THE BIG PICTURE

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Expect more currency volatility

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Market participants survived considerable bouts of volatility during the financial crisis of 2008-09 as virtually every type of security saw wide swings in value on a seemingly ongoing basis. Not surprisingly, the world's currencies also suffered dramatic fluctuations during this period. However, since that time, the Canadian dollar has continued to experience recurring, exaggerated moves in pricing against its U.S. counterpart. These movements can be beneficial or problematic on a number of fronts. A weaker currency benefits Canadian exporters, as shipments become cheaper in foreign currencies. Similarly, more tourists head to Canada when prices are lower. A stronger domestic currency benefits consumers of imported products or vacationers heading outside of Canada. For investors, a strong home currency can widen the range of options for foreign investment while a weaker currency can restrict those choices. Most would prefer to have some currency stability to aid in longer-term planning, but that does not appear to be in the cards for the foreseeable future. Taking advantage of professional advice and sticking to a financial plan can help calm emotions even during periods of volatility.

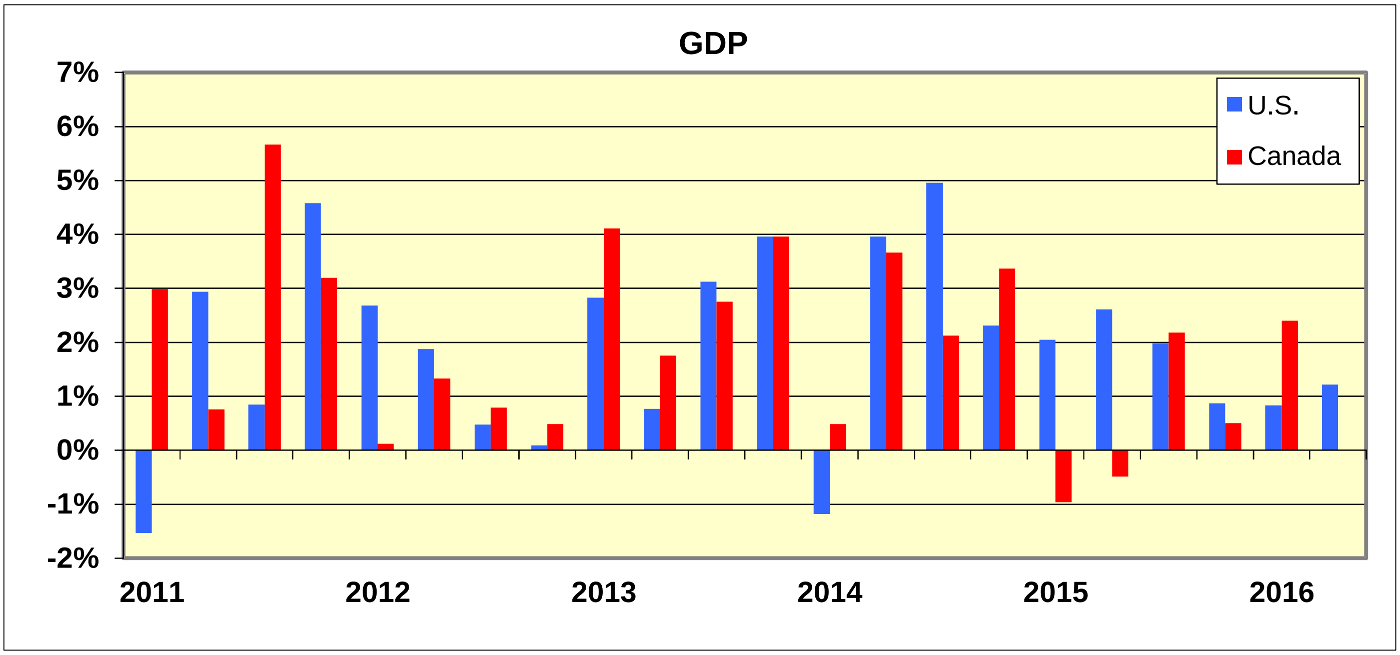
Spot the loonie

Source: Bank of Canada

The Canadian dollar has seen a number of cyclical moves over the past 10 years. However, those moves appear to be exaggerated when compared to the period that preceded it. Looking back further, the secular decline in the value of the currency took it from just under US$0.90 in early November 1991 to a record low of US$0.62 on January 21, 2002. This 28-cent move took more than a decade. By comparison, the fundamental shift away from government deficits, improved economic growth, neutral inflation and political stability here in Canada allowed the currency to rise from this all-time low to an all-time high of US$1.10 on November 7, 2007, a move of more than 48 cents in less than six years.

