High flight

You can bet your loonies that the C$ will remain strong against the US$.

by David Derwin

WE INITIALLY FORECAST THE STRENGTH IN the C$ more than five years ago, when the loonie was still drowning near 65 cents. (See "Keep your eye on interest rates", *Canadian Treasurer*, February/March 2001). At that time, the C$ still had the anchor of market pessimism around its neck. Many people expected that it would sink into the foreign-exchange sea to a depth of about 50 cents.

Despite the prediction of a strong undercurrent pulling it lower, we forecast that the loonie would instead shed its shackles and take flight. We based this forecast on our analysis of interest-rate differentials between Canada and U.S. short-term rates. At that time, the Canadian yield curve was above the U.S. curve. Our outlook then was for U.S. rates to fall even further below Canadian rates, helping the loonie to float and eventually soar above the U.S. greenback. Since then, we have consistently stated in our annual forecast articles that the C$ would remain strong and continue to rise against the US$.

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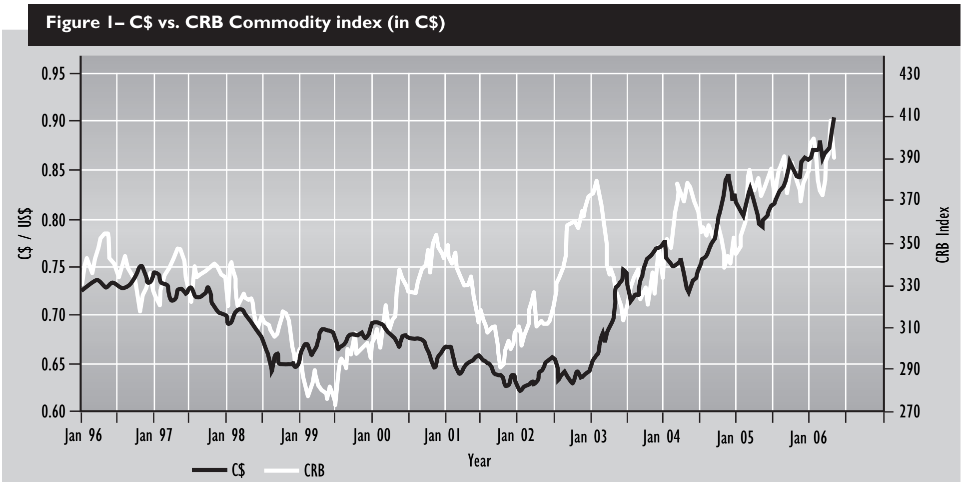
At different times, different factors will affect exchange rates: interest-rate differentials, tax policies, fiscal debt and deficit levels, asset values, trade balance or relative economic growth, just to name a few. More recently, the strength of commodity prices has taken the baton and put wind under the wings of the loonie. Figure One, compares the Commodity Research Bureau Index (CRB) in C$ to the US/Canada exchange rate, in order to isolate the impact of commodity strength on the C$ versus the US$.

While we Canadians know that we as a nation, with our diverse economic base, are far much more than hewers of wood and drawers of water, many people overseas and even south of the border still see us as a commodity-based economy and currency.

Not only are we seeing inherent strength in the C$ because of rising commodity demand, there are also healthy trade and budget surpluses. But while there's underlying strength in the C$, there's also the other side of the coin: significant weakness in the US$. In particular, the greenback's status as a

Figure 1– C$ vs. CRB Commodity index (in C$)

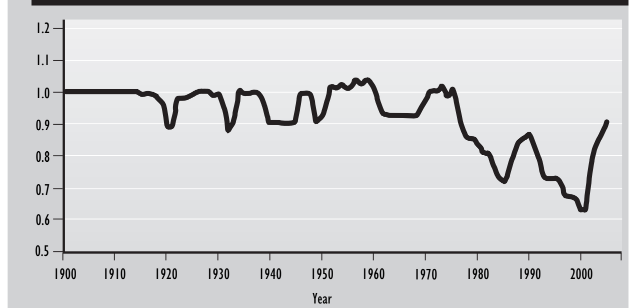


global reserve currency is dwindling. A few years ago, the US$ accounted for 75% to 80% of global reserves in central banks around the world. Today it represents approximately 65%. The euro and gold have taken its place. We expect this major shift to continue. Here's why: First, many Asian countries that had a pegged or weak currency policy to promote exports have eased their policies. China is the most obvious, as it began to let its currency float in July last year. Furthermore, with the Japanese economy finally moving forward after a 15-year recession, and with Japanese interest rates edging up, Japan no longer has a weak currency policy. These two largest purchasers of US$ will reduce future buying. In fact, Japanese holdings of US Treasury bonds have been flat over the past two years, since the country stopped executing its weak yen policy. There have also been discussions of a pan-Asian common-currency unit for a few years. With Asia building as a predominant financial and economic powerhouse, Asian countries will have less need for the US$.

The same currency trend has begun in the Middle East. By 2010, the six states of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates will be working with the European Central Bank (ECB) to implement a plan for their own monetary union. A viable Middle East currency means petrodollars no longer need to go into US$. Large liquid currency alternatives in both Asia and the Middle East will further reduce the reserve status of the US$.

Finally, the US itself may not mind a weaker US$. In fact, most rhetoric out of the White House and the Federal Reserve lately has pointed toward encouraging a weaker US.

Figure 2: C$ vs. U.S.$



With all this in mind, where does this leave the C$ vis-à-vis the US$? Well, barring any separatist talk from Quebec, Figure Two, our long-term chart of the C$/US$ exchange rate, points toward a return at least to par, a level around which it has held for much of its history since 1900. Could the C$ trade at a premium to the US$? You can bet your loonie on it.

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E-COMMERCE

Microsoft plans to establish **Windows Mobile** as one of the leading smartphone operating systems competing with rivals such as Symbian, the Palm operating system and Research in Motion's BlackBerry device platform. Currently 47 manufacturers ship Windows Mobile devices through 115 mobile operators in 55 countries.

◆

Trust in the **Internet** has doubled since 2002, surveys show, and newspapers are no longer the most trusted source of content. Online youth trust all sources of traditional media less than their adult counterparts do.

◆

CBS has launched a new broadband television network, responding to demand from **advertisers** to reach viewers on **the Internet**.

◆

Nearly one-third of **online adults** who have teenagers at home say they use parental controls to protect the computer they use most often. Slightly more than one-fourth of **teens** have circumvented the **controls**.

◆

Verizon Communications, the second-largest U.S. telephone company, cut the cost of its broadband voice over Internet Protocol (**VoIP**) service, which includes unlimited local and long-distance calling by US$5 to US$24.95 a month, the same price as rival **Vonage Holdings**, which recently filed for an initial public offering. Traditional telecommunications companies continue to report customer defections.

◆

The **Internet-based phone** and video phone service **Skype**, owned by online auctioneer eBay Inc., now serves more than 100 million registered users, up from about 54 million in September 2005.

◆

Skype has admitted that its partner in **China** has filtered text messages, defending this compliance with **censorship** laws as the only way to do business in the country.

◆

Most consumers give their **financial institutions** passing grades when it comes to protecting their assets from **online fraud** and protecting the privacy of their personal information. But the consumers who don't feel as well protected are less satisfied with their banks, brokerages, and insurers and are less likely to buy another product from those providers.

◆

Surveys show that 11.5 million Canadians use **Internet banking services**, and 51% of Canadians pay bills online. But three-quarters of Canadians are concerned about e-mail fraud, 40% say those concerns prevent them from paying bills online, and 27% say it's easier to pay by cheque.