SECOND QUARTER 2015

We're not there yet

The Canadian dollar still has room to fall

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A year ago, in my inaugural commentary for Fidelity Canada (see "Leaving Home", Second Quarter 2014), I argued that the Canadian economy needed rebalancing. Growth had for too long relied on debt-fueled consumption and housing investment at the expense of exports, meaning that "the Canadian dollar may have to become clearly undervalued – and, importantly, stay there for a considerable period of time – in order to restore the competitiveness and encourage the rebuilding of industrial capacity needed to keep the economy on track in the years ahead."

That process is now playing out abruptly, with the Canadian dollar falling from parity two years ago to 90 US cents six months ago to around 80 US cents as I write. The acceleration downward in recent months has owed primarily to the crash in oil prices, which has shut off what had been the ultimate source of much of the strength in Canadian domestic demand.

As Exhibit 1 on page 2 shows, we've actually gone through something like this twice before in Canada over the past half-century – in the early 1980s following the last big commodity boom, and in the 1990s following the last big housing boom. The current episode combines both, implying that the ultimate adjustment this time around might need to be that much bigger.

But how much bigger? At what level is the Canadian dollar (CAD) 'cheap enough' to support the needed adjustments in the economy?

We can say with confidence that we're closer to the end than the beginning of the CAD's depreciation – the currency is off about 25 US cents from its cyclical peak in mid-2011, and I can't envisage a world where it goes down another 25 cents. But neither we nor anyone else can credibly be much more precise than that. That's largely because the exchange rate depends on so many different factors – both inside and outside of Canada – that are themselves uncertain. For example, a CAD at current levels is almost certainly far too cheap at $100/barrel oil and far too expensive at $20/barrel oil.

So rather than play the mug's game of trying to point-forecast all of these variables, we deploy our process in considering the macro, bottom-up, valuation and sentiment signals that would indicate a bottom in the CAD.

Not yet seeing signs of a CAD bottom

Starting with valuation, according to most of our longer-term models, the CAD has gone from overvalued to roughly fair value. But the currency likely needs to get into clearly undervalued territory to encourage the necessary rebalancing; our equity PMs and analysts see no evidence that companies are immediately planning to ramp up investment in Canada just because it's no longer prohibitively expensive to produce here. A 'cheap' currency will be one signal that the CAD's depreciation has run its course. We're not there yet.

KEY TAKEAWAYS

1. Oil price plunge forcing Canadian rebalancing
2. Weaker CAD playing its appropriate role
3. Expect a further exchange-rate tailwind to foreign assets

