

A Tale of Two Dollars

On recent trips to visit clients in Canada, one of the most frequently asked questions was: “Why aren’t U.S. and global funds posting better returns this year, especially with the major stock market indexes doing so much better?”

The answer is very straightforward, though hardly comforting. The value of the Canadian dollar against the U.S. dollar has risen by about 14% this year. This means that even

though the U.S. market was up by almost 10% in U.S. dollar terms in the first five months of the year, its value fell by 4.5% in Canadian dollar terms over the same period (See Table 1). Ditto for the MSCI World Index, which was also up by about 8% in U.S. dollars and down by 6% in Canadian dollars. Ouch.

For Canadian investors this tale of two currencies obviously raises a number of important questions: (1) Why is it happening now? (2) Is more U.S. dollar weakness likely? (3) What does this trend mean for fund investors with substantial foreign content in their funds?

GLOBAL EQUITY MARKET PERFORMANCE

Canadian Dollar versus U.S. Dollar as at May 31, 2003

MSCI Index	Year-to-Date		Since Oct. 9, 2002	
	C\$	US\$	C\$	US\$
U.S.	-4.5%	9.9%	7.5%	24.7%
Canada	4.6%	20.4%	21.3%	40.8%
Europe x-UK	-4.6%	9.7%	11.1%	28.9%
United Kingdom	-8.8%	4.9%	-1.6%	14.0%
Japan	-17.1%	-4.7%	-14.1%	-0.4%
Asia x-Japan (Pacific Free)	-4.5%	9.9%	-0.5%	15.4%
Emerging Markets	-6.1%	8.0%	4.8%	21.6%
World (Developed)	-5.9%	8.2%	5.1%	21.9%

Source: MCSI

Table 1: In U.S. dollar terms, global markets are up nicely this year. However, returns in Canadian dollars remain negative because of the impact of the surging currency.

Since the Canadian/U.S. dollar exchange rate normally moves by about 3% or 4% per year, this recent move has been nothing short of extraordinary. As shown in Chart 1, the Canadian dollar was in a strong downward trend against the U.S. dollar over most of the 1997-2002 period. In five short months this year, that entire move was reversed and the Canadian dollar has returned to the range it traded at during the mid-1990s.

Why Now?

For a number of years, we (and most currency analysts) believed that the Canadian dollar was fundamentally undervalued based on a number of measures. We discussed this in these pages a year ago in an article called “How High Can the Loonie Fly?” In that article, we pointed out that numerous comparisons of the purchasing power of Canadian dollars and U.S. dollars suggested that “fair value” or



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“purchasing power parity” (PPP) was somewhere in the range of 75 to 80 cents US.

That said, we also pointed out that such measures have historically not been very helpful for predicting short-term or even intermediate-term moves in currency markets. Currency values have often diverged from purchasing parity estimates for long periods of time. That means that currencies that are cheap on a PPP basis often remain cheap for many years – and vice versa. While there has been some tendency

for currencies to eventually revert back to their “fair value” range, such moves have tended to take place over five-year periods rather than five-month periods.

The loonie’s big move this year seems to be based on a confluence of developments that include: (1) mounting concern over U.S. trade and budget deficits, (2) political trends that call into question U.S. government support for the greenback, (3) robust growth in Canada’s economy relative to the U.S., and (4) rising interest rates in Canada relative to the U.S.

and political considerations suggest more broad-based U.S. dollar weakness ahead. On the other hand, we believe that the last two forces – which are specific to the U.S. dollar/Canadian dollar relationship – are likely to abate. That suggests that weakness in the U.S. dollar against the Canadian dollar will be more muted than in recent months. Put differently, it suggests that the Canadian dollar may weaken a bit on cross-rates with other currencies like the euro, even if it strengthens modestly against the U.S. dollar.

Broad-based U.S. dollar weakness is likely to persist because the country is now running a massive trade and current account deficit of nearly 5% of GDP. With sluggish growth overseas, it will be hard for the U.S. to export its way out of its deficit even with the cheaper dollar. At the same time, the Fed has signalled that it is likely to keep interest rates low for an extended period of time. That may make it harder for the U.S. to attract foreign capital looking for high returns. As shown in Chart 2, U.S. short-term real interest rates (i.e., interest rates minus annual inflation) are actually negative and are the lowest of the major developed nations.

