Currency Thoughts

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Paul Lennox, CFA, President EncoreFX

These are my observations regarding the US and Canadian dollars as of June 30th. This report is for informational purposes only and does not construe investment advice.

Long-term Perspective

Currency markets often move in 4-6 year trends reflecting underlying economic dynamics so it is important to understand the big picture…

After more than a decade of devaluation the US dollar is back in favour. The dollar started its decline at the turn of the century as the Federal Reserve lowered interest rates dramatically to limit the fallout from the .com and NASDAQ bubble bursting in 2000. 9/11 leading the US to war and a sharp rise in US government spending put further pressure on the dollar. The global credit crisis in 2008 and the PIIGS crisis in 2010 caused the dollar to rally on a flight to safety play. The aggressive monetary easing by the

Federal Reserve through to mid-2014 kept the dollar contained in spite of signs of growing global economic risks.

The US Federal Reserve remains extremely dovish, otherwise the US dollar would likely be much higher given the state of the global economy. The liquidity provided by the Federal Reserve for almost 15 years has flooded into emerging markets, stocks, commodities and real estate. With the Fed turning off the liquidity taps and US interest rates on the rise companies and investors who have borrowed cheap dollars are vulnerable and may have to scramble to cover their short dollar positions. This rush for dollars caused the massive appreciation in the dollar in the 1980's.

