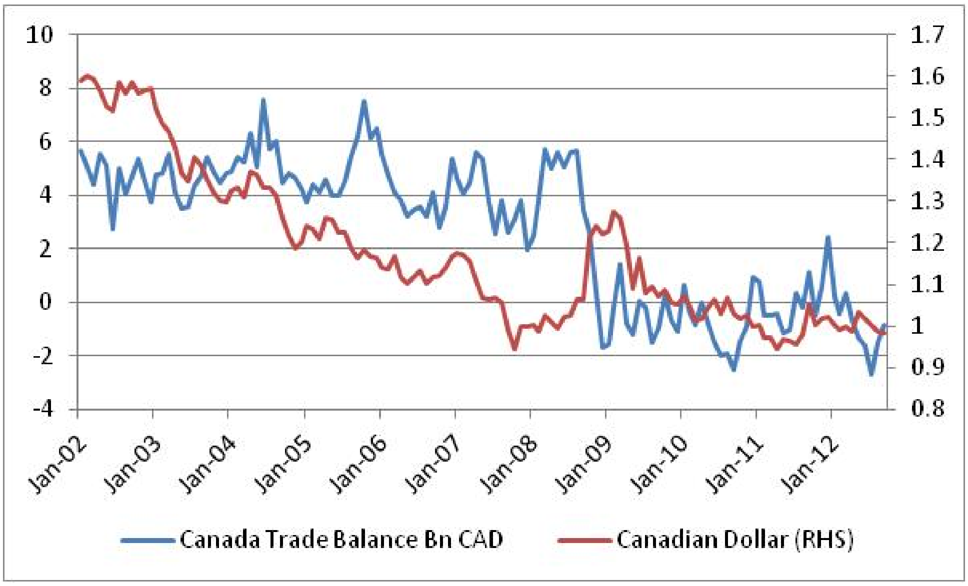
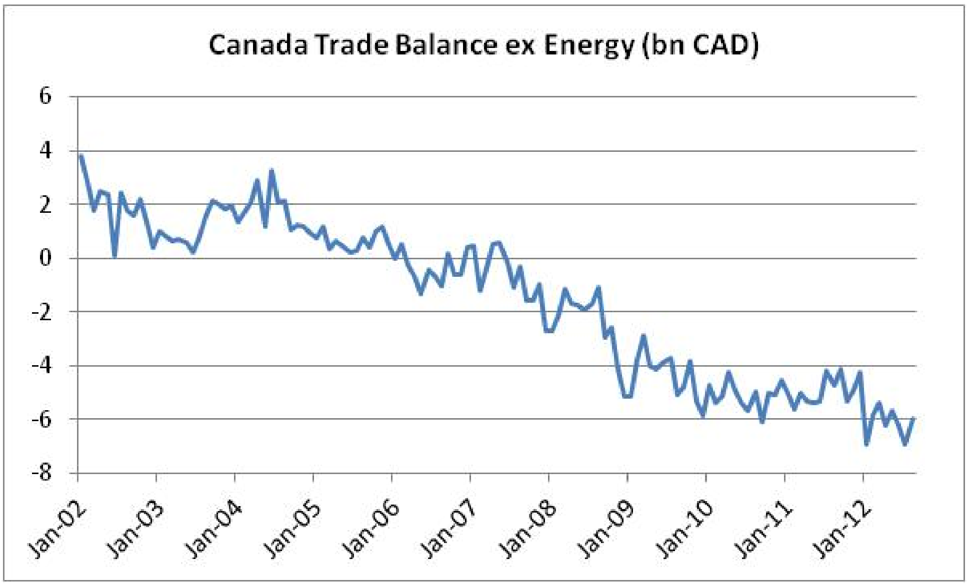
CANADIAN DOLLAR – TROUBLE AHEAD

The Canadian dollar has been a popular investment destination for investors troubled by the currency debasing policies of its large southern neighbour. Investors who bought the Canadian dollar in 2003 have been rewarded as the "Loonie" has risen from 1.60 against the USD to parity today. The arguments for the Canadian dollar are relatively straight forward, it has the largest energy reserves in the world by some measures, and Canadian interest rates have generally been higher than those of the U.S.

