Laurentian Bank Securities
ECONOMIC RESEARCH AND STRATEGY

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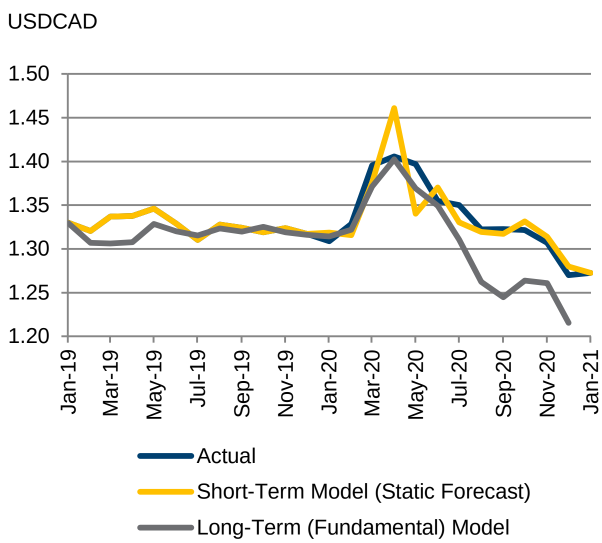
Despite the rally, the Canadian dollar remains undervalued relative to its fundamentals

In the final three months of 2020, the loonie gained ground at a fast pace against the greenback. It averaged 1.27 in December and briefly touched 1.26 in the later part of January, its strongest level since April 2018, peak of the previous global manufacturing cycle. One oft-cited reason behind the rally was the general weakness of the U.S. dollar, declining around 4% in the fourth quarter of 2020 as measured by the DXY. The positive results from coronavirus vaccines' late-stage trials announced in early November certainly played a role in this global foreign exchange movement: the foreseeable end of the pandemic would pave the way for a cyclical economic upswing. The Bank of Canada (BoC) took note, flagging the loonie's strength as a potential headwind to Canada's international trade position. However, beyond the broad-based U.S. dollar weakness fuelled by this "reflation trade", our short-term model reveals that non-energy prices formed the largest contributor to the 3% Canadian dollar appreciation in December (chart 1 and 2).[1] In fact, the global demand for materials remained strong with all components of the BoC commodity price index ending 2020 on a strong note, thanks particularly to China's commodity imports (chart 3). Closer to home, a reduction of U.S. softwood duties on Canadian forestry producers, scarcity in lumber supply and strong demand for residential construction led to a 21% increase in forestry prices in December.

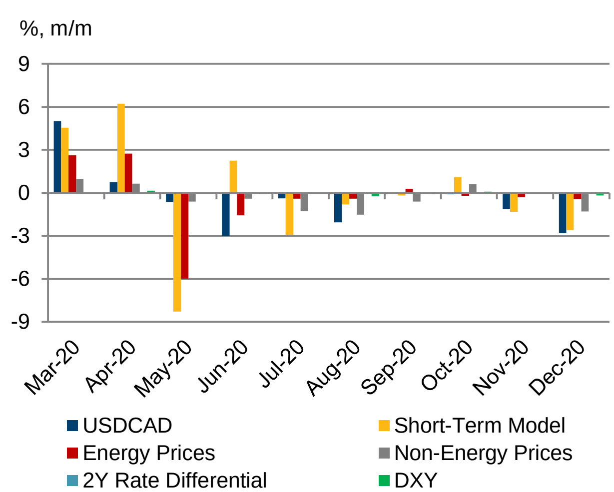
Higher energy prices also contributed to the improved valuation, but to a lesser extent than in May and June when the Canadian dollar erased most of its early-2020 losses. The BoC energy commodity price index gained 6% in December as WTI crude oil prices averaged US$47, almost completely erasing its losses earlier in 2020. Finally, the Canada-US 2-year interest rate differential, a proxy for expected policy divergence between the BoC and the Federal Reserve, remained insignificant and largely unchanged for a 12th consecutive month. Indeed, after lowering their target for the overnight rate near zero and ramping up bond purchases in response to the pandemic, both central banks consistently pledged to keep rates at these depressed levels for many years. As a result, expected policy divergence did not play a significant role in the loonie's fluctuations last year.