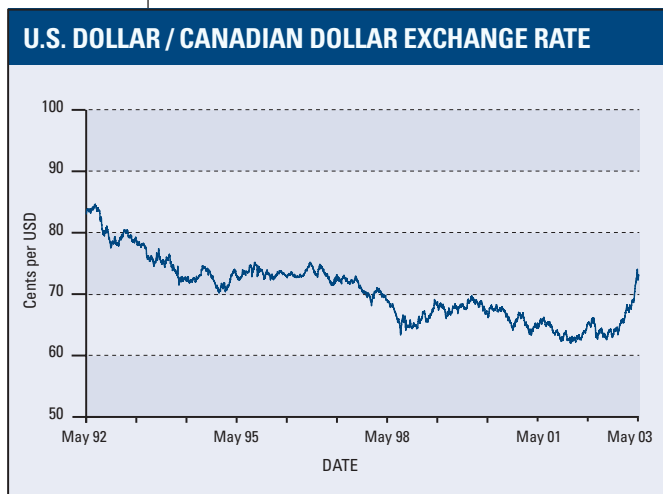


Chart 1: After trending down for most of the 1997-2002 period, the value of the Canadian dollar has risen a remarkable 14% against the U.S. dollar this year. The Canadian currency is now trading at the same level it did in the mid-1990s.

Will U.S. Dollar Weakness Persist?

Taken together, these forces have created a kind of “Perfect Storm” for the U.S. dollar that helps account for the remarkable move that has occurred this year. The key question for global investors is whether this Perfect Storm will continue, or whether some of these forces will abate in coming quarters.

Our view, in brief, is that the first two forces listed above are likely to continue for some time to come. In other words, trade imbalances

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Recent comments from U.S. Treasury Secretary John Snow have also cast doubt on the administration's support for a strong dollar and called attention to the positive aspects of U.S. dollar weakness for U.S. export industries. With a presidential election looming next year, it is difficult to see why the administration would want a stronger dollar if it meant raising interest rates or crimping the prospects of large export-oriented industries.

On the other hand, the Bank of Canada has recently dropped hints that it is rethinking its policy of raising interest rates in view of the surprising strength of the Canadian dollar. U.S. economic indicators like the ISM survey are finally beginning to perk up while recent Canadian data suggests that Canada's margin of outperformance over the U.S. is beginning to shrink. Canada's labour market in particular has shown softness over the past several months and several one-time shocks like SARS and the mad cow scare are now hanging over the economy.

currency strength. For the Bank of Canada, which initially appeared to encourage Canadian dollar strength, it may now be a case of "Be careful what you wish for."

What Should Fund Investors Do?

If our analysis is correct, the Canadian dollar may have 3% to 5% more upside against the U.S. dollar over the next six to 12 months, but not another 15%. That suggests that foreign funds may still face a moderate headwind in terms of generating strong returns in Canadian dollars, but not a gale force wind as experienced in recent months.

We are still tilting both our stock and bond funds toward Canadian dollar exposure and would recommend that Canadian investors do the same with their mix of funds. That said, we think that arguments for international diversification still make good long-term investment sense and that most investors are best served making gradual, deliberate changes in their asset allocation, instead of all-or-nothing bets.

Accordingly, even though broad-based U.S. dollar weakness is likely to persist, perceptions that the relative strength of the Canadian economy merits a much stronger Canadian dollar seem likely to fade. Canadian export industries will definitely be feeling the pinch from lost competitiveness at current exchange rates, while U.S. competitors will benefit. Canada is still running a large trade surplus, which for now remains a supportive factor for the Canadian dollar. However, that source of support will probably begin to fade in coming quarters as exporters feel the pinch of

