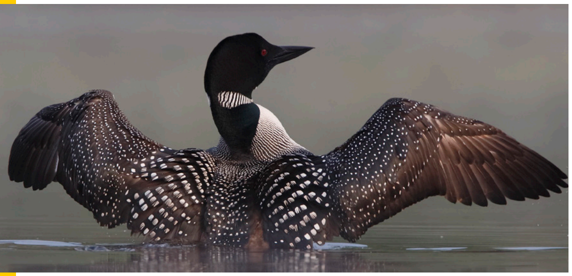

The Good, the Bad and the Loonie

Craig Fehr, CFA • Investment Strategist

After a long descent that began in 2014, the Canadian dollar (CAD) has rebounded modestly. Downward pressure from oil prices has given way to the Bank of Canada's (BoC) shift toward slightly tighter interest rate policy. Fluctuations in the CAD have wide-ranging impacts, including national trade, travel and consumer goods expenses, and investment returns. So where does the loonie go from here, and what are the implications for investors?

The Good:

The CAD rose more than 12% from May to early September of this year, responding to stronger growth in the domestic economy and the first rate hike in seven years from the Bank of Canada. A strengthening currency signals rising growth, inflation and rates. At the same time, a lower loonie also offers the benefit of making Canadian goods and services more attractive to foreign buyers.

The Bad:

The CAD fell 27% from 2014 to early 2016 due to plunging oil prices and a material slowdown in Canada's economy. A weak CAD raises some input costs for domestic businesses and makes it more expensive for Canadians to purchase foreign goods and international investments.

The Loonie:

While the Canadian dollar has risen above US$0.80 recently, we think it's likely to trend in a range around the upper US$0.70s. In our view, most of oil's downward pressure has passed. However, we don't expect the loonie's recent summer ascent to persist, as we anticipate more modest economic growth ahead. While cases can be made for a stronger or weaker dollar, a range-bound loonie could present a bit of a goldilocks scenario – not too strong, not too weak. Trending around the current level could:

- Offer ongoing support for export growth, a key contributor to domestic GDP
- Help reduce deflationary pressures while keeping inflation at a level where the Bank of Canada has the flexibility to raise rates very slowly
- Lessen the currency impact – upward or downward – on international investment returns

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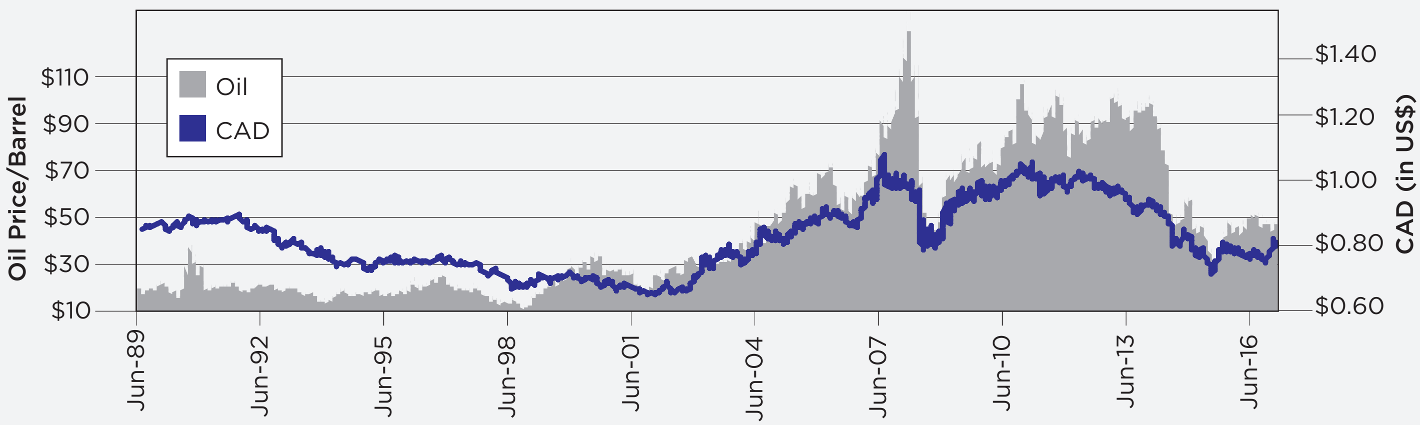
What's Driving the Dollar?