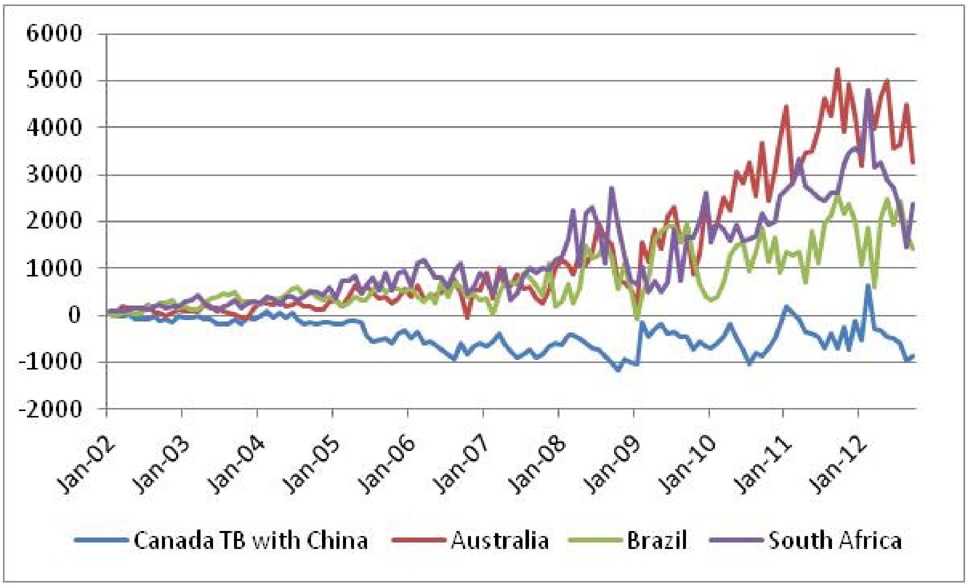
However the rise of the Loonie has caused Canada to move from a trade surplus to a trade deficit.



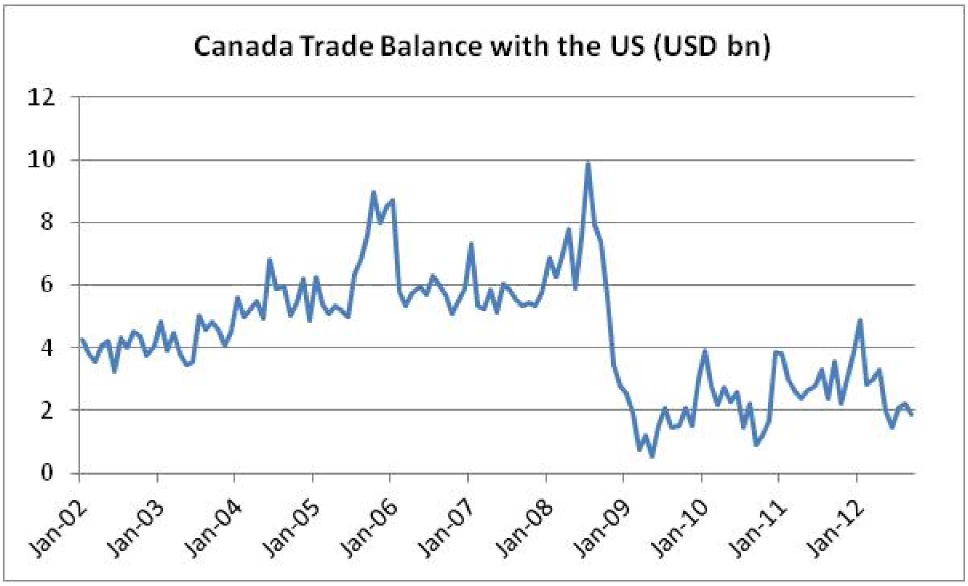
The Canada trade balance excluding its energy exports has deteriorated since 2002 (see below) and so Canada is more heavily dependent than ever on energy exports.



