

August 8, 2017

# MARKET ETHOS

The latest market insights from the Connected Wealth team



[Sign up here](#) if you do not already receive the Market Ethos directly into your inbox

## Unhedged

Craig Basinger, CFA

Currency has clearly become a hot topic over the past few months as the loonie rose materially against the U.S. dollar, bucking a multi-year trend. We visited this topic a number of times recently including reports titled “Oil, C\$ & Yields” and “Has the C\$ Turned?” available to the right under Past Reports. In this edition of Ethos, we will revisit our expectations and views on the USD/CAD, how we recently closed our short term currency hedge and share our longer view on why we typically embrace currency exposure.

### Our View

We still like U.S. dollar exposure. The recent rapid rise in the loonie appears to have been driven by a confluence of factors that may prove fleeting over time. That being said, it certainly took us by surprise. There is no doubt the Canadian economic data has improved and this emboldened the Bank of Canada to begin a tightening cycle for the overnight rate. We do wonder if this would have transpired had the Bank of Canada known the U.S. Fed was about to start talking more dovish. The data had softened in the U.S., creating this environment for a rapid rise in the loonie.

This relative economic performance can be easily seen in the two-year spreads between Canada and the U.S. In early June, U.S. yields were 60bps higher than Canada, today they stand at only 10bps. (2<sup>nd</sup> chart)

Can't argue with the data, it came out very positive for the loonie. Looking six months out or longer, we just are not sure it will continue. The Canadian economy remains very sensitive to movements in the housing industry which has started to show some cracks. We continue to be cautious on the price of oil. Oil has taken a back seat to the economic data as a driver in the exchange rate, but it still has influence. The data in the U.S. has been softer, but appears to have started regaining momentum. Expectations for U.S. tax reform is now very low, opening the door for a potential positive surprise. NAFTA talks as well may not be very positive for the C\$.

From a fundamental perspective, the C\$ does not appear to be undervalued anymore (1<sup>st</sup> chart). Could we move into overvalued territory, of course anything is possible. Political turmoil in the U.S. could

### Past Reports

[Herd Behaviour](#)

[The Consumer Part 2](#)

[The Consumer Part 1](#)

[Oil, C\\$ & Yields](#)

[Is the Reflation Trade Back On?](#)

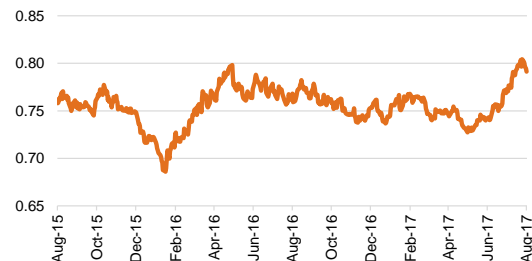
[Oil in Purgatory](#)

[Has the C\\$ Turned?](#)

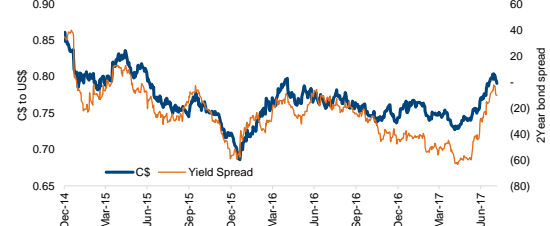
[Canadian Housing: Cracks in the Foundation?](#)

[Market Cycle: Little Wobble](#)

C\$ on the Rise



2 year spreads narrowed, driving a higher loonie



cause selling of the U.S. dollar or a fumbling of the next debt ceiling issue. These are not our baseline expectation and at 79-80 cents, we simply see greater value in U.S. exposure.

As a result, we closed our currency hedge in the Redwood Core Income Equity Fund. This fund can hold up to 35% U.S. securities. The Canadian equity market is very concentrated in a few sectors and we use our U.S. allocation to improve diversification into sectors lacking in Canada. We typically don't hedge the currency exposure but decided in late April to hedge one quarter of our U.S. holdings from a currency perspective.

We decided to close the hedge in the early days of August as the economic data appears to be starting to change momentum and the number of speculators who have moved from shorting the loonie to being long appears overdone (2<sup>nd</sup> chart). The Canadian dollar moved too far, too fast.

