RBC Dominion Securities Inc.
July 2017

Burden of expectations could limit the loonie's flight

A special report by the Portfolio Advisory Group

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All values in Canadian dollars and priced as of July 21, 2017, market close, unless otherwise noted.

For important disclosures, see page 7.

Wealth Management
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Burden of expectations could limit the loonie's flight

The loonie has been soaring amid growing optimism for the domestic economy and prospects for tighter monetary policy from the Bank of Canada. We weigh the factors that could propel the loonie further or clip its wings, and conclude that there is a strong set of arguments that suggests upside from current levels may be difficult to achieve.

The recent sharp move higher in the Canadian dollar reflects a fairly optimistic view of the economy and expectations of meaningful interest rate hikes from the Bank of Canada (BoC). We believe the unwinding of a significant short position in the Canadian dollar has contributed to the magnitude of the move and we recommend investors use the Canadian dollar's strength as an opportunity to add U.S. dollar and foreign currency exposure. A rebound in commodities, continued sluggishness in U.S. inflation, and a lack of progress on U.S. tax reform could extend the recent rally in the loonie.

However, we see a stronger set of arguments that suggests upside from current levels may be more difficult to achieve. Namely, high debt levels may curtail the BoC's ability to meaningfully raise interest rates through next year, especially as regulators mull tighter mortgage regulations which could dampen the need for rate hikes. Moreover, a further rally in the Canadian dollar could be self-limiting because of the negative impact a stronger Canadian dollar would have on exporters.

BoC policy shift spurred a surge in the loonie

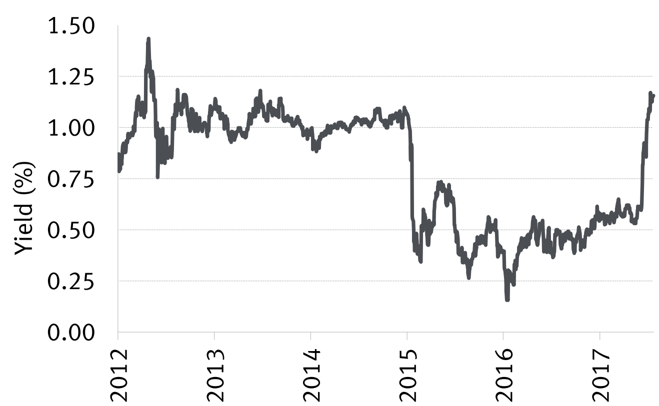
The Canadian dollar currently sits at a nearly 2-year high at US$0.80, following a 9% rally since early May as the market adjusted to an evolving message from the BoC. In a matter of six months, the central bank has shifted from having a rate cut 'on the table' in January, to implementing a 25 basis point (bps) rate hike in July. This shift in policy prompted a radical adjustment in market expectations and the Canadian dollar has been the best-performing currency amongst its G10 peers since May.

The market is pricing in a second 25 bps rate hike coming from the BoC in October, and the overnight rate reaching approximately 1.5% by mid-2019. As recently as early June, consensus among both market participants and forecasters was that the BoC would not begin hiking rates until mid-2018. We believe the BoC will need to not only raise rates, but also convince the market we are getting more rate hikes than are currently priced in for there to be a continuation of the recent moves higher in short-term yields which have translated into a stronger Canadian dollar.

Market is pricing in more rate hikes and that is reflected in a higher 2-year Government of Canada bond yield

2-year Government of Canada bond yield

9-month forward BoC overnight rate expectation



Source - RBC Dominion Securities Inc., Bloomberg; data as of 3:58 pm GMT 7/24/17

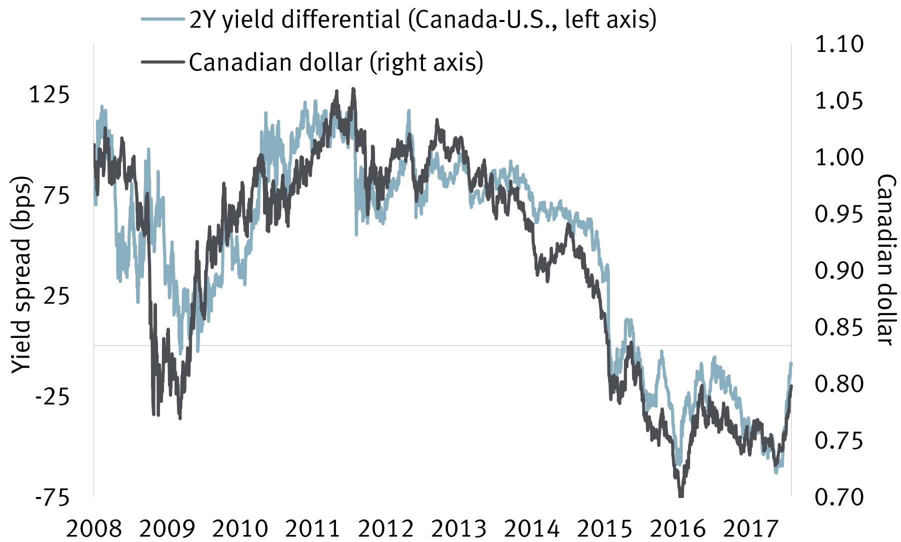
Higher short-term yields help lift the loonie

