Thackray Report

Canadian Dollar – Is it set to Outperform the US Dollar?

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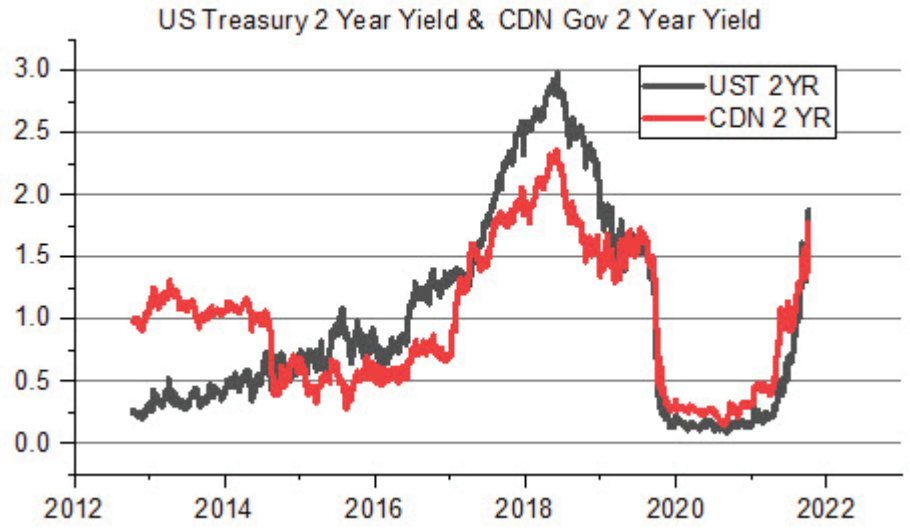
Is the Canadian dollar about to outperform the US dollar? The aggregation of evidence suggests that this is the likely case in the short-term.

The Canadian dollar went nowhere when oil prices were rising from the beginning of December 2021 into March 2022. What is next?

The Canadian dollar is often labelled a petro-currency because of its value's close relationship with the price of oil. There are other variables that have an impact on the Canadian dollar. Another major influence on the Canadian dollar is the differential between the spread of the 2 Year Canadian government bond yield and 2 Year US Treasury Note yield. If the Canadian 2 year yield is outpacing the US 2 year yield, this is typically favorable for the Canadian dollar and vice versa. On average, over the long-term, the price of oil and yield spread are two of the biggest drivers affecting the Canadian dollar.

Rising 2 Year Yields - Equal impact in Canada and US

Recently, the 2 year yields in both Canada and the US have been rising at the same rate as shown by the graph below. In other words, rising rates in both Canada and the US have not played a major part in determining the relative value between the Canadian dollar and the US dollar.



Rising Oil Prices Pushing Up the Canadian Dollar Countered by Risk-Off Move in Markets

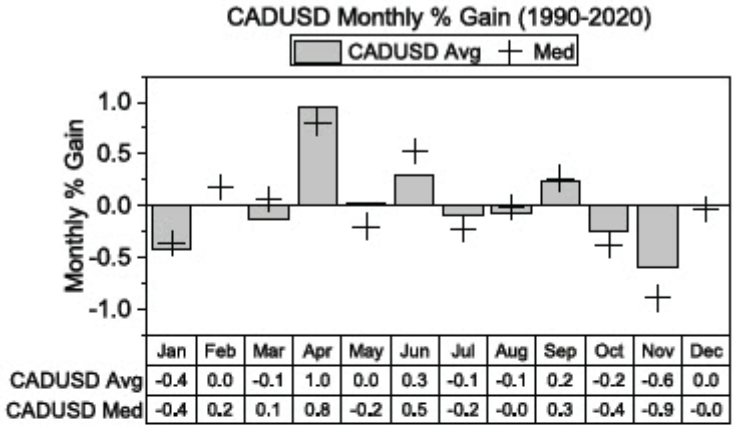
The price of oil has been rising rapidly, which usually pushes the Canadian dollar higher. However the Canadian dollar has been trading sideways relative to the US dollar since December 2021. When a comparison is made between the performance of the Canadian dollar versus the US dollar, and the US dollar versus world currencies, the Canadian dollar has been performing relatively well compared to world currencies.