At this stage we do not know if the 20% gain in the dollar over the past year is the beginning of another secular bull run in the dollar like we saw in the eighties but we can't rule it out. Despite all of its challenges the US economy is in relatively better shape than most others and the US could outperform for years to come. Weak commodity prices as seen in the following charts for the CRB index and copper are reflective of a weak global economy.

Copper prices down 42% over past 3 years…

Falling commodity prices reflect a weak global economy…

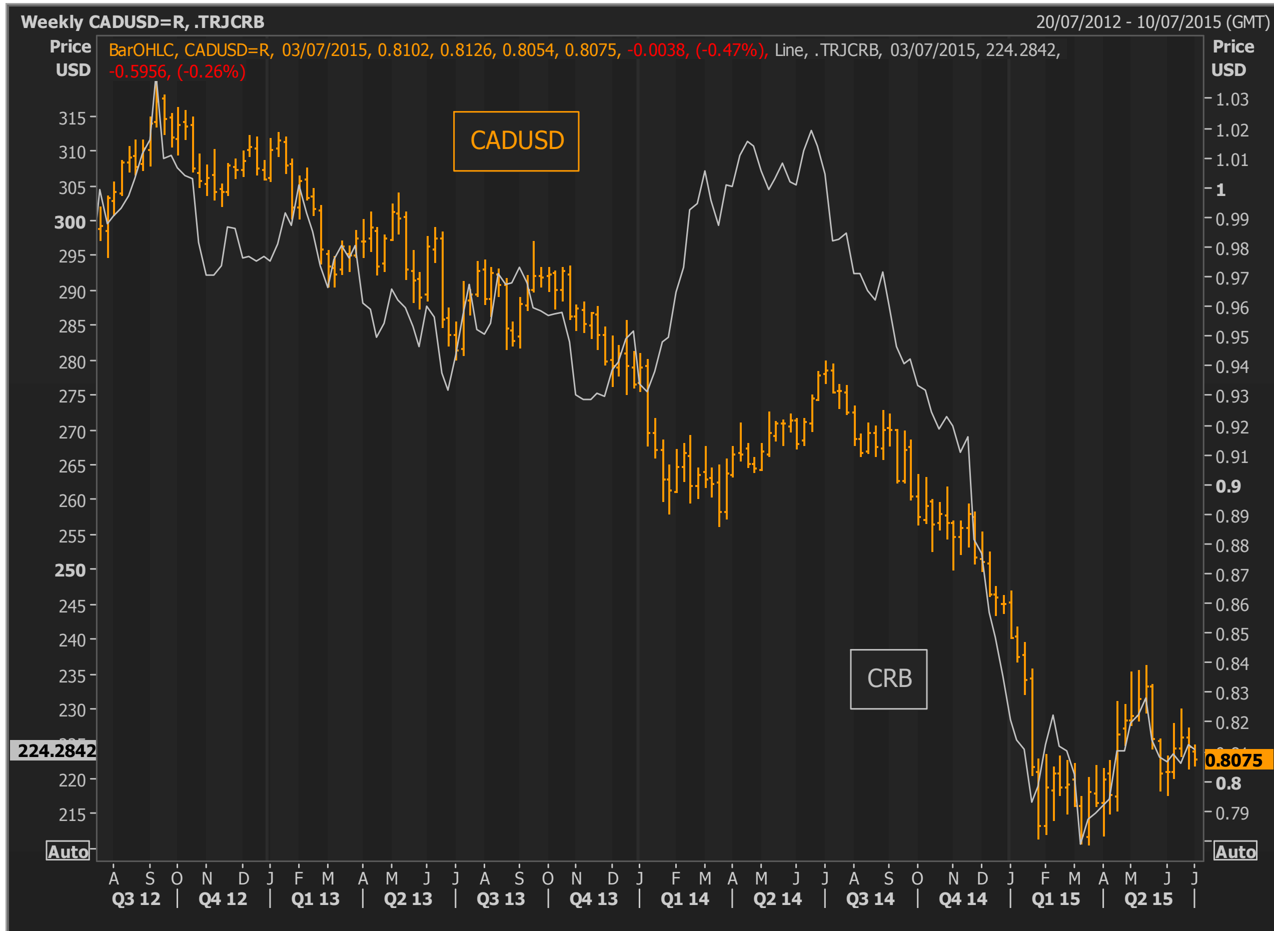
Why does slow global economic growth favour the US dollar? For one thing, trade makes up a smaller portion of the US economy than it does for many other countries so the US is less reliant on foreign buyers of its economic output. And because the US economy is outperforming, capital flows to the US because of more attractive investment opportunities and rising bond yields. Also, commodities are generally priced in USD so the US economy benefits more from falling commodity prices than other countries whose currencies are falling relative to the US dollar. This dynamic becomes a positive feedback loop causing commodity prices to fall and the US dollar to rise much more than expected as we saw in the 1980's when the dollar index rose over 100%.

