

# MONTHLY INSIGHT

*“...many pundits call the Canadian dollar a “petro-currency” because of oil’s big influence on our economy but the correlation between the currency and the price of oil is only 0.25.”*

	10 Year Bond Spreads	
	C\$	U.S.
High	\$ 1.06	0.43%
Average	\$ 0.95	-0.13%
Low	\$ 0.75	-0.82%

	10 Year Bond Yields	
	Canada	U.S.
High	3.50%	3.73%
Average	2.22%	2.35%
Low	1.24%	1.40%

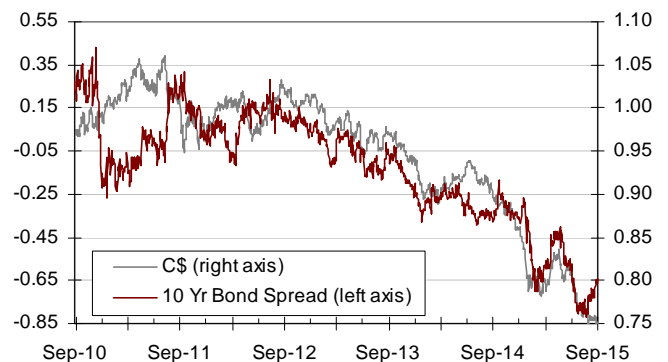
The first table shows the high, average and low values for the Canadian dollar relative to the U.S. dollar, as well as these values for the difference (spread) in yields for the Canada and U.S. 10 year bond for the last 5 years. The second table confirms that the yield on the 10 year U.S. bond has consistently been higher relative to the Canada bond, thus supporting a strong U.S. dollar relative to the Canadian currency.

## CANADIAN DOLLAR LIMBOS LOWER

The global financial markets are intertwined into one gigantic and convoluted web. Nowhere is this truer than with the relationship between currencies and bond spreads which are the difference between various countries’ interest rates. Bond yield differentials play a significant role in determining the direction of a currency and have more influence on currency movement than the underlying bond yields themselves.

Currency valuations reflect economic fundamentals over time, although there can be temporary imbalances that disturb the underlying fundamentals. The price of currencies can be impacted by the monetary policy decisions of central banks around the world. However, central banks like the Bank of Canada only administer short term interest rates, or the front end of the yield curve. Market forces drive market sentiment and ultimately determine the yields on longer dated bonds. It is the longer dated bonds (10 or more years to maturity) that are the primary force for determining exchange rates.

Bond yield differentials usually move in tandem with the corresponding country’s currency as capital flows are attracted to higher yielding currencies. As a general rule when the yield spread widens in favor of a country, then its currency will appreciate more than other currencies. While it is not uncommon for currency movements to lag as much as a year after interest rate differentials have moved significantly, this is not the case between Canada and the United States. Quite simply, the Canadian and U.S. government 10 year bond spreads accurately dictate the direction of the Canadian dollar better than any other indicator. As the chart to the right and data to the left indicate the relationship between the 10 year bond spread and the Canadian dollar is highly correlated. Over the past 5 years of daily activity the correlation is 0.87 (with 1.0 indicating perfect correlation and 0.0 meaning no correlation). To further put this into perspective the correlation between the 10 year Government of Canada bond yields on their own and Canadian dollar is 0.56; while the correlation between the 10 year U.S. Treasury bond yield and Canadian dollar is only 0.14. Interestingly, many pundits call the Canadian dollar a “petro-currency” because of oil’s big influence on our economy but the correlation between the currency and the price of oil is only 0.25.



*This chart confirms the high correlation between the 10 year Canada / U.S. bond yield spread and the Canadian dollar. Over the past 5 years the correlation was a very high 0.87.*

Canadian and U.S. interest rates are low in absolute terms but the lower Canada’s interest rates go relative to the U.S., the lower our dollar will go. While there certainly appears to be a concerted effort to stimulate the Canadian economy through a lower Canadian dollar it could risk a currency crisis and a Canadian dollar in freefall below its 2003 low. The problem is that once momentum is established and a trend develops, it is very hard to reverse its course. In the past five years the Canadian dollar peaked at \$1.06 and is currently at \$0.75. This is 29% depreciation and there is no indication that market sentiment is going to change meaningfully to alter this course. The only real question is “how low will it go?”