During the 2008-09 financial crisis, "safe-haven" flows saw many panicked investors turning to U.S. dollar-denominated assets. Along with virtually every other currency, the loonie sold off, reaching a relative low of US$0.77 at the height of the crisis on March 9, 2009. This represented a 34-cent loss in less than a year-and-a-half. Once the broader sense of panic eased, many international market participants recognized that Canada had weathered the storm significantly better than many other nations. Once again the currency was on the upswing, peaking at US$1.06 July 26, 2011. It gained 30 cents in less than two-and-a-half years. However, at this juncture, some relative stability had been achieved. The Canadian dollar traded above par relative to its U.S. counterpart from December 2010 to September 2011, the longest such stretch ever recorded. However, as commodity prices, particularly oil, came under pressure, currency weakness returned. After an initial break below US$0.90 on October 9, 2014, the loonie bottomed out at US$0.68 January 20, 2016. Surprisingly, this was weaker than the bottom seen during the financial crisis. This sharp decline produced an equally sharp rebound as the Canadian dollar hit US$0.80 on April 29, 2016.

Underlying economic growth

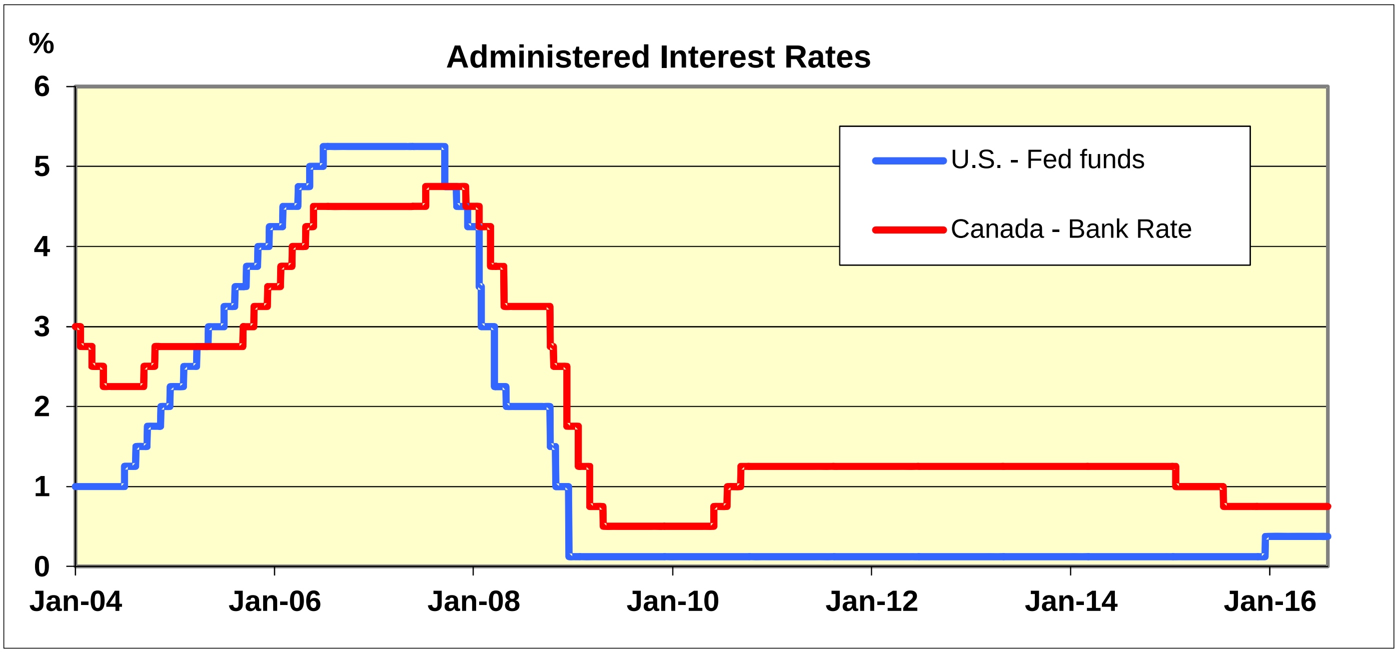


Source: U.S. Bureau of Economic Analysis; Statistics Canada

The currency market's enchantment with the resilience of the Canadian dollar during the financial crisis and the subsequent "Great Recession" has faded, at least in part, due to less inspiring domestic economic results. As can be seen in the above chart, the pace of economic growth in Canada has been far from consistent. Despite some market disappointment over the U.S. economy recording a relatively soft annualized 1.2% pace of GDP growth in the second quarter of 2016, things are expected to have been considerably weaker here in Canada. The Alberta wildfires, which struck during the quarter, are widely expected to have pushed the growth of Canada's economy into negative territory. Frequently, the period that follows the occurrence of this type of economic disruption exhibits a rebound as reconstruction begins. The timing and the extent of these rebuilding efforts, and how they will be reflected in the official economic data, remain to be seen.

