

Currency poker

Loonie's strength preoccupies Bank of Canada

October 23, 2009 – Last Tuesday, as expected, the Bank of Canada left the target for its benchmark overnight interest rate at 0.25% – still just barely above zero. The Bank's statement accompanying its rate decision and the release of its quarterly Monetary Policy Report two days later highlighted its continuing concern about the strength of the Canadian dollar. And that tends to shore up the Bank's pledge to keep rates low until June 2010, all other things being equal.

By way of explanation, the Bank said that although an economic recovery is underway in Canada, the volatility and strength of the Canadian dollar "are working to slow growth and subdue inflationary pressures." Signalling its dramatic shift in focus from softening the recessionary blow of the 2008 credit crisis to preventing a relapse, the Bank added, "The current strength of the dollar is expected, over time, to more than fully offset the favourable developments since July." (Emphasis added.) In other words, the loonie at its current value against the US greenback has become a sort of toxic avenger on the recovering health of the Canadian economy.

Indeed, the Bank left its projections for 2010 GDP growth unchanged at 3.0%, despite projecting a slightly higher rate of growth in the second half of this year than it previously forecast. Very likely, the Bank has factored the suppressive effects of continuing loonie strength on exports into its calculations for growth next year. And for 2011, it revised projected GDP growth downwards, to 3.3%, from an earlier forecast of 3.5%.

It may well be that the Bank of Canada is staging a bit of monetary policy theatre with its latest releases. Without actually doing anything – remember, it left its policy rate unchanged – the Bank may well be attempting a head-fake on currency speculators who have been betting on rising near-term rates, bidding up the loonie as a result. By act and by implication, the BoC is saying that no such rate hike is imminent or contemplated in the near term, because neither growth nor inflation prospects in the near term warrant such a move. Perhaps the Bank is hoping that the speculative herd will move away towards currencies of countries where yields are climbing, like Australia, which raised its rate a couple of weeks ago.

If so, the BoC's strategy might work in slowing or halting the loonie's surge towards parity with the US dollar. If not, well, underneath the Bank of Canada's usual central

bank mumblespeak still lies a threat (a bluff?) of more serious intervention, as indicated in Mr. Carney's statement that "the Bank retains considerable flexibility in the conduct of monetary policy at low interest rates," as outlined in previous policy reports.

Currency markets have a way of calling central bankers' bluffs, however, so this little game of "find the loonie" has yet to be fully played out. For example, jawboning has done little to sap the euro of its strength against the dollar, as it recently tested the US\$1.50 level. The Australian dollar, the Japanese yen, and other currencies have all recently gained at the greenback's expense as traders fled US Treasuries for riskier assets when markets stabilized and then rallied impressively since March.

But now that economic growth is taking hold globally, currency markets' focus is shifting back to economic fundamentals and, of course, monetary policy. That may imply a bottoming of the US dollar, and slowly returning strength over the next year. In which case all bets are off.

Increasingly, economic fundamentals are painting a picture of a recovering US economy. The US Federal Reserve Board's Beige Book, an indicator of regional business conditions across the US, showed manufacturing activity stronger in most areas. The housing market appears to have stabilized. And unemployment, of course, remains high, with September's 9.8% figure likely to expand and break the 10% mark in coming weeks.

The US banking sector, on which so much depends, remains fragile. Despite increasing profitability from trading divisions, the banking sector continues to suffer from a combination of rising loan losses and weak demand for business and consumer credit.

What's keeping the banking sector afloat right now is the giant IV bag of easy money flowing into its veins. It's basically what allowed Wells Fargo & Co. to report a record profit in the third quarter, based almost entirely on its mortgage banking business. Morgan Stanley reported its first profit in 12 months, derived from its equity and debt underwriting business.

Stock markets, meanwhile, have been engaged in something of a consolidation pattern for the past couple of weeks, after scaling new year-to-date highs. Third-quarter earnings reports have once again proven the truth of the old traders' maxim, "Buy on the rumor, sell on the news." Largely positive third-quarter earnings reports failed to keep the after-burners on market indexes last week, and most closed below year-to-date highs, with losses on the week.

The S&P/TSX Composite Index ended the week down 1.1%, after touching a year-to-date closing high of 11,538.39 last Monday. Even several recent forecasts for a much colder-than-normal winter for most of the central and eastern portions of North America failed to broadly support Canadian energy issues. Crude oil and natural gas futures continued to rise from expectations of growing demand going into the peak heating season. But crude oil stalled at around US\$80 as the US dollar showed some strength. Canadian energy issues, and resources in general, flagged as the week progressed.

The Dow Jones Industrial Average lost ground for the first time in three weeks, closing the week with a loss of 0.2% after reaching a year-to-date high close just shy of 11,000. While reaching a year-to-date high close of 1,097.91 last week, the S&P 500 Composite Index failed to maintain momentum, and closed down 0.7% from the previous week's close.

As of last week's high-water mark, the S&P/TSX has rallied 55% from its March low with no major correction. The S&P 500 has advanced 65%. That's seven months' worth of bull. We've been urging investors to exercise a little risk mitigation for awhile now. We continue to do so. ■

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