With U.S. bond yields set to rise, prepare for loonie to fall

By Scott Barlow
August 30, 2016 – *The Globe and Mail*

The oil price continues to get all the attention but where the loonie is concerned, bond yields continue to represent the more important driver. With an interest rate hike by the U.S. Federal Reserve becoming more likely after Fed chair Janet Yellen's speech Friday, Canadians may need to prepare for another downdraft in the domestic currency.

The first chart, below, shows the bond yields for Canadian and U.S. two-year government bonds. The value of the Canadian dollar is not on this chart, but as we'll see in a moment, when the relative yields of Canadian and U.S. bonds diverge, big changes in the value of the loonie almost always result. For example, in the initial part of the chart, from August to December, 2014, the yield on domestic bonds was far higher than for U.S. bonds. The loonie averaged 88 cents (U.S.) for this period, more than 10 cents higher than current levels.

The chart also clearly shows that October, 2015, is when the tide changed, and U.S. bond yields started moving higher in anticipation of last December's central bank rate increase. From October to December, the loonie declined by 7 per cent.

The second, lower chart shows clearly that the value of the loonie follows relative bond yields. The orange line plots the yield differential between Canadian and U.S. two-year yields by simply subtracting the domestic yield from the two-year Treasury yield.

The dollar's value is tracking the yield differential almost exactly (and this is backed up by correlation calculations). The loonie climbs as U.S. yields fall relative to domestic yields, and drops as U.S. bond yields rise. The relationship between yields and the Canadian dollar is closer than the connection between the oil price and the loonie, although not by an enormous amount.

Ms. Yellen, in a speech Friday in Jackson Hole, Wyo., stated that "in light of the continued solid performance of the labour market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened." Markets are widely interpreting these words as an indication of an imminent U.S. rate increase, if not in September than December.

A Fed rate hike will almost certainly push two-year U.S. bond yields higher. There is no discussion of a Bank of Canada interest rate increase – odds are skewed more in favour of a domestic rate cut, if anything – so Canadian bond yields are likely to decline relative to Treasuries and the orange line on the chart will fall. The loonie, if current trends persist, will also head lower.