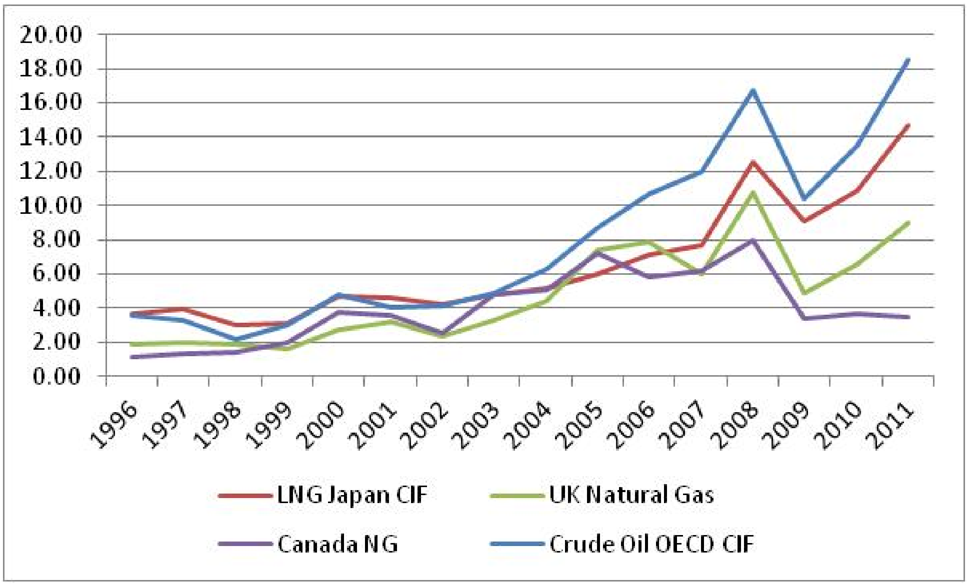
What also sets Canada apart from almost every other commodity exporter is that it runs a trade deficit with China (see chart below).



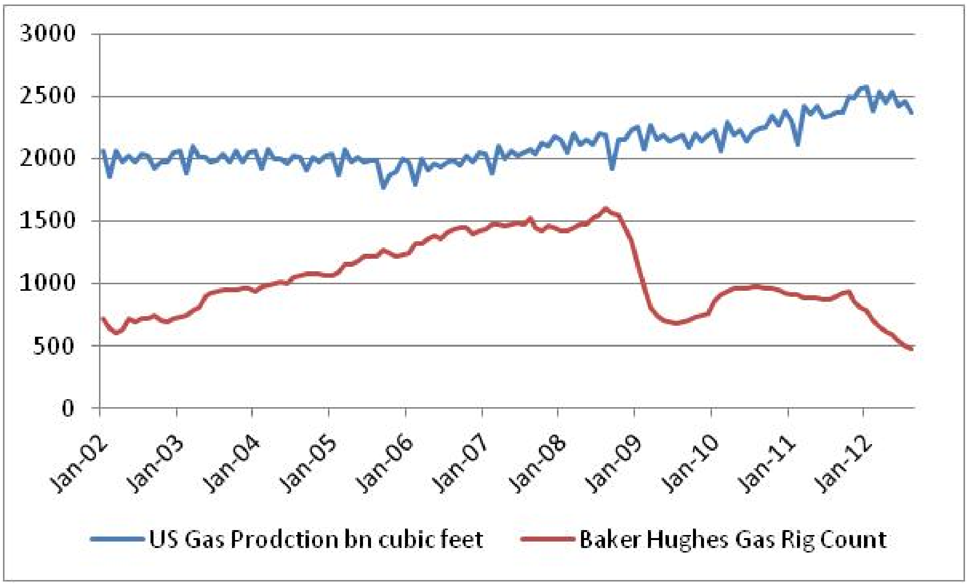
The trade deficit with China is offset by the surplus with the US, but since the financial crisis when the surplus diminished, it has not had a significant recovery.



