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STERLING'S WORLD REPORT

How High Will The Loonie Fly?

“Having endeavoured to forecast exchange rates for more than half a century, I have understandably developed significant humility about my ability in this area.”

*Alan Greenspan
November 30, 2001*

In last month's *Perspective*, we ventured the opinion that the U.S. dollar had peaked and could be headed for further substantial depreciation against a number of major currencies, including the Canadian dollar. So let us continue the line of thought and get specific: How much could the greenback fall against the Canadian dollar?

As indicated by Alan Greenspan's comment above, that is a question that needs to be approached with some humility. But for those who do think the Canadian dollar is fundamentally undervalued, as we do, there are at least some benchmarks that can be helpful in gauging how much potential it has to move up against its U.S. counterpart.

We touched on this issue last month when we described *The Economist* magazine's "burger-nomics" analysis. Once a year, the magazine's staff attempts to gauge the relative purchasing power of different currencies based on a survey of how much one standardized product – a McDonald's Big Mac hamburger – costs around the world.

By that measure, the Canadian dollar at the time of *The Economist's* survey was undervalued by about 15%. That is, with the Canadian dollar then trading at 63.7 cents against the U.S. dollar, it was 15% lower than what they reckoned was its

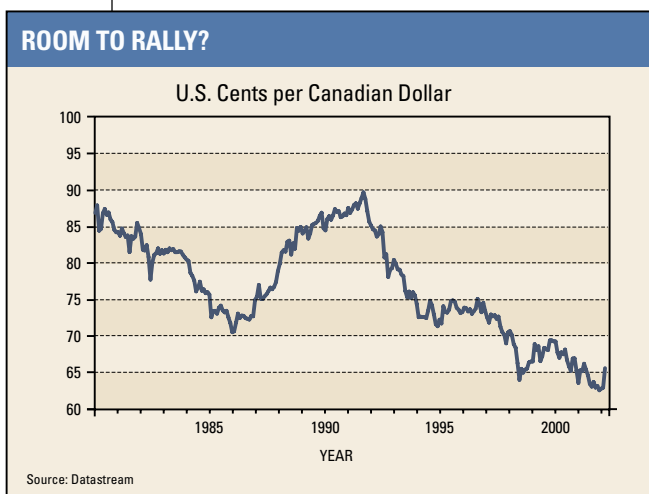


Chart 1. Even after a modest rally against the U.S. dollar in recent months, the Canadian dollar has still lost nearly 27% of its relative value since 1991.



How High Will The Loonie Fly? (cont'd)

burger purchasing power parity rate of 75 cents. In other words, at an exchange rate of 75 cents, Canadian Big Mac prices are exactly in line with U.S. Big Mac prices.

If the Big Mac index is any indication, then the nascent recovery of the Canadian dollar may have much further to go. Chart 1 shows that, even with the recent rally, the Canadian dollar is still 27% lower than the level it traded at against the U.S. dollar in 1991 and far below the average level of 76 cents that has prevailed since 1980.

Beyond Burgernomics

To be sure, *The Economist's* burger survey is merely a light-hearted attempt to assess the classic economic theory of “the law of one price.” That theory dictates that prices in one country can't get too far out of line with prices in another country. In practice, of course,

substantial price discrepancies do exist and sometimes persist for years. This is especially true for local products, like hamburgers, that are not traded actively across borders.

Amazingly enough, *The Economist's* simple survey has often correlated quite well with far more detailed surveys of purchasing power parity that try to compare the purchasing power of different currencies in terms of a large basket of goods and services. To get a broader picture of relative price levels across borders, we use a method developed at the International Monetary Fund. Based on this method, we currently get a purchasing power parity estimate for the Canadian dollar/U.S. dollar exchange rate of 80 cents.

Interestingly, that is not far from the Big Mac estimate and implies that the Canadian dollar is still 18% undervalued. This estimate is based on comparing consumer prices indexes in both countries to their long-term average. It is also based on the assumption that over long periods, like 20 years, the markets get the exchange rate about right in terms of equalizing price levels across borders.

According to this analysis, shown in Chart 2, the fundamental value of the Canadian dollar – at least in terms of its relative purchasing power – has been rising since 1991. That is because Canada's inflation has been lower than U.S. inflation since then. That followed a period in the 1980s when the fundamental value of the Canadian dollar had plummeted due to much higher inflation in Canada.

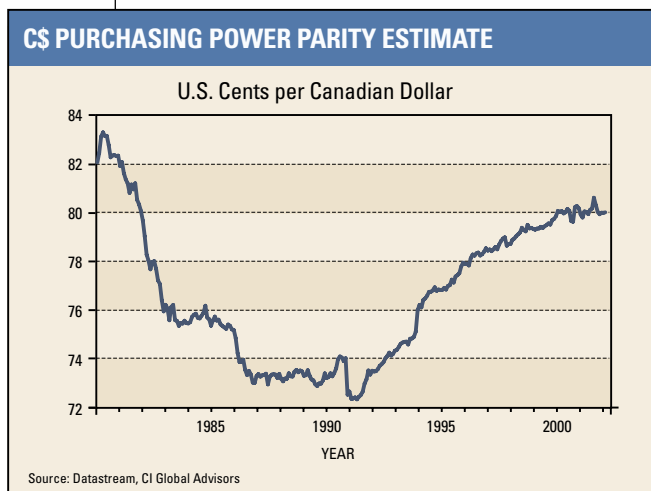


Chart 2. Based on purchasing power parity (PPP), the Canadian dollar should trade at about 80 cents US. The Canadian dollar's PPP value has risen since 1991 due to lower Canadian inflation.