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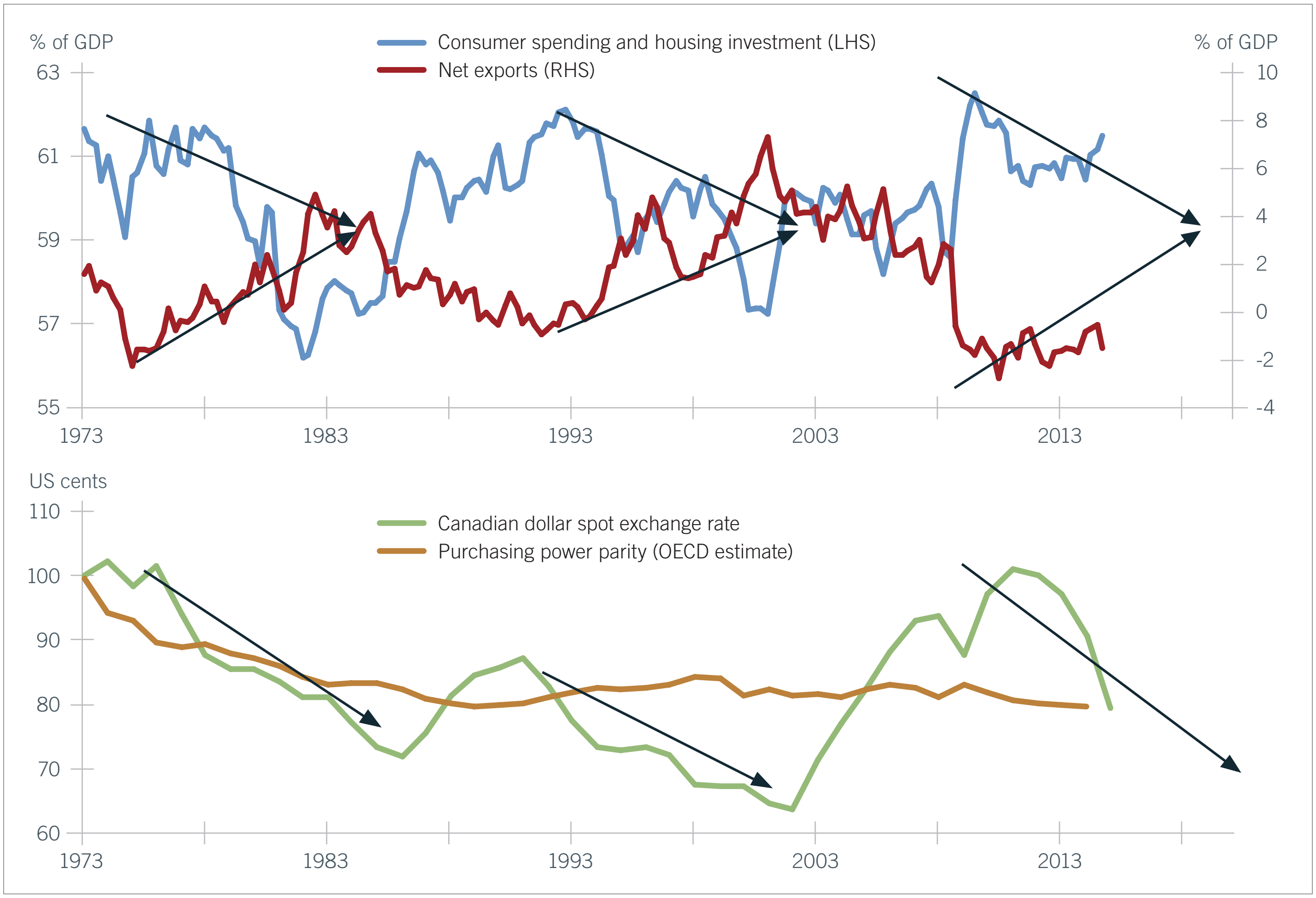
EXHIBIT 1: Canadian rebalancing will (again) likely require an undervalued exchange rate



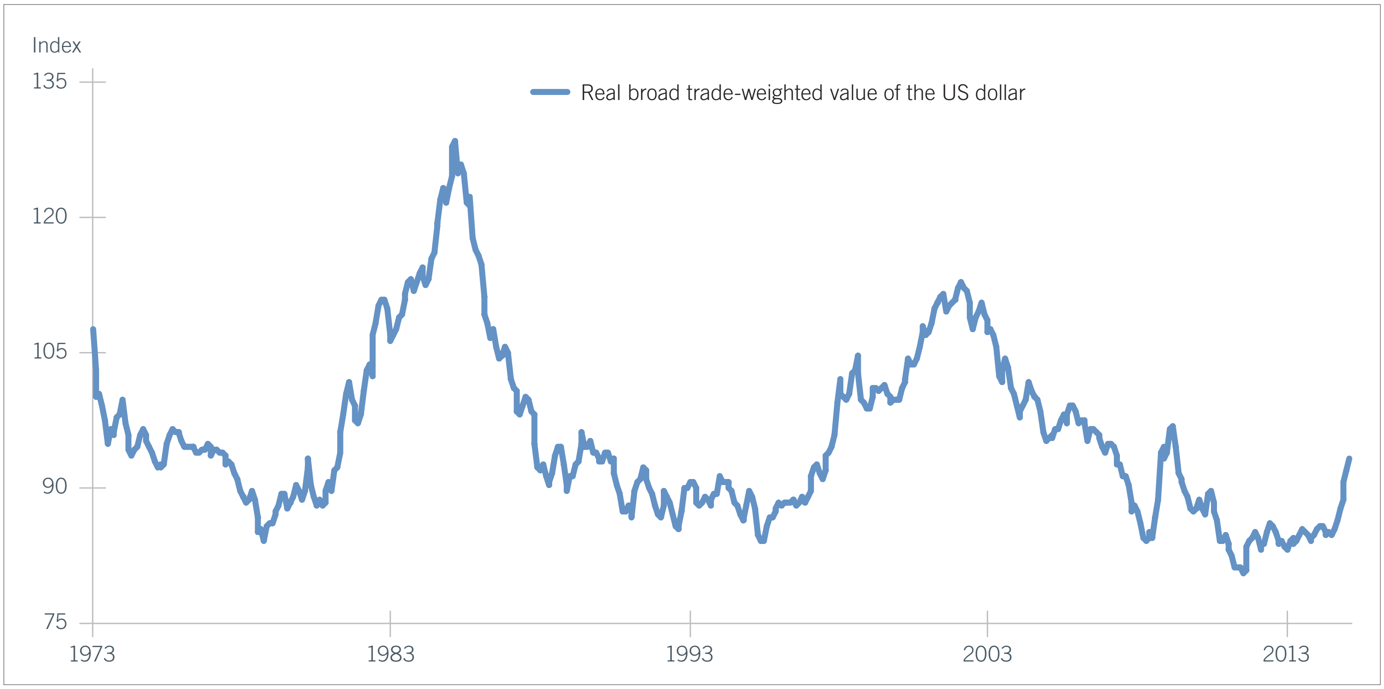
Sources: Statistics Canada, Bank of Canada, OECD, Haver Analytics, FMR Co

