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Market Ethos

The latest market insights from
Richardson Wealth

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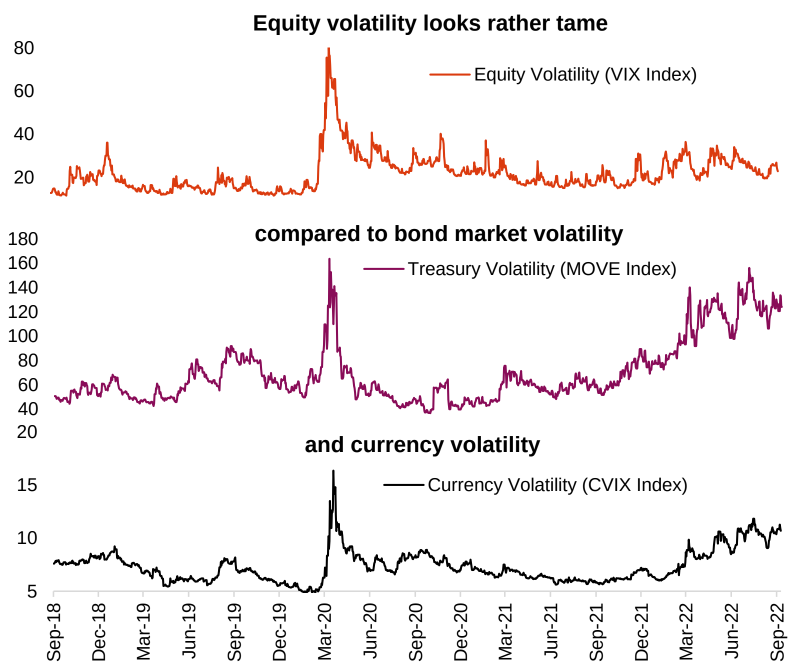
Making ‘cents’ of currency uncertainty

In normal times (if you can remember those), asset class volatility was a declining range from the most volatile equities to bonds to the least volatile currencies. We are not saying this relationship has changed, but with bond and currency volatility historically high of late, the range has certainly narrowed. Given the inflationary environment and response from central banks, the elevated bond market volatility is understandable. Even the risk-free rate, which is normally stable, has become unstable and uncertain. **But today we are talking currencies.**



Source: Bloomberg, Purpose Investments

There are many factors contributing to higher currency volatility. Divergent central bank policies are one, with the U.S. Fed currently on a more aggressive tightening path compared with the European Central Bank and even more so compared with the relatively dovish Bank of Japan. But relative interest rates have taken a back seat to fundamental factors. Europe has an economy that may be flirting with a recession and an ongoing energy crisis. Couple this with inflation, and the region is in a tight spot that is not supportive of the euro. Japan is not yen positive, with its dovish policy and as a big importer of energy with lower inflation. None of this is news and it’s likely well priced into current levels.

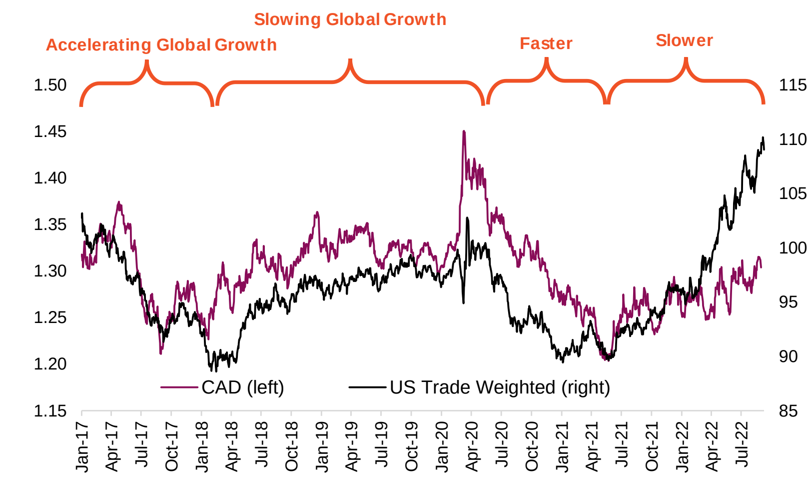
Meanwhile the U.S. enjoys a stronger economy than most; it's also a nation that is largely energy and food independent. **Energy and food self-sufficiency has become a big driver of currencies during this period of energy and food uncertainty.** This has also helped our Canadian loonie. While on the surface it may appear that the CAD has lost ground against the USD, the CAD is up nicely against most other currencies.

What's next?

When it comes to currencies, who knows. Forecasting currencies is arguably one of the harder components of portfolio construction. If you believe the global economy is set to continue to decelerate, the USD tends to perform well against that backdrop. There has been a strong negative correlation between the USD/CAD exchange rate and global growth. If growth is accelerating, the CAD does well, and if decelerating the USD does better. We are in the camp of a slowing global economy.

Even if you have a more negative view of the USD, given its rise, or a positive view on CAD, for some reason, **you cannot deny the diversification benefits of USD exposure within a Canadian investor's portfolio.** This has been a challenging year for all, with equities and bonds falling simultaneously. The more common negative or zero correlation between equities and bonds is clearly not evident during this re-pricing of all assets. However, the USD has been strongly negatively correlated against equities, providing a strong diversification benefit for portfolios.

If global growth is slowing, stay long USD

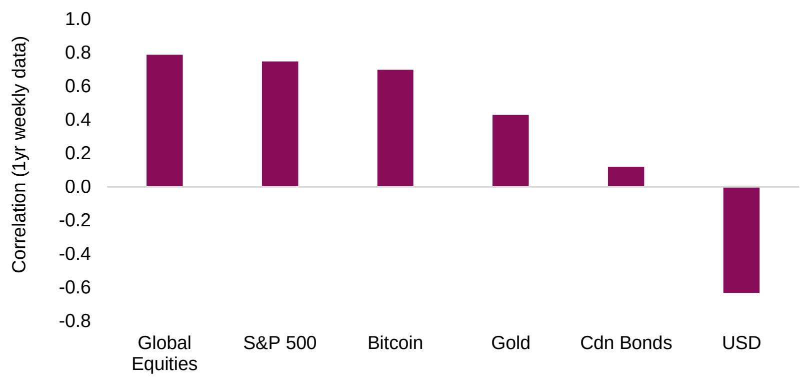


Source: Bloomberg, Purpose Investments

Impact on portfolios

With the global economic growth outlook slowing, we continue to believe that U.S. dollar exposure in portfolios is a good factor. We are not saying we are very bullish on USD vs CAD at current levels, but given the slowing Canadian economy, it is likely the Bank of Canada will blink first compared with the Fed. It is a bit more challenging globally, but worth noting that the euro and yen are at very depressed levels vs the CAD (and obviously vs the USD). As such, we tend to shy away from a global hedge at this time.

Correlation vs TSX



Source: Bloomberg, Purpose Investments

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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