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Macro Market Insights

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Dead Cat Bounce

The US dollar index has fallen around 3 per cent since its high the beginning of March. This past week saw the best weekly performance for the Canadian dollar in the last four years. Obviously the two events are related as one currency's strength is another's weakness; moreover, the question is whether the Canadian dollar is rising on its own merits, the US dollar rally is over or taking break, or perhaps, a combination of both.

The strong rally witnessed in the Canadian dollar this past week was reaffirmed by retail sales numbers for the Canadian economy in the month of February, and core inflation jumping to 2.4 per cent annually in March. Not only do retail sales numbers suggest that the blow from an "atrocious" energy sector in the first quarter might be subdued (to borrow an adjective from Bank of Canada Governor Stephen Poloz), but also core inflation registering at the upper end of the Bank's target decreases the likelihood of a subsequent interest rate cut. And it is both these factors that are obviously supportive of an economy that has been a far cry from inspirational.

As much as the aforementioned fundamentals can tell a story about the direction of currency markets, it's difficult to deviate from the single most important factor in pricing the Canadian dollar over the last year, and that has unequivocally been US dollar strength. This trend has been challenged on multiple occasions over the last month, particularly this past week, which saw oil prices peak to their highest level in 2015. It was largely based of a report that production levels in the state of North Dakota (second largest producer by state in the US) had slipped from their peak. Coincidently, global oil production has risen to its highest level on record, over 1 million barrels/day more than February, and Saudi output was at its highest level in 30 years. However it was US benchmark prices for crude that led the global markets in regaining their footing.

The global supply story for oil has not changed. Especially from the standpoint that US production is not being cut back so much as active wells withholding production from the market, potentially awaiting higher prices, which could prompt a second wave of oversupply. This global commodity picture is one factor that could see the US dollar regain a second stage of selling pressure. The second is Europe.

This market is failing to get a grasp on the distortion being created from negative interest rates and how such a deflationary scenario is being created in Europe. The idea of negative interest rates ranging from lines of credits to business to 90 per cent of the mortgages in Portugal being based on a variable rate will eventually translate to real assets and their goods' sector deflating. The Eurozone is transforming into a something from nothing economy. How growth and stability can be projected over the long term is a conundrum with interest rates where they are. If Quantitative Easing was an experiment in the US, it has become 10 times the gamble in Europe. As this risk plays out, it seems undoubtedly the US dollar will find a renewed round of strength.

The markets are setting the stage for dollar dilemma round 2. We have seen justifiable reasons for uncorrelated and negatively correlated assets rallying against the dollar, but the rationale is not convincing enough to buck the trend. An overused expression seems extremely applicable; simply put, this is a dead cat bounce.