THE FORTNIGHTER

May 15, 2015 – Issue #39

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The topic of the last couple of issues of the Fortnighter has been currencies – specifically, the nice gains that Canadian investors have experienced over the past few years if their portfolios contained at least some exposure to the U.S. dollar.

Well, what goes around comes around. The U.S. dollar has NOT been the place to be over the past quarter – in fact, having U.S. exposure has actually been a drain on portfolio performance.

It may surprise you to hear that since bottoming at about 78 cents U.S. a couple of months ago, the Canadian dollar stands today at a bit over 83 cents U.S. – a huge reversal in currency terms. That's about a 6 ½% move in only 2 months!

To put this in perspective, if you had a portfolio with a 25% weighting in U.S. stocks or securities, the move in currency alone would have knocked about 1.6% off your rate-of-return for the quarter (when looked at in Canadian dollar terms). No wonder the quarter looked so lackluster.

This raises a couple of questions for Canadian investors. First of all, why did this happen? And second, is this a "trend" that is likely to continue, or some short term aberration in a longer term pattern?

The "why" question is simply supply and demand. Currencies rise when investors disproportionally buy them (so that they can purchase assets in a particular country). If an investor is positive on the U.S. market or economy, they need U.S. dollars to purchase U.S. assets. Demand goes up and so does the currency. Interest rates are a key component of this. If investors believe that interest rates are going up in a country, or the rate that they can get on a country's bonds are higher than they are in another jurisdiction, money flows to that higher interest-rate country. In fact, many investors engage in something called a "carry trade" where they borrow money in a low-yielding currency (like the Yen) to put it into a higher-yielding currency (like the U.S. dollar). In the major currencies, the value of these transactions is huge.

Back to the U.S. EVERYONE is watching what the Federal Reserve is doing because at some point in the next while, the Fed is raising rates. Earlier in the year, the market believed that the Fed was going to raise rates early in 2015, attracting money to U.S. and away from other currencies like the Canadian dollar. Hence, a "falling" Cdn$.

Now, the market generally believes that the Fed won't be raising rates till at least the fall and perhaps even into early 2016. This has caused a large exodus of money out of the U.S. and into other assets, driving down the currency. Hence, a "rising" Cdn $.

This suggests that money will likely come back to the U.S. when the Federal Reserve finally initiates its tightening cycle. We could very well see the Canadian dollar back into the "high 70s" at this point and maybe even lower – once again providing a nice "tail wind" for U.S. focused portfolios.

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