Interest rates

The link between the relative strength of the economy and interest rates is fairly well entrenched. Establishing lower administered interest during periods of weak economic growth is part of the traditional and familiar approach to monetary policy by the world's major central banks. The reverse, the use of higher interest rates to "cool off" an economy, has not been put into practice for some time, but it is anticipated, at least for the United States. Standard economic theory states that, all other things being equal, a difference in interest rates will attract investment activity. Foreign buyers of a country's interest-bearing instruments will drive up the value of the currency as they acquire it in order to make the intended investments. Not surprisingly, since the U.S. Federal Reserve raised the Fed Funds rate by 25 basis points (a basis point is 1/100th of one percent) on December 16, 2015, there has been considerable speculation as to when a follow-up move would take place. Given the influence that the U.S. economy has on our own, even anticipated differences in interest rates can have a major impact, thus contributing to currency volatility. For the Bank of Canada's part, officials are quite aware of this influence and, even though the bank does not specifically manage the value of the currency, they have stated that the objective of monetary policy is to preserve the value of money. Naturally, a more stable currency would be in line with this objective. Currency traders will continue to closely watch both central banks for any signs of "managing" inflationary pressures and buy or sell accordingly. The "flat" appearance of interest rates in the U.S. and Canada in the following graph, belie the influence exerted by the expected change.