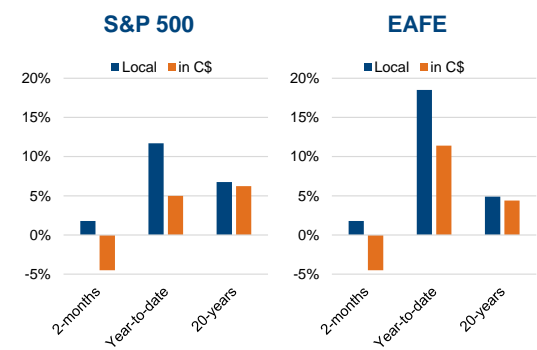
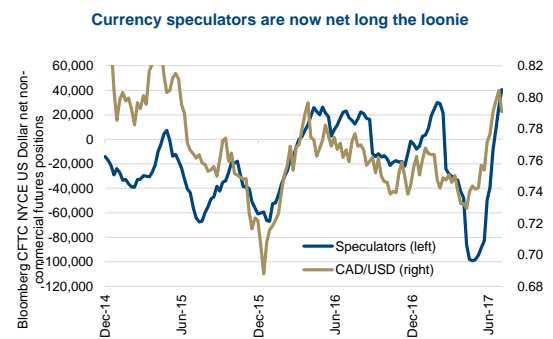
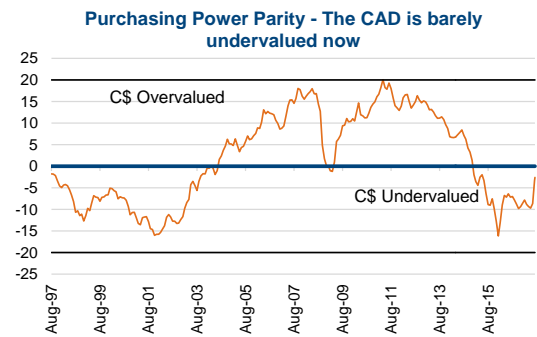
**Longer Term Currency Exposure**

Currencies are often a zero sum game over the long run, especially between the currencies of well developed economies. While things can stay out of whack for quarters or even years, there are gradual forces that correct disequilibrium. A country's currency that rises too far will become less competitive, slowing the economy and gradually bringing the currency back down. Or a low currency may attract more foreign acquisitions from a value perspective. While this may be true in the long run, the short run is certainly volatile. The 3<sup>rd</sup> chart is the S&P 500 and MSCI EAFE Index returns during the past two months, year-to-date and over the past twenty years (annualized). The last two months, translating back to Canadian dollar, have sucked all the positive performance away. Even the year-to-date numbers look much less impressive. But notice how close the twenty-year local and Canadian dollar returns are. A few basis points, probably not worth the trouble of hedging in the long term.

There is another reason to embrace the U.S. dollar, it is a good diversifier for Canadians. Ok, follow us here. U.S. dollar exposure is a negative when the Canadian loonie is rising against the U.S. dollar. Given that global investors view Canada as a resource country, the loonie does best when global growth is accelerating, which has been the case this year. When global growth is healthy, our markets do really well too. So as a Canadian investor, your Canadian investments are thriving but your U.S. holdings are a bit of a drag due to the currency. Think of this as insurance.

When global growth slows, or due to some geopolitical hot spot, the market turns to become more risk averse, that has a negative impact on our market but is often good for the U.S. dollar. The U.S. dollar is viewed as a safe haven currency and during times of turmoil, money flows to the U.S. During times of turmoil, it is not good for global growth levered markets such as ours. So when times are bad, having exposure to the U.S. dollar acts as a partial buffer.....hence it is a good diversifier for Canadians and generally we believe investors should be unhedged.

But yes, currency has not been kind over the past few months.



*Charts are sourced to Bloomberg unless otherwise noted.*

This material is provided for general information and is not to be construed as an offer or solicitation for the sale or purchase of securities mentioned herein. Past performance may not be repeated. Every effort has been made to compile this material from reliable sources however no warranty can be made as to its accuracy or completeness. Before acting on any of the above, please seek individual financial advice based on your personal circumstances. However, neither the author nor Richardson GMP Limited makes any representation or warranty, expressed or implied, in respect thereof, or takes any responsibility for any errors or omissions which may be contained herein or accepts any liability whatsoever for any loss arising from any use or reliance on this report or its contents. Richardson GMP Limited is a member of Canadian Investor Protection Fund. Richardson is a trade-mark of James Richardson & Sons, Limited. GMP is a registered trade-mark of GMP Securities L.P. Both used under license by Richardson GMP Limited.