# MARKET DATA

## 30 SEPTEMBER 2015

### Index Total Returns (%) (C\$)

	1 Month	1 Year	5 Years
S&P TSX	-3.7	-8.4	4.5
S&P TSX High Dividend	-3.4	-16.8	5.9
S&P TSX Small Cap	-6.8	-21.8	-2.7
S&P TSX Preferred Shares	-5.6	-19.6	-1.2
S&P 500	-1.7	19.7	20.2
Russell 2000 (US Small Cap)	-4.3	20.2	17.1
MSCI EAFE	-4.3	10.5	11.1
MSCI World	-2.9	15.0	15.7
MSCI Europe	-4.0	6.6	7.8
MSCI Asia	-5.3	5.6	5.1
MSCI Emerging Markets	-2.5	-4.4	0.3

Currencies:	US\$			
(%) (C\$)				
	EURO	0.4	6.1	1.3
	GBP	-0.8	12.1	4.7
	YEN	1.9	9.0	-1.9

### Bond Total Returns (%) - DEX Indices

	1 Month	1 Year	5 Years	Yield
Universe	-0.3	5.3	4.5	2.04
Short Bonds	-0.2	3.0	2.7	1.22
Mid Bonds	-0.2	6.6	5.3	2.04
Long Bonds	-0.4	7.5	6.7	3.19
Federal Bonds	0.0	5.4	3.5	1.19
Provincial Bonds	-0.7	6.5	5.4	2.41
Corporate Bonds	-0.1	4.0	4.9	2.66
Real Return Bonds	0.7	3.4	4.4	0.48
91 Day T-Bills	0.0	0.6	0.9	0.43

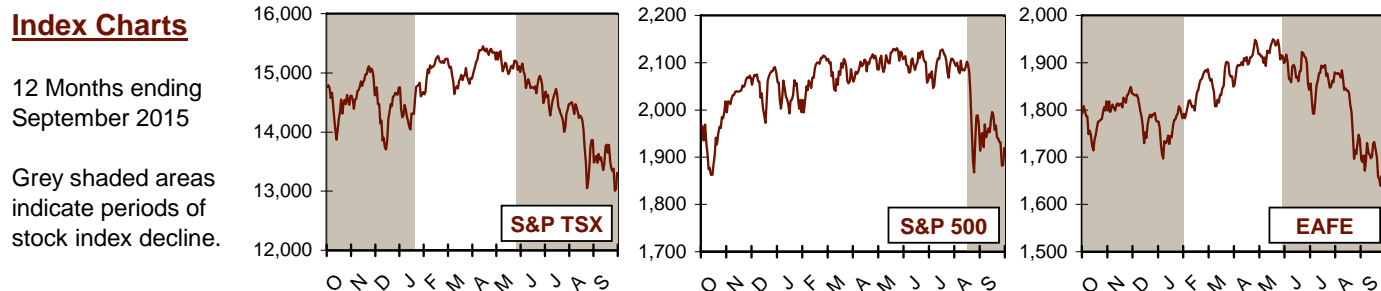
Barclays Aggregate Bond (US\$)	0.7	2.9	3.1
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Commodities:	Index			
(%) (US\$)				
	Oil	-6.1	-49.3	-8.5
	Gold	-1.5	-7.8	-3.1
	Wheat	-2.2	-27.5	-9.1

### Sector Returns (%)

	S&P TSX (C\$)				S&P 500 (US\$)				MSCI EAFE (US\$)			
	1 Month	1 Year	5 Years	Weight	1 Month	1 Year	5 Years	Weight	1 Month	1 Year	5 Years	Weight
Consumer Discretionary	0.3	16.1	13.3	6.3	-0.8	11.4	17.5	12.3	-4.3	-2.5	5.5	13.2
Consumer Staples	1.9	30.3	20.6	2.4	0.1	4.3	11.0	9.2	0.1	-0.6	5.6	11.0
Energy	-9.0	-43.1	-10.2	21.6	-6.8	-31.7	1.5	7.9	-7.9	-37.3	-7.6	5.6
Financial Services	-0.6	-7.0	5.8	36.1	-3.2	-2.5	9.6	15.8	-5.7	-11.9	-0.2	25.7
Health Care	-18.5	18.0	20.0	6.0	-5.8	3.5	16.7	15.9	-5.9	-5.1	9.2	11.7
Industrials	0.3	-13.2	10.1	8.3	-2.0	-5.7	9.8	10.5	-6.5	-10.7	1.3	12.6
Information Technology	-3.1	19.4	11.9	2.3	-1.1	0.6	12.5	20.1	-4.6	-7.1	1.6	4.9
Materials	-9.8	-30.8	-16.3	10.5	-7.6	-19.7	4.4	2.6	-9.6	-24.3	-7.2	7.5
Telecommunication	0.4	10.2	7.8	4.5	-3.7	-12.4	3.0	2.5	-8.3	-6.1	1.6	4.5
Utilities	0.2	-1.6	0.0	2.0	2.6	2.7	6.6	3.2	-2.7	-13.7	-5.0	3.3
Growth Index	-3.5	4.9	4.6		-2.3	0.7	12.7		-4.1	-6.4	2.6	
Value Index	-3.5	-15.3	1.3		-3.0	-6.9	9.1		-6.6	-15.3	-0.6	

### Index Charts



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