Regarding sentiment, we know that currency markets tend to overshoot, with the trend often reversing only when sentiment becomes virtually unanimous that it can't happen. I recall in 2002, with the CAD down to 62 US cents, sentiment being so negative that some argued we should adopt the US dollar while our currency still had some value left. The CAD proceeded to appreciate by over 50% to above parity over the following decade – to the point where I recall being challenged on the Bank of Canada's convention of assuming a flat Canadian dollar because 'everybody knows it's still going up.' Sentiment on the CAD is clearly negative, but when the most common question I get these days asks whether the CAD has stopped going down, it probably hasn't.

On the macro front, we would judge that even after the Bank of Canada's surprise rate cut in January, market participants still appear to be underestimating the challenge posed by the oil price collapse to Canada's economy. Against the backdrop of an historic drop in Canada's terms of trade and a procyclical (i.e. tightening) fiscal policy, it falls on the exchange rate to promote the needed rebalancing of demand, and it falls on the central bank to make sure that happens without the economy going off the rails. No one knows precisely the right level for Canadian short-term interest rates to ensure that outcome, but it seems to me that in a world with rates effectively at zero in most developed economies, Canada no longer has reason to be an exception. We're closer to that point than we were at the outset of the year, but we're not there yet, and markets are not yet pricing us to get there.

The above three signals derive largely from developments within Canada, but there's obviously another side to the exchange rate that's been at least as important in the CAD's recent depreciation – the broad strength of the US dollar. That trend still has some ways to go in our view. As Exhibit 2 shows, the recent rise in the

EXHIBIT 2: Still upside to the USD



Sources: Federal Reserve Board, Haver Analytics

US dollar's valuation is actually not that significant in a historical context. Moreover, in a world of competitive depreciations, the United States looks to be just about the only economy in the world that can take a stronger exchange rate on a sustained basis, given its economic momentum and relative insularity. Previous cyclical bottoms in the Canadian dollar have tended to coincide with tops in the US dollar more broadly; we'd expect this time to be no different, and that point is probably a ways off yet.

Positioning implications

As should now be clear, our positioning in the funds does not rely on a specific level forecast for the Canadian dollar. Rather, as always, we think about currency exposure in the context of the constellation of positions within our multi asset class funds, weighing return potential and our conviction level against risk and uncertainty. The prospect of further CAD depreciation has been one factor leading us to overweight foreign assets within our funds. We will continue to manage those exposures actively as the market environment evolves. □

David Wolf, March 30, 2015.

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