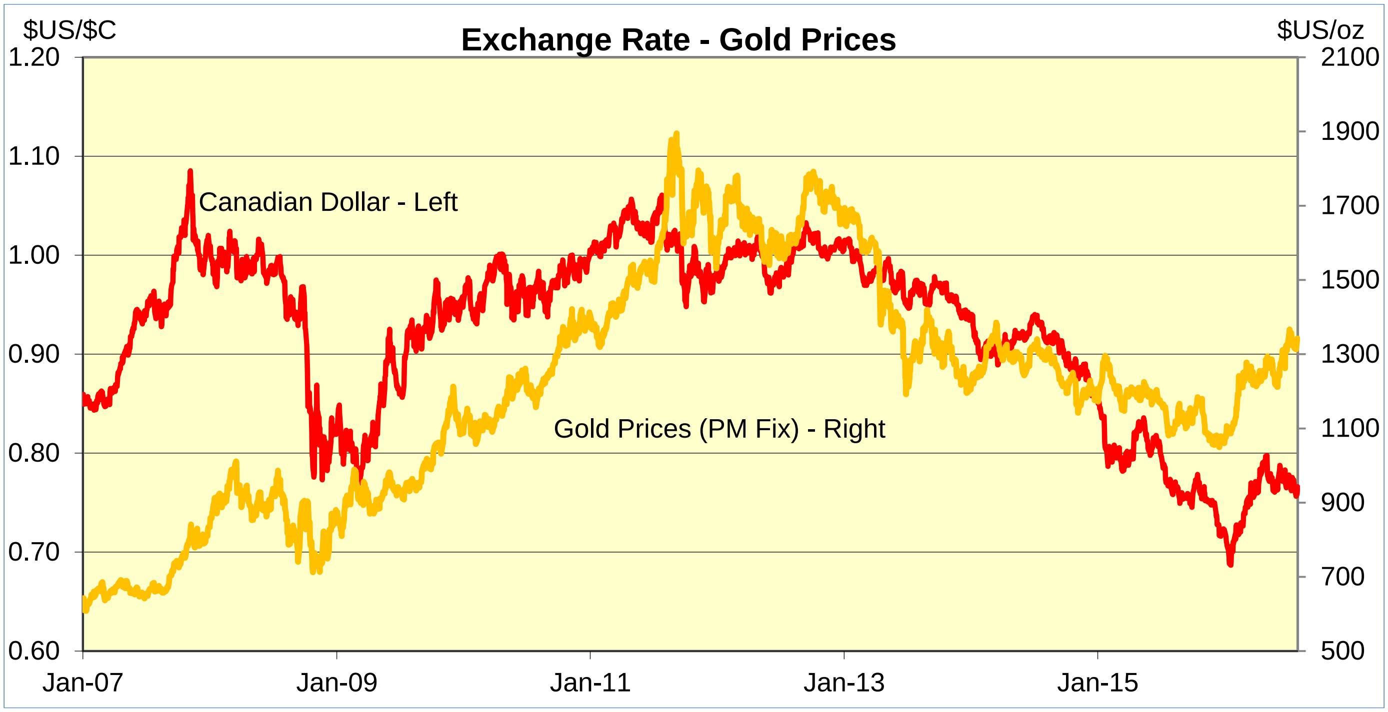


Source: U.S. Energy Information Administration

Gold

The secular rise in gold prices that began in mid-1999 with the precious metal at US$250 per ounce continued through the financial crisis and ended only after the economic and market recovery was underway. Gold prices peaked at US$1,921.15 per ounce on September 6, 2011. Even though this nominal price was an all-time high, on an inflation-adjusted basis it was still below the price of US$850 set on January 21, 1980 (the equivalent of approximately $2,300 in September 2011). Canada is the world's fifth-largest gold producer[1]. As can be seen in the following graph, the Canadian dollar and the price of gold followed similar patterns over a portion of the past 10 years. As a result, over much of that period, Canadian investors in gold would have only seen a fraction of the returns seen by investors in the U.S. While gold and the Canadian dollar have shared some recent trends, another commodity appears to be exerting a much greater influence.

