LOONIE'S FLIGHT PATH CHARTED BY GLOBAL EXPANSION

At Scotia Capital, we have been longstanding Canadian dollar bulls. However, it would be disingenuous to say that at the start of the year we foresaw anything close to the appreciation that has unfolded in recent months. On a year-to-date basis CAD is up 20% against the USD—the fastest gain for a 10-month period since Finance Minster Benson announced in 1970 that the government would no longer target a value for the currency of 92.5¢ (US). The initial move through parity on September 20th, 2007 was met with cheers on dealer floors along Toronto's Bay Street. While a significantly stronger currency can be a mixed blessing, parity has been a source of national pride. Currency strategists are being treated like rock stars, getting stopped on the street. OK, the last part isn't true, but you get the point.

SLOW START TO 2007

The strength in CAD this year was the result of a "perfect storm" of supportive fundamental developments, a favourable structural backdrop, and just a little bit of luck. The year didn't start that well for CAD. In fact, it was the worst-performing G10 currency in the fourth quarter of 2006, falling 4% against the US dollar and counting only the hapless yen as company in the loss column. Oil prices weakened over the second half of 2006 as the market worried about a US slowdown and raised its expectations for Fed rate cuts. This proved to be particularly negative for CAD given the potential for terms of trade losses for Canada and the spill-over of weakness in its largest trading partner. Negative sentiment against the currency became considerable—by early January speculators had amassed a record net short position against CAD of 85,000 contracts (US$7.3 billion), according to the Commodity Futures Trading Commission.

FROM LOONIE TO PHOENIX

However, early 2007 saw a sequence of developments that turned the tables dramatically. A string of solid Canadian employment reports indicated Canada's economy was withstanding the US slowdown admirably. Equally important was newfound optimism regarding the US economy. We have maintained that weakness in the housing market would force the Fed to cut interest rates in 2007, but several better-than-expected housing reports through the turn of the year challenged this forecast. In the statement announcing the decision to hold rates steady on January 31st, the Fed went so far as to mention "tentative signs of stabilization … in the housing market." By late January the Fed funds futures market had reversed itself, with not a single rate cut priced into the curve for 2007.

Commodities resumed their rally, with oil prices rising from $50/barrel in mid January to more than $65/barrel by the end of March. Base metals also strengthened, with nickel prices soaring by more than one-third in the first quarter. The tipping point for CAD came on March 20th, when Canada's core CPI for February leapt to 2.4% year-over-year—uncomfortably above the 2% mid-point of the Bank of Canada's (BoC) target range. The interest rate futures market—which had been priced for steady policy from the BoC during 2007—began pricing in rate hikes. With CAD's interest rate support increasing, those who had speculated on CAD depreciation were caught wrong-footed. The record CAD speculative net short position swung to a record net long position of 77,000 contracts (US$7.2 billion) by late July.

Another important variable during this period was the nature of M&A announcements involving Canadian companies. Between May and July a sequence of sizeable cross-border M&A deals were announced, with the heavy majority of the largest deals involving the purchase of Canadian companies by foreigners.

The final piece of the "parity mosaic" was a weakening US dollar. The greenback came under pressure as the enormity of the difficulties in the US housing market became evident. Defaults on sub-prime mortgages snowballed into a full-blown global credit crunch this summer, causing the Fed to abandon its hawkish posture and cut interest rates. The move further undermined the dollar's interest rate support and fostered concerns over inflation and the diversification by foreigners away from US securities. This sent the USD reeling, enabling an effortless rush to parity by CAD as September drew to a close.

GLOBAL EXPANSION HELPS LOONIE FLY

A look at relative currency returns in 2007 leaves little question that commodity prices have been a principal market driver. The G10 countries boasting the three strongest-performing currencies year-to-date are all major commodity exporters. The pull from these countries' natural resources sectors has helped foster the tightest labour markets in decades (Canada's unemployment rate stands at a 33-year low), fanning inflation and forcing central bankers to raise interest rates.

Anyone who hasn't been hiding under a non-bituminous rock is aware of what is behind the second-strongest commodity run-up in the post-war period. China's industrialization and integration into the global economy have been a boon for global growth. Its demand for commodities has soared, pushing prices higher and endowing commodity-producing countries with considerable terms of trade benefits. Canada sits atop the world's second-largest proven oil reserves, is the world's largest producer of uranium and potash, and ranks in the top 10 in nickel and wheat production.

A FAVOURABLE STRUCTURAL POSITION

Those who are familiar with the "carry trade" know that interest rates have also been a key determinant of relative currency performance this year. The currencies that have performed best generally offer relatively high interest rates, while the two worst-performing G10 currencies have been the low-yielding yen and Swiss franc. The importance of interest rate levels makes CAD's G10-beating 20% year-to-date gain all the more noteworthy. At 4.5%, administered rates in Canada are almost exactly equal to the G10 average. CAD has not been a compelling carry play, yet has flourished.

We believe that part of the reason CAD has been an exception to the carry trade rule is that Canada offers a favourable structural economic backdrop. Canada is the only G7 country running a surplus in both its current and fiscal accounts. The terms of trade gains that Canada has enjoyed in recent years have certainly reinforced both surpluses. However, Canada got its fiscal house in order well before the fat years enabled by the commodity boom began.

WHERE TO FROM HERE?

At 0.9770, USD/CAD is within reach of its post-float low of 0.9576 set in April 1974. Considering the broad weakness in the USD, we could easily see trade below 0.9300 before year-end. However, in light of the aforementioned factors, there are reasons to expect CAD gains will be more temperate over the coming year and that we could even see corrections back above the 1.0500 area in USD/CAD.

While Canada is a commodity powerhouse and its export markets have become more diverse, the country is still heavily reliant on trade with the United States—merchandise exports to that country account for roughly 25% of Canada's nominal GDP. Already Canadian exports of vehicles and forestry products have fallen materially, and the climb through parity will increase the pressure on the manufacturing sector. Canadian shoppers are clamouring for price reductions given the discrepancy between prices paid by US and Canadian consumers for many of the same items. Seventy-five percent of Canadians live within a two-hour drive of the US border, which will put pressure on retailers to capitulate. With the Canadian economy expected to slow in the quarters ahead and inflation pressures moderating, the BoC should have the flexibility to lower rates and take some loft away from the loonie.

CAD would also be vulnerable should global growth slow down. Tabulating annual currency returns alongside world GDP growth shows that CAD is relatively sensitive to the global growth cycle. Already there are signs that the US slowdown and this summer's credit crunch are working to curb the pace of growth in a number of other countries.

A final reason to remain cautious is that, with the currency so strong, it is unlikely that future M&A developments will be so unambiguously CAD-positive. The strongest currency in a generation will surely send Canadian companies on the hunt for opportunities abroad.

These factors provide reason for caution, but not outright bearishness. Canada's economic prospects remain positive given our expectation that China will continue to expand at a brisk pace, underpinning commodity prices. Meanwhile, the favourable structural backdrop provides additional reason to remain bullish even as global growth ebbs and flows. The loonie's namesake spends part of its time underwater. However, Canada's currency is likely to remain airborne for some time to come.

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