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# Palos Weekly Commentary

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CONTENTS


| | |
|---|---|
| The Canadian Dollar is Resilient: An Inflection Point? | 1 |
| The USMCA Trade Agreement | 2 |
| US Secretary of Commerce | 3 |
| Disclaimer & Contacts | 4 |


# Macro View

*By Hubert Marleau*

## The Canadian Dollar is Resilient: An Inflection Point?

Just as almost everybody was ready to sell Canada short, the Loonie makes a spectacular turn, rising 1.6% vis-a vis the greenback in a matter of days to 75.25 US cents on its way to its PPPR of 77.50 US cents. If it had not been for the marked differential in interest rates favoring the U.S., the exchange value of the Canadian dollar would have had an even more bullish trend. Despite hitting a rough patch late last year and in the first few months of 2019, the Canadian economy is now moving forward. It may not be totally in the clear; but a recent batch of economic indicators promises that past currency weakness might be over. On May 16, I wrote that "the Loonie was trading way below its 10-year average, suggesting that an awful lot of bad news was priced in. Then suddenly out of nowhere, a series of unexpected bullish prints became evident, killing the belief that the bank of Canada imminently was about to cut its target rate and giving credence to the "Poloz belief" that the economy will soon pick-up."

It is interesting to note that the monthly GDP data for March was very strong, with a sudden pop of 0.5%. As a result of this unexpected burst in economic activity, there is an assurance, all other things being equal, that there is an inherent annual rate of growth of 1.0% built into Q2.

Given that:

1) The Canadian merchandise trade deficit narrowed in April, coming in at C$966 million versus a monthly average of C$3.083 trillion in Q1,
2) The Ivey Purchasing Index stayed in an expansion zone at 55.9 in both April and May versus a monthly average of 53.2 in Q1,
3) Large influx of immigrants, and
4) Total employment in Q2 is currently running at an annual rate of 2.8% over Q1, it would not surprise me that when the June quarter is over, the Canadian economy will register an increase way above 2.0%.

# Macro View cont.

*By Hubert Marleau*

What is particularly interesting is that the Canadian economy has the potential to take it all in because labor force participation and industrial utilization rates are down. According to surveys by Nanos Research Group for Bloomberg News, Canadians are less pessimistic about the economic outlook. Consequently, there is a good chance that things could play-out well for Canada, creating an inflection point.

Last Friday, President Trump said: "I am pleased to inform you that The United States of America has reached a signed agreement with Mexico. The Tariffs scheduled to be implemented by the U.S. on Monday, against Mexico are hereby indefinitely suspended." Lawmakers are happy but more particularly businesses. The breakthrough opens the path for the USMCA trade agreement.

Canada is a small open economy which badly needs ratifications of the USMCA without further delay in order to reap the trading benefits of this modernized agreement and make sure that the new depreciation allowances will keep the recent surge in business capital formation going. During the March quarter, business investment in structures, machinery, and equipment was broad-based and increased at the spectacular annual rate of 15%-items that are much needed to boost lagging productivity.

If the North American price for oil continues to trade near its overall marginal cost of production of $55 a barrel and given that the potential return on investing in Canada remains alluring, the performance of the Canadian dollar may surprise us to the upside. Why? There is an increasing probability that the Bank of Canada will drag its feet even if the Fed decides to introduce a rate cut. The thing is that the economy is doing much better at this time in Canada than the U.S. Presently, high frequency economic trackers are forecasting a Q2 growth rate of only 1.3% for the U.S. compared to 2.5% for Canada and the inflationary content of the misery index is higher in the U.S.. Adjusted for the usual 2.0% gap between the Canadian and U.S. unemployment rate, the Palos Monetary Policy Index stands at 142 in Canada compared to 71 in the U.S...

Disentangling signal from noise is always difficult. Traders that look at charts plotting technical indicators like 200-day moving averages that matter a lot in the foreign exchange market, may believe that it is a good time to take profit. However, what is behind the numbers, suggest that a stronger Loonie may be in the offing. International investors believe that the Loonie is a good bet. During Q1, foreign investment in Canadian securities totaled $40.0 billion while Canadians only purchased $1.0 worth of foreign securities----on a net basis. The Canadian attraction may continue for a while longer because the yield advantage of the U.S. dollar has considerably narrowed over the past 60 days. As a matter of fact, bearish views on Canada are diminishing as the underlying trend of gross short positions is declining suggesting the possibility of a reversal is in play.

# Macro View cont.

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P.S. On May 23, the US Secretary of Commerce Wilbur Ross announced that he intends to "impose countervailing duties on countries that act to undervalue their currency relative to the dollar." This move tells me that the Administration is tired of Treasury's technical studies that fail to accuse certain countries as currency manipulators. Last Saturday, Mnuchin admitted that the dollar was part of the tool kit to address countries that used their currency for competitive purposes and devalues it for the purposes of trade. It may sound superficially harmless but does not when one considers that Trump has often publicly refuted these official reports. He prefers discretion when it comes to labeling a trade partner as a manipulator for currency weakness. He asserts that many nations are using monetary policy to manipulate their currencies. It is impossible to think that he is not exasperated by the tenacity of the greenback amid the trade war. In this connection, it is almost certain that Trump will soon ask his staff to engineer an unofficial weak dollar policy, jawboning the dollar and interest rates lower. Last Monday on CNBC, he produced more criticism on Chairman Powell, calling the Fed's interest rate policy disruptive. Under the aforementioned circumstances, and given the tepid May reading for import, producer and consumer prices, I suspect a spirited debate next week at the Fed meeting over the merits to frame an easier policy like secretly scheduling rate cuts for July and September---especially if the G20 meeting fails to make any progress.

# Disclaimer:



PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 276-0110

www.palos.ca