[1] Mineral Commodity Summaries 2016, United States Geological Survey

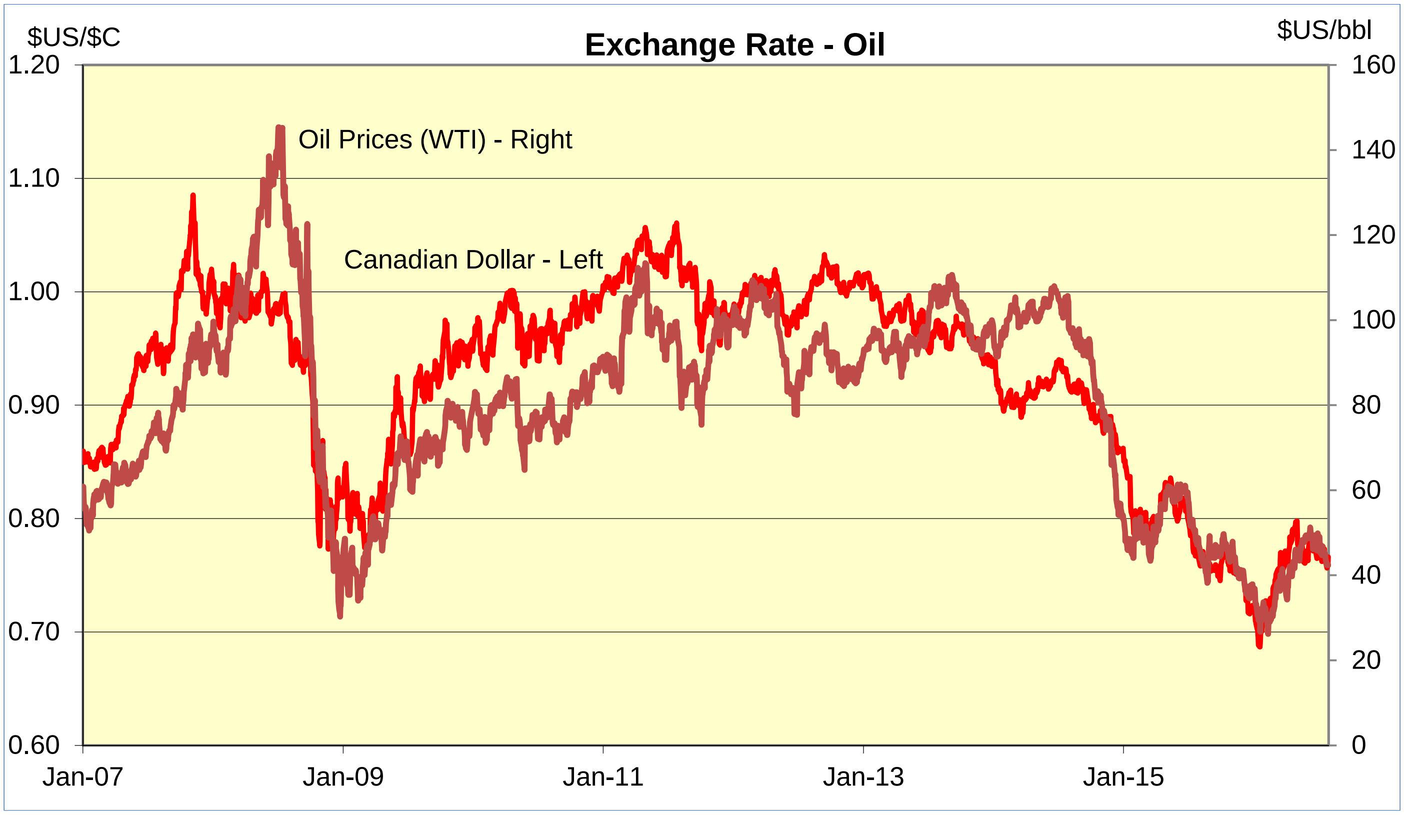


Source: London Metals Exchange; Bank of Canada

Oil

Between the beginning of 2007 and the present, world oil prices tracked the Canadian dollar much more closely than gold (see Appendix 1). Perhaps this is not too surprising, given that Canada ranks third in the world in terms of proven crude oil reserves[2]. The real emphasis right now appears to be on the linkage between oil prices and the Canadian dollar. The following graph shows how closely the two "prices" have moved for the last 10 years. Unfortunately, as long as this association remains strong in the minds of market participants, the two will continue to move together. The implication is that, so long as oil prices remain volatile, so too will the Canadian dollar.

