

Loonie in flight

The Canadian dollar has been on a tear over the last year. The loonie increased 7.5% from its March 2020 lows to the end of last year versus a basket of other currencies, including a 14% appreciation versus the US dollar. It is up a further 6% this year on broad-based gains against its major trade partners (+5% versus the USD and euro, 11% against the Japanese yen and 2% for the British pound), putting it at the top of the league table and to levels not seen in six years.

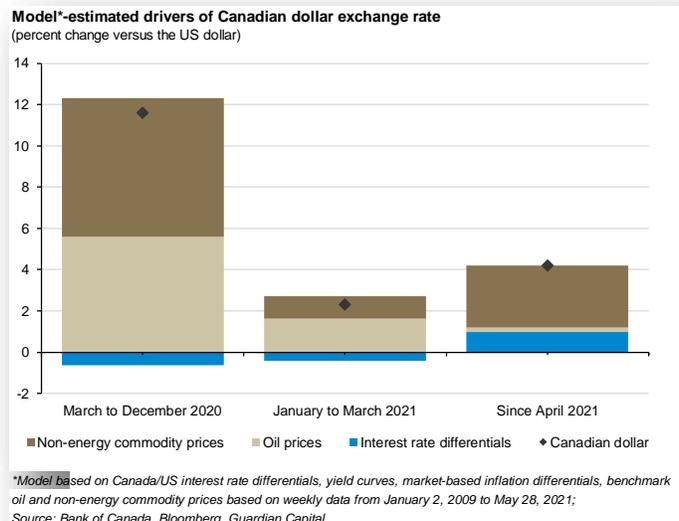


The main driver behind the bulk of the strength through the second half of 2020 and the early months of 2021 was the rally in commodity prices. Long have Canada and its currency's fortunes been closely tied to the natural resource markets, which typically account for roughly half of the nation's exports. While the collapse in demand at the onset of the pandemic drove a plunge in prices, the subsequent robust global economic recovery has seen prices for crude oil rebound to pre-crisis levels (+200% from the end of March 2020), while prices for non-energy commodities (+45% over the same time period) have surged to their highest levels since 2015.

The sustained rise in commodity prices in recent weeks has continued to provide a fundamental underpinning for the soaring loonie, however, there has been another support gaining prominence: interest rate differentials.

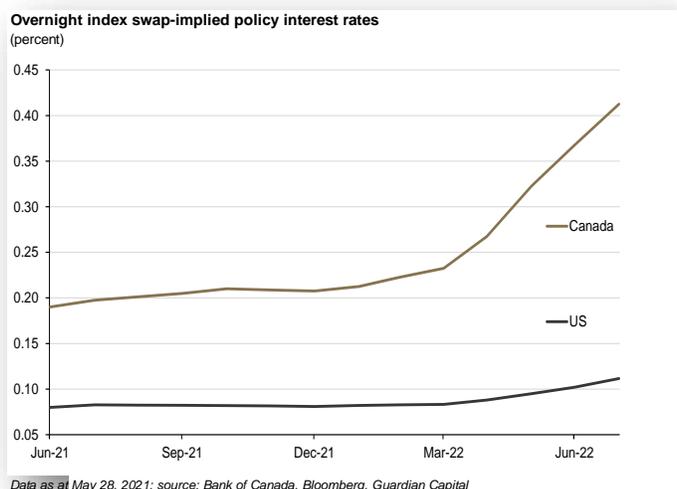
While the pandemic continues to present significant risks to the forecast horizon, expectations for growth in the coming months have been re-rated higher thanks to the combination of surprising economic resiliency amid renewed lockdowns, the steady flow of fiscal stimulus and, perhaps most importantly, progress with vaccination programs.

Indeed, the improved economic momentum forced the Bank of Canada (Bank) to acknowledge that the progress on recovery did not necessarily warrant continually adding stimulus. To that end, policymakers began laying the groundwork for tapering the asset purchase program they introduced in March 2020.



There was also a marked upgrade of the Bank's forecasts in the updated Monetary Policy Report, which implied they would move the start of the hiking cycle forward as well (though this was consistent with market pricing ahead of the event).

For their part, the US Federal Reserve (Fed) opted to make no changes to its policy stance or forward guidance, which reinforced the market's expectation that Canada would move first in tightening up policy. The net result was that the gap between Canadian and American short-term interest rates widened, which made Canadian assets more attractive to investors seeking yield.



Looking forward, models of the exchange rate suggest that there is potential for further increases in the Canadian dollar. With that said, the factors that have provided much of the thrust to the loonie's rally are not expected to provide the same degree of support going forward.

As it currently stands, market forecasts are for commodity prices (both energy and non-energy) to remain fairly range-bound in the coming months as an easing of earlier supply constraints offsets the positive demand backdrop that comes with the economic reopening.

On the monetary policy front, the strength of the recovery in the US is going to drive the conversation at the Fed toward its own exit strategy sooner rather than later and likely

emphasizes that any head start the Bank of Canada has in unwinding its crisis-era stimulus will be short lived.

Additionally, the fact that net speculative positioning in the futures and options markets has swung to its most bullish in nearly two years makes the Canadian dollar vulnerable to downswings in market sentiment, and there is the near-term potential for the loonie, like its namesake diving bird, to take a dip despite the continued underlying improvement in domestic conditions.

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