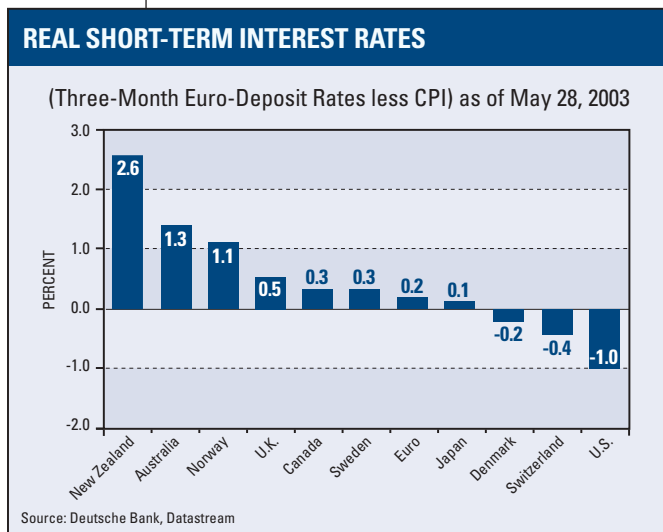


Chart 2: A major reason for the decline in the U.S. dollar is that U.S. short-term real interest rates are negative and are the least attractive among those of the major industrial nations.

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Some investors have asked whether this might not be the time to aggressively increase exposure to foreign content on the view that the Canadian dollar has overshot to the upside – on the view that there is good money to be made by betting on a sharp reversal in the Canadian dollar's recent trend.

Our answer to that question is NO. One can never rule out sharp short-term reversals in currency markets, where volatility tends to be the rule. However, from a longer-term

investment viewpoint, it is important to keep the Canadian dollar's recent move in perspective. Yes, it may have moved up by nearly 15% over the last six months. However, by some PPP-type measures the Canadian dollar was close to 25% undervalued before it made its move.

As shown in Chart 3, recent work by Deutsche Bank's foreign exchange group estimates that the Canadian dollar is still undervalued by roughly 10% against the U.S. dollar – even after this year's dramatic gains. Other methods put the Canadian dollar much closer to fair value, but we don't know of any analysis that claims that the Canadian dollar is overvalued and needs to fall.

We would also note that momentum-type trading often drives currency markets more than other financial markets. In momentum markets, Newton's law rules: a body in motion tends to stay in motion.

That said, remember what Fed Chairman Alan Greenspan had to say about currency forecasting a few years ago: "Having endeavoured

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

No matter how strong one's views on currency trends happen to be, Mr. Greenspan reminds us that it is still very easy to be wrong. That's why we recommend partial hedging of foreign currency exposure, or moderate tilts toward Canadian dollar exposure in one's fund portfolio, rather than all-or-nothing positions.

On currencies, as in other financial matters, the wisdom of the ancient financial sages still applies: Betteth not thy entire wad.

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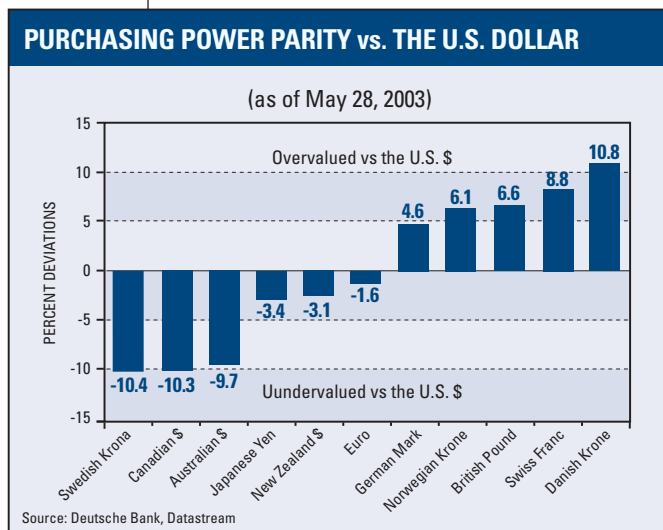


Chart 3: Despite this year's appreciation of the Canadian dollar, analysts at Deutsche Bank estimate that it is still 10% undervalued against the U.S. dollar based on its purchasing power.