One out of three ain't good

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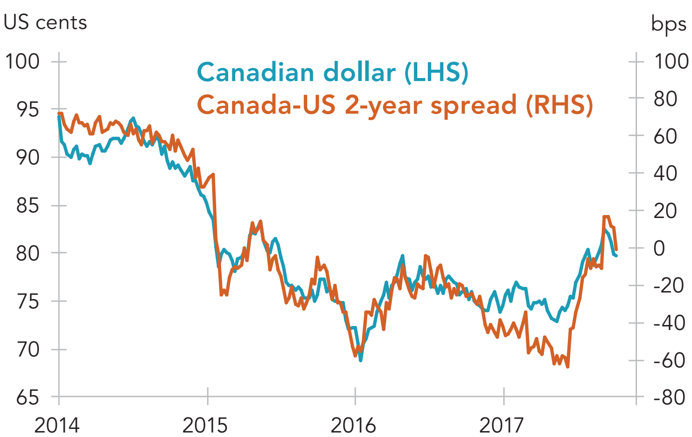
Key Takeaways

- The summer surge in the Canadian dollar reflected the jump in Canadian interest rates relative to the US in particular.
- Markets now expect more of the same ahead.
- We don't.

EXHIBIT 1: BoC tightening has driven up spreads, CAD



Sources: Bank of Canada, Federal Reserve, Haver Analytics, FMR Co.

The Canadian dollar exchange rate remains a top-of-mind issue for Canadian investors, including for us in the management of our multi asset class funds. In recent commentaries (see *Currency management* and *Sale of foreign assets! Limited time!*), we've discussed how our longer-term investment horizon and risk management approach lead us generally to own foreign assets on an unhedged basis, and that our cyclical outlook leads us to further diversify away from Canadian dollar-denominated assets. In this commentary, we drill down on the latter view.

> We retain **strong conviction** that, to address these imbalances and thus preserve the longer-term stability of the economy, the **Canadian dollar needs to weaken again.**

CAD bounce has been driven by interest rates

Interest rate differentials tend to be among the most important determinants of exchange rate movements. For the Canadian dollar's value vis-à-vis the US dollar, these rate spreads have been pretty much all that's mattered in recent years. As Exhibit 1 shows, there has been a near-perfect correlation between the Canadian dollar and the spread between Canadian and US 2-year government bond yields, which captures the current and expected relative paths of monetary policy in the two countries.

The underperformance of the Canadian economy between 2012 and 2016, which intensified in 2015 following the collapse of oil prices, led the Bank of Canada (BoC) to ease policy even as the Federal Reserve began to normalize rates in the US. The Fed has remained on that course this year, but the BoC has done a 180-degree turn to tighten in response to the Canadian economy's rebound through the first half of 2017. This has led to the repricing of the short end of the Canadian yield curve and the observed spike in the value of the Canadian dollar.

So forecasting the Canadian dollar effectively means forecasting the 2-year Canada-US spread, which in turn means the relative movements of the Bank of Canada and the Fed. With the 2-year spread currently slightly positive vs the slightly negative official rate spread, the market is effectively predicting that the BoC will out-tighten the Fed ahead.

We think that's unlikely.

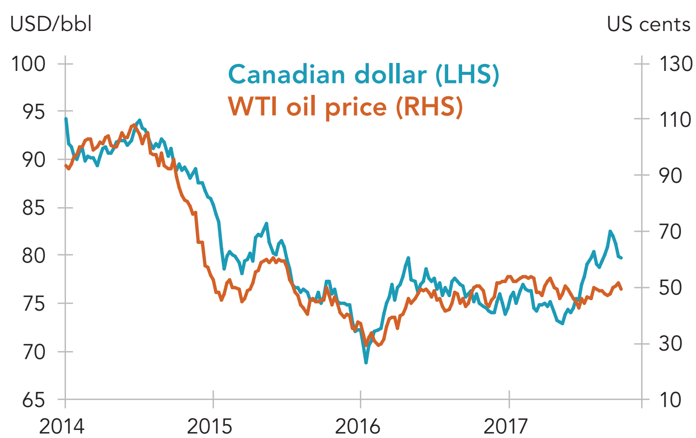
The basic reason why is that the Canadian economy has clear excesses that the US economy does not. American households have spent years repairing their balance sheets; Canadian households, now with higher debt levels than in the US at the peak, haven't even started. Thus the BoC is tightening into a far more leveraged domestic environment than the Fed, meaning that any given increase in interest rates can generally be expected to 'bite' faster and harder in Canada than in the US.