The bond market has responded aggressively to the shift from the BoC over the past month, with the yield on the 2-year Government of Canada bond having moved more than 60 bps higher. Short-term interest rate differentials play an important role in currency valuations as capital tends to flow wherever it earns the highest return (provided the destination offers a stable inflation and economic outlook).

Accordingly, the Canadian dollar has been a beneficiary of the recent move higher in interest rates. Canadian 2-year bonds still yield less than their USD counterpart, but the extent to which Canadian bonds yield less than U.S. bonds has compressed dramatically over the last six weeks. Historically the 2-year yield differential and the Canadian dollar have traded in sympathy with each other and that trend has continued as the BoC-induced bump in short-term bond yields was mirrored by a move higher in the Canadian dollar.

Higher relative yields on shorter-term CAD bonds versus USD bonds have helped lift the Canadian dollar

Canadian dollar versus CAN-U.S. 2-year spread



Source - Bloomberg, RBC Dominion Securities Inc.; data as of 7/21/17

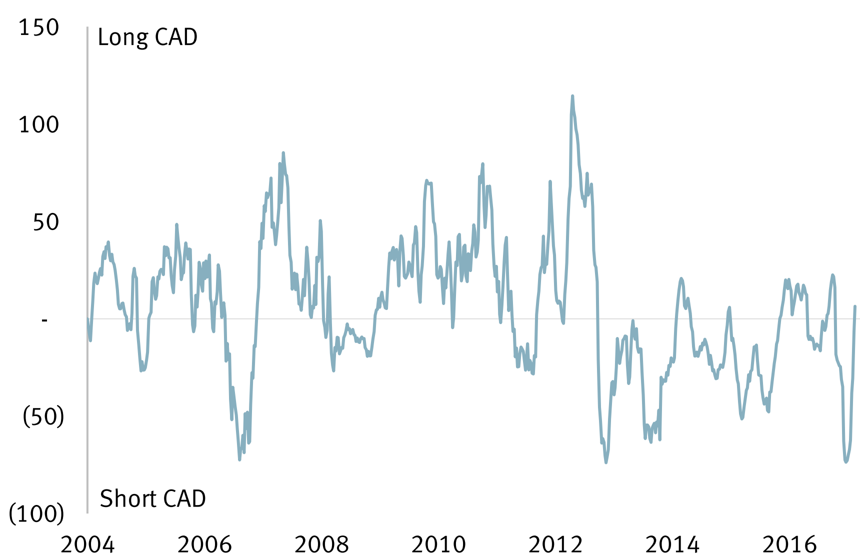
Short covering may have played a role in the sharpness of the Canadian dollar's rally

The loonie's recent strength comes after a large net short position had been built in the currency, which left it vulnerable to a positive surprise. A large net short (or long) position has limited directional predicative power, but it does create a vulnerability to a sharp move in the opposite direction to the crowded trade. This generally occurs when news emerges that runs counter to how the majority of market participants are positioned.

The Canadian dollar shorts first felt the pain in June following comments from BoC Governor Stephen Poloz that suggested that the 2015 interest rate cuts had 'done their job' and the BoC was ready for 'a new policy decision.' A second wave of short covering came after the BoC's July 12 meeting when the central bank signaled the start of a tightening cycle focused on normalizing interest rates, rather than simply reversing the twin 25 bps rate cuts from 2015. With the Canadian dollar positioning now more neutral, we think demand for the loonie driven by short covering may be less of a driver going forward.

