Canada's competitive disadvantage

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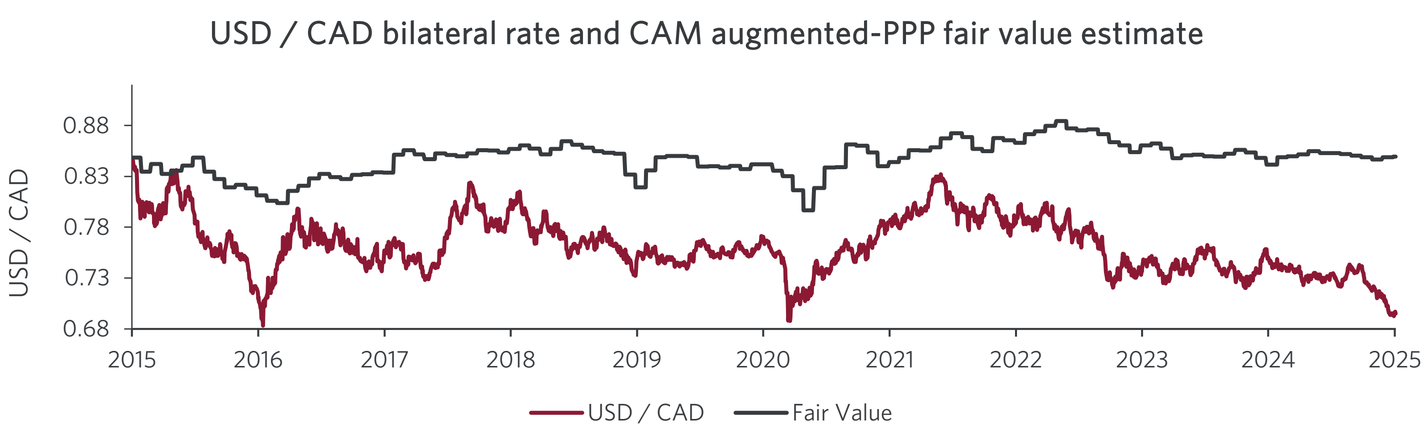
Key takeaways

- The Canadian dollar (CAD) has traded below its estimated fair value against the US dollar for many years. CAD weakness reflects persistent underperformance of the Canadian economy versus the US.
- This underperformance appears unlikely to reverse any time soon, suggesting a risk of further trend CAD weakness.
- This risk must be framed within the current highly uncertain economic and political environment. This suggests the risks around CAD are more two-way than longer-term economic analysis would suggest.
- Reflecting the myriad cross currents, we recently implemented a small tactical currency hedge on US equity mandates. We will continue to monitor this hedge, and adjust as appropriate.

The weak Canadian dollar reflects important structural impediments

The Canadian dollar (CAD) has spent more than a decade in undervalued territory, drifting below its estimated fair value. Based on CIBC Asset Management's valuation metrics, the last time it screened as fairly valued was in the spring of 2015 (Chart 1), with fair value estimated at approximately 83 US cents. Since then, CAD has consistently traded in undervalued territory against the USD.

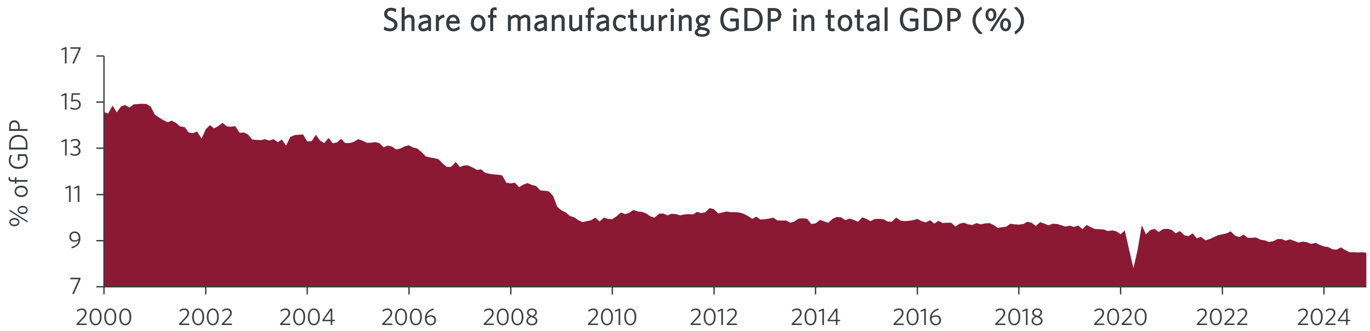
Chart 1: CAD was fairly valued a decade ago



Source: Refinitiv-Datastream, February 2025. For illustrative purposes only.

