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Market Ethos

The latest market insights from Richardson Wealth

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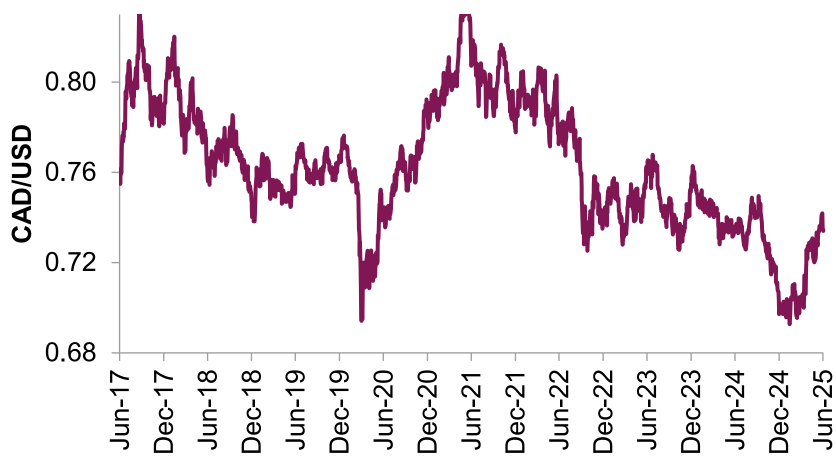
RICHARDSON Wealth

The hedge debate

The U.S. dollar (USD) has lost about 5% of its value relative to the Canadian dollar (CAD) so far this year, while the trade-weighted USD has dropped -9%. All else equal, that means any U.S. denominated investments have faced a 5% headwind so far in 2025 for Canadian investors, assuming unhedged. This has led to a recurring topic in recent conversations on currency, specifically whether to hedge or not hedge U.S. dollar exposures. This isn't a 'soup' question, as there are many different considerations beyond whether the CAD at 73 cents is going to 75 cents or back down to 70 cents.

Canadian dollar - Rebounding from tariff-induced lows

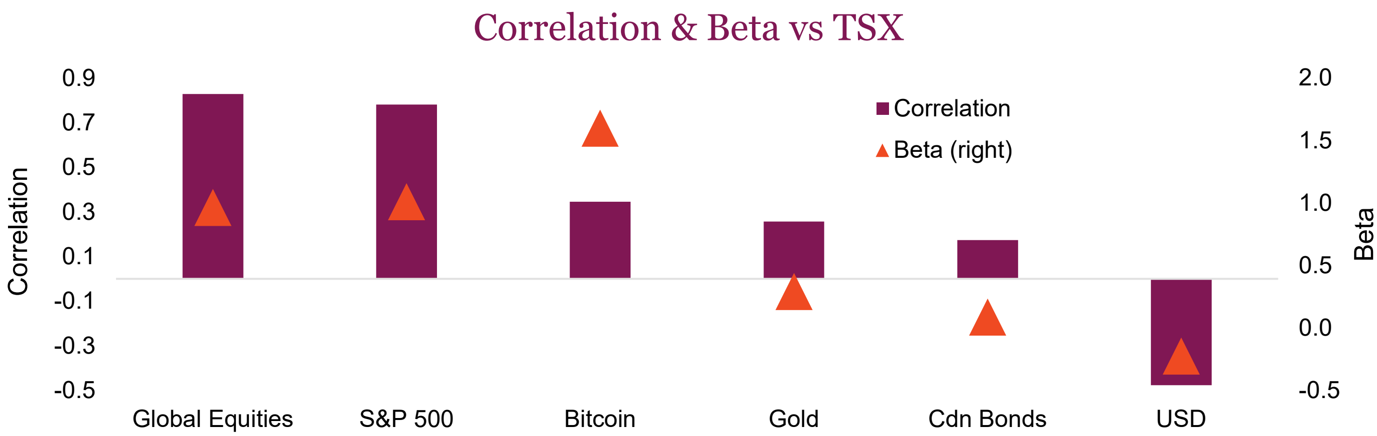


Source: Bloomberg, Purpose Investments

Accurately forecasting where a currency is going to go next is rather challenging. Additionally, for a Canadian's portfolio there are many other considerations when it comes to the question of hedging. USD exposure has a portfolio diversification benefit and there are much longer-term trends that should be considered. Below, we will share our views on all these aspects and our current thoughts on currency hedging.

