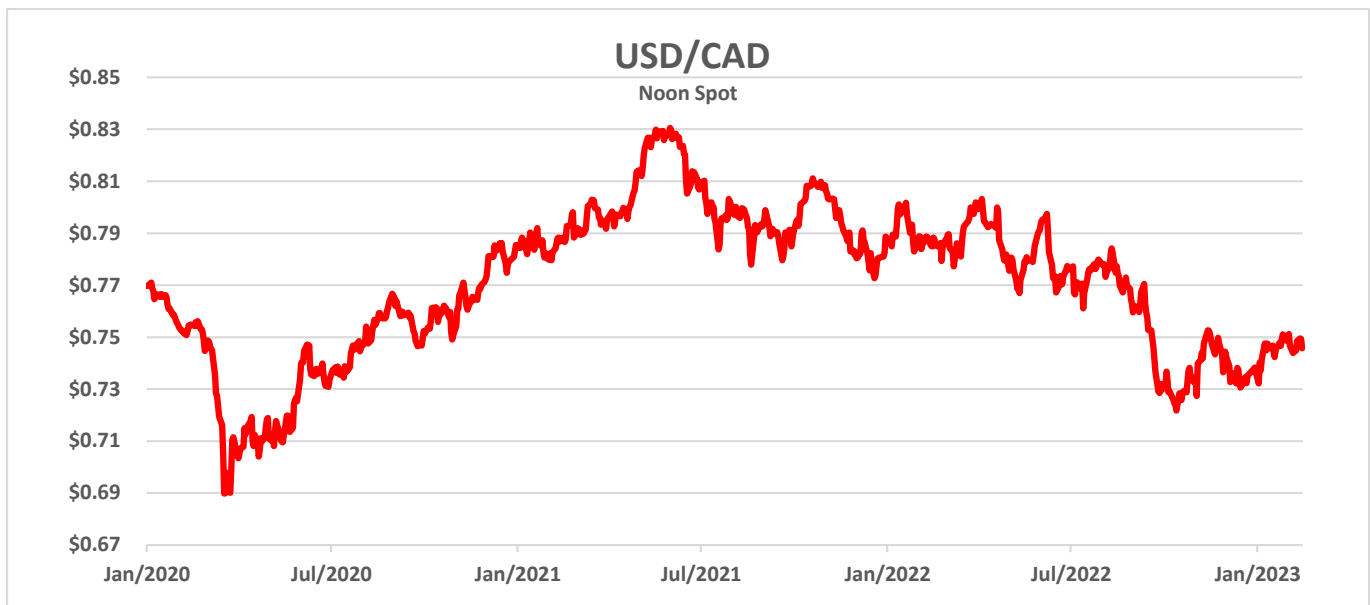


Loonie struggles continue

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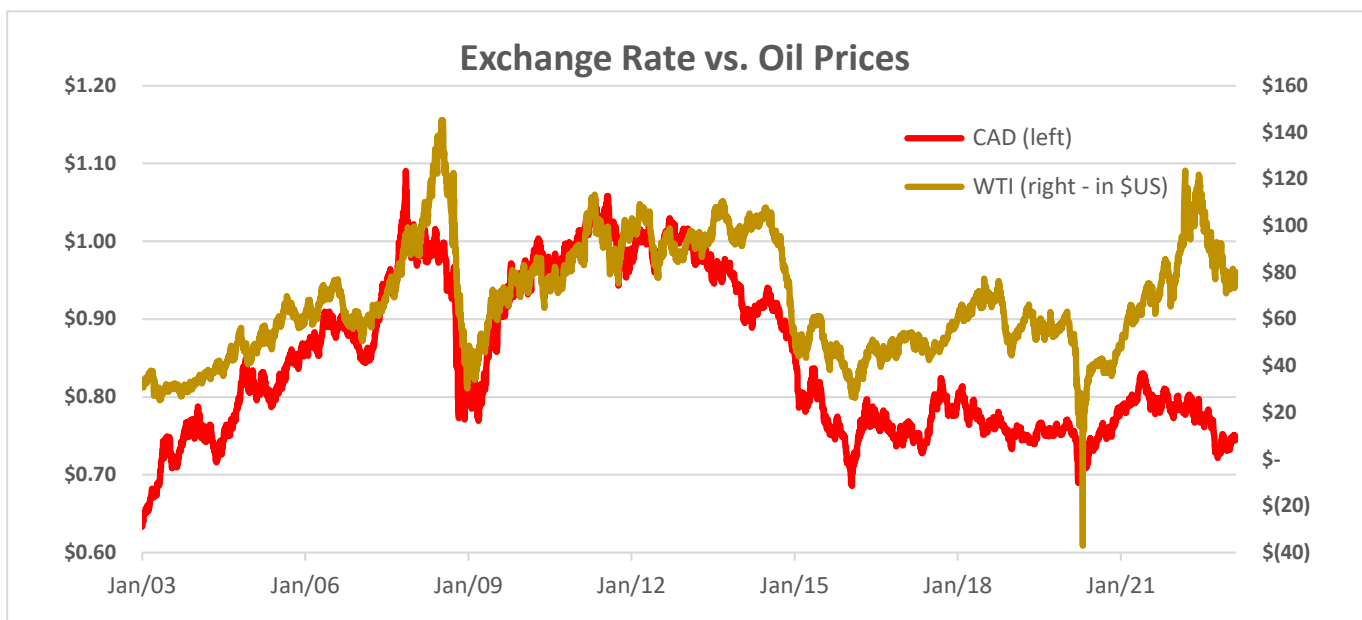
During the onset of the COVID-19 pandemic, global markets struggled to forecast the economic impact amid considerable uncertainty. Not surprisingly, a traditional “flight to quality” ensued and the United States—particularly U.S. Treasury debt instruments—benefited from significant capital inflows. Conversely, the value of the Canadian dollar fell against its U.S. counterpart, as outlined in the accompanying graph. The loonie tumbled to a low of US\$0.681 in the early stages of the pandemic, its weakest trading level in 17 years. Subsequent expectations for a material rebound in global economic activity and the commensurate increase in demand for Canadian resources provided material support for the Canadian dollar. It was sufficient to drive the currency to US\$0.833 by June 1, 2021, a fresh six-year high. Since then, however, market optimism has faded. Several challenges continue to buffet the currency. Some of these influences are transitory, but markets will continue to weigh the long-term implications of both monetary and fiscal policy decisions as well as the fundamental structural issues that continue to face the domestic economy.



Source: Bank of Canada.

Energy, inflation, and interest rates

Historically, commodity prices supported the value of the Canadian dollar in international markets. As Canada is typically ranked number three¹ in established oil reserves, the currency’s movements have been highly correlated with energy prices. Still, uncertainty over the direction of traditional energy development has weakened this support, particularly in the wake of the COVID-19 pandemic. As can be seen in the accompanying graph, the movements of the Canadian dollar closely tracked the world price of West Texas Intermediate (WTI is a light, sweet crude oil that serves as one of the main global oil benchmarks) between 2003 and 2015. Since then, broader gains in energy prices generally—and oil prices specifically—have not produced commensurate advances in the value of the currency.



Source: Bank of Canada; U.S. Energy Information Administration.