We expect two factors – oil and interest rates – to drive the direction of the CAD. In the near term, these could be relatively neutral influences, especially compared to the sizable swings they've prompted in recent years, when the CAD went from US$0.94 to US$0.69 and back to US$0.82. Longer term, rising oil prices and interest rates could lead the loonie higher, trending closer to its historical average in the mid-$0.80s.[1]

Oil Prices

Oil prices have stabilized a bit after dropping 75% from 2014 to early 2016 and then roughly doubling off the 2016 lows. Looking ahead, firmer demand along with production controls from OPEC should support oil prices. At the same time, elevated stockpiles and rising production in the U.S. are likely to prevent a sizable oil price increase. If oil remains in the $45-$55 range, we don't expect a sustained material shift in the Canadian dollar.

Oil vs. the CAD

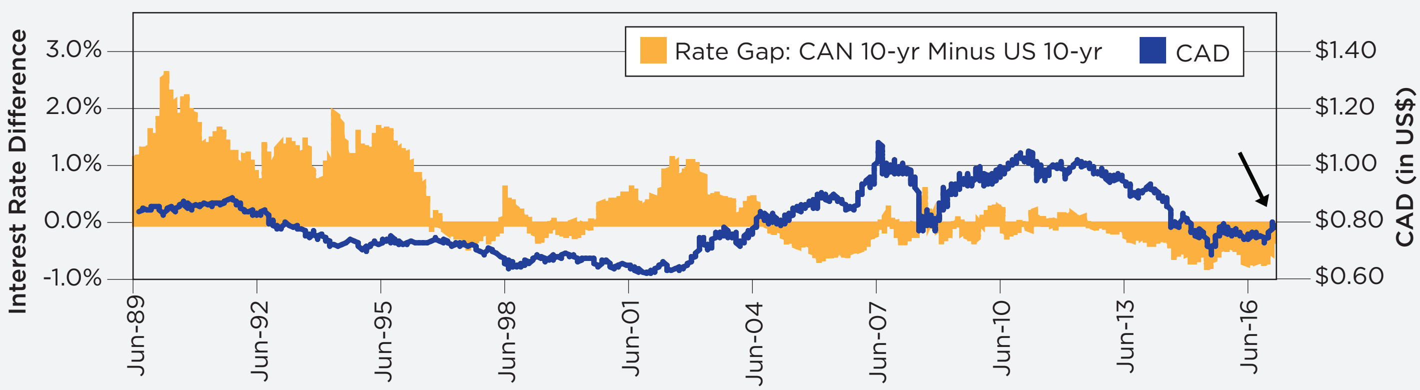


Sources: Bloomberg, CAD per U.S. dollar.

Interest Rates

Ten-year interest rates reached a record low in 2016, reflecting the economic slowdown and rate cuts (stimulus) from the Bank of Canada. While still well below average, the 10-year rate has risen significantly in response to stronger economic readings and rate hikes in July and September from the BoC. We believe the interest rate gap between Canada and the U.S. will continue, if not widen, due to faster U.S. growth, continued withdrawal of Fed stimulus, slower Canadian growth and a gradual approach to additional BoC rate hikes. That will likely hold back sustained appreciation in the loonie this year.

Interest Rates vs. the CAD



Sources: Bloomberg, CAD per U.S. dollar. 10-year rates for Government of Canada and U.S. Treasury bonds.

