The Canadian dollar: Well positioned to participate in future Dollar weakness

September 2020

The Canadian dollar has been a laggard amongst developed market currencies this year, falling sharply against a strong dollar as the market searched for safe assets at the peak of the COVID crisis before rallying neither as far nor fast as other major currencies like the Euro, Pound or Australian dollar once the impact of looser monetary and fiscal policy boosted markets. After several years where our assessment of the fundamentals has justified a weak real exchange rate in Canada we are finally seeing some signs of improvement, and see scope for the Canadian Dollar to outperform over coming months.

We have agreed with the consensus view that the CAD has been somewhat cheap to long run averages in recent years, however our chief concern has been that the balance of payments dynamics had not suggested the currency was sufficiently cheap to affect a meaningful rebalancing of the economy. When assessing currency valuation we use balance of payments analysis as a cross check on our long run valuation assessments, looking for a response from the components such as the goods trade balance that play a key role in economic rebalancing as a result of currencies deviating from fair value levels.

EXHIBIT 1: CAD/USD AND RELATIVE PURCHASING POWER PARITY

CAD/USD FX rate

Source: J.P. Morgan Asset Management. Data as at 28 August 2020.

AUTHORS

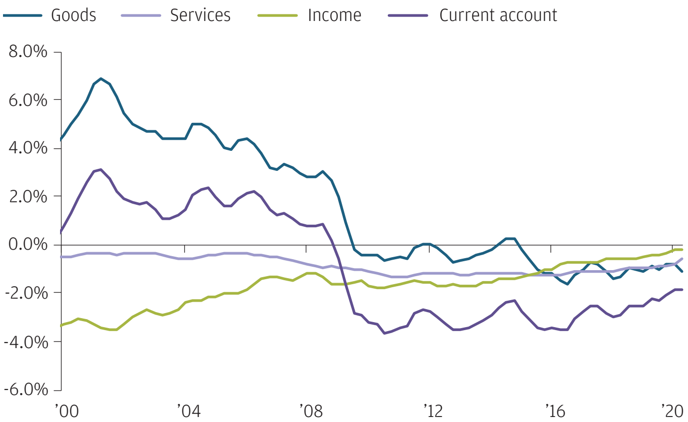
Roger Hallam
CIO of Currency Management

Nigel Rayment
Client and Product Management

The Canadian current account has remained in significant deficit since the global financial crisis, with little sign of sustained improvement as energy price falls and export capacity bottlenecks offset gains in production volumes. Other industrial sectors still appeared uncompetitive even at a moderately cheap exchange rate as they faced the challenge of more assertive US trade policy.

Over the last two years we have finally seen some improvement in the Canadian goods trade balance, which combines with longer term trends of improving balances in services trade and investment income to produce one of the best current account trends in developed markets. Finally Canada's balance of payments is behaving like the CAD is a cheap currency.

EXHIBIT 2: CANADIAN BALANCE OF PAYMENTS SHOWS SIGNS OF REBALANCING (% GDP)

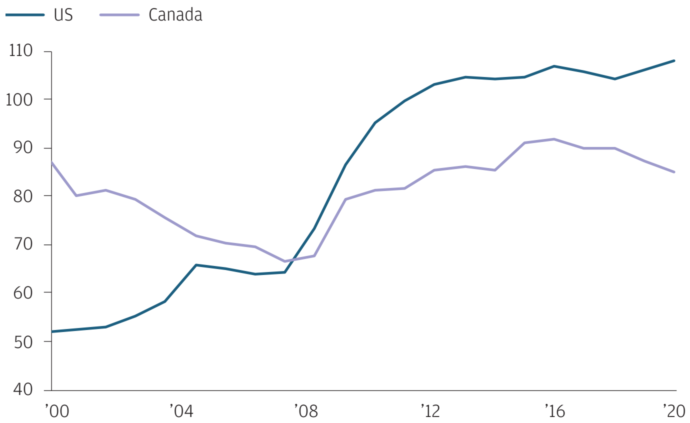


Source: J.P. Morgan Asset Management, Bloomberg. Data as at 30 June 2020.

As currency markets assess the risks to various currencies of debasement through unprecedented monetary and fiscal policies the Canadian Dollar also has a couple of advantages. Canada entered this global crisis from a relatively favourable position, with less poor government debt levels and more room to cut interest rates than many developed market peers. As the Bank of Canada have been less aggressive than some global peers in their approach to unconventional monetary policy our measurement of the effective policy stance using shadow rates has declined less than the US or other dollar bloc markets such as New Zealand.

The CAD also has some offset to inflationary concerns via the links to the oil price, since oil represents a larger share of Canadian exports the terms of trade boost from rising oil prices has tended to outweigh the downward pressure on real interest rates that comes from higher oil prices mechanically feeding through into higher inflation. This stands in contrast to the US market, which the terms of trade effect is significantly smaller and the downwards pressure on real interest rates from rising oil prices and rising inflation expectations is becoming increasingly important under an average inflation targeting framework that makes it much harder to look for tighter monetary policy in response to transitory boosts to inflation.

EXHIBIT 3: CANADA IS STARTING FROM A MORE SUSTAINABLE FISCAL POSITION, GOVERNMENT DEBT (% GDP)



Source: J.P. Morgan Asset Management, Bloomberg. Data as at 30 June 2020.

The easing delivered by the Federal Reserve to cushion the US economy from the effects of the COVID crisis has been significant. We believe the loss of interest rate support is likely to continue to weigh on the US dollar in coming months as the vast flows into US fixed income in recent years take time to unwind. We expect this effect to outweigh the support the Dollar may receive from US equity markets that continue to lead the world because of the performance of the global tech giants. When faced with the backdrop of a weak US dollar it is hard for the Canadian dollar to avoid appreciating.

Approaching the US election we see two routes for a potential boosts to the Canadian dollar, firstly from expectations of a less confrontational approach to bilateral trade under a potential Biden administration and secondly if the risks of an escalation of trade conflict and further weaponisation of the US financial system under a potential second Trump term see Asian reserve managers choose to pre-emptively diversify away from the US dollar towards other AAA rated developed bond markets.

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Important information

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