Loonies and Housing and Budget Bears, Oh My!

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While the FOMC's much more dovish-than-expected turn was this week's dominant market driver—taking an axe to yields globally, yet again, and even inverting the Treasury curve—**Canada pried its way into the spotlight as well, and not in a good way**. In a week that normally would have been highlighted domestically by a pre-election Federal Budget, replete with a variety of new spending measures, instead the **headlines were full of sour views on Canada's prospects**. To highlight just a few of the veritable "Sell Canada" stories:

- A strategist at one of the world's largest asset managers predicted that the **Canadian dollar** will return to all-time lows of around 62 cents (last seen in early 2002), citing the lack of a growth driver with an over-extended consumer.
- A hedge fund investor, made famous by **The Big Short** (think Steve Carell), took a similar line of reasoning—that housing had seen its best days—to predict that the domestic banking sector could be challenged as well.
- Fitch Ratings chimed in that even **Canada's fiscal position** may no longer be worthy of its gold-plated reputation (which includes a triple-A rating for the federal government), given overall public sector debt levels.

While these items took a temporary swipe at the loonie—with a surprisingly soft January retail sales report on Friday piling on—it's notable that the currency finished the week down all of 0.5% (at around \$1.34, or 74.5 cents). Equities also hung in there, with the TSX almost holding flat on the week. Providing some important ballast for the Canadian dollar and stocks was a **further strengthening in oil prices**, both for WTI and WCS; the former neared US\$60 before a Friday retreat, while the latter is now not far from US\$50. As well, the **further dovish turn by the Fed** is no foe of the loonie or equities, with the FOMC deciding to slow its balance sheet runoff in May, and halt it in October (sooner than expected) and the latest dot plots showing a clear majority of members now believing no further rate hikes are necessary this year (see this week's Focus for details).

Addressing the three "Sell Canada" items in order, and why we may beg to somewhat differ on a few of them:

Tin Man: Starting with the currency, note that **the single-biggest driver for the Canadian dollar** over the past 30 years has been **the U.S. dollar** itself. It's zero coincidence that the loonie was plumbing record lows in early 2002 just as the broad-trade weighted greenback was hitting its second highest levels on record (topped only by the mountain in 1985). While it's true that the U.S. dollar has been the best-looking horse in the currency glue factory in recent years, suffice it to say that we are not bullish on its prospects—not with the Fed moving to the sidelines and fiscal stimulus winding down. The combination of a drifting U.S. dollar and underlying firmness in oil prices is not the right stuff for a serious drop in the Canadian dollar.

Scarecrow: Turning to the **housing market** concerns, as we set out in Focus in greater detail, **we have heard this song many, many times before**. And while there are no doubt legitimate concerns about the outlook for Canada's housing sector, we can readily point to **three factors that could provide support**. First, the **steep drop in bond yields** has all but eliminated rising rates as a drag—five-year GoCs plunged below 1.5% this week, down 100 bps in under six months. Second, **population growth** is still running at a pace not seen in decades—up 1.4% y/y in Q1, or a massive increase of 527,000 people in the past year (more than one person per minute). Third, this week's **Budget** was loaded with **housing-supportive elements**; while some will take time to kick in, and many analysts have questioned the need for such measures, they will support demand. Finally, we would just remind that one of the reasons that housing demand looks so soft in some key markets is because **Canadian policymakers have been applying a full-court press for the past two years to dampen activity**; the surprise would have been if housing had *not* cooled.

Cowardly Lion: Last, on **Canada's credit rating**. This one we have a bit more sympathy for—a few years ago, we penned a piece titled "*CanadAAA?*", openly questioning whether Canada fully deserved its gold-plated credit rating, given the relatively high level of gross public sector debt (combining Ottawa with the provinces). What's notable is that this report by Fitch lands in a week when Ottawa's finances were a tad better than budgeted (even as they spent the bulk of the revenue windfall) and no fewer than three provinces unveiled surplus budgets (Quebec, New Brunswick and Saskatchewan). Combined government debt levels have remained relatively stable at just above 80% of GDP pretty much since the recession ended. While the ratings agencies can decide whether or not that's worthy of triple A status, note that the market is still ready and willing to lend Ottawa money for 10 years at just 1.6%, and for 30 years at 1.9%, both below the Bank of Canada's inflation target. If Canada were to be downgraded at some point, it may be a small blow to national pride; but, in practical terms, the reality would still be exceptionally low borrowing costs for the federal government.

Global bond yields took another giant step down the staircase in barely a week. While the surprisingly **dovish FOMC statement** was the primary driver, a particularly weak March reading from Germany's manufacturers delivered another kick at the can on Friday. **Markit's PMI for Germany** fell to just 44.7, an eyebrow archer at the worst of times, and enough to send 10-year bund yields careening back into negative terrain (joining their Swiss and Japanese counterparts). This downdraft, in turn, gave another leg to the seemingly unstoppable Treasury and GoC rallies, carving 10-year U.S. yields to just 2.43% at one stage on Friday, a bit below 3-month bills—the Fed views the **10s/bills** spread as the best leading economic indicator, and that is a clear warning bell. In Canada, meanwhile, 10s had even sliced through the overnight rate last week, and the 10s/bills curve also inverted on Friday, with 10-year GoC yields dropping to their lowest level since mid-2017.

The deep drop in yields and the partial inversion of the Treasury curve rattled equity markets. After enjoying a one-day rally on the Fed's new dovish garb, the bond market action took the gains right back on Friday. Notably, the latest dive in yields comes in a week when the U.S. economic data were broadly positive (e.g., home sales popped 12% in February), although mostly of the second-tier variety. Next week brings a slew of consumer and housing-related indicators which will give a better sense of whether the U.S. economy is following the downward lead of the Euro Area; our sense is that the answer will be “no”.

Canada will not be so fortunate, as the main release domestically is the monthly GDP for January on Friday. While some of the clues have been positive on this one—solid volume gains for manufacturing and wholesale trade—the headline number will be crunched by the mandated cuts in Alberta oil production at the start of the year. As such, we look for GDP to drop 0.2%, its third consecutive monthly setback, and no doubt providing some short-term fodder for the Canada bears.