Loonie breaks from oil as bears shift focus to economic woes

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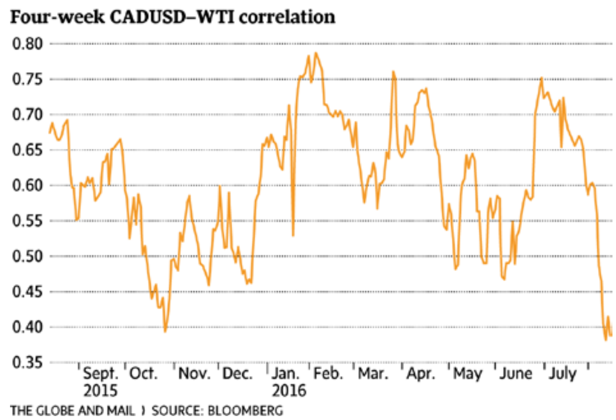
Canada's economic recovery is lagging so far behind the United States that even a rebound in crude prices is failing to boost the country's currency.

The four-week correlation between the Canadian dollar and crude fell to an 18-month low last week. With oil surging 8 per cent in August, the loonie is up just 0.5 per cent, trailing other commodity-linked currencies such as the Norway's krone and the Mexico's peso.



Canada's relative economic weakness, highlighted Aug. 5 when jobs data showed the U.S. economy continues to gain traction while Canada's slips, has overtaken oil as the major driver for the loonie. Yet the currency's uncoupling from crude may prove a blessing for Bank of Canada Governor Stephen Poloz, who is counting on non-energy exporters to spearhead the country's economic comeback.

"The market's finally turning its attention away from that tiring story line, and other drivers of the Canadian dollar are stepping into the spotlight," said Bipan Rai, senior foreign-exchange and macro strategist in Toronto at Canadian Imperial Bank of Commerce. He expects the loonie to weaken to 74.07 cents (U.S.) by year end, from 77.42 cents, where the Canadian dollar closed in trading Monday. "Traders are taking a more macro-focused approach to the Canadian dollar."

The four-week correlation between Canada's currency and crude oil futures fell to 0.38 last week from this year's high of 0.79 on Feb. 3, according to data compiled by Bloomberg. A reading of 1 implies the two are trading in lockstep. Crude oil has been Canada's second-largest export this year, behind passenger cars and light trucks, making up more than 8 per cent of the country's shipped goods, according to Statistics Canada.

That's left the loonie at the mercy of a growing divide between North America's two largest economies. While U.S. employers added 255,000 jobs last month, more than the most optimistic estimate in a Bloomberg survey of 89 economists, Canada's labour market unexpectedly contracted for a second straight month.

Even worse, Canada's economy shrank 1.5 per cent at an annual rate in the second quarter, the most since 2009, according to a separate Bloomberg survey. Statistics Canada will report the quarterly figure on Aug. 31. The country posted its largest-ever trade deficit of $3.6-billion (Canadian) in June, fuelling speculation additional monetary easing will be needed to get back on track. Derivatives prices indicate a 20-per-cent chance of an interest-rate cut in Canada by year-end, while the U.S. Federal Reserve is more likely to raise rates.

Foreign inflows into the Canadian bond market have also helped the loonie break away from crude, according to National Bank of Canada and Nomura Holdings Inc. Canada is issuing the most debt in seven years this month as the government takes advantage of near-record low borrowing costs to jolt the economy with a dose of fiscal stimulus.

Canada may cut its benchmark rate from record low 0.5 per cent this year, said Steven Englander, global head of Group-of-10 currency strategy at Citigroup Inc. in New York.

“There’s concern the Bank of Canada will ease policy, even if oil remains stable,” said Mr. Englander, whose bank is the world’s largest currency trader, according to Euromoney magazine. “The focus has shifted away from oil to the non-oil part of the Canadian economy.”

Mr. Englander sees the loonie slipping to 71.42 cents (U.S.) by the end of 2016. According to the median forecast in a Bloomberg survey, the currency will weaken to 75.76 cents by year-end.

Conditions were different earlier this year. Tracking the oil market, the loonie tumbled to a 13-year low in January before rallying to an 11-month high in May as the commodity rebounded.

Crude oil futures gained 6.4 per cent last week to $44.49 a barrel in New York, after falling to as low as $26 in February.

“Oil is trading in a dead spot for the Canadian dollar, it’s neither good nor bad,” said Shaun Osborne, chief foreign-exchange strategist at Bank of Nova Scotia in Toronto. “Oil would have to move above $50 per barrel or higher to make a change for the loonie.”