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Macro View

By Hubert Marleau

The Purchasing Power Parity Rate of and the Outlook for the Canadian Dollar

The Purchasing Power Parity (PPP) is a theory of exchange rate determination. It asserts that the exchange rate change between two currencies over any period of time is determined by the change in the relative price changes in the two countries. The PPP is an essential element of an open economy for two reasons. It's a benchmark by which to judge whether the level of an exchange rate is over or undervalued and, in turn, serves as a prediction model for monetary policy. Under regimes of floating exchange rates when domestic prices and wage rates result strictly from the forces of demand and supply, the model does provide a neat and ready-made measure of the equilibrium value of the exchanges.

In this connection, comparative GDP price deflators combined with consumer and producer prices indices between Canada and the U.S. suggest that the Canadian dollar is worth around 78.25 US cents. While empirical time series reflecting price, changes do offer a reliable reference point, monetary policy, terms of trade, and investment flows deserve special attention. They can seriously impact market conditions and force the exchange price of the Loonie to deviate from its intrinsic value.

Last December, the Canadian dollar was trading at 73.25 US cents; it rose to 76.06 US cents by the end of July on its way to its PPP of 78.25 US cents. The outlook for the Canadian economy had improved, the expectations for rate cuts were very low and terms of trade were rising under firmer oil prices.

Suddenly, the early days of August brought about geopolitical uncertainties as the trade war changed into a currency war, bittered the global economic outlook and deteriorated the Canadian terms of trade as oil prices fell. Now, the chance that the Bank of Canada will announce an interest rate cut on September 4, has significantly increased. The yield curve is completely inverted across the board and the neutral rate (1.25%) is considerably below the target rate (1.75%) of the Bank of Canada. Canadian investors are certain that the Bank of Canada is not ignoring what is going on in the domestic debt market. It is aware of the global phenomenon of

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negative interest rates and is cognizant of the worldwide target rate cuts that central banks are imposing on their banking systems. Although the Canadian economy appears to have recovered from several challenges, it would almost look normal for the Bank of Canada to pre-empt the Fed with a reduction in its own policy rate to 1.50%. Money market traders see a 50% chance that the central bank will cut its benchmark rate by 25 bps compared to less than 5% throughout most of July.

It explains why the Loonie weakened in August and traded as low as 75.00 US cents on several occasions. If it had not been for huge foreign inflows of capital in the Canadian bond market, the Loonie would not have held as well as it did. The relative cheapness of the Canadian dollar, the abundance of investment grade borrowers and positive interest rate returns have drawn "en masse" foreign investors. As a matter of fact, foreign capital inflows have been large enough to cover both the budget and current account deficits. Interestingly, the two-year and ten-year spreads between the U.S. and Canadian bonds have narrowed considerably since last December.

Yet, the street consensus calls for more Canadian dollar weakness over the short term, perhaps because there is a general belief that the Central bank may capitulate to international pressures creating a bearish tone in the marketplace. The risk-off environment has created a 60% probability that the CAD will fall until November, explaining why speculators are still net short, albeit less than they were earlier. I've seen forecasts for the Loonie as low as 72 US cents by year end.

In spite of this negativism, I believe that we may end up with a surprise to the upside for the Loonie. The Bank of Canada is conservative, and it may prefer to wait and see what the Fed will do at the end of September before taking any action. Governor Poloz has several good reasons to be patient:

Firstly, Canada's economy is currently outperforming the U.S for the first time in two years. High frequency economic models are tracking an annualized rate of growth of 3.0% for Q2 compared to 2.1% in the U.S.. The slowdown in manufacturing sales was concentrated in the energy sector and not enough to derail the undergoing expansion.

Secondly, core inflation in Canada is right on target at 2.0%. As a matter of fact, the inflation content on the Misery Index is normal at 26%.

Thirdly, Canada is a widely open-ended economy with relatively large budget and current account deficits at a time when private savings are very low, making the country fully dependent on external funds to finance domestic business investments and infrastructure projects.

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Fourthly, the current price for oil is around $55.00 a barrel which is the marginal cost of production including exploration, development and transportation. Given that the price of oil is near a floor-price, it is possible that tighter supply stemming from sanctions on Venezuela and Iran (two major producers) could provide an extra boost of economic activity in the western provinces.

Lastly, the Palos Monetary Policy Index which takes into account price stability, economic growth, employment and the viability of the balance of payments presently stands at 105--a clear message that the Bank should stand pat.

Based on the aforementioned observations, I would be a buyer of the Canadian dollar should it weaken further from its current price of 75.00 US cents, especially if you believe as I do that there is no recession out there.

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