How High Will The Loonie Fly? (cont'd)

Obviously, Canada did not get much credit in the foreign exchange markets for its improving fundamentals over the past decade because the actual exchange rate continued to slide. (The deviation of the actual exchange rate from the level suggested by purchasing power parity is shown in Chart 3.) Pity the political leaders who were vilified in the media for letting the Canadian dollar fall despite much lower inflation, budget surpluses and the emergence of a large trade surplus as well.

The major cause for the Canadian dollar's decline was simple. Despite improving fundamentals, capital poured out of Canada to take advantage of economic trends that appeared to be even more promising south of the border as the U.S. economy boomed in recent years. During the boom, the U.S. acted as a magnet for capital, with the result that the U.S. dollar rose dramatically against almost every major and minor currency, not just against the Canadian dollar.

Canadian Strength or U.S. Weakness?

In that sense, it was not Canadian dollar weakness, per se, but across-the-board strength in the U.S. dollar that was the dominant force that created such a major undervaluation of the Canadian dollar. The counter-trend that now appears to be emerging is precisely the opposite, one of across-the-board dollar weakness in response to a number of the forces we discussed last month.

The laundry list of factors now undermining the U.S. dollar is long and growing. It includes the massive U.S. trade and current account deficits, the re-emergence of U.S. budget deficits at the federal and state levels, disappointing returns on capital in U.S. financial markets reflected in low interest rates and weak equity returns, and investor confidence issues. The confidence issues relate not only to accounting and corporate governance scandals, but also to a host of controversial decisions by the Bush administration on international trade issues, including lumber, steel, and agricultural subsidies. War fears are also part of the picture since the United States is on the hook to finance the war on terror with its own resources, unlike the case in the Gulf War.

Against this backdrop, as we indicated last month, there are some analysts who believe that the U.S. dollar will need to fall by almost 40% against the currencies of its major trading partners, of which Canada is at the top of the list. We expressed the view that active dollar support from China and Japan could support a much

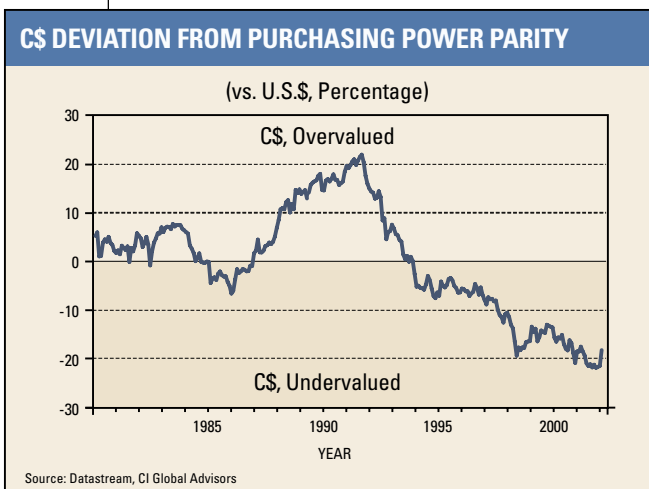


Chart 3. Even after this year's rally, the Canadian dollar still trades 18% below its estimated purchasing power parity value of 80 cents U.S.



How High Will The Loonie Fly? (cont'd)

softer landing for the dollar, with an overall decline of only 10% or so over the next year. That said, more pronounced U.S. dollar weakness should by no means be ruled out.

A Caveat – It May Take Years

An important caveat is that large deviations from purchasing power parity can take years to develop and years to correct. Just because the Canadian dollar is undervalued by 18% according to purchasing power parity (PPP) does not mean that it will appreciate 18% next month or next year. The consensus among academic researchers is that the speed of convergence to PPP rates is quite slow, with about 15% of the gap being eliminated in a typical year. Put differently, the “half-life” of deviations from PPP exchange rates in industrial nations is about 4 ½ years. Policymakers do not like to see their nation’s currency move too quickly in any direction, so there tends to be a variety of countervailing forces that can slow the adjustment of exchange rates.

However, it is also worth noting that exchange rates can and do often overshoot their PPP values in both directions. So once a big trend is underway to correct the Canadian dollar’s undervaluation, it would not be surprising if the Canadian dollar ends up overvalued for some time, as we saw in the late 1980s.

A final caveat is that the Canadian dollar may be undervalued against the U.S. dollar, but that does not mean that it is undervalued against all major currencies. As Table A indicates, based on estimates by Deutsche Bank, the Canadian dollar is actually modestly overvalued against the euro (4%) and the Australian dollar (5%), while being undervalued against the yen (-13%) and the British pound (-13%).

In conclusion, we remain tilted away from U.S. dollar and Japanese yen exposure in our funds and toward exposure to the euro and selected emerging market currencies. Based on our currency view, we continue to believe that broadly diversified international mutual funds are likely to outperform U.S. funds over the next year, while international bond funds do well relative to domestic bond funds.

Finally, if you are thinking about summer vacation plans, now may be the time to think about a trip to continental Europe or Scandinavia. Save that big vacation in the U.S. for next year!

THE CANADIAN DOLLAR IS NOT UNDERVALUED AGAINST ALL CURRENCIES

Currency (vs. C\$)	31-May-02 Spot Rate	PPP Estimate	% Over/Undervalued
US Dollar	0.65	0.80	-18.2%
Euro	0.70	0.67	4.2%
Japanese yen	81.31	93.36	-12.9%
British Pound	0.45	0.52	-12.9%
Australian Dollar	1.15	1.10	5.3%

Table A. The Canadian dollar is not uniformly undervalued against all major currencies, and appears to be modestly overvalued against the euro and the Australian dollar.

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