Chart 1: The Canadian dollar remains undervalued



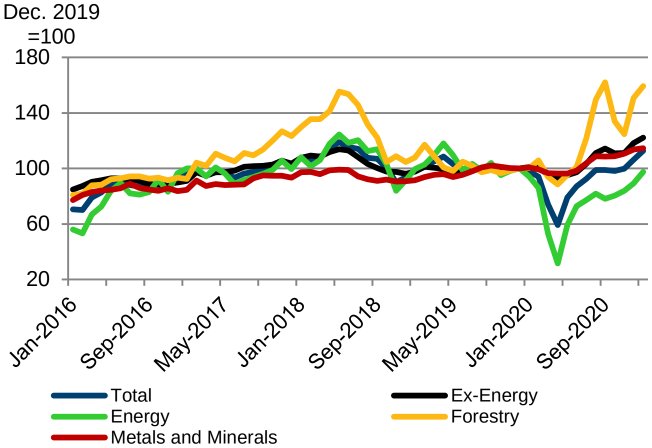
Source: LBS Econ. Res. and Strategy.

Chart 2: Contributions to monthly variations in the Canadian dollar



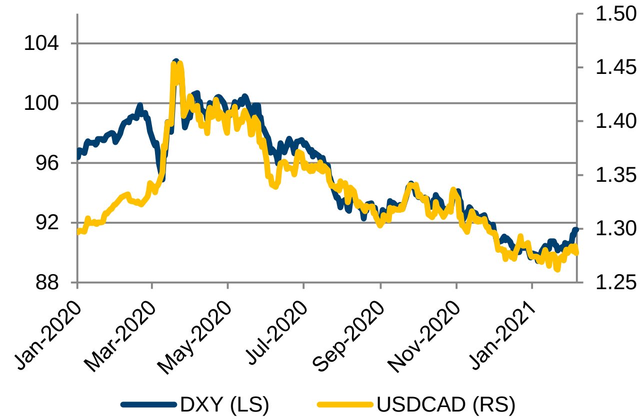
Note: Variables represented as contributions to % m/m change in short-term model, excluding the error-term.
Source: Bank of Canada/Haver, Refinitiv, LBS Econ. Res. and Strategy calculations.

Chart 3: Commodity prices benefit from the "reflation trade"



Note: Last data point is January 2021.
Source: Bank of Canada, LBS Econ. Res. and Strategy.

Chart 4: Biden's stimulus package helped the greenback in early 2021



Note: Last data point is February 5.
Source: Refinitiv.

The U.S. Dollar firms up in January – Our forecast remains mostly unchanged

As mentioned in our 2021 outlook, we interpret the late 2020 movement in the USDCAD as a front-loaded reaction to the upcoming end of the pandemic. Most of the future global recovery has now been priced in. In early 2021, following President Biden and the democratically-controlled U.S. Congress' intention to pass a US$1.9T stimulus and relief package through the budget reconciliation procedure i.e. without Republican support, the U.S. dollar gently rallied (chart 4). The Canadian dollar consequently stabilized around 1.28. Considering that a gigantic U.S. stimulus and a faster vaccine rollout so far could lead to an over-performance of the U.S. economy relative to Canada, we slightly increase our USDCAD forecast from 1.23 to 1.25 for the end of 2021Q1 and leave it unchanged at 1.22 in 2021Q2. Our year-end 2022 1.25 forecast is unchanged but the delay in Canada's vaccination campaign relative to the U.S. poses a downside risk to the loonie.

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[1] Our short-term model decomposes the monthly USDCAD variation between energy prices, non-energy prices, the DXY and short-term Can-US interest rate differential. The model generally tracks well the monthly variation in the currency, but also misses the magnitude and direction from time to time. This reflects other events that affect the currency not currently captured in the model. The long-term (fundamental) value is derived from the Canadian dollar's long-term relationship with energy and non-energy commodity prices. The long-run value is not a forecast, but rather an informative tool about the valuation of the Canadian dollar.