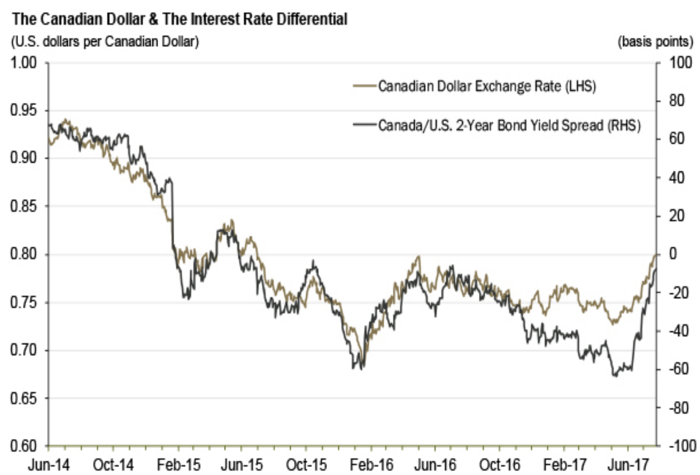
What's up with the Canadian dollar?

The once unwanted and unloved Canadian dollar has seen a reversal of fortunes over the last few months, rallying 10% from its recent trough in early May to breach $0.80 against the U.S. dollar for the first time in two years — and the vast majority of this appreciation has come in just the last six weeks.

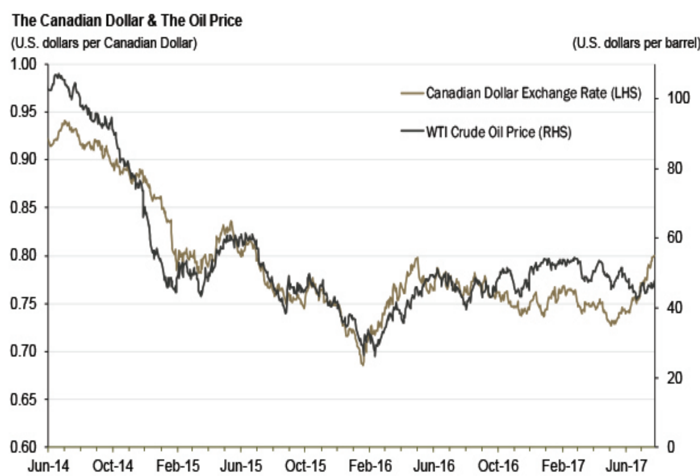
What is all the more interesting is that this resurgence has come in the absence of support for the crude oil price, which has basically been treading water over the period.



The Canadian dollar has traditionally been viewed by many as a petrocurrency, with its fate largely contingent on the price of oil. The tight-knit relationship between the currency and the commodity was perhaps never more evident than when crude began its slide in the summer of 2014, with the Canadian dollar plunging in lock-step with the price of oil.

But while the Canadian dollar saw some recovery in tandem with crude as oil prices stabilized in the middle of 2016, the loonie again faced downward pressure from another source: interest rate differentials.

As the first half of 2016 drew to a close, the Canadian economy was dealt a blow as wildfires shelved activity in the oil patch at a time when the broader economy was struggling to gain traction. Against this, expectations of stimulus akin to the "insurance" cuts to interest rates made in 2015 by the Bank of Canada began to rise. This resulted in a growing gap between interest rates stateside and those in the Great White North, which made U.S. assets look more attractive and drove funds out of Canada at the detriment of the loonie.



The divergence in interest rates was further compounded into the end of last year as the U.S. Federal Reserve signaled its plan to resume its move toward policy normalization. The Fed ultimately hiked rates in December 2016 and followed that up with a move in March and another in June while also projecting at least one more hike before year-end. With Canadian central bankers looking content to sit on the sidelines, the rate differential widened even further and pushing the currency to the year's lows.

But that all abruptly changed. The economic data north of the 44th parallel proved to be persistently solid, prompting the Bank of Canada to do a sudden and unexpected about face in the middle of June, hinting that not only may a reversal of 2015's rate cuts be warranted, but the moves may come sooner rather than later. Markets rapidly adjusted their expectations for interest rates in Canada, driving a narrowing in rate spreads and consequent strengthening in the loonie, and on July 12th the Bank raised the overnight rate for the first time in seven years.

The prospect of further hikes from the BOC, perhaps beyond removing the emergency cuts of 2015, in the context of the Fed looking as though it will hit pause could see the currency fly higher.

Importantly, however, a lot is already in the price and those in the market wagering against the Canadian dollar have covered their bets over the last 6 weeks, meaning that a lot of the heavy lifting has already been done. Add to this the fact that the oil price is likely to remain range-bound, as well as the uncertainty over what will come from Washington with respect to re-writing trade policy, there is scope that the loonie, like its namesake diving bird, to take a dip despite the underlying strength in domestic conditions.