# Ask Forstrong
## Lights Out For The Loonie?

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### Key Takeaways

- The Canadian dollar and a long list of currencies outside the US are now priced for near-apocalyptic economic outcomes.
- With five consecutive rate cuts and a more business-friendly government on the horizon, Canada's economy is poised for cyclical improvement despite ongoing productivity headwinds.
- Canada's small, open economy reacts strongly to global macro trends. As the US-led recovery broadens globally, the conditions are emerging for a bottom in CAD/USD.

### Ask Forstrong: What is your outlook for the Canadian versus the US dollar (CAD/USD)?

Welcome back to the pages of Ask Forstrong, dear readers. 2025 has barely begun and already markets have served up enough volatility to derail even the most disciplined dry January practitioners. With Trudeau's "sunny ways" now a distant memory and Trump's inauguration just days away, trade and tariffs are looming large in the minds of Canadians.

But, if our inbox is any indication, the burning question is whether the robust gains of 2024 can carry forward into the new year. For Canadian investors, last year's US equity rally came with an extra kicker—currency conversion effects. With the loonie sliding 8% versus the USD (its largest annual decline since 2015), unhedged US dollar-denominated investments delivered outsized returns for Canadian portfolios.

### What Drove The Loonie's Decline?

Unlike past routs in CAD driven by recessions or oil price crashes, last year's retreat reflected a stark divergence between US and Canadian dynamics. While America could seemingly do no wrong last year, news flow north of the border was grim. In March, the Bank of Canada declared a "productivity emergency"—an unusual move for an institution traditionally dedicated to monetary policy. The data, however, speaks volumes. Canada's capital stock of machinery and equipment has shrunk 2.8% since peaking in 2014, marking seven years of decline out of the past eight—an unprecedented stretch in records dating back to 1961. A lack of international competitiveness continues to be Canada's longer-running issue.

Without the cushion of gushing oil revenue last year (Canada's largest export), other structural issues also became hard to ignore: high household debt, weakening domestic consumption, rising unemployment and lower interest rates. Then, toss in Trump's tariff threats and colourful plans to redraw the map of America to include a 51st state, and the challenges intensified.

## Catalysts For A Turnaround

In financial markets, astute investors always ask how much bad news is already priced in? For the loonie, we believe a significant portion has been. The real effective exchange rate (REER) has fallen to levels last seen in the 1990s.


Sources: Macrobond, IMF, Forstrong Global Asset Management

Sentiment is also overwhelmingly bearish, with short positions in CAD near decade highs. While investors have had ample time to factor in Canada's headwinds, catalysts for a reversal are less discussed. Here's where upside surprises could emerge:

- **Economic Rebound:** While interest rate differentials are a driver of currency movements, economic growth also plays a significant role. After five consecutive rate cuts (and more to come), Canada's highly interest rate-sensitive economy is poised for cyclical improvement. Canada's housing market is already firming, showing that rate cuts are taking effect. Meanwhile, a weaker starting point for the currency boosts export competitiveness, creating a tailwind for trade that could help mitigate the impact of any tariffs implemented in the months ahead.

- **Political Shift:** With Trudeau stepping down, polls suggest a near-certain conservative majority in the next election. A more business-friendly government will bolster market confidence and attract investment flows.
- **Global Recovery:** Canada's small, open economy reacts more to global macro trends than domestic developments. Our investment team anticipates that the US-led recovery is now in the process of broadening globally. Trump's trade wars have already catalyzed easing interest rates and heightened fiscal stimulus in economies outside America (see our latest "Super Trends" outlook). Historically, periods of firming global growth have coincided with Canadian dollar strength. We see no reason this time will be different.

## Investment Implications

The Canadian dollar is just one casualty of the "America first" theme. A long list of currencies and international asset classes—with far better macroeconomic fundamentals than Canada—are now priced for near-apocalyptic economic outcomes. Yet heading into 2025, the consensus continues to hold that America has what the rest of the world lacks: corporate leadership, innovation in the seemingly limitless world of artificial intelligence, and, in the words of incoming Treasury Secretary Scott Bessent, a "growth mindset". Unsurprisingly, strategic US equity allocations remain pinned at record highs.

But, looking closer, America also has many things that the rest of world would rather avoid: a frothy stock market, an overvalued currency (according to Bank of America, the most overvalued in history) and an increasingly ornery and uncooperative domestic bond market (30-year Treasury yields have risen 100 basis points since mid-September). Elevated valuations and high expectations naturally dampen future returns.

History, however, reminds us that markets thrive on surprises. Turning points often present the greatest opportunities. For Canadian investors, conditions are falling into place for a bottoming process in the loonie and other deeply undervalued foreign currencies and asset classes. But with the world's leading stock market showing unmistakable signs of exuberance and Trump's tariff rhetoric set to intensify, some turbulence should be expected in the months ahead. Still, now is the time to prepare portfolios for these pivotal shifts. With the bull market likely to broaden in 2025, the case for global diversification—and the opportunities it presents for macro investing—has rarely been more compelling.

**Tyler Mordy, January 2025**

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