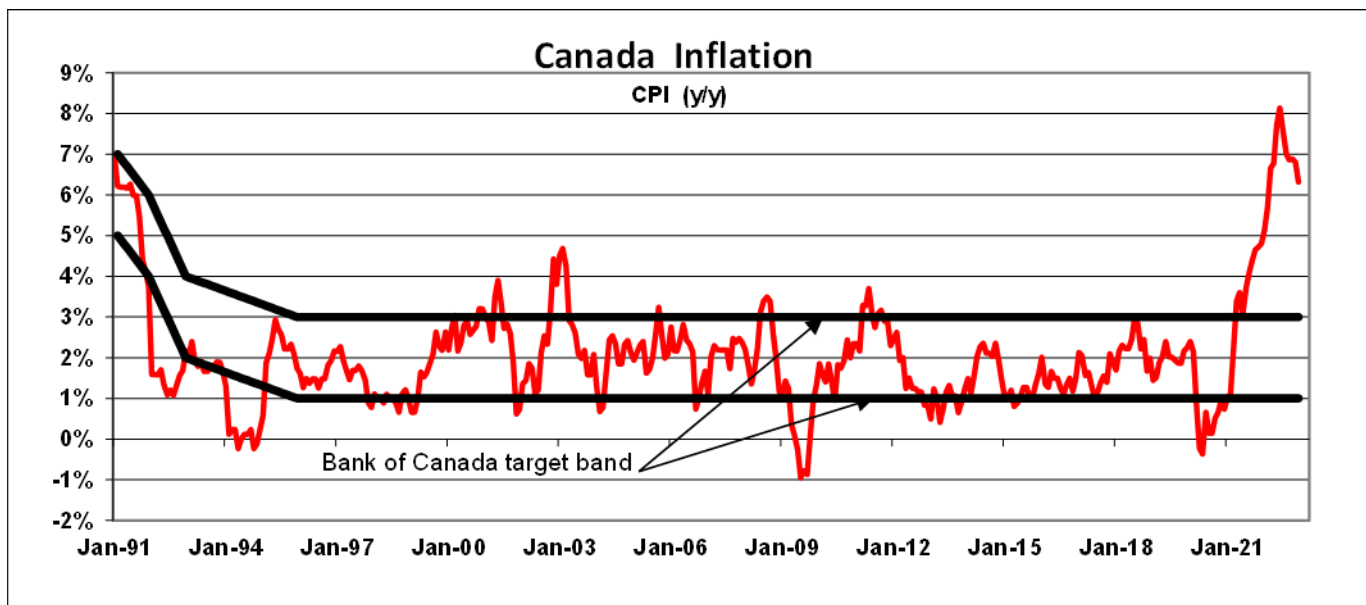
One of the other knock-on effects of the pandemic has been a very strong resurgence in inflationary pressures. In Canada, the Consumer Price Index (CPI) accelerated to an 8.1% annual growth rate in June 2022. This was the fastest pace since January 1983 (8.2%). As can be seen in the graph below, inflationary pressures have begun to ease. The annual pace of CPI hit 6.3% in December 2022. This was the smallest annual gain since February 2022, but it remains well above the Bank of Canada’s (BoC) target range. Since its introduction in 1991, the BoC’s Inflation-Control Target has been the focal point of monetary policy in Canada. Of primary importance has been the ability of the BoC to manage the expectations of Canadians. Over that 30-year stretch, Canadians had come to expect that inflation would remain in the 2 per cent range over the long run. This expectation served to reduce uncertainties for business and individuals as they made their respective financial plans.

¹ U.S. Energy Information Administration - EIA - independent statistics and analysis. International - U.S. Energy Information Administration (EIA). (n.d.). Retrieved January 4, 2023, from <https://www.eia.gov/international/data/world>.

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In a speech delivered on February 7, 2023, Bank of Canada Governor Tiff Macklem stated, “With economic growth slowing to close to zero in the first half of 2023, inflation should drop to around 3% in the middle of the year and reach the 2% target in

2024.” Still, BoC watchers have been quick to note that the same Governor, in a July 29, 2021 column in the Financial Post, also said, “Inflation should move back inside our target range next year.”² This was well before any tightening of monetary policy had emerged, or even appeared to be required. Similarly, inflation in the United States followed a sharp upward trajectory and moved even further away from their central bank target. While the annual pace of U.S. CPI has now eased to 6.4% (January 2023) from the 40-year high (9.1%) reported for June 2022, it remains well above the U.S. Federal Reserve Board’s 2.0% bogey.