The biggest risk to the bullish dollar outlook is the US Federal Reserve which is very dovish and will not look favourably on a persistently rising dollar. If the US economy does continue to outperform, however, the best the Fed will be able to do over the coming years is to slow the dollar down, not prevent its inevitable appreciation. Odds favour a strong and likely strengthening US dollar for the foreseeable future. However, as we saw recently, there will be USD retracements and corrections for dollar buys to take advantage of.

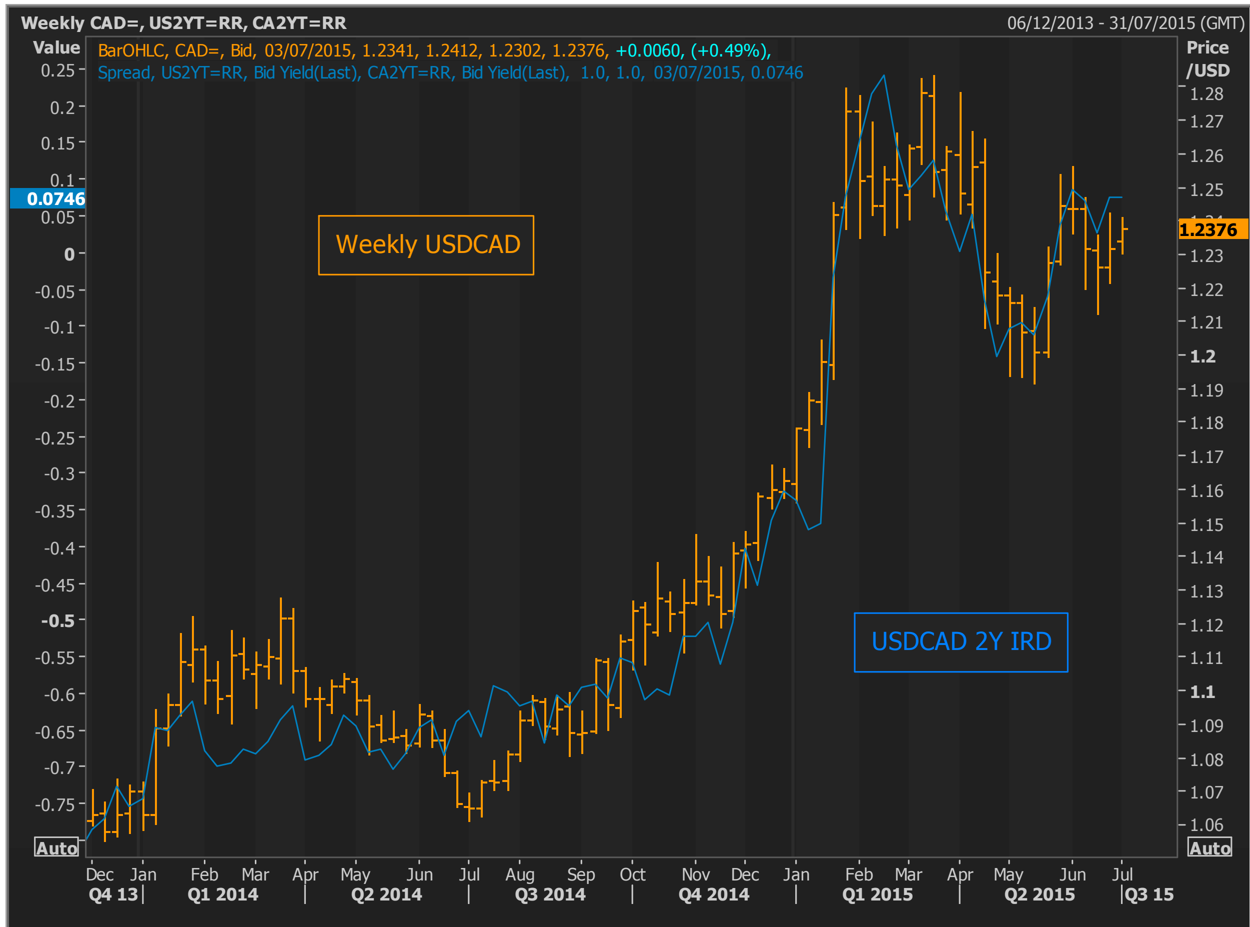
USDCAD

The Canadian economy is in a tough spot relative to the US economy. Debt levels are higher in Canada, export prices are falling and productivity is lower. Manufacturing has a hard time competing with the US and Mexico since NAFTA so Ontario and Quebec are not yet seeing significant gains from the 20% fall in the Canadian dollar over the past year. The Canadian economy actually shrank in Q1 and Q2 is not looking much better.

The Canadian dollar is following commodity prices lower in an environment of slow global growth…



Because economic growth is stronger in the US, US interest rates are rising relative to Canadian rates and this favours the US dollar…



If the capital markets become unsettled because of fallout from Greece or other high risk events, US interest rates could fall and the dollar rise in a flight to safety play. There is not always a positive correlation between interest rate differentials and exchange rates; it depends on why interest rates are rising or falling.