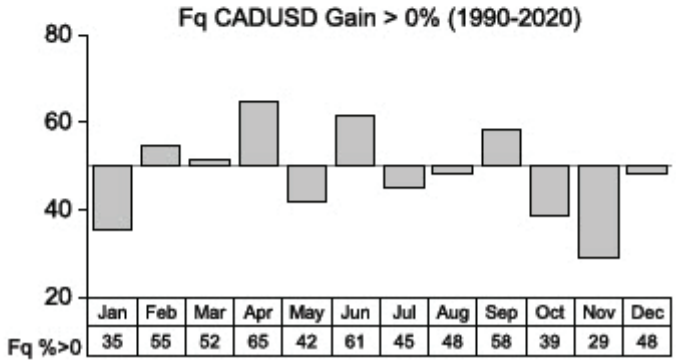
When the stock market shifts to a risk-off mode, investors are attracted to safe-haven investments. The US dollar is considered to be one of the major safe-haven investments. As the stock market has been falling in 2022, the US dollar has been rising and the Canadian dollar has been relatively flat versus the US dollar. In a cross relationship, the Canadian dollar has been outperforming world currencies. Given the risk-off environment that has been occurring in the markets, the Canadian dollar has been performing relatively well, despite not outperforming the US dollar.

The graph below shows the relationship between the Canadian dollar versus the US dollar, US dollar vs World Currencies, S&P 500 and West Texas Intermediate Crude. In 2022, the USD has been outperforming world currencies ②. At the same time, the Canadian Dollar has been "flat" relative to the US dollar ①. Rising oil prices ④ should have pushed the Canadian dollar higher. However, the S&P 500 has been correcting ③, creating a risk-off environment helping to support the US dollar. The net result of the competing factors has been a flat Canadian dollar versus the US dollar ①.

Seasonal Trends Favor the Canadian Dollar at this Time - For Now

On a seasonal basis, the Canadian dollar tends to perform well from March 15 to April 30. On a monthly basis, April stands head and shoulders above all of the other months for the strong performance for the Canadian dollar. In the graph below, from 1990 to 2020, the Canadian dollar has produced an average gain of 1% and has been positive 65% of the time.





One of the reasons that the Canadian dollar performs well in April, is that oil tends to perform well in April. However, even in years when oil is not positive in April, the Canadian dollar tends to perform well, just not as strongly as when oil is increasing during the month. If you had to invest in the Canadian dollar for only one month of the year, on a seasonal basis it would be April.

Technicals - Close to a breakout for Canadian dollar?

Technically, the Canadian dollar has bounced off its support line at $0.78 CADUSD. It is now poised to break above its downward trend line of lower highs, which is a positive development, indicating that the Canadian dollar could move higher, possibly up to $0.83 (the high of 2021) under favorable conditions. Technically, most investors would wait for the breakout above the downward trend line before taking a position long the Canadian dollar. However, before the start of a strong seasonal period, legging into a position ahead of a break above a trend line can be profitable. In other words, a break above the downward sloping trend line would reaffirm a positive trend for the Canadian dollar.

Canada's budget could have a negative impact on the Canadian dollar

Government debt....about to matter?

A long, long time ago, government debts mattered and had an influence on currency values. When countries went deeper in debt, investors perceived this as borrowing from the future and as a result slower growth was expected in the future. Investors also believed that larger government spending resulted in a less productive economy. The net impact of large deficits and debts was a weaker currency.

Fast forward to today's "reverso world" where everything is opposite. It is now largely believed that government spending is good for the economy and helps strengthen the currency and no one seems to worry about productivity any more. The switch to the "reverso world" viewpoint was largely funded by the trend of declining interest rates and the lack of consequences of money printing.

Well, things are changing. Central banks are in a hiking cycle and as interest rates increase, the cost of government debt is going to weigh on society and currency values. The US is politically in a semi-gridlock position in regards to government spending. With the US mid-term election coming in November, not much is expected to change and it is expected that no new large spending programs will be announced in the US. However, Canada is a totally different story.

The Canadian Liberal and NDP parties just announced a coalition as I was finishing this report. This means that Canadian government spending that is already out of control is going to get worse. This is going to have a negative impact on the Canadian dollar, maybe not right away, but over time it will push the value of the Canadian dollar lower.

The Canadian federal government is expected to release a budget in April. Given the newly minted coalition between the Liberal and NDP party, Canadians should probably expect more government spending. This might not have an immediate negative effect on the Canadian dollar as we have not transitioned out of "reverso world" yet, but increased government spending is not expected to be a positive for the Canadian dollar.

Conclusion:

Longer term the Canadian dollar has substantial head-winds that it is fighting. In the shorter-term the risk-off trade has been weighing on the Canadian dollar and counter balancing the effect of increasing oil prices. Given that the Canadian dollar is on the door-step of its strongest month on a seasonal basis, April, if oil continues its upwards trajectory and the stock market moves to a risk-on mode, the Canadian dollar will probably outperform the US dollar in the month of April. Investors should note that although the Canadian dollar could bounce in April, its positive seasonal push fades in May. In other words, a strong Canadian dollar looks likely, but the trend may be short and sweet.