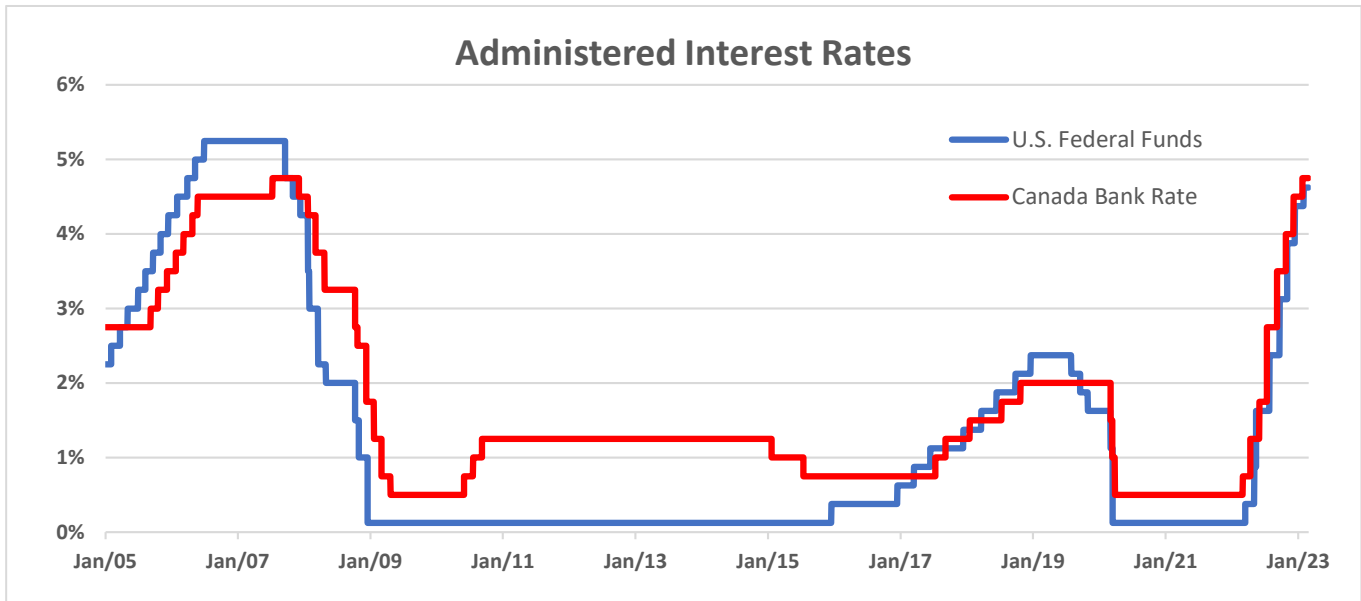


Source: Bank of Canada; Statistics Canada

Forty-year highs in inflation in North America have led to the sharpest tightening of monetary policy in decades. Following its latest two-day monetary policy meeting, the U.S. Federal Reserve Board (Fed) raised administered interest rates by 25 basis points (a basis point is 1/100th of one percent), moving the target range for the federal funds rate to 4.50% to 4.75% (from 4.25% to 4.50%). As can be seen in the graph below, this move takes the cumulative rate hike to 450 basis points from the first move of the tightening cycle on March 16, 2022. This is now the largest total increase since interest rates on federal funds rose 1,525 basis points from 4.75% in November 1977 to a record high of 20.0% in May 1981. In the press release that accompanied the announcement, the Fed specifically stated once again that the Federal Reserve Board Open Market Committee (FOMC) “anticipates that ongoing increases in the target range will be appropriate.” The 25-basis point move matched market expectations at the time with some participants anticipating that the Fed would next move to hold rates steady despite the apparent clarity of the statement. News that the CPI had increased 0.5% in January revived market expectations of further tightening of monetary policy. Along the same lines, a string of interest rate increases has been seen at the Bank of Canada. The cumulative 425-basis point hike (since the first move on March 2, 2022) is now the largest set of interest rate increases since the period from November 1987 to May 1990, when the reference Bank Rate was moved from 8.09% to 14.05% (596 basis points).