[2] Annual Statistics Bulletin, OPEC 2016

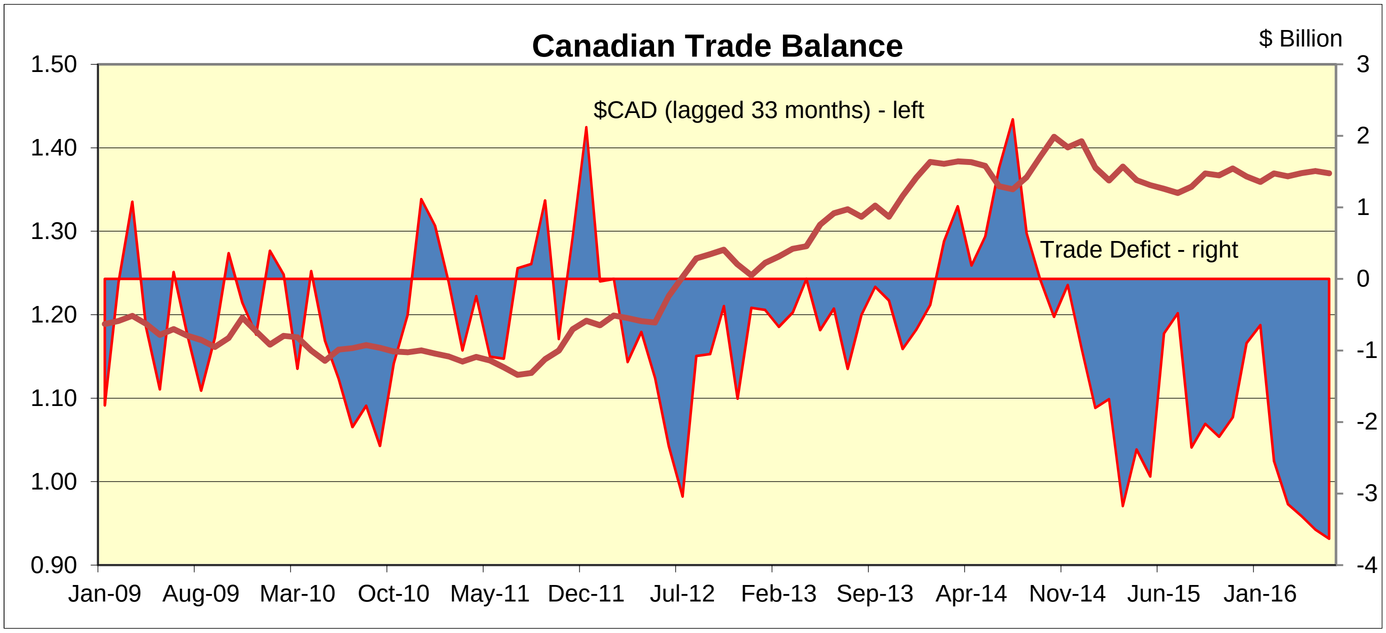


Source: U.S. Energy Information Administration; Bank of Canada

Trade

Domestic currency weakness gives foreign buyers greater purchasing power and Canadian goods, at lower prices, become more popular. The natural “shock absorber” effect of the currency and its subsequent influence on trade has helped bolster Canada’s economic growth during periods when it has otherwise been relatively weak. Historically, the lower value of the Canadian dollar, particularly when it has been significantly below par with its U.S. counterpart, has been instrumental in bolstering trade. As the following graph shows, merchandise trade balances trended with the lagged value of the Canadian dollar (the best fit of the data is a 33-month lag – see Appendix 2). However, volatility in the value of the currency adds another layer of complexity.

From an investor’s perspective, diversification is key and choosing to look outside our borders when the Canadian dollar shows relative strength can provide long-term benefits. Looking beyond the U.S. may present other opportunities as world currencies are constantly moving in different directions. Added volatility increases the uncertainty around decision making.



Source: Statistics Canada

Conclusions

- Volatility in the Canadian dollar raises concerns and opportunities. Seeking professional advice can help alleviate worries over the influence of the change in the value of the currency.
- From a historic perspective, lower values of the Canadian dollar have supported trade, albeit with a delay. It is likely that these influences will remain intact and bolster economic growth.
- Along with a weaker currency come concerns over inflationary pressures. Given the current economic environment, it is unlikely that the Bank of Canada would be preoccupied with “imported inflation”.

Appendix 1

The tables below provide the regression analysis results for:

1) The Canadian dollar value (in U.S. dollars) as the dependent variable and the price of gold (in U.S. dollars) as the independent variable over the period from January 2007 to July 2016.

2) The Canadian dollar value (in U.S. dollars) as the dependent variable and the price of oil (in U.S. dollars) as the independent variable over the period from January 2007 to July 2016

SUMMARY OUTPUT		Gold						
Regression Statistics								
Multiple R	0.36118063							
R Square	0.13045145							
Adjusted R Square	0.13009257							
Standard Error	0.08143933							
Observations	2425							
ANOVA								
	df	*SS*	*MS*	*F*	*Significance F*			
Regression	1	2.410886771	2.41088677	363.5034	1.27436E-75			
Residual	2423	16.07021737	0.00663236					
Total	2424	18.48110414						
	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95.0%*	*Upper 95.0%*
Intercept	0.79990463	0.006658943	120.124863	0	0.786846816	0.812962439	0.786846816	0.812962439
X Variable 1	0.00010229	5.36489E-06	19.0657651	1.274E-75	9.17655E-05	0.000112806	9.17655E-05	0.000112806

SUMMARY OUTPUT		Oil						
Regression Statistics								
Multiple R	0.83235139							
R Square	0.69280884							
Adjusted R Square	0.69268206							
Standard Error	0.04840515							
Observations	2425							
ANOVA								
	df	*SS*	*MS*	*F*	*Significance F*			
Regression	1	12.80387238	12.8038724	5464.5969	0			
Residual	2423	5.677231756	0.00234306					
Total	2424	18.48110414						
	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95.0%*	*Upper 95.0%*
Intercept	0.67429702	0.003503515	192.463029	0	0.667426821	0.68116721	0.667426821	0.68116721
X Variable 1	0.00311082	4.20819E-05	73.9229115	0	0.003028296	0.003193337	0.003028296	0.003193337

Appendix 2

The tables below provide the regression analysis results for:

1) Canada's merchandise trade balance as the dependent variable and the lagged value of the Canadian dollar (versus the U.S. dollar) as the independent variable over the period from January 1988 to June 2016.

SUMMARY OUTPUT								
Where Canada's merchandise trade balance is the dependent variable and the value of the Canadian dollar (lagged 33 months) is the independent variable								
Regression Statistics								
Multiple R	0.780							
R Square	0.608							
Adjusted R Square	0.607							
Standard Error	1.527							
Observations	342							
ANOVA								
	df	*SS*	*MS*	*F*	*Significance F*			
Regression	1	1228.7	1228.7	527.0	0.0			
Residual	340	792.6	2.3					
Total	341	2021.3						
	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95.0%*	*Upper 95.0%*
Intercept	-12.0	0.6	-19.5	0.0	-13.2	-10.8	-13.2	-10.8
X Variable 1	11.0	0.5	23.0	0.0	10.1	12.0	10.1	12.0