A significant factor contributing to this undervaluation has been a widening competitiveness gap between Canada and the United States. This gap is evident in the relative performance of Canada-U.S. labor productivity, and is even more striking when examining the deterioration of Canada's manufacturing sector (Chart 2). Since 2018, Canadian manufacturing activity has contracted by 5%, signaling a troubling trend of economic erosion. In contrast, the U.S. manufacturing sector has expanded by 10% over the same period, highlighting a stark divergence in industrial growth.

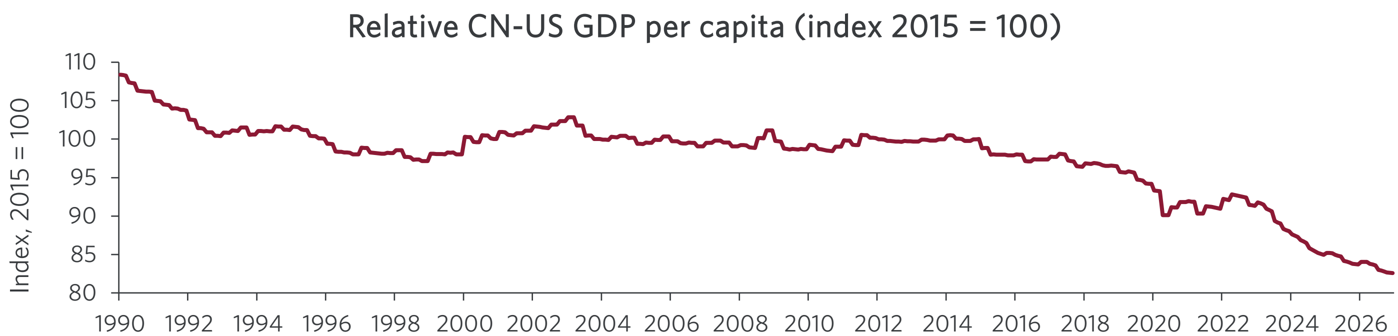
Chart 2: The atrophy of Canadian manufacturing sector



Refinitiv-Datastream, February 2025. For illustrative purposes only.

Canada's growing competitive disadvantage is having a significant impact on its standard of living. Since the early 1990s, this has declined by 23% relative to the United States; the pace of relative decline has accelerated since 2015 (Chart 3).

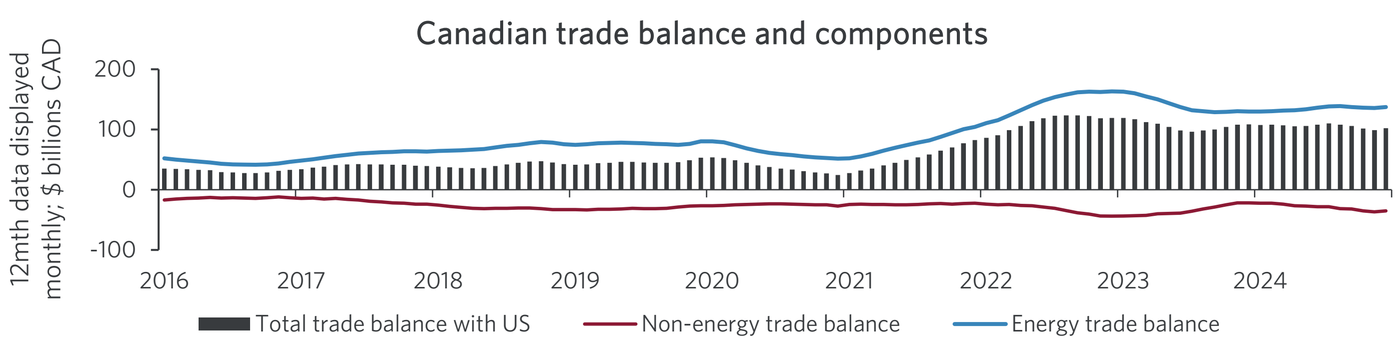
Chart 3: Canada's free falling standard of living



Source: Refinitiv-Datastream, February 2025. For illustrative purposes only.

Canada's competitiveness challenges are particularly evident in the composition of its bilateral trade balance with the U.S. While Canada maintains a significant energy trade surplus, it faces a substantial non-energy trade deficit—a trend that has persisted for over a decade (Chart 4). This persistent imbalance underscores a structural competitiveness issue relative to the U.S.

Chart 4: Wide Canadian non-energy trade deficit



Source: Refinitiv-Datastream, February 2025. For illustrative purposes only.