Reversal of large short position has coincided with Canadian dollar strength

1M net non-commercial CAD positions



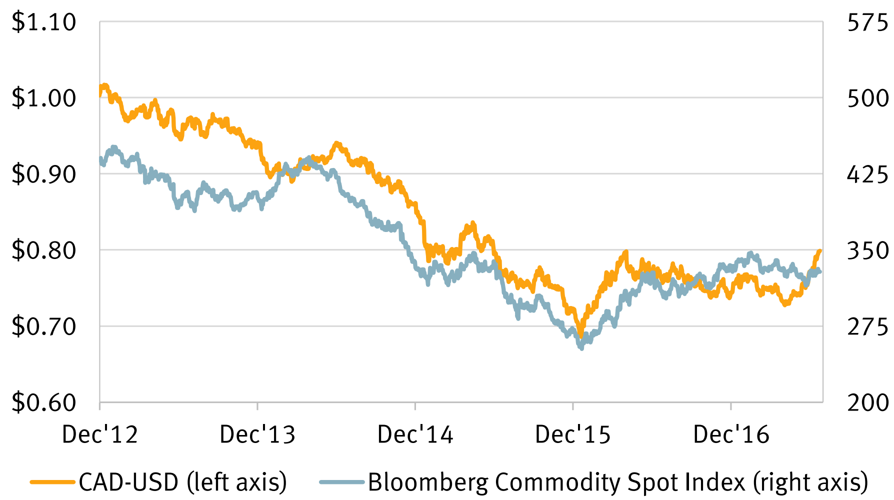
Source - Commodity Futures Trading Commission, Bloomberg; data as of 7/14/17

What could drive the loonie even higher?

A follow-through from the rebound in commodity prices

Stabilization in the commodity complex last year helped bolster confidence in the currency. But commodities have been in consolidation mode recently even as the Canadian dollar has carved out fresh highs. Within the commodity complex, crude oil prices tend to have the largest impact on the Canadian dollar and have been the most important driver in recent years next to interest rate differentials. Oil is firmly in the middle of its recent US$40–$55 per barrel trading range, but a supply disruption or a geopolitical development could push oil toward the upper end of this range and extend the recent phase of Canadian dollar strength.

Commodity prices have recently stalled as the Canadian dollar marches higher



Source - Bloomberg, RBC Dominion Securities Inc.; data as of 3:58 pm GMT 7/24/17

Growing uncertainty for tax reform in the U.S.

Tax and health care reform have been two sources of political uncertainty through 2017. The Republican majority government has not been able to pass its proposed repeal of the Affordable Care Act. The potential exists for market participants to start to question whether the government will be any more successful with tax reform, which arguably may have more consequences for the growth and inflation outlooks in the U.S. Growing uncertainty on this front could further pressure the U.S. dollar and result in more upside for the Canadian dollar.

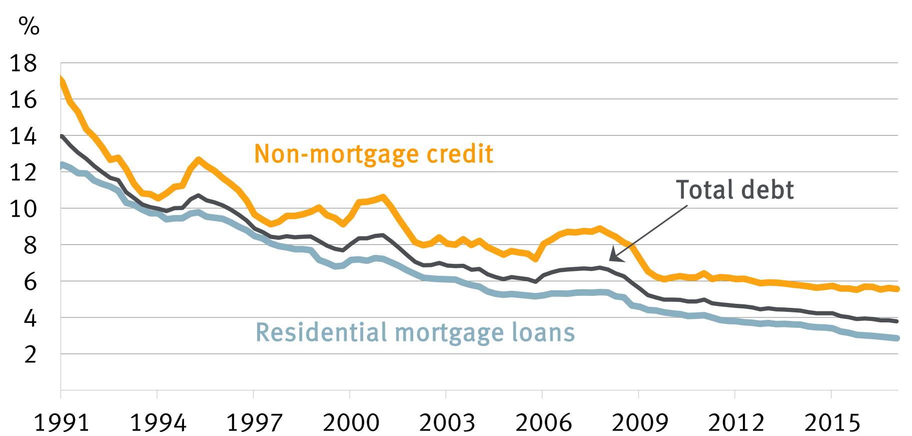
What could limit further upside or weigh on the loonie?

High levels of household debt could tie the BoC's hands

Elevated household debt could constrain the BoC's ability to meaningfully increase interest rates and embark upon a traditional tightening cycle. A shallower-than-expected tightening cycle could limit the extent to which short-term bond yields rise, which could cap the upside on the Canadian dollar.

A closer look at the evolution of Canadian household debt over the last 10 years points to a heightened amount of borrower sensitivity to interest rates. An approximate 300 bps decline in the effective interest rate over the last decade means that Canadian households are outlaying

A lower effective borrowing rate has enabled Canadians to carry more debt without higher interest payments



