Integra Market Insights

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Issue #25 - "The Free-Falling Loonie"

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"If the governments devalue the currency in order to betray all creditors, you politely call this procedure "inflation."

- George Bernard Shaw

Following the surge in the US stock market last year, we have witnessed a sizable depreciation in the value of the Canadian Dollar ($CAD) against the American Dollar ($USD) in 2014. This month's issue of Integra Market Insights will try and bring some clarity to the situation by explaining *Why* the dollar has dropped, *How* this may affect you, and discuss *Where* it is going.

To understand the recent fluctuations in the currency market, it helps to remember that the value of the $CAD, like all other markets, is defined by the balance between offer and demand. If more people are seeking goods sold in $CAD over the $USD, then the $CAD will appreciate, or vice versa. For this reason, it is important to look at economic growth in the two markets to determine the change in relationship between offer and demand.

Economic Growth in the US – Balance of Trade

As we have discussed in previous issues of Integra Market Insights (#14-Dead Cash Walking), there has been a rebirth in the American manufacturing sector as companies have become re-shoring production. This "Made in 'Merica" push has had an important impact on employment, exports and the balance of trade in the US (imports vs exports). As discussed above, a greater demand for goods manufactured in America leads to a greater demand for $USD which in turn, sees it appreciate over other currencies. Another factor affecting this same balance of trade has been falling imports.

As the US consumer has been paying down debt more aggressively than in other nations (Canada in particular), imports of consumer goods have fallen. To a much larger extent however, the change in energy imports in the United States has had an important impact on both the currency and the economic recovery. [1]

An energy independent super-power?

For the first time in over 20 years, the United States is now producing more oil than it is importing. In the past five years alone, it has reduced its imports of crude by 25% [2]. A rate that is now accelerating due to the shale gas boom taking place in North Dakota and Texas. As 'Fracking' technology, a new process of extracting natural gas that was once unreachable with conventional methods, continues to improve, it is expected that the United States will be the world's largest oil producing nation by 2017 [3] and is expected to reach total energy independence by 2035. [4]

Although this is great news for Americans who will likely see their pocket books padded with extra dollars as this fundamental economic commodity continues to fall in price (offer ↑ vs demand →), the effect on the Canadian oil exporting industry will be significant. In this light, we understand why the Canadian government is anxious to secure the Keystone XL pipeline, thus ensuring cost-effective delivery of oil to American refining facilities.

A great deal of tax dollars and political capital went into developing the infrastructure of the Canadian oil sands, and there is concern that without this pipeline, the costs associated with refining the heavy oil sands tar may make the product economically unviable without the pipeline. For any oil exporting nation, a drop in America's importing requirements will be significant, even more so for its number one trading partner, us.

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Cheap capital and chasing returns

As we have discussed in past issues, the Federal Reserve, the Bank of Canada and all other G8 central banks have been taking an active role in supporting the economic recovery through loose monetary policy in the form of ultra-low interest rates. Given the economic uncertainty in the 'real economy', much of this cheap capital has found its way onto the stock market, artificially pushing the US stock market to all-time highs thanks to leveraged investing. Combined with the economic momentum of the United States, this had meant a flood of investors seeking to profit from the US recovery.

As investors from around the world flock to the US chasing returns, they are converting their local currencies (selling ↓) to the $USD (buying ↑). This has created additional pressure on the $CAD/$USD exchange as it continues to gain momentum by boosting returns for investors who profit from their investments held outside of their (falling) currency.

How low, can you go?

Given the factors listed above as well as Canada's slow economic recovery, poor job growth numbers and potential for a real estate slow-down, we do not expect to see the $CAD near parity for a long, long time. We believe that the $CAD remains fairly priced around the .89cent to .90cent range. Should it drop below 0.85cents per USD, we will seek to profit from what we consider to be overselling or speculation by shifting back into the currency.

How this affects you?

If you are an avid cross-border shopper, Amazon.com consumer or a snowbird following the warm weather to Florida or Phoenix, the fall of the Loonie will have an impact on your purchasing power. For other Ontarians however, the fall of the $CAD will likely be a positive boost to economic growth as exporters see their profit margins increased, or their ability to undercut prices improve. For those who have made it through the last five years despite dollar parity, the sliding currency will directly pad their bottom line.

Individuals earning US dollars (My Isagenix crew!!!) will also see their take-home income increase as the US dollars you earn will convert back to more and more Canadian dollars.

As an investor, a drop in the $CAD should mean increased profits as holdings outside of Canada produce additional profits from the currency exchange, while Canadian exporters benefit from increased margins as discussed herein. In our opinion, it will be important for investors to actively select securities positioned to benefit from these changing dynamics. In particular, passive investors holding index funds or ETFs will likely underperform stock pickers as the TSX's exposure to oil and gas as well as commodities will be a significant damper on returns, akin to last year's disappointing returns for index investors.

As always, we will continue to monitor the situation closely and recommend changes to your portfolio as needed. As we have discussed with many of you, we are expecting an important pull-back in US equities over the next month as the debt ceiling debate is reignited in the US. Following the poor deployment of Obamacare, the US President is short on political capital and voter appeal, which will allow the Republicans more lee-way as they hold the economic recovery hostage for their own benefit. But, more on that next month as the drama unfolds!

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