²Macklem, T. (2021, July 29). *Tiff Macklem: The Bank of Canada remains firmly committed to keeping inflation under control*. Financial Post. Retrieved February 18, 2023, from <https://financialpost.com/news/economy/tiff-macklem-the-bank-of-canada-remains-firmly-committed-to-keeping-inflation-under-control>

Like the U.S. Fed, questions remain concerning the timing of any additional interest rate increases domestically. From a foreign exchange perspective, Canada must remain attractive to foreign lenders and any diversion from the rising interest rate pattern seen in the United States would translate into a renewal of Canadian-dollar selling.



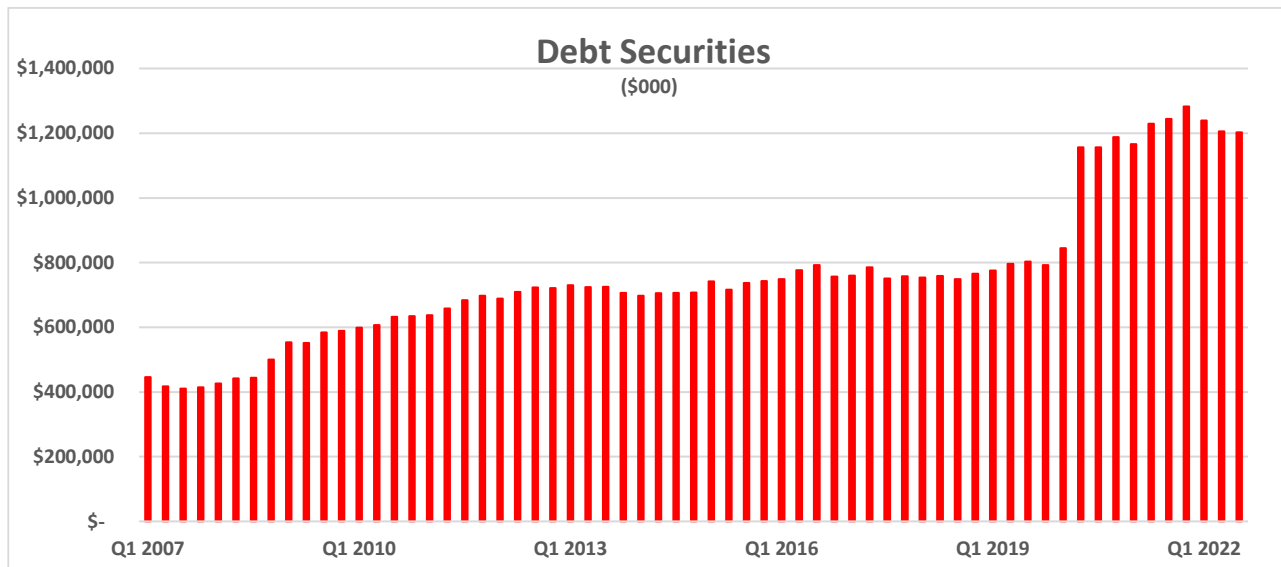
Source: Bank of Canada; U.S. Federal Reserve Board

