Wealth Management
Dominion Securities

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# Canadian currency update

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It is important to note that economic growth in Canada has surprised all economists by its strength since the beginning of the year. The likelihood of a rate hike by the Bank of Canada at the start of the year was virtually non-existent. However, today we find ourselves already with two rate hikes and a probable third one next month. The Federal Reserve, meanwhile, did not move a bit, although a rate hike in December is not impossible (the current probability of a Fed interest rate hike before year end is 35%).

It is assumed that the Canadian dollar is mainly influenced by the price of oil, which is partly true. But beyond oil, the main influence of the currency is the difference in interest rates between Canada and the United States. The strong economic growth in Canada in 2017 caught the market by surprised. So rather than observing rate hikes by the Federal Reserve in 2017, it was the Bank of Canada who surprised the market and the economists by increasing the interest rates. Which explains the rapid rise of the Canadian dollar. In the United States, the element that has put a brake on the Federal Reserve's rate hikes is the decline in the economic momentum that was predicted following the election of Donald Trump.

How has the strong appreciation of the Canadian dollar affected your portfolios? One of the main impact was a lower rate of return of the US portfolio when reported in our local currency. In fact, the year-to-date return for the S&P500 as of August 31, 2017 is 11.93% in US dollar terms but for a Canadian investor, the return is 4.10% when the currency is taken into account. The S&PTSX (Canadian market) has risen by only 1.35% since January 1, 2017. The combined performance of a 50% S&PTSX / 50% S&P500 portfolio for a Canadian investor would have been 2.72% since the beginning of the year meanwhile our stock portfolio is up 4.60% over the same period.

The depreciation of the Canadian dollar in the recent years has enabled us to record excellent returns with our overseas investments. The recent volatility of the currency is unfavourable to our short-term performance, but we remain convinced that US and foreign markets offer great long term potential. Our philosophy is to find companies that are well managed and that will reward our investors. In an investment diversification philosophy built around reducing risk in portfolios, we must seek outside our borders investment opportunities in sectors that are underrepresented in our Canadian market. Indeed, some sectors of the economy do not exist in the Canadian stock market or consist of merely few companies, such as the healthcare, technology, consumer and industrial sectors. In fact, 70% of S&PTSX's market capitalization is concentrated in only three sectors: financials (banks and insurance companies), energy and metals. For this reason, we will therefore retain an approximate 50% weighting in foreign markets (mainly in the United States).

Where are we with the appreciation of the Canadian dollar? Our strategists believe that a final rate hike in Canada is likely in December if not next month. The market is already anticipating one last rise by the end of 2017 (with a current probability of 75%). Our strategists also indicate that the Bank of Canada could then take a break until the second quarter of 2018 to give time to the economy to digest the rate hikes of 2017. They forecast that the probability of a Federal Reserve rate hike in December 2017 is greater than what the market is currently pricing. They even went out on a limb and said that it is possible that the Federal Reserve raises its rates every quarter in 2018. Under this scenario, the appreciation of the Canadian dollar could come to an end.

We continue to monitor these events closely.

Sincerely.