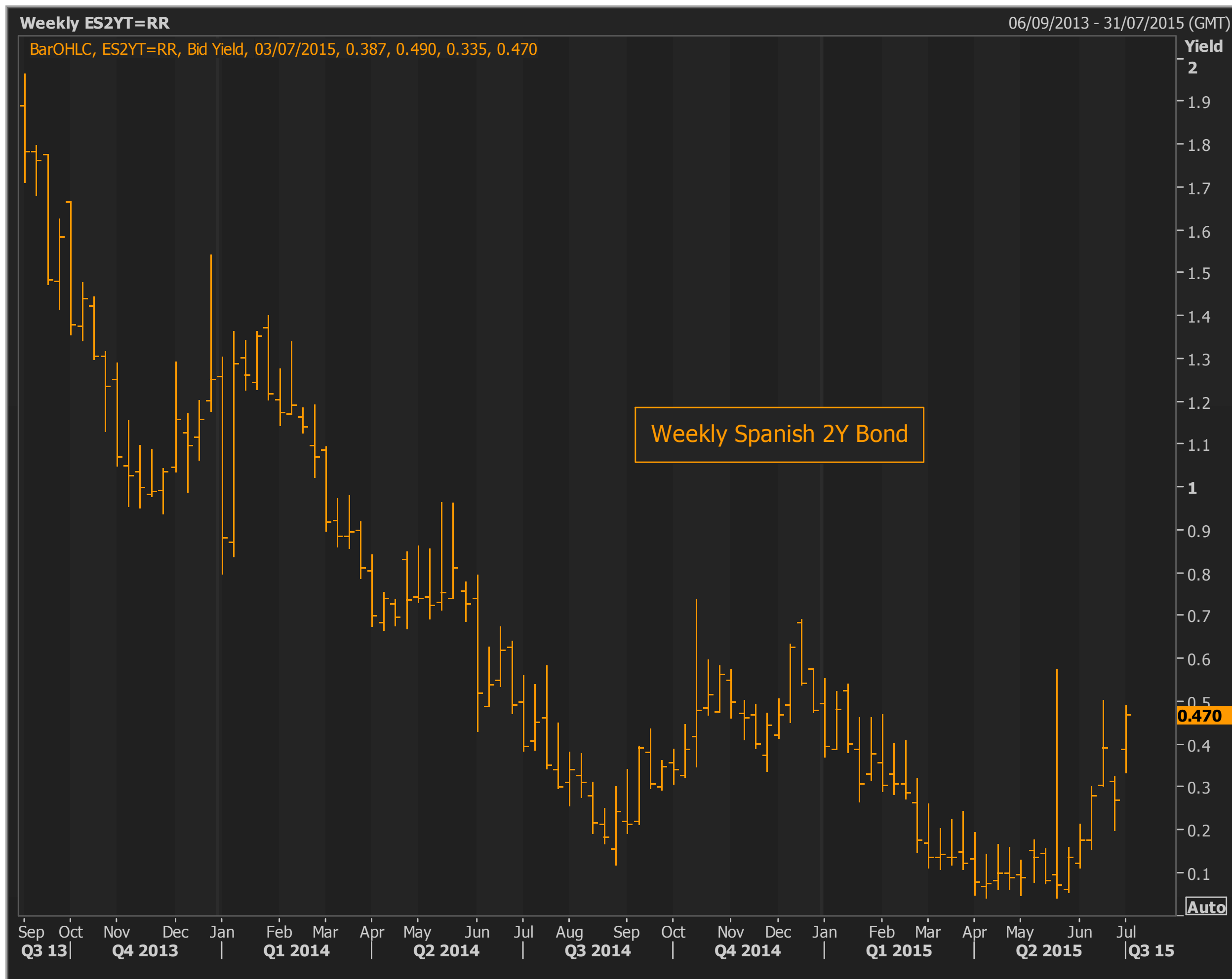
Stock prices in Canada are looking vulnerable meaning Canada may be less attractive to foreign investors…

The US dollar has gained more than 25% relative to the Canadian dollar over the past few years. There is serious resistance for the dollar around 1.28, an area that last held in 2009 during the credit crisis. Keep in mind, however, that the 2009 dollar spike was a flight to safety play in a panicked market so it was not sustainable and the US Federal Reserve came in and flooded the market with dollars. This time, the dollar appreciation is due to US economic outperformance so it is more constructive and sustainable. And the consolidation we've seen over the past few months looks like base building for another push higher rather than a technical breakdown. Dollar momentum remains strong. Expectations are we will see the US dollar at 1.35 before we see 1.15 again.