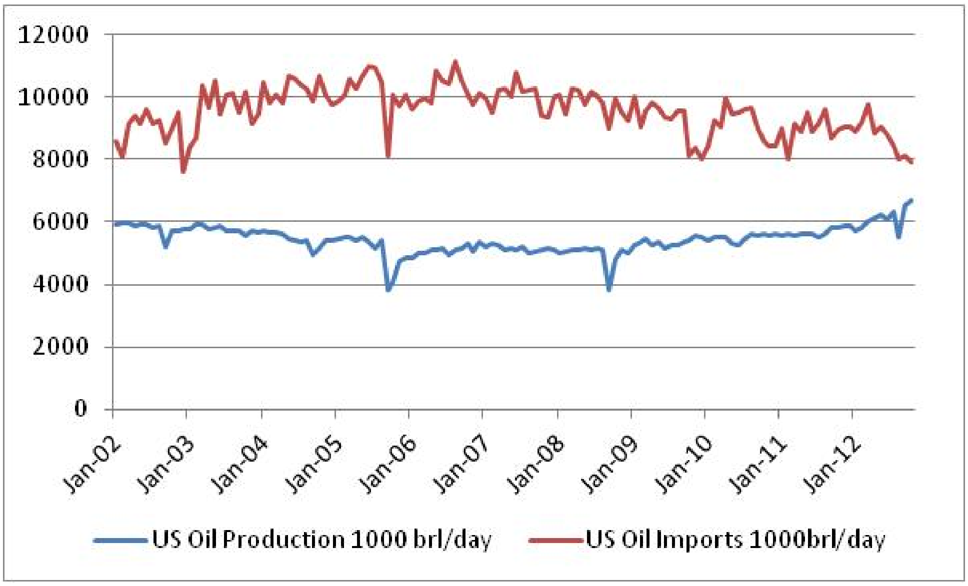
The graph below shows the relative prices of natural gas in Japan, UK and Canada as well as the international oil price. Canadian gas prices have plunged, while prices elsewhere have held up well. The BP Oil Report shows that Canada had no LNG exports in 2011. Canada's gas is mainly exported by pipeline to the U.S. meaning that they are locked into the lower prices for gas prevalent in North America.



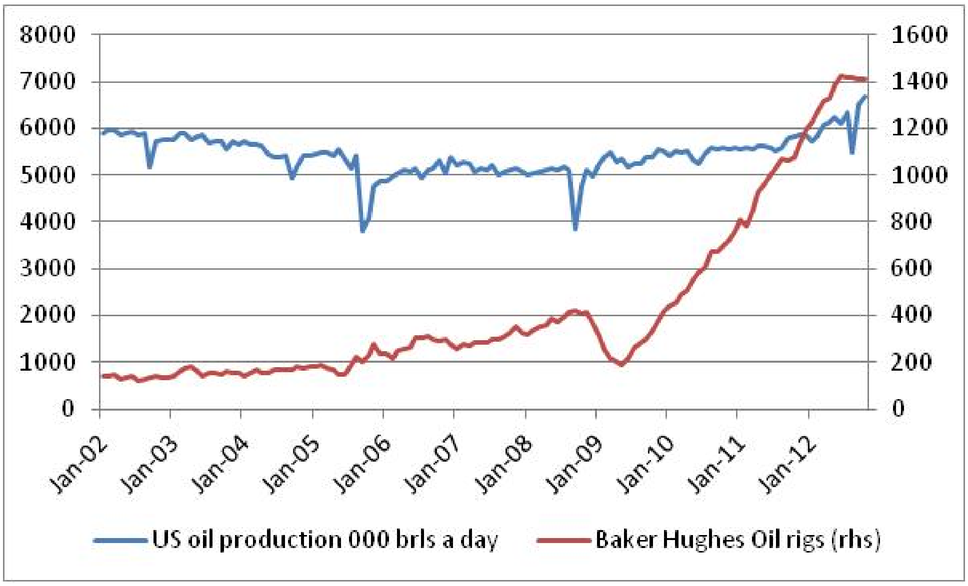
While Canadian gas exports to the U.S. look troubled, a key question for Canada and its energy exporting business is by how much U.S. oil production might continue to grow. I cannot provide a strong answer, but a look at the U.S. natrual gas market is instructive. Since natural gas prices began to fall in the US, gas producers have been reducing gas rigs in favour of oil rigs. However, despite 5 years of much lower levels of gas rigs, gas production is only now beginning to stabilise.



As the U.S. has increased its oil production it has reduced its imports of oil. For the time being this has largely displaced Middle East crude, which has been exported to Asia instead. Currently, all of Canada's oil goes to the US, but at some point it may need to begin exporting oil elsewhere and at a cost.



If U.S. oil rigs have a similar production profile to the U.S. natural gas rigs, we may only be at the beginning of a major increase in U.S. oil production. IEA has recently predicted that the U.S. will overtake Saudi Arabia production by 2020 with a forecast of 11.1m barrels a day, up from the current 6.5m barrels a day production.



Historically, I have noticed that big changes in exchange rates are normally preceded by prolonged periods of current account deficit. Canada currently exhibits this, and is facing a structural issue in that its largest customer needs less of its product. To my mind, shorting Canadian dollars versus U.S. dollar is a low cost position with an attractive risk/reward profile.

INFORMATION

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