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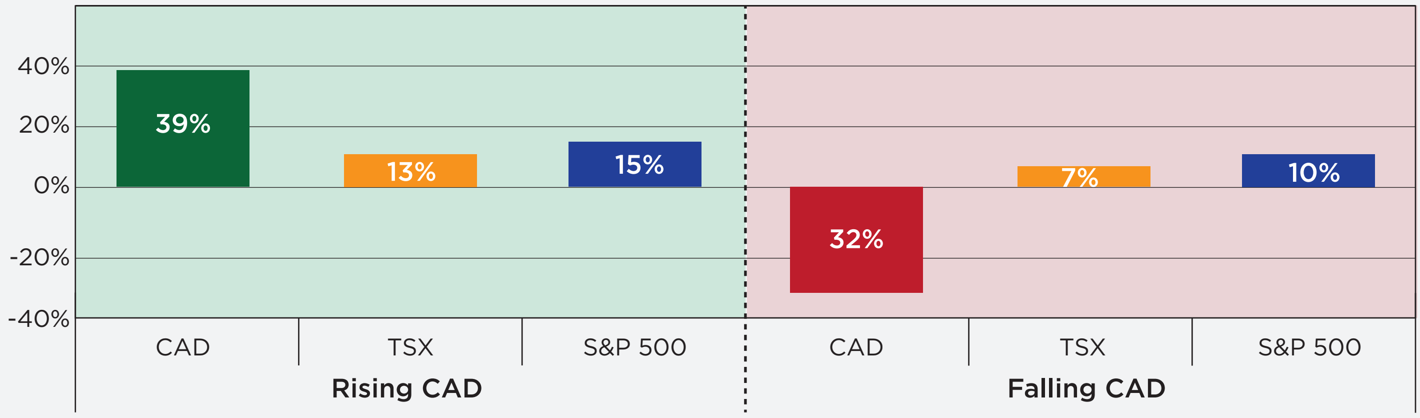
Currency Moves and Stock Market Returns over the Long Term

Average CAD Change and Average Annualized Stock Market Returns During Extended Periods of a Rising/Falling Loonie



Sources: Bloomberg, CAD per U.S. dollar.

Actions for Investors

» Over longer periods of time, currency fluctuations tend to have less impact on investment performance, so we don't recommend making sizable changes to your portfolio based simply on the Canadian dollar. As the chart above shows, over the past 40 years, stocks have provided positive returns in extended periods of both a rising and falling loonie. That said, we do see opportunities for enhanced diversification with a somewhat flat or fluctuating CAD.

Maintain international allocations:

Don't avoid U.S. investments because they may seem too expensive with a cheap loonie. One year ago, the CAD was at US$0.76. Since then, the TSX has had a total return of 6.2% versus a total return of 11.4% for U.S. stocks, after converting back to Canadian dollars (15.4% in U.S. dollars).[2] Moreover, the CAD was near current levels (US$.0.79) 16, 26 and 31 months ago. From each of those points, U.S. stocks have provided an average return in Canadian dollars that was more than double the return of Canadian stocks.[3]

Look for domestic companies with broad reach:

More than 50% of revenues of TSX companies come from international markets, so domestic corporate earnings receive a boost as those profits are converted at a lower CAD. Similarly, export activity has improved recently, as companies with export businesses benefit from the lower currency.

Build exposure to global asset classes:

After underperforming for several years, global equities have been the strongest performers over the past year. In fact, overseas large-, mid- and small-cap equities and emerging-market equities delivered an average return in Canadian dollars that was three times that of the TSX. We maintain our recommended overweight international allocation, as we believe global growth and more attractive valuations can support international performance.

Talk with your Edward Jones advisor today if you have further questions about currency impacts or opportunities that may be right for you.

Past performance of the markets is not a guarantee of how the markets will perform in the future.

Equity investments carry risk, including the loss of principal. There are special risks inherent in international and emerging market investing, including currency, withholding taxes and high levels of taxation, political, social and economic risks. The prices of small cap and mid cap stocks are generally more volatile than large company stocks.

Sources: 1. Bloomberg. 2. Bloomberg, as of 8/30/2017. 3. Bloomberg, as of 8/30/2017, returns measured by the S&P/TSX Composite index and S&P 500 index since 2/1/2015, 7/1/2015 and 5/1/2016.

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