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MARKET ETHOS

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C$ - Has It Turned?

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"When the facts change, I change my mind. What do you do, sir?" – John Maynard Keynes

We need to start by outlining where we are coming from – we have been U.S. dollar bulls for over five years. This is most evident in our Core Income mandate that is primarily focused on Canadian dividend paying companies but can hold up to 35% U.S. companies for better diversification, both at the company level and from a currency perspective. Our view on the USD/CAD can be easily seen in how much U.S. equity the portfolio has held over time. When we launched the strategy in April 2011, we had below 6% U.S. exposure. Two-year yields were higher in Canada than the U.S., the Fed was adding more quantitative easing, their credit rating had been downgraded, there were persistent debt ceiling issues and oil was between $80-100/bbl. But in March 2012, we increased our U.S. weight in the portfolio from below 10% to 25% and by October of that same year we were pretty much at our maximum 35% U.S. weight. None of the aforementioned factors had changed, the increase in U.S. holdings was driven from a fundamental valuation perspective.

The chart at the right shows the Canadian dollar in relation to its maximum and minimum value since a floating exchange rate was adopted. While a simplistic approach that ignores factors such as oil prices, yield spread, etc, when close to the maximum (green line) upside has been limited and when close to the minimum (red line) further downside has been limited. In 2012, the loonie was close to its record level, implying more upside may prove difficult and there may be greater upside in the undervalued U.S. dollar. Also, based on purchasing power pairity, looking at the major country currencies, in 2012 all were overvalued against the U.S. dollar except the Swedish Krona. Today, most are undervalued including the Canadian dollar (2nd chart).

Falling from parity to the mid 70 cent range, having U.S. dollar exposure provided a boost to returns. The problem now is, with the Canadian dollar near the lower end of its historical range and somewhat

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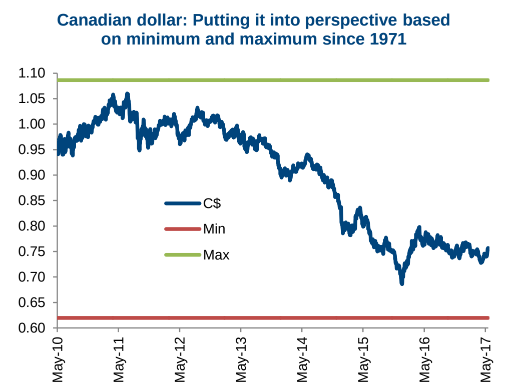
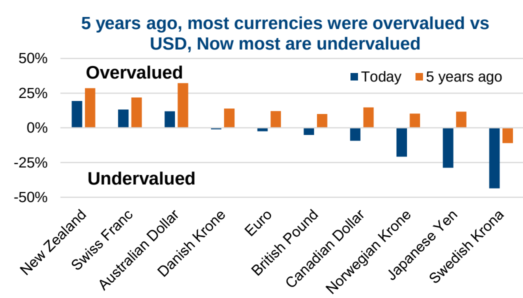




undervalued vs. the U.S. dollar, should we continue to be bullish on U.S. dollar exposure?

The Narrative

The bullish case for the U.S. dollar (vs the Canadian) is very strong and compelling. The Federal Reserve is raising rates, until last week a Bank of Canada rate hike was not even on the horizon. Now there is talk a rate hike may happen in early 2018 or even later this year. Still, the U.S. economy is on a more solid foundation. Add the prospect of a corporate tax cut for U.S. companies that may include a tax holiday or break on repatriating overseas profits, this would be very positive for the U.S. dollar. Here at home we have oil, which continues to languish below $50 and a looming trade war with the U.S. Put all that together and it paints a rather compelling narrative to continuing to be long the greenback.

But the narrative was equally bearish on the U.S. dollar in 2012, and clearly the trade was to own U.S. dollars. And there have been some material changes in the past few weeks that have fueled the rise in the loonie from $0.73 to $0.756. These have included:

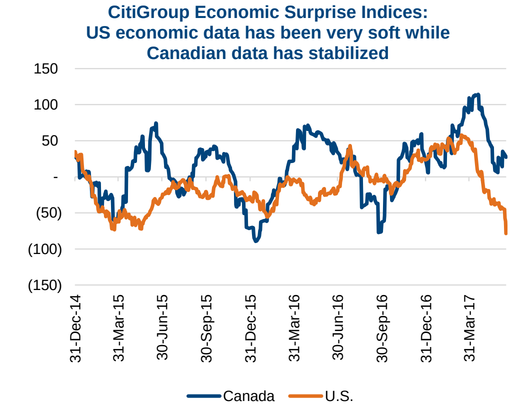
- **Better economic data** in Canada and softness in the U.S. Canadian GDP grew 3.7% in Q1 compared to 1.2% in the U.S. Strong labour gains in Canada and cooling inflation pressure in the U.S. This can be easily seen in the relative moves in the Canadian and U.S. Citigroup Economic Surprise Indices. Canadian data has stabilized while the U.S. data has really been disappointing of late. (top chart)
- **Central Banks** are not as divergent. The improving data in Canada has opened the door to talk of a rate hike. Up until this point there has been little to no appetite to raise rates since former BoC governor Mark Carney last rose rates in 2010.
- **Valuations** of the Canadian dollar were about 10% undervalued before the recent rally. Now this is closer to 5%.

