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Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Canadian Dollar Is the Pressure Gauge to Monitor

At the end of May, the exchange value of the Canadian was 73 us cents. At the time, I observed that the Loonie was trading way below its 10-year average and suggested that an awful lot of bad news has been priced in. Then out of nowhere a series of unexpected but bullish economic data points have made headlines. The Loonie raced upward to 76.60 US cents, closing in on its newly calculated PPPR of 77.95 US cents.

Whether the Canadian dollar will cross the Rubicon is the new question mark. It will depend on three factors that have historically been the main drivers behind the performance of the Canadian dollar. These are the relative attractiveness of Canada as an investment destination, Canadian terms of trade, and interest differentials between Canada and the U.S. At this time, an amelioration in anyone of the aforementioned factors could spark a short squeeze. There are still many skeptical speculators with relatively large short positions. Consequently, there is some room left for the Loonie to run further. This morning the Loonie was trading around 76.61 US cents.

In the four months ended April 2019 foreign investment in Canadian securities totaled $26.0 billion. It would have been much higher if it had not been for an unusual large volume of mergers and acquisitions which resulted in a sizable reduction of Canadian securities in foreign portfolios. Meanwhile, Canadian investors marginally reduced their holdings of foreign assets by $2.0 billion. Thus, for the period under review, a net inflow of $28.0 billion was recorded. Considering that there is a worldwide movement towards easier monetary policies, a reflation rebound combined with the relative cheapness of commodity assets could make the Canadian financial, mining and energy sectors an investment destination of choice. During the months of May and June, Canadian entities borrowed billions of dollars in record amounts from domestic and international investors seeking yield advantages.

Macro View cont.

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Canadian terms of trade are improving as recently exemplified in the May merchandise trade report. Increases in export volumes were broad with 9 out of 11 products printing gains. Viewed another way, export prices rose 0.6% compared to a decline of 0.2% for import prices. Currency traders, commercial players and international investors should be aware that the terms of trade (export prices/import prices) are a crucial element in determining foreign exchange values. When a country has favorable terms of trade it means that it is receiving extra money for the same amount of exportable production. Rising terms of trade bring in extra capital. Unfortunately, Canadian terms of trade are very sensitive to oil prices which are not home grown. Assuming that the all-inclusive marginal cost of oil production is around $55 a barrel, there is no way that OPEC and its allies will let the price fall below $50. OPEC will probably extend production cuts until demand picks up.

Since the beginning of May, yields on 3-month treasury bills and 10-year bonds between the U.S. and Canada have narrowed considerably from 75 bps to 50 bps and from 75 to 25 on two-year notes. The explanation for the above occurrence stems from the fact that economic considerations have eased pressure on the Bank of Canada to exactly match the expected rate cut in the U.S. There is just a 3% chance that the Bank of Canada will decrease its policy rate at the July 10 meeting compared to 90% chance that the Fed will succumb to a rate cut. Perhaps surprisingly, the case is even stronger when one considers that the market is pricing a quarter point cut in the Canadian target rate over the next twelve months compared to a full percentage point in the U.S.

The Canadian economy has accelerated in Q2 while the opposite has occurred in the U.S. High Frequency Economic Trackers predict that the Canadian economy will have increased at the annual rate of 2.5% in the June quarter. Growth could even have reached 3.0%, if the oil-sands extraction which jumped 11% in April was maintained. Meanwhile, growth in the U.S. is slowing and all the economic trackers that I watch closely are pointing to an annual rate of growth of less than 1.5% for Q2. Moreover, the inflation prospects are much stronger in Canada. They reached a cycle-high in May. On this last count, the CPI was up 2.4% year-over-year in Canada and only 1.8% in the U.S. Average hourly wages are rising vigorously in Canada. They rose up 3.8% year-on-year in June compared to 3.1% in the U.S.

Macro View cont.

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The BLS's recent employment report may be a fly in the ointment with blowout job numbers for June. It argues against preemptive easing from the Fed. The chance of a 50 bp rate cut is now zero. However, job data is not a forward-looking indicator. Given that average hourly earnings are holding steady at 3.1% year-over-year, with the string of data misses including signs of manufacturing weakness, the employment report may not be enough to tip the scales against a July rate cut. The job numbers may have eradicated the fear of an imminent recession. They were nevertheless in complete contrast to the weakness shown in the ADP and ISM reports.

This ambiguity clouds the picture as to whether the Fed will implement a rate cut of 25 bps in July. Disappointing the stock market is a risky proposition when expectations are as lopsided as they are. Additionally, the dollar index (dxy), a good proxy of the exchange value of the dollar, jumped to an unwanted level-- 97.30. The thing is that the Fed is more likely to watch price signals than employment data because the economy is in a good place---no boom and no bust. It's hard to get into an accident when economic growth is moderate.

The dynamics in Canada have improved and it looks as if they will be sustained, even though the Canadian employment report did not meet expectations. The Canadian Federation of Independent Business reported that its confidence index strengthened to 61.5 in June. Since readings between 65 to 70 indicate the economy is operating at full potential, there is room to keep going for a few more quarters. As a matter of fact, the run of good economic data could indeed continue. The Citi's economic surprise index is near its highest level in nine years. The Macdonald-Laurier Institute's Leading Economic Indicator (LEI), a tool designed to predict changes in the business cycle, rose by 0.2% in May, representing the third consecutive increase. Since March, the LEI has risen by a total of 0.8%.

As a matter of fact, consumer sentiment is rebounding. The Bloomberg Nanos Canadian Confidence Index, a composite indicator derived from weekly surveys of Canadian households, reached 58.3 a week ago--a major increase that bodes well for growth. The Ivey Purchasing Managers' Index came at 52.4, a bit lower than expected, but above the 50 mark--a reading that indicates continuing expansion. Residential construction took a big step forward in June. Housing starts totaled 246,000 units on a seasonally adjusted basis. Canada's labor market saw little change in June. Employment inched lower, falling by 2,200. What is noticeable is that the increase in the number of full-time employees did offset the decline in part-time workers. The big takeaway is that employment growth is running at an annual rate of 2.3% whereas U.S. employment is tracking an annual pace of less than 1.0%.

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I don't think that the Canadian dollar will go above the US$0.78 mark. The Bank of Canada may tolerate a movement up to its PPPR, but not beyond. Governor Poloz would not take the pain comfortably because he's banking on international trade and business investments to keep the Canadian economy afloat.

P.S. A recent Reuters poll predicted that the Canadian dollar will edge higher against the U.S. over the coming year.
P.S. The Bank of Canada kept the policy rate at 1.75%, citing that economic growth is regaining momentum, but not enough to warrant higher interest rates.
P.S. Fed Chair Powell's prepared remarks to the U.S. House Financial Services Committee implied that a July rate cut is almost a sure thing.
P.S. The FOMC made a roundabout reference to reflexivity. The minutes read; "while overall financial conditions remain supportive of growth, those conditions appeared to be premised importantly on expectations that the Federal Reserve would ease policy in the near term to help offset the drag on economic growth stemming from uncertainties about global outlook and other downside risks." The logical justification for rate cuts is reflexivity because the U.S. is still growing moderately from decent productivity gains.
P.S. Clearly, the outlook for the Canadian monetary stance is not as dovish as in the U.S.

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