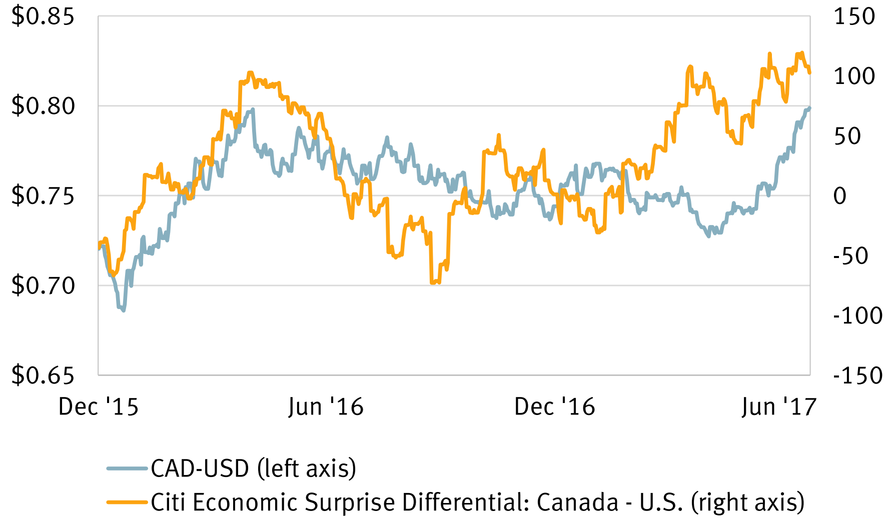
Year	Household debt	Interest paid on outstanding credit balances	Effective rate
2007	$1,230B	$82.41B	6.70%
2017	$2,040B	$77.52B	3.80%
Change	$810B	-$4.89B	-2.90%

Source - Stats Canada, RBC Economics, RBC Dominion Securities Inc.; data through March 2017 less in annual interest payments in 2017 than they were in 2007, despite carrying nearly twice as much household debt 10 years later. A relatively modest move higher in interest rates would have a significant impact on today's much larger balance of outstanding debt.

Market-based expectations for future rate hikes are higher in Canada than in the U.S.

Markets are pricing in more hikes in Canada than the U.S. over the next 12 and 24 months. This stands in stark contrast with RBC Capital Markets' most recent forecast which calls for three rate hikes from the BoC over the next 18 months, but five hikes from the Fed over the same time period. If the RBC Capital Markets view plays out, that would likely result in a weaker Canadian dollar.

Economic surprises in Canada have recently ran ahead of those in the U.S.



Source - Bloomberg, Citigroup, RBC Dominion Securities Inc.; data through March 2017

Despite the recent string of softer U.S. economic data compared to improved readings in Canada (see chart), we believe the U.S. economy is better equipped to handle higher short-term interest rates than the Canadian economy as its labour market boasts lower unemployment and higher wage growth, which filters through to a higher inflation profile for the broader economy. RBC Capital Markets is forecasting 2.8% GDP growth in the U.S. in 2018 versus 2% in Canada in 2018.

Regulator-imposed tighter lending standards could reduce the need for rate hikes

Concurrent with the BoC rate hike in early July, the banking sector regulator (Office of the Superintendent of Financial Institutions) released a draft proposal for mortgage underwriting guidelines that contained a number of provisions that could cool mortgage originations. While this is only a proposed policy at the moment and much uncertainty exists, RBC Capital Markets recently noted that the adoption of some or all of the measures included in the draft guidelines could reduce the availability of mortgage credit. We believe this variety of tightening could reduce the need for the BoC to increase interest rates going forward.

A strong Canadian dollar is a headwind for an already struggling export sector

Despite raising rates, the BoC lowered its export projections in 2018 and 2019 in the *July Monetary Policy Report*. The Canadian dollar is nearly at both purchasing power parity and its long-term average after the recent rally and incremental strength would pose a headwind to Canadian exporters.

NAFTA renegotiations: A wild card for the Canadian dollar

The Trump administration recently laid out plans to renegotiate NAFTA and meetings could start as soon as August. Canada has a more balanced trade relationship with the U.S. than Mexico so these negotiations appear to present a higher risk profile to Mexico relative to Canada. Nevertheless, these negotiations represent a source of event risk to the Canadian dollar that could resolve itself in either direction depending on the outcome of the negotiations. RBC Capital Markets views these negotiations as a source of downside risk to the Canadian dollar.

Closing thoughts: Longer-term weakness likely

Our partners at RBC Global Asset Management and RBC Economics are both forecasting a weaker Canadian dollar over the medium term.[1] We concur with this view and regard the Canadian dollar move as an opportunity for investors to add U.S. dollar and foreign currency exposure. Strength in commodities or continued gridlock in Washington are two of the more meaningful drivers that could help propel the loonie higher in the near term. But from a longer-term perspective, we think the Canadian dollar already reflects an optimistic view of the direction of the economy and expectations of meaningful interest rate hikes from the BoC. We think the burden of expectations could eventually weigh on the currency.

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[1] The 12-month forecast from RBC Economics is US$0.7576 and the most recent 12-month outlook from RBC Global Asset Management is US$0.6944. Click here for the RBC Economics forecast (published on June 30) and click here for the latest RBC Global Asset Management forecast (published on June 1). Click here for the most recent report video from George Davis, RBC Capital Markets, LLC's chief technical analyst, fixed income and currency strategy.

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