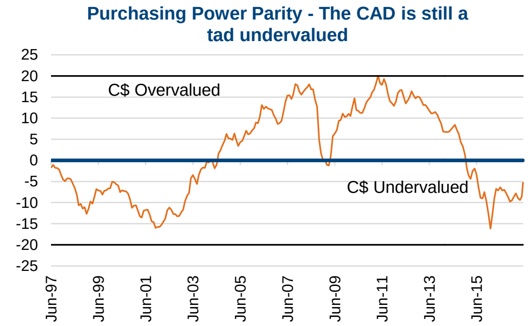
Have the Facts Changed?

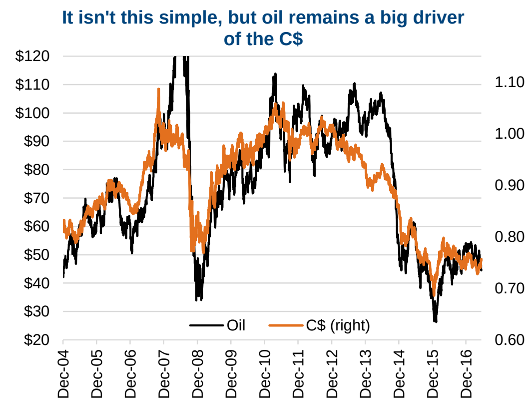
There have clearly been some big moves in the data and sentiment over the past couple of weeks that have fuelled a rally in the C$. And as the opening quote insinuated, if the facts change, you should change your mind. But not so fast Mr. Keynes, and here is why we are not abandoning our U.S. exposure.

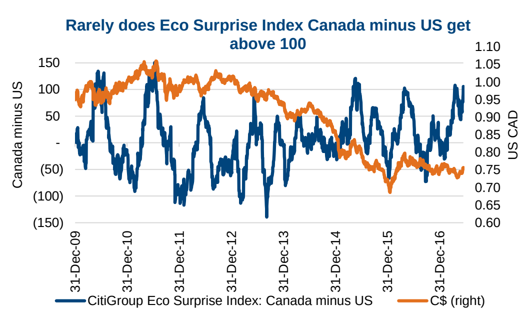
Economic data oscillates around its true path and while there is no doubt the data of late has been better in Canada, we would expect a mean reversion. Historically, when the Citigroup Economic Surprise Index Canada minus U.S. touches a 100, which it is currently, it comes back down.

Taxes and Trade could easily fuel a rapid rise in the U.S. dollar vs our currency. During the bear market for the U.S. dollar from 2002 to 2008, the only year it rose was 2005, after then President Bush provided a tax break for companies to bring back overseas profits. This could happen again later this year or early 2018. On the trade side, NAFTA appears poised to be renegotiated or updated later this summer. In any trade





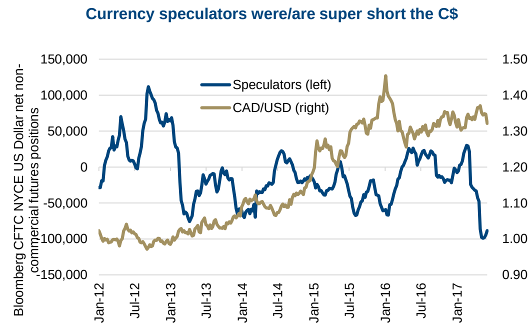




renegotiation, the advantage typically goes to the country with the trade deficit and that is the U.S.

You need to have a positive view on oil to have a positive view on the Canadian dollar. And while we are intrigued at $45/bbl, the global glut continues and we see limited upside in the near term. Short term, it has been impressive as this advance in the C$ occurred while oil has been weakening. It is questionable whether this disconnect will persist for long.

The valuations gap just isn't there at the moment. Purchasing power parity has the C$ undervalued by a mere 5% which is not enough to have us change our view (middle chart on previous page). When the C$ was a little over 10% undervalued, we currency hedged some of our U.S. exposure, but at 5% we are certainly getting closer to unwinding that hedge, not adding to it.



Investment Implications

The C$ could continue to appreciate but we do believe it has experienced a compilation of positive factors that probably won't persist. The Canadian and U.S. data could continue to diverge, but more likely it will revert. A rally in oil prices would further fuel the C$, we don't expect that. Then there are the speculators. One of our concerns and why we hedged some of our U.S. exposure was due to how many speculators were short the C$ (top chart). When everyone is on one side of the boat, it is often best to go the other way, short term anyhow. Keep in mind this data is released weekly and delayed a bit so the last data point on that blue line was from Tuesday June 13. We will see June 20th data at the end of this week. Our guess is that there has been some big short covering (unwinding) during the past week which has likely exacerbated the rally in the C$.

At 75.5 cents, we are pretty neutral, adding a little on the U.S. side. While not our expectation, if the C$ continued to rally closer to 80 cents we would consider closing out our hedge (clearly wishing we had hedged more). Our base case is this rally in the C$ will fade and we will see a lower exchange rate in the coming months that will offer an attractive point to add to our hedge or trim U.S. exposure.

Charts are sourced to Bloomberg unless otherwise noted.

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