Portfolio diversification – From a Canadian investor's perspective (most of our readers) the USD is fantastic!! The TSX and the Canadian dollar are risk-on assets and more sensitive than many others to trends in global economic growth. Growth is improving, markets are more risk-on, and our equity and currency tends to win. Conversely, when growth slows or recession risks rise, the TSX and CAD tend to fall while the USD rises. Even if you dislike policy coming from America, the USD remains a safe haven currency. If markets go risk-off, money tends to flow back to America, bidding up the currency.

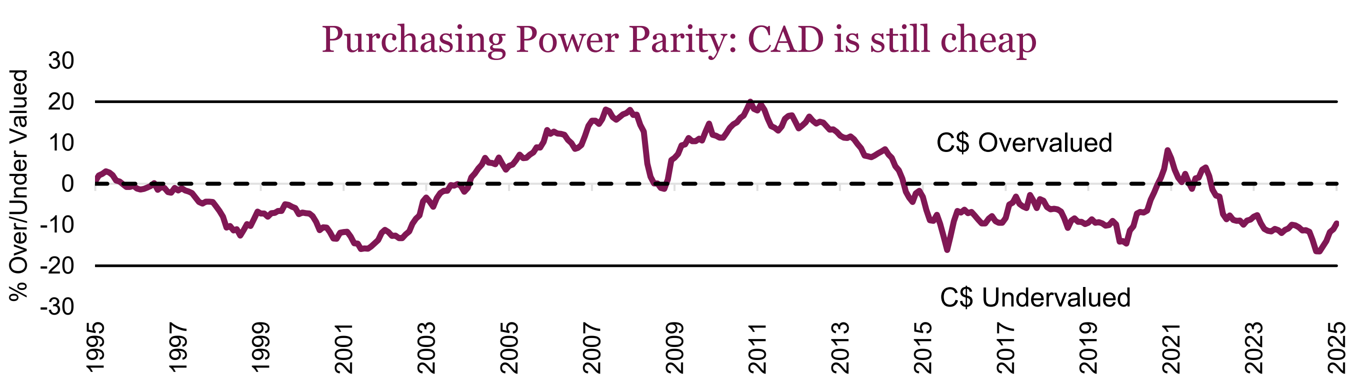
As a result, USD exposure often acts as a ballast for Canadian investor portfolios – even more so than bonds. The following chart is the correlation of various investment vehicles to the TSX. USD exposure carries a negative correlation. Also included in the chart is beta, as this helps demonstrate the size of the relative moves, not just the direction. Again, the USD stacks up very well as a diversification tool for Canadian portfolios.



Source: Bloomberg, Purpose Investments, 5-year weekly data

These numbers look similar over longer time periods as well. So, this would support not hedging, given the diversification benefits. But there are other considerations.

Long-term trends – It is very difficult to put a valuation or fair value on a currency exchange rate. Variations in economic activity, and shorter-term interest rates certainly drive exchange rates over subsequent months or quarters. Much longer-term purchasing power parity does play a role, but you have to look really long term. If a currency is very cheap in one country vs another, capital flows and trade will gradually reverse the spread (more reliable among developed nation currencies). The freer the flow of capital, the faster the process; the more restrictions, the slower it goes. But it is not fast either way.



