

Weekly Perspectives

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A Weekly View of Global Economies

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When the Canadian dollar was plummeting, several years ago, there were jokes about the diving loonie. The situation has changed considerably since then, and now there are plenty of remarks about the flying loonie. For those not in the know, the popular name given to the Canadian currency is derived from the Loon, an aquatic bird whose image graces the dollar coin along with the queen's visage.

In the past few years, the CAD has appreciated dramatically from the lows reached in 2002. More recently, it has experienced a sharp appreciation that cannot be counted as being unique to the Canadian currency. It is part of the increasing aversion that investors have been demonstrating towards the US dollar. Lowered expectations of interest rate increases in the US, better prospects of growth as well as rate rises elsewhere, concerns about American structural deficits and fears of even greater political risk regarding US strategy in the Middle East have all played their part.

Given how high it has already flown, what's the general outlook for the loonie? We'll examine the case from a fundamental perspective. But we shouldn't forget that exchange rates are also determined on the basis of technical and psychological factors, particularly in the short run. In making trading and investment decisions, a professional approach is to analyse fundamental, as well as technical and sentiment indicators. And the shorter the time frame, the more important are the latter two categories.

Getting back to the fundamentals, one measure of a currency's fair valuation is its relationship to purchasing power parity (PPP). Many people will be familiar with the Economist magazine's famous Big Mac index which establishes PPP exchange rates based on hamburger prices in various countries. Of course, there are fancier ways of measuring purchasing power using a basket of goods, but the principles are the same. Using this method, the loonie is now somewhat overvalued versus the PPP rate.

However, that is not going to stop it from diverging even more from fair-value calculations. Currencies normally overshoot or undershoot PPP substantially and stay that way for years on end. The great value of using PPP is when a currency has overshot the mark considerably and, simultaneously, a number of other indicators are beginning to signal a turn -- which is what happened in 2002.

Turning to the balance of payments, Canada benefits from a substantial current account surplus as a proportion of GDP. This is definitely a positive factor, given that its largest trading partner, the United States, is running very large deficits.

There is another factor that is less supportive, namely the interest rate spread. The negative spread vis-à-vis the US has been widening and is larger than it has been for many years.

One measure of international competitiveness that analysts examine is the real effective exchange rate, which takes into account price

changes, as well as weighted exchange rates against all trading partners. Currently, the sharp rise in the value of the Canadian dollar is reducing competitiveness.

Looking at the economy's productivity performance, it has been notably poor relative to the United States in recent years. What's more, it doesn't look like the trend is reversing. In contrast, during the 1970's Canadian productivity was outpacing the US.

Of course, an important reason behind the appreciation of the Canadian dollar has been the boom in commodities and energy. A good deal of money has been pouring into Canada for this reason. If the likes of Jim Rogers are right and we are still in the midst of a multi-year commodity boom, then over the longer run the loonie should continue to find support from this source.

But, in the short term, if the global economy comes off the boil in the second half of the year, then commodities, as well as oil, may be due for a degree of correction. And this will most likely affect the CAD.

Furthermore, the Canadian economy is closely tied to the United States. A slowdown in the south will be reflected north of the border, reducing the current account surplus. As for the manufacturing sector, the rapid currency appreciation has made it increasingly tough for it to compete.

The loonie's rise has effectively tightened monetary conditions. Because of the degree of openness of the economy, changes in the exchange rate have a bigger impact than they have for a relatively closed economy such as the United States.

In considering the lagged effect of monetary policy on the economy, the Bank of Canada certainly monitors the exchange rate, as well as economic prospects for the US. Consequently, it may be less aggressive in introducing further interest rate increases.

So, putting it all together, from a fundamental perspective further upside for the Canadian dollar is likely to be limited. At the same time, there is little reason for a significant pullback. But it is not as simple as that. Bearish sentiment towards the greenback isn't waning. In addition, political risk associated with the US dollar may incite investors to look for safe-haven countries. And those with current account surpluses will be favoured.

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