The Stan Clark Financial Team's

PERSPECTIVES

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Asset Allocation

Currency ebbs and flows

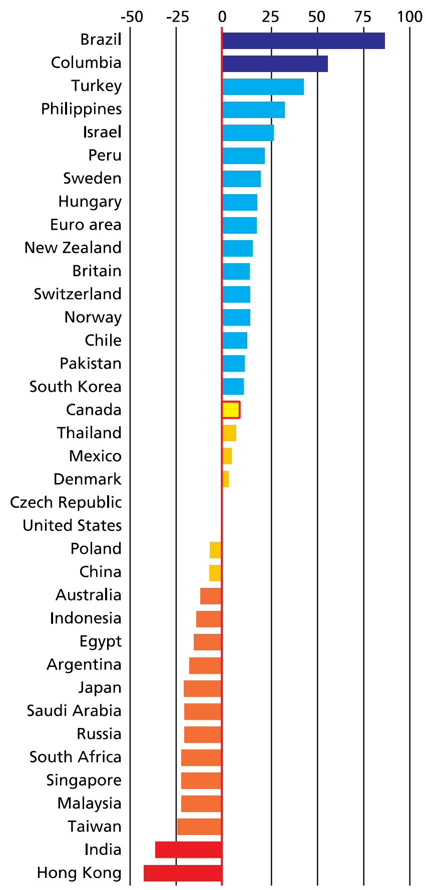
By Michael Chu, Investment Advisor

We don't have to look very far for proof that currencies are volatile. We all witnessed the Canadian dollar move from just below par in the early 1990s, way down to almost 60 cents in 2002. Then we saw it rise past par in 2007 and yet again in 2011 – only to fall back down again to around 85 cents today.

Why do currencies change so much, and how do we determine what they're really worth?

Unfortunately, there's no easy answer. Of course, there are lots of theories on what a currency "should" be worth. But whether that's where the currencies actually trade today is a whole other matter.

Big Mac Index
(% over/undervaluation vs. US Dollar)



Source: The Economist

One major theory of currency valuation is the *purchasing power parity*, or PPP. Basically, the theory is that exchange rates should move towards the rate that equalizes the prices of an identical basket of goods in two different countries. *The Economist* magazine has a simplified version of this, called the Big Mac Index.

Based on *The Economist*'s model, the prices of Big Macs should be about the same around the world. If they are not, the exchange rates would naturally move to make the prices the same. According to *The Economist*, the average price of a Big Mac in the U.S. was $4.80. In China, the price was only $2.73. This implies that the Chinese yuan is about 43 percent undervalued.

But are things really that simple? After all, no one is going to go buy Big Macs in China, and then ship them to the U.S. to re-sell them. More importantly, the Big Mac Index can be distorted by differences in local costs, such as wages and rent. So, maybe Big Macs should be cheaper in China. To compensate for this issue, *The Economist* has a more "gourmet" version of the Big Mac Index, which adjusts for GDP per person. After adjusting for GDP, the yuan is a much more reasonable 6.4 percent undervalued.

In July 2014, the adjusted Big Mac Index put our Canadian dollar at 8.8 percent overvalued. That's a modest amount of overvaluation, but don't read too much into it. It's just one theory, and a simple one, at that. We can still ask: Based on this theory, why doesn't the dollar trade at fair value?

Canada is a major exporter of natural resources such as lumber, base metals and precious metals; but more importantly, oil. Canada is by far the largest oil exporter to the U.S. The Canadian dollar is also known as a petro currency, meaning that it is highly correlated to the price of oil. If oil prices go up, then the Canadian dollar goes up. Conversely, if oil prices go down, then the Canadian dollar goes down. However, as mentioned earlier, oil isn't Canada's only major export. Precious metal and base metal prices will also have an effect on the Canadian dollar.

Based on the Big Mac Index, the theoretical fair value of the Canadian dollar is around 86 cents. The fair value hasn't changed much since at least 2010, demonstrating how linked our economy is with the U.S. Coincidentally, 86 cents is about where the dollar is today. Perhaps the recent decline in oil prices has resulted in less support for the Canadian dollar, reducing the overvaluation back in July to being fairly valued today. We'll discuss more about oil in our upcoming year-end review.

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In summary, as you can see, currencies are complicated. While it's easy to look at them in isolation and see patterns, there's often a lot more behind their movements than meets the eye. Our take on currencies is: Don't try to predict their movements; rather, we should think about using a diversified approach. This means having some of your investments outside of Canada, such as in the U.S. and around the world.

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To learn more about CIBC Wood Gundy, the Stan Clark Financial Team and the many ways we can help manage your wealth, please contact us by phone or by email as listed below.

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