Source: Bloomberg, Purpose Investments

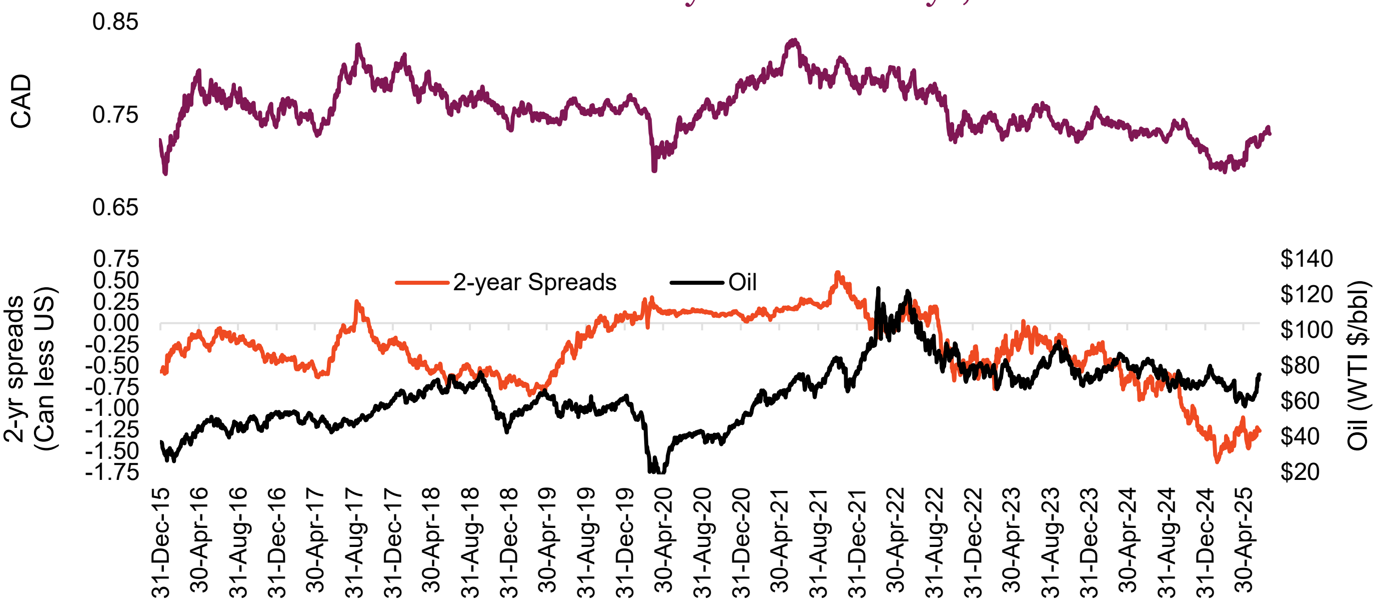
Even after the recent rise in the CAD vs USD so far in 2025, the CAD is still cheap or undervalued. But that's been the case for most of the past decade, as it was overvalued for the previous decade. There are very long and slow-moving cycles. Taking a really long view, the CAD was a dog during the '90s, the USD was a poor-performing currency in the '00s and then the CAD sucked again in the '10s to 2025 so far.

If it is a coin flip as to which currency performs better in the next five or ten years, we would say it is a well loaded coin in favour of the CAD. But there are likely many moves in both directions during that time period, some with the potential longer-term trend and some moves that are countertrend. Likely a long-term trend of a weaker USD and strong CAD, would support hedging USD exposure.

Near term – And then there are the rest of the factors, MANY factors, driving near-term volatility in exchange rates. The CAD has often been influenced by oil prices, but this relationship was stronger pre-2020 than it has been lately. Conversely, changes in short-term relative yields between Canada and the U.S. has become a larger determinant. A narrowing of the spread between 2-year yields has supported the Canadian dollar rebound, as has the spike in oil prices as Middle East conflicts intensify. Add in cooling uncertainty on the path of tariffs, halving the quantity of short CAD futures contracts and a minor 'anti' U.S. theme in markets, and the CAD bounce has many supporting tailwinds.

These are all "known knowns" in the currency world and likely reflected in the recent USD weakness / CAD strength, rallying from below 70 cents to the current 73 cent level. So, in the near term it really comes down to what happens next. If we get more clarity on tariffs, we'll likely see more CAD strength. If we see economic data continue to decelerate, we'll likely see USD strength, or some other aspect will rise up to move exchange rates that surprises everyone.

CAD is more about relative yields these days, less about oil



Source: Bloomberg, Purpose Investments

Final thoughts

So, there you have it, no simple answer to this difficult question. From a portfolio construction perspective, don't hedge because you want that diversification benefit. From a likely long-term trend perspective, the USD should weaken, supporting hedging. Near-term factors are noisy. We would only act on these when it moves too far or too fast. At 73 cents we are rather ambivalent, it is too high to get us excited about adding any USD currency hedges, but not higher enough to entice us to remove any existing hedges.

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

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*This report is authored by Craig Basinger, Chief Market Strategist at Purpose Investments Inc. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.