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MARKET INSIGHTS

The latest Market Insights
from the Connected Wealth team

CAD/USD: Old trade getting tired?

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Summary

- Five years ago, the narrative was very negative US$, yet that was the more profitable trade.
- Today, the narrative is very positive US$, but is it the most profitable trade now?
- We are still US$ bulls but we believe the vast majority of the gains have been made.
- If we see another nickel in the coming months, we will likely be reducing US$ exposure.

Investing vs. Story Telling

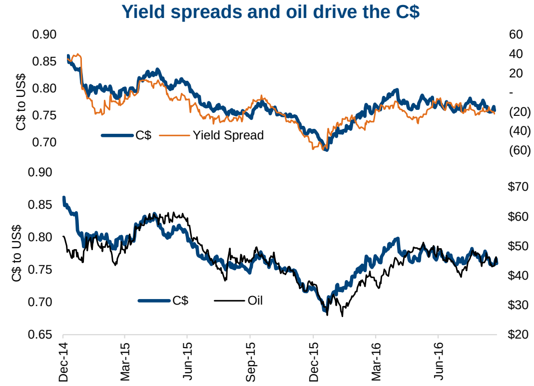
Finance is awash in storytelling. Many people are employed or tasked with creating stories to fit what is happening in the market. While a noble task for enlightening/comforting investors and readers as to what is going on, it doesn't do so well when it comes to managing money. Allow me to demonstrate by telling a story (Irony is not lost on me!).

Hindsight makes it clear being long U.S. dollars (US$) in 2011 was a great trade. The loonie was almost at par and in the coming years would decline to even briefly trade below $0.70 in early 2016. However, if you listened to the prevailing 'stories' at the time, you would shudder at the thought of owning US$. Let's go back in time and here are the highlights:

- Canada growing faster. In 2010, Canada outpaced the U.S., growing 3.6% vs 2.7%. In 2011, Canada wins again 3.1% vs 1.7%.
- Oil is trading at $100/bbl, concerns of peak oil abound
- U.S. was pouring on the quantitative easing
- U.S. credit downgrade in September 2011
- Canada two-year yields are 1.0% compared to 0.25% in the U.S.

Canadian dollar: big multi year decline, brief reprieve, where to next?

Yield spreads and oil drive the C$



Looks like a no brainer, right? Go long Canadian dollars given better economy, oil, credit and yields. Yet that was the wrong trade.

Story vs. Path of Least Resistance

Our view five years ago was certainly contrarian by going heavy U.S. in our North American Core Income portfolio, but not recklessly so. Sure there was lots of fundamental reasons to believe in avoiding the greenback and putting all your money in loonies, but currencies are tricky. Outside currencies that get crushed due to hyperinflation or structural issues, it is a zero sum game. Which means currency gains in one year can just as easily become currency losses the next. Our contrarian view back in 2011 and 2012 was predicated on valuations and where the currency had come from.

The US$ had lost 40% of its value from 2002 to 2011, so to call it cheap was likely an understatement. Looking at purchasing power parity, the C$ was 20% overvalued relative to the US$ (top chart). However value isn't enough for us to make a call in the face of so much counter information floating around.

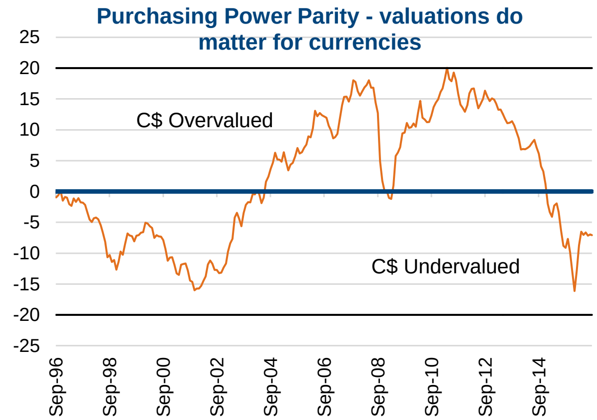
Sometimes the trend just changes and that was what we noticed back in 2011/2012. The credit downgrade of the U.S. resulted in the US$ moving higher, not lower. Quantitative easing stopped having such a negative effect on the currency. These were signs that a direction change may have begun or the path of least resistance was now higher for the US$. When the good news stops moving something higher or bad news stops moving assets, for instance, lower, it is a sign the trend may be exhausted and investors should take note (remember this in the next section).

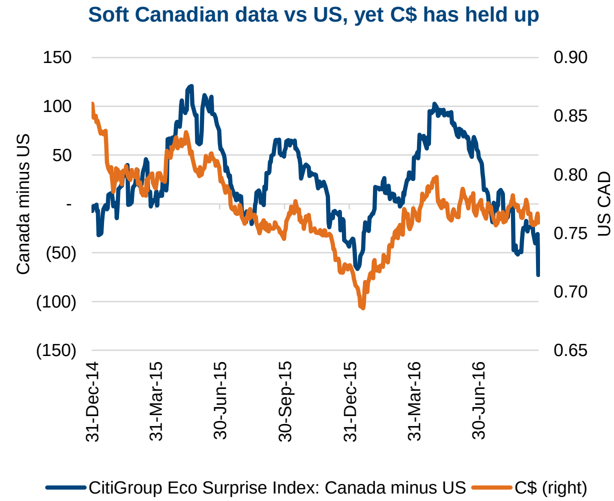
Today: C$ is $0.76

Now back to today. Our Core Income portfolio remains very US$ weighted, at 30% compared to a maximum of 35%, so we are clearly still US$ bulls. However, we do acknowledge we are likely at the point where maybe there is another nickel to be gained as the majority of the gains have already been reaped.

There are lots of reasons to believe the US$ should go higher. Their central bank is poised to raise rates at some point, clearly not the case in Canada. Recently, economic data has been soft in both countries, but softer in ours. Today especially. Still too much oil. Yet the C$ continues to trade in the $0.75-0.77 band.

The 2nd chart is the Citigroup Economic Surprise Index for Canada minus the U.S. (blue line) compared to the US$/C$ (orange line). When the blue line is rising Canadian economic data is better than the U.S. and vice versa. On a relative basis, our data has been





dismal since April compared to the U.S., yet our exchange rate has been stable.

We remain US$ bulls, for now, as we believe oil is at risk of declining in the near term. And the Fed is likely to raise rates by year end. And with an election, we could see some risk-off behavior that could benefit the US$. However, we are of the mindset that the time to start reducing US$ is getting to be close at hand.

Charts are sourced to Bloomberg unless otherwise noted.