

Issue #38 - “Loonie Tunes”

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“A nickel ain’t worth a dime anymore.” –Yogi Berra

With the loonie losing double-digits to its green-backed counterpart this year, snowbirds are facing an expensive winter. The Canadian dollar is down 13% since January 1st and more than 20% below its 2014 highs, and so this month’s issue of Innova Market Insights dives into dollar to discuss why it has taken a beating, and for how long it will continue!

To understand the recent fall of the dollar, it is important to remember that currency markets are made of buyers and sellers just like any other market. When there are more buyers than sellers, demand sets the stage for market optimists, commonly known as ‘bulls’, to drive prices higher. Conversely, when there are more sellers than buyers, the bears timidly accept more modest prices as offer exceeds demand. Clearly, we’ve seen the price of the \$CAD slide which would indicate an increase in offer or a glut in demand – or in the case of the loonie, a combination of the two.

Demand

International companies and individuals looking to purchase Canadian goods must convert their dollars into \$CAD before they can make transactions in the local currency. When our companies are exporting, more and more buyers need to convert their local currencies into our loonie – which creates demand for it. The bulk of exporters in Canada fall into one of two categories: extractors and manufacturers.

Extractors

Everyone who follows the news or drives a vehicle is aware of precipitous fall in oil prices over the last two years. As recently as fourteen months ago, barrels were trading in triple digits. Since then, prices have fallen approximately 57%. We’ve examined this subject extensively in the past, particularly in IMI#32 – Black Tar Friday. Thanks in large part to shale oil production, the U.S. has transformed itself from a net importer of oil and gas to the world’s second largest producer. Canada’s biggest client for oil suddenly lost his appetite and along with it, his pull on the loonie.

In the world of base metals, concerns over the Chinese economy have awoken the market pessimists, or ‘bears’, who beat commodity prices down to decade-long lows. Glencore Xstrata, the world’s largest miner by revenues, saw their stock price drop some 77% year-to-date amidst concerns that even if they sold all their mines at current prices they still wouldn’t be able to repay their debts. This worry will likely lead to further belt tightening, which means less money coming in from overseas to be used in developing and opening mines.

Manufacturers

NAFTA, the free-trade agreement between Canada, Mexico, and the United States was signed in 1994, back when the loonie was trading in the low-70s¹. So long as it stayed in that range there was a net benefit to producers to move from Detroit to Windsor as comparable wages were almost 30% cheaper based on currency alone. As the loonie began its rally to parity in 2003, large manufacturers began to compare Canada and Mexico as potential suitors for new plants. Given the cost of labour and electricity in our fair province, home to 46% of Canada’s manufacturing base², Canada started to lose production lines. A decade later, Ontario’s manufacturing sector has lost over 300,000 jobs³ with few new large-scale plants on the horizon. Once again, this is a case where less demand for the products we are selling leads to less demand for our currency.

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Offer

On the other side of the balance sheet, downward pressure is added to the \$CAD when large amounts of dollars on offer exceed demand, as is the case when Canadian dollars are sold to buy other currencies. This situation is precisely the case for both international and local investors seeking to move their money out of Canada and into the U.S.

In 2010 global investors began pouring into the Canadian markets when Canada appeared to have skated around the Financial Meltdown of 2008. Naturally they bought the stocks we had to offer on our Toronto Stock Exchange. At the time it was made up of 27.3% energy stocks and 18.5% materials⁴. Given the current conservative outlook for these two sectors, international investors are cutting their allocations to the TSX and thus selling Canadian dollars.

Interest rate speculation is also fueling this move away from the loonie for investors. The markets are factoring in an imminent raise in rates by the U.S. Federal Reserve while the Bank of Canada wrestles with another potential cut to rates. This disparity means potentially better interest rates for investors in the U.S. than in Canada, without the nagging fear for a further drop in the currency.

The New Normal

Given this imbalance between offer and demand, the scales are clearly tilted against the loonie. So where do we go from here – is this ‘The New Normal’ and what does it mean for you?

Firstly, it’s important to remember that economic ebbs and flows will move currencies up and down over time. Furthermore, the loonie has only been above parity for 3 of the last 30 years, so the recent run up was more an anomaly than a trend. When we look out over the next few years, we simply do not see an end to the above-referenced headwinds.

As China continues its transition towards a service based economy, investment in infrastructure will moderate and along with it, the need for commodities. Meanwhile, the easing of economic sanctions against Iran will allow their oil to flow into the markets and further increase pricing pressure. With regards to manufacturing, only a sustained weak loonie would incentivize global firms to re-establish export firms here, which would only act as a stabilizing force and not a driver for a rebound in the \$CAD.

These combined factors lead us to believe that the goldilocks zone for the loonie will be between the high 60s and the low 80s, at least until commodity prices rebound.

What does this mean to you?

A weaker currency mainly affects importers and consumers. Going forward, foreign travel and cross-border shopping (Amazon.com) will undoubtedly hit the bottom line harder than it has in the past few years. Furthermore, we can expect to see price inflation in goods that are no longer manufactured here in Canada. According to an electronics and durables’ merchandiser, the price of GE washing machines, refrigerators, and Lazy-Boy recliners will increase in price by 10% by next year.

Fortunately for INWB investors, our target portfolio was tactically over-weight U.S. and International stocks for the last six years. As the Canadian dollar depreciated, our international holdings priced in other currencies are valued higher when converted back to our dollar. In large part, this led to substantial gains for us as investors and, more recently, offset the stock market correction on the TSX. Over the next few months we expect Canadian stocks to continue their downward trend and we will be on the look-out for opportunities. Should a worthwhile opportunity present itself, you can expect to hear from us!

1. <http://www.canadianforex.ca/forex-tools/historical-rate-tools/yearly-average-rates>

2. https://en.wikipedia.org/wiki/Economy_of_Ontario

3. http://www.thestar.com/news/insight/2013/11/23/fergus_plant_closing_shows_ontarios_decline.html?google_editors_picks=true

4. http://www.weighhouse.com/newsletters/March_2010.aspx