The base case scenario, therefore, is that the BoC will need to return to lagging behind the Fed's tightening cycle due to the greater interest rate sensitivity of the Canadian economy, pushing both short rate differentials and the Canadian dollar back down. The more worrisome scenario is that the abrupt increase in Canadian interest rates this year, in conjunction with regulatory tightening measures aimed at the housing market enacted at both the federal and provincial levels in recent quarters, ends up 'pricking the bubble.' This would likely result in the first 'made in Canada' downturn in a generation and a reversal by the BoC to resume easing, putting acute downward pressure on both spreads and the CAD.

Oil, equities have their doubts

Other markets are corroborating the doubts about the sustainability of the appreciation in the Canadian dollar. First, oil prices have barely budged. Oil prices also tend to be highly correlated with the Canadian dollar, because they reflect the relative value of Canada's exports and thus act as a good proxy for Canada's terms of trade, which is a fundamental determinant of any country's exchange rate. But as Exhibit 2 shows, oil prices have remained in a tight range around $50/bbl for more than a year, failing to validate the summer spike in the CAD.

EXHIBIT 2: Oil has not ratified the jump in the CAD



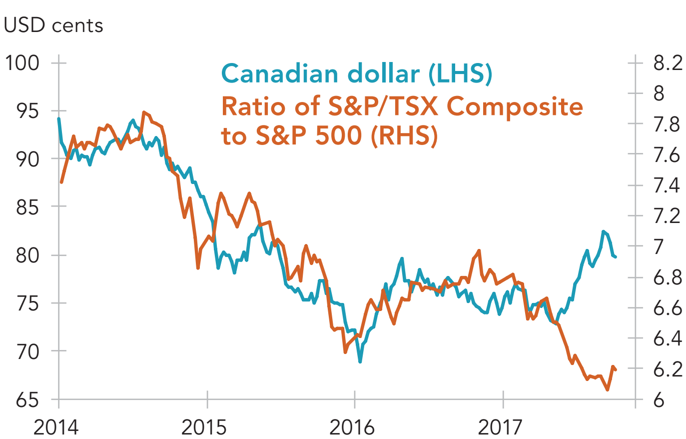
Sources: Bank of Canada, Haver Analytics, FMR Co.

And as Exhibit 3 demonstrates, equity market movements imply that the Canadian dollar should still be going down, not up. Canadian stocks have been among the worst performing in the world this year, with the flattish TSX contrasting with double-digit gains in the US and many other markets. While the relative performance of equities is less of a traditional currency valuation indicator than interest rate spreads or oil prices, it is not surprising to see the generally-strong correlation here, given that changes in the relative prospects for Canadian and US businesses should be related to changes in the prospects for the two economies overall.

Drilling down into Canada's laggard equity performance this year provides further evidence of equity investor doubts regarding the Canadian outlook. While part of the Canadian equity lag has owed to sector composition (the TSX has lots of energy companies and very few tech companies), nearly every sector of the TSX has also underperformed its US or global counterpart this year.

The underperformance of the Canadian banks vs US banks is particularly noteworthy. One generally expects financials to do better as interest rates rise from low levels, due to the positive effects of rising rates on bank net interest margins (NIMs). So in the context of the idiosyncratic upward shift in Canadian interest rates in recent months, one would have expected Canadian financials to be world-beaters. But the reverse has been true – that correlation has actually been negative in Canada this year, with financials only rising in recent weeks as market expectations of future interest rate increases have ebbed. This suggests that market participants are more worried about the risks posed to bank earnings by the impact of higher rates on the over-levered Canadian consumer than they are cheered about the direct boost to those earnings from higher NIMs.

EXHIBIT 3: Canadian equity markets sending a warning



Sources: Bank of Canada, Standard & Poor's, Toronto Stock Exchange, Haver Analytics, FMR Co.

CAD needs to get cheap (again)

In our very first commentary for Fidelity Canada nearly four years ago (see *Leaving home*), we argued that the Canadian dollar needed to get cheap and stay cheap, reflecting the imbalances that had emerged in the Canadian economy. The exchange rate dutifully fell from 95 US cents to below 70 cents. It got cheap, but it didn't stay cheap, with the currency now near its longer-term fair value around 80 cents. At the same time, the imbalances in the Canadian economy, manifested in excesses in household balance sheets and the housing market, have only gotten worse. We retain strong conviction that, to address these imbalances and thus preserve the longer-term stability of the economy, the Canadian dollar needs to weaken again. That is why we've taken the opportunity of what looks like an unsustainable bounce in the currency to steer further away from Canadian dollar-denominated assets in our multi asset class funds.

David Wolf and David Tulk, October 17, 2017

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David Tulk is an Institutional Portfolio Manager at Fidelity Investments. In this role, he serves as a member of the investment management team, maintaining a deep knowledge of portfolio philosophy, process, and construction. He assists portfolio managers and their CIOs in ensuring portfolios are managed in accordance with client expectations.

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