Longer-term influences

Unfortunately, the higher interest rate environment has created another market impact. The rollover of the Government of Canada’s debt, at considerably higher interest rates, has dramatically raised the cost of its refinancing operations. As can be seen in the following graph, it is not just the rollover of previous debt issues that is the problem. The outstanding amount of Government of Canada debt securities stood just below the \$700 billion mark as recently as the first quarter of 2014. However, the most recent figures reveal an unprecedented increase above \$1.2 trillion, as of the third quarter of 2022. In addition, sharply increased borrowing has come at the same time that the Bank of Canada has begun to reverse its quantitative easing (QE) by liquidating its own stockpile of government bonds into the market. Unfortunately, the unwinding of QE has come with yet another unforeseen cost to Canadians: the Bank of Canada reported a loss of \$522 million in the three months ended September 30, 2022. This is the first time the institution had been in the red since it was created almost 90 years ago³. The Bank is now liquidating its holdings at a loss. Even though the Bank did not embrace QE during the 2008-2009 financial crisis, former Governor Stephen Poloz, decided to use this monetary tool in the early stages of the pandemic. The Bank began buying government bonds from private lenders by adding to their deposit accounts at the central bank. While bond investors have thus far been willing to absorb this vastly increased supply of debt instruments, all is not calm. The federal government threw the market a curve by

³ Carmichael, K., & Hughes, S. (2022, November 29). *FP Answers: The Bank of Canada lost \$522 million in three months — here’s why*. Financial Post. Retrieved February 18, 2023, from <https://financialpost.com/fp-answers/why-bank-of-canada-losing-money>

announcing it would cease issuing real return bonds⁴, a product that has been in existence since 1991. Market participants have raised concerns over future liquidity and questioned the government’s commitment to low inflation. Uncertainty in the market for Government of Canada debt dampens buying interest for the loonie.



THE BIG PICTURE



In addition to the challenge of keeping Canadian debt products attractive to foreign bond holders, other long-term domestic economic issues have recently made headlines. The latest figures from Statistics Canada revealed that labour productivity in the third quarter of 2022 was virtually unchanged from the pre-pandemic (fourth quarter of 2019) level. This compares poorly with the United States, where non-farm productivity increased by 4.2% over the same period. While COVID-19 has had a clear influence on the more recent data, the current figures are simply a continuation of a much longer-term trend. As can be seen in the above graph, productivity growth had been lagging since the fourth quarter of 1987; however, a far greater divergence began in the fourth quarter of 2001. Similarly, business investment dropped 5.1% (seasonally adjusted, annualized) in the most recent data (third quarter of 2022) following a 9.5% contraction in the second quarter of 2022. This too is part of a longer-term trend that is closely tied to productivity and has dampened Canada's long-term growth potential.

In 2019, Canada fell from the top 10 in an index of the world's most competitive countries; last year, the ranking had fallen to 14th place⁵. As well, the OECD recently ranked Canada last out of 38 countries in per capita economic growth⁶ and predicted it would be the "worst-performing advanced economy over 2020 to 2030 and the three decades after." Higher relative interest rates can attract foreign lenders, but fostering business investment and improving productivity growth require different policy responses. While traders will focus on day-to-day fluctuations in the currency, challenges remain for longer-term investors. Having a solid financial plan with the backing of a professional advisor will ensure that a broadly diversified investment portfolio is able to weather uncertainty in foreign exchange markets during volatile times.

⁵ IMD. (2022). *IMD World Competitiveness Booklet 2022*. Retrieved January 26, 2023, from <https://imd.cld.bz/IMD-World-Competitiveness-Booklet-2022/4/>.

⁶ Guillemette, Y., & Turner, D. (2021). The Long Game: Fiscal outlooks to 2060 underline need for structural reform. *OECD Economic Policy Papers*, (29). <https://doi.org/10.1787/a112307e-en>

THE BIG PICTURE



CONCLUSIONS

- The coincidental movements of inflationary pressures and interest rates, including the official announcement of these statistics, can have a profound influence on prevailing foreign exchange rates. Significant volatility can be expected to continue for some time.
- The Canadian dollar last traded at parity with the U.S. dollar on February 14, 2013. Since that time, shorter-term and longer-term influences have weighed heavily. Only time will tell if these influences can be offset or reversed.
- Investors who plan to eventually spend Canadian dollars are right to seek to cushion the blow from shifting currency markets. The assistance of a professional advisor and sticking with a disciplined, diversified, long-term plan to build an investment portfolio is the best approach.



For more information, we encourage you to speak to your advisor or visit us at [assante.com](https://www.assante.com)

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