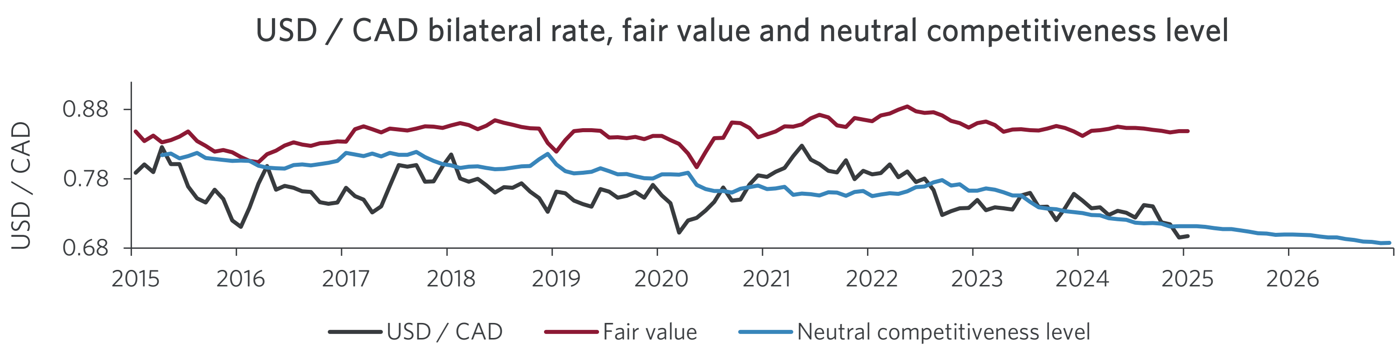
A similar conclusion emerges from relative Canada-U.S. corporate earnings. Canadian corporations have consistently generated lower profits than their U.S. counterparts since 2015. This profitability gap has been a key factor in the prolonged underperformance of Canadian versus U.S. equities (Chart 5).

Chart 5: Lacklustre Canadian corporate profitability

Source: Refinitiv-Datastream, February 2025. For illustrative purposes only. Total returns of S&P/TSX Composite Index & S&P 500 Index.

Given these developments, a significant price discount—reflected in a weaker CAD/USD exchange rate versus its estimated fair value—appears necessary to offset Canada's competitiveness gap. A decade ago, Canada was considered competitive with the U.S. when the Canadian dollar traded at approximately 83 US cents. Today, a considerably weaker exchange rate is required to restore this competitiveness. Our analysis suggests that Canada needs a 16% discount to fair value to achieve a competitive position relative to the U.S. (Chart 6). CIBC Asset Management's proprietary fair value estimate currently stands at 85 US cents; the level needed to restore Canada's competitiveness appears closer to 69 US cents, which aligns relatively closely with current pricing ($0.7044 as at February 18, 2025; see Chart 6). It is important to note that this is a dynamic situation. The decline in Canada's relative competitiveness risks intensifying, which could further lower the fair value of CADUSD–Canada's productivity challenges are rooted in structural economic shifts, insufficient investment, inadequate policy support, and pressures from global markets.

Chart 6: Cheaper Canadian dollar required



Source: Refinitiv-Datastream, February 2025. For illustrative purposes only. Neutral competitive level calculated as the CADUSD level required to fully compensate for the competitive disadvantage.

This analysis does not account for the impact of additional tariffs levied by the U.S. on Canadian exports. Our baseline economic outlook assumes that any comprehensive US tariffs on Canada (and retaliatory Canadian tariffs imposed on the US) will be short lived. But the situation is highly uncertain, and risks around this view are skewed to tariffs remaining for a longer period—or that they could resurface after initial removal. If these risks are realized, they would likely add additional downward pressure on CAD.

To hedge or not to hedge?

When evaluating the appropriate currency hedging position for our mutual funds and institutional mandates with U.S. dollar exposure, we follow a disciplined investment process that integrates both quantitative and qualitative assessments. From a quantitative perspective, as discussed above, there seems to be a risk of further CAD weakness, at least for the next several months. In this context, unhedged currency exposure makes sense. But we also must contextualize this strategic analysis with current events. This is where our fundamental analysis becomes particularly important.

Economic and political uncertainty is particularly high at present, and is likely to remain elevated for the foreseeable future. Recently, market participants have begun to focus on the prospect of an earlier ceasefire in Ukraine than previously expected. A ceasefire would likely benefit the broader European economy, providing positive support for the euro and other pro-cyclical currencies, including CAD.

Given the numerous cross currents impacting currency markets, we are proceeding cautiously but have recently initiated a small tactical hedge of USD exposure in relevant client mandates. We will look to adjust the size of this hedge as the push-pull of strategic CAD weakness, heightened uncertainty, and potential impact of tariffs and political developments evolves in coming weeks and months.

About CIBC Asset Management

At CIBC Asset Management, we believe that every customized investment solution begins with research and rigour. We specialize in a variety of investment solutions such as equities, fixed income, currency management, liability-driven investments, asset allocation, and responsible investments.

Across a spectrum of investment solutions, we commit to robust research. Dedicated sector and regional analysts focus on industry research and security-specific idea generation. Our investment professionals leverage deep and diverse expertise by sharing proprietary research across asset-class teams. By sharing insight across asset class teams, we maximize opportunities to add value to our client portfolios.