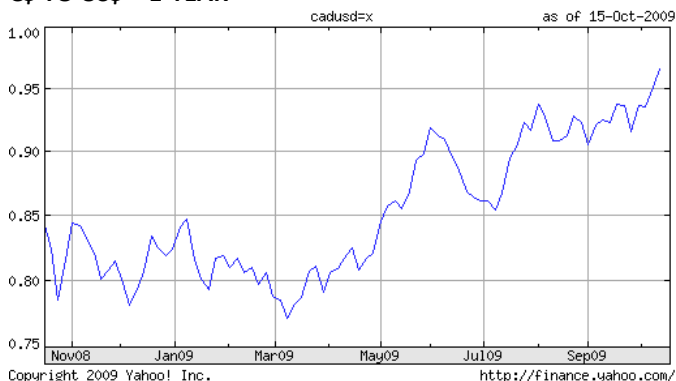


Jawboning the loonie *But rate hike not imminent*

October 16, 2009 – As the Canadian dollar approaches parity with the US dollar, government and monetary poobahs have been taking to the stumps in what seems to be an effort to explain the loonie’s strength. It might also be an effort to jawbone the Canada-US dollar exchange rate down and answer the rampant rumors of a sooner-than-expected increase in the Bank of Canada’s target overnight rate.

That bit of speculation has been making the rounds ever since the Reserve Bank of Australia raised its overnight rate by 25 basis points a couple of weeks ago to head off rising inflation. It’s no coincidence, as conspiracy theorists are so fond of saying, that Prime Minister Stephen Harper pointedly mentioned the strength of the loonie in a speech last Tuesday. He just as pointedly mentioned that Bank of Canada Governor Mark Carney had also recently publicly fretted about the volatility of the loonie.

C\$ TO US\$ – 1-YEAR



Mr. Harper said that while Canada’s economy is stronger than just about all other developed nations, “the governor of the Bank of Canada has been clear that too rapid a rise in the dollar is a risk to our recovery.”

These aren’t just the idle musings of someone with too much time on his hands. We must remember that Mr. Harper is speaking as the Prime Minister of Canada. He is also an economist by trade – an unusual combination for a politician, most of whom are lawyers. As such, he chooses his words with more than extra care when speaking of matters affecting Canada’s monetary policy.

What was most interesting about the way he phrased his comments in terms of “too rapid a rise in the Canadian dollar.” This is not about the loonie moving to parity against the US dollar. We believe that is inevitable. In fact we think the loonie will move well past parity over the next year. The bottom line is Canada has resources that the rest of the world covets and the rest of the world is willing to pay our price to get them.

So when the Prime Minister says; “There are many risks, some of them within our control, some of them beyond our control, and obviously the value of the Canadian dollar is a risk to recovery,” his message to foreign exchange markets is about the speed of the ascent, not the inevitability of the loonie’s ascent.

And it worked...if only temporarily. The Canadian dollar ended last week at about US\$0.96, after spiking to a high of US0.9760

All eyes will be on the Bank of Canada when its governors meet on Tuesday to discuss the fate of the loonie, among other pressing matters. Make no mistake, the BoC will leave interest rates as they are. Most likely, its press release will indicate a more hawkish tone than we’ve been used to. But that need not necessarily be taken as a sign that the BoC would be willing to shorten its self-imposed mid-2010 deadline for its first round of tightening since dropping its target for overnight bank loans to 0.25% back in April.

From a consumer price standpoint, the Bank of Canada has no pressing urgency to raise rates. The September consumer price index rose a minuscule 0.1% month over month in September, giving it an annualized -0.9% reading. Likewise, core inflation rose 0.1% on the month, for a 1.5% year-over-year increase, down slightly from the 1.6% posted in August.

With those all-important (for the BoC) core prices trending downwards for the next few months, with the strong loonie keeping a lid on prices for now, and with economic recovery still in its early stages, it’s hard to imagine a scenario where the BoC would actually follow through with a rate hike before the middle of next year.

In the US, there’s even less taste for contemplating interest rate hikes than there is in Canada. Annual US all-items inflation posted a -1.3% annual decline in September, mostly because of the 21.6% plunge in energy prices. Although recent rises in energy prices will remove that part of the puzzle going forward.

Still, core inflation, excluding food and energy, inched up to 1.5% but remains on a moderating trend. Bottom line, neither inflation nor deflation appear to be a problem just now, making the choice of whether to leave the fed funds rate where it is (near zero) for the long term an easy one.

Meanwhile, the US economy continues to struggle out of the hole. Industrial production rose a surprising 0.7% in September as the final “cash for clunkers” money flows through to the auto sector. Even with those stimulus funds coming to an end, at least until just before the next election cycle, inventory rebuilding is helping to stimulate production,

while the low US dollar provides support for exports. But none of this has shown up in new job creation, and won't likely have an impact for some time. Currently, US unemployment rate is closing in on 10%.

Still, the US housing market is struggling, with only feeble signs of life in new construction. The bulk of the housing market continues to be under pressure by rising defaults, foreclosures, and tight credit, as the high unemployment rate starts to take its toll on middle-income earners.

JPMorgan Chase & Co.'s robust earnings report last week showed that most of the bank's net income gains came from the investment banking side. JPMorgan Chase, the second-largest bank in the US, saw income from its retail division plummet 90% from a year earlier, as it doubled loan loss reserves to \$4 billion in anticipation of further home mortgage losses.

Bank of America reported a \$1 billion net loss in earnings in the third quarter, as mortgage loan losses climbed to \$10 billion. BofA added \$11.7 billion to its reserves. And so it goes. The US banking biz will stay in the dumpster for as long as consumers remain ravaged by the housing market.

After climbing through the 10,000 level last week, the Dow Jones Industrial Average retreated to 9,995.91 at Friday's close, posting a 1.3% on the week overall. Bank loan loss troubles and International Business Machines' negative outlook put pressure on the Dow Industrials by the end of the week. The S&P 500 Composite Index also retreated on Friday, but ended with a weekly gain of 1.5%.

Canada's S&P/TSX Composite Index closed the week just 0.5% above breakeven week over week, as energy issues lost ground and weak US bank earnings weighed on TSX financials. ■

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