

# What's holding back the Canadian dollar?

March 2019

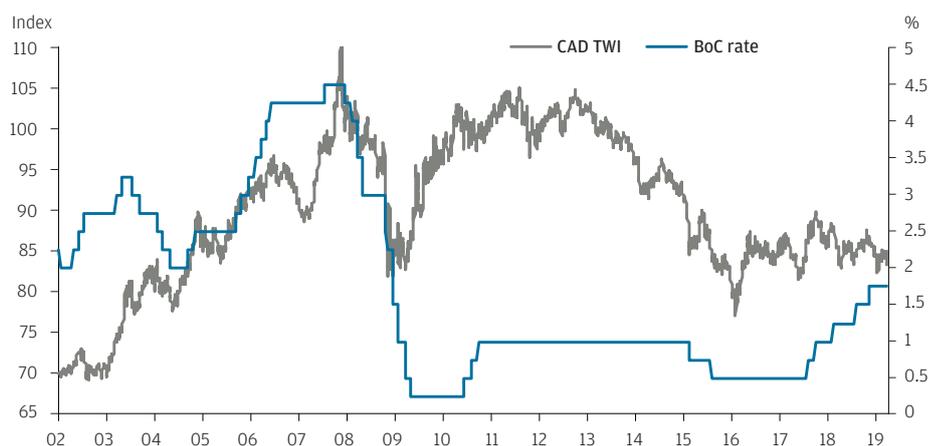
Unusually, and despite the currency generally being regarded as cheap, the Canadian dollar has weakened throughout the Bank of Canada's hiking cycle over the last two years. With economic growth stalling towards the end of 2018 and the Bank of Canada adopting a more balanced outlook, questions are re-emerging about the outlook for the currency over the medium term.

## Conflicting signals

While purchasing power parity is a widely accepted framework for determining long-term valuation there is still plenty of room for differences of opinion on the exact results, as demonstrated by the relatively wide gap between the two long-run measures we use to assess the Canadian dollar. Our measure using absolute prices adjusted for income levels suggests the Canadian dollar is close to fair value, while our relative measure assessing long-run price trends sees the currency as more significantly undervalued.

When we qualitatively assess currency valuation we examine balance of payments dynamics as an important cross check on purchasing power parity, to see whether a currency that appears expensive is behaving like an expensive currency. The results for the Canadian dollar raise some interesting questions as Canada has run a significant current account deficit since the financial crisis, with little sign of any trend improvement even during the periods when the currency was at its cheapest. The deterioration has come primarily through the goods trade balance, which is typically the area most sensitive to currency valuation. The Canadian dollar has not behaved like a cheap currency.

THE CAD HAS WEAKENED DESPITE THE BOC RAISING INTEREST RATES



Source: Bloomberg, J.P. Morgan Asset Management; data as of 13 March 2019.

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## Structural challenges

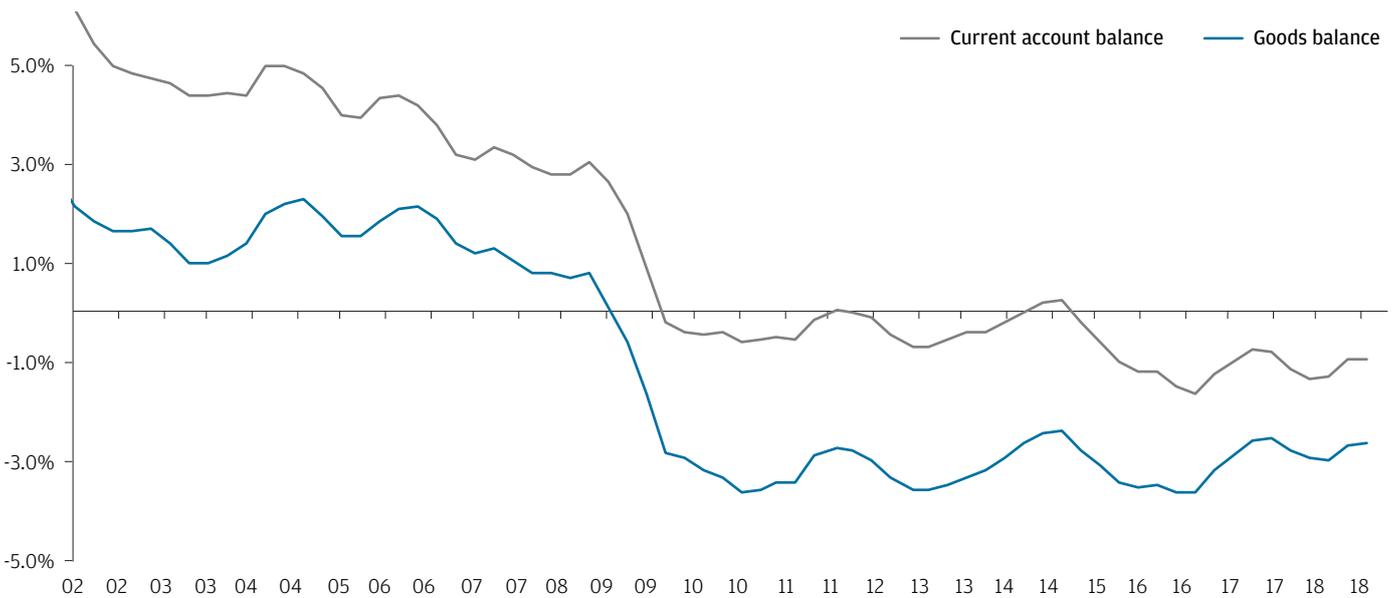
Our research highlights two specific structural issues that may be behind the weakness in the goods trade balance, which if they could be resolved might allow the Canadian dollar to behave more like the cheap currency that our valuation models suggest.

Infrastructure bottlenecks are constraining exports from the energy sector, which is additionally depressing the price of particular grades of Canadian oil and compounding the failure to benefit from the higher volumes that recently completed investment projects should be producing. The impact on prices has reversed following the Alberta government’s introduction of production caps late last year, but ultimately more export capacity is required to allow export revenues to reach their potential.

Debt levels in Canada have also risen substantially since the financial crisis, both due to the strength of the housing market and as a result of the low cost of debt in recent years. Some of the persistent current account deficit can be explained by wealth effects related to the housing market boosting spending. However, the sensitivity of the economy to rising rates may have increased as a result of the higher debt burden. This is a double-edged sword for the currency, as rate hikes delivered since 2017 may be quite effective at curtailing import demand but there is also a risk to the Canadian dollar from downward revisions to investor expectations of the neutral rate of interest in Canada.

It may take some time to resolve these structural challenges and along the way the currency may weaken to levels that provide a more compelling opportunity for longer-term value-driven investors, but we ultimately believe that our assessment of fair value for USD/CAD in the low 1.20s is still reasonable.

BALANCE OF PAYMENTS ARE NOT CONSISTENT WITH PPP VALUATION



Source: Bloomberg, J.P. Morgan Asset Management; data as of 31 December 2018.

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