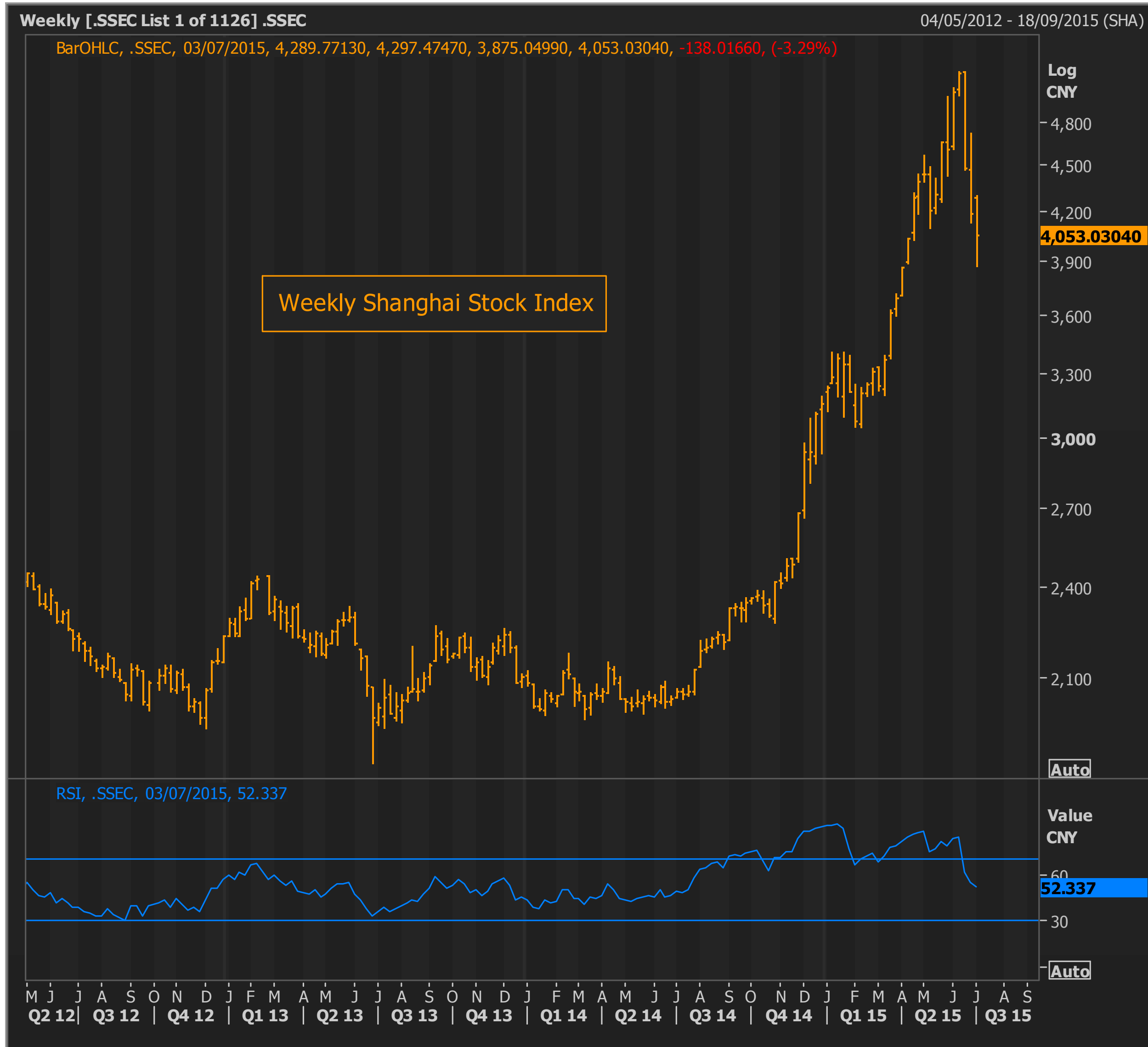
Risk

Let’s consider at a few charts we routinely look at for clues to potential currency developments.

