adjustment which have pulled prices back into line with the longterm trend (graph 15). For the time being, we do not foresee a collapse in prices, but their contribution to any appreciation of the loonie will be more limited.

Energy prices will continue to drive the loonie up

On the contrary, there is every reason to believe that pressures on energy prices will continue to rise (graph 16). In the short term, the arrival of the summer driving season in the U.S. and the beginning of the hurricane season in the Gulf of Mexico should send the price of crude soaring. After that, the recovery of the American economy will stoke demand and keep prices high into 2008.

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3 For a more in-depth explanation of the cyclical nature of metals, see the Economic Viewpoint of November 17, 2006, “Global Slowdown Ahead: Should We Expect a Drastic Correction in Raw Materials Prices?”
Over the longer term, it is the structural change in demand, reflecting the rapid industrialization of the Asian economies, that will drive oil prices up to record levels. China is already the second largest consumer of oil in the world, after the United States, and things are just getting started. The urbanization of China and the higher incomes of Chinese households are being reflected in an explosion in the number of automobiles on the roads. Given the difficulty of increasing production to a significant degree, China’s appetite for oil, which is likely to increase tenfold, will result in higher prices in the years to come.

Mergers and acquisitions of Canadian companies

Canada’s enviable position with respect to natural resources has made it a prime target of international investors wishing to expand or consolidate their position in the market. Multiple mergers and acquisitions have taken place over the past few quarters. Since the beginning of this year, over 600 company buy-out proposals have been made, with a value of over US$100B. Consider Alcan (US$32.4B), the increased bid by Xstrata for LionOre Mining International (US$4.8B), Abitibi-Consolidated (US$4.4B) and, expected soon, BCE.

There is an undeniable correlation to be made between the numerous buy-outs of Canadian companies and the performance of the Toronto Stock Exchange, and the same holds true for our currency. In fact, there is every reason to believe that this helped support the Canadian dollar when the price of oil dropped to around US$50 per barrel back in mid-January. According to our model for estimating the Canadian exchange rate, all else being equal, a $10 reduction per barrel in the price of oil leads to a US$0.03 drop by the loonie. Consequently, it would seem that the flurry of acquisitions kept the Canadian dollar from falling below US$0.82 (graph 17). Of course, it is impossible to quantify the volume of forthcoming transactions exactly, but the enthusiasm for raw materials should ensure that acquisitions of Canadian companies will continue.

The foreign exchange market will put the loonie to the test

The remarkable appreciation of the Canadian dollar and, more importantly, the recent attainment of a 30-year peak have generated a real craze for the currency. Consequently, it is not surprising to see the idea of parity with the greenback resurfacing. With no technical barrier ahead of us (the previous peak, US$1.0307, dates back to October 26, 1976), market players will certainly want to testjust how far the loonie can go, and it would not be surprising to see it cross the psychological thresholds of US$0.94, US$0.95 and perhaps even higher, in the near future (graph 18).

However, if we rely on speculative positions, the market’s feeling about the greenback is excessively negative (graph 19 on the next page) and the American currency could possibly experience a rebound, although the scope of the correction should be small and brief.

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4 For more details about the Desjardins exchange rate model, see the Economic Viewpoint of October 11, 2006, “Petrocurrency”: Good or Bad for Canada’s Economy?”
On the other hand, we must also keep close watch on the craze for the Canadian dollar. Net long positions on the loonie are once again firmly in positive territory (graph 20), a situation which, in the past, has always led to a correction for the loonie.

Implications for the BoC

For the time being, anticipations of an interest rate hike are firmly supporting the Canadian dollar. The spreads on anticipated rates have narrowed, and they may narrow still further in the short term (graph 21).

However, our exchange rate model shows that the loonie’s current level is undervalued compared to its equilibrium value, that is, its value estimated exclusively on the basis of fluctuations in the prices of energy and non-energy raw materials (graph 22). We may therefore conclude that the currency’s rise since last March is due primarily to Type 1 appreciation, as defined by the BoC, which gives monetary authorities free reign to adjust key interest rates as needed5.

5 Consider the example of a gain in the Canadian exchange rate. We usually apply the term “Type 1” to any movement in the Canadian exchange rate that is caused by a direct increase in demand for Canadian goods and services, or an improvement in the terms of trade. In such a situation, it is understood that the appreciation of the loonie will partly offset the initial demand shock by discouraging exports and stimulating imports. In this case, intervention by the BoC is not really necessary. On the other hand, the term “Type 2” refers to fluctuations in the Canadian exchange rate that are not the result of a direct change in the demand for Canadian goods and services, such as portfolio movements, capital flows or a multilateral depreciation of the currency of an important trade partner. In this situation, the negative effect on the foreign sector leads to a net reduction in demand, which may compel the BoC to lower its key interest rates.
Clearly, the Canadian monetary authorities are very concerned about the acceleration of inflation in the country and by the remarkable improvement in the economic outlook. We are continuing to bank on a moderation of inflationary pressures in Canada, but developments over the coming months will be subject to some degree of uncertainty due, in part, to high food and lodging prices and, also, to the reform of the CPI planned for June. Not only will the base year be changed, but the weight of the various components will also be revised. It is likely that the lodging component will bear more weight in the index, given the surge in housing prices in recent years. Since this component is still one of those that is increasing the fastest, upwards pressures on the CPI may well intensify after the reform.

In these circumstances, the BoC’s message seems unmistakable: monetary authorities are prepared to raise key interest rates as early as next July if inflation continues to give cause for concern.

**Exchange rate forecasts**

The loonie’s current level is largely a reflection of the market’s expectations concerning interest rate spreads and, barring a decline in U.S. federal funds between now and the end of the year, the pressures associated with rate spreads will be limited. Consequently, significant movements by the Canadian dollar in the near term will depend primarily on fluctuations in raw materials prices.

As we mentioned earlier, we anticipate a period of stabilization in metals prices. Some have already undergone a correction, and we think that reduced demand in the second half of the year, combined with an increase in supply in 2008, should trigger a slight stagnation in prices towards the end of 2007 and in 2008. However, it is likely that this will be offset by firmer oil prices between now and the end of the year and, especially, next year.

Thus, according to the basic scenario, our Canadian exchange rate model shows that the loonie will stay close to US$0.93 until the end of 2007 (graph 23). Certainly, it will quite probably spike to levels much higher than that, but in order for it to appreciate significantly, the trade-weighted U.S. dollar index would have to depreciate further (which is unlikely) and, more importantly, prices for energy and non-energy raw materials would have to continue rising at a frenetic pace. We estimate that linear monthly growth, bringing oil prices to US$82 and metals prices up by 20% by the end of 2008, would be required in order for the loonie to reach parity with the greenback before 2009.

**Conclusion**

We maintain our position that much of the loonie’s appreciation is now behind us. The rise of the past few months now puts the Canadian dollar slightly above last year’s level and, although the majority of determining factors remain positive, future gains will be more limited. Apart from expectations regarding interest rates and raw materials prices, it is possible that improvements in productivity may give the loonie a boost. After a dismal showing in this regard in recent years, the adjustments that have been made in the Canadian economy may begin to bear fruit. Foreign exchange market adjustments can be severe, and it would not be surprising, given the current craze for the loonie, for it to confound the most optimistic projections once again.

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**Graph 23 – Our exchange rate model shows that gains will be limited**

Sources: Datastream and Desjardins, Economic Studies