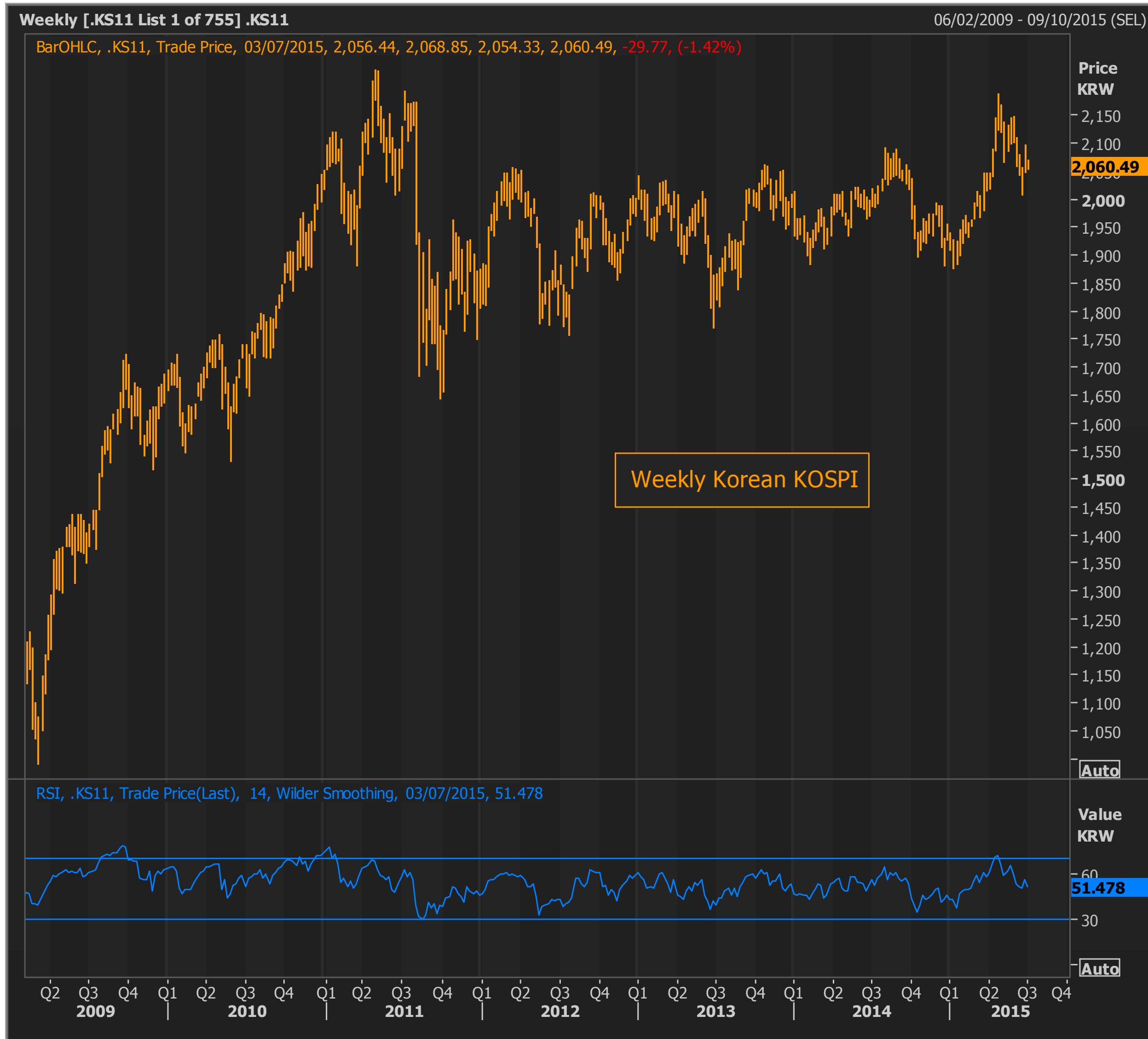
Spanish bond yields are showing signs of market nervousness. With the turmoil in Greece the biggest concern is the risk of contagion to other European countries and beyond. Global central banks have done a good job protecting creditors from loan losses so governments have been able to borrow very cheaply. If the investment community loses confidence in the ability of the central banks to continue to protect them risk premiums and interest rates will rise sharply. Pick your country but keep an eye on high risk debt for signs of a renewed flight to safety move which will favour the US dollar.



Chinese shares have been on a tear once again, doubling over the past year in spite of a slowing economy. A stock market correction in China could spill over into other global equity markets potentially leading to a flight to USD safety.



The Korean stock market is a bell weather for the global economy as trade makes up a huge portion of the Korean economy. The Korean KOSPI has not gone anywhere for 4 years – a slowing global economy has kept it in check in spite of massive central bank money printing. A break down in the KOSPI would be USD supportive.



Conclusions

Odds favour continued USD strength, possibly for a few more years.

Canadian importers should consider sourcing non US suppliers. For their USD exposure, importers should hedge as far forward as they can prudently manage. Hedging beyond 12 months might be prudent if cash flows are supportive. Be prepared to buy US dollars on dips to significant technical support levels. A hedging ration of 80% or more should be considered.

Canadian exporters should maintain an underweight US dollar hedge position. 30% to 40% might be prudent, adding to positions on USD spikes. Do not oversell US dollars in this environment.

Paul Lennox is President of EncoreFX.
Previously he ran a foreign exchange hedge fund for four years and was VP and Treasurer at Custom House.
He has more than 20 years experience in the financial markets and is a CFA Charter holder.
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