

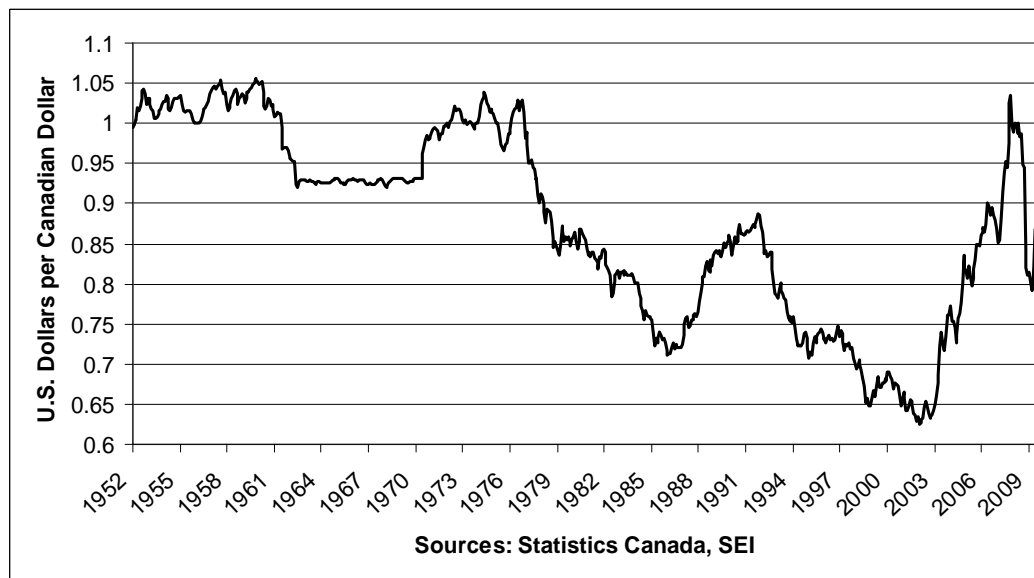
## The Outlook for the Canadian Dollar

*By: James Solloway, CFA, Senior Portfolio Manager, Global Portfolio Strategies*

The Canadian dollar has experienced sharp volatility in recent years, complicating the investment process for Canadian investors that have exposure to U.S.-dollar assets. Examining some of the fundamental drivers behind the USD/CAD relationship provides insight into a possible path the currency may take over the next 12-18 months.

Exhibit 1 provides a long-term view of the Canadian dollar/U.S. dollar relationship since 1952. The relationship was relatively stable in earlier decades, following the 1944 Bretton Woods currency framework. Even for a few years after the collapse of that currency regime in 1971, the Canadian dollar's value remained relatively stable around parity against the U.S. dollar. The Canadian dollar broke out of this narrow range in the late 1970s, however, commencing a long period of depreciation that took the currency toward USD 0.71 by 1986. Over the next four years (1987-1991), the CAD rallied back toward USD 0.90. Thereafter, the currency resumed its slide, hitting a low of USD 0.62 in 2002. Between 2002 and 2007, the CAD logged a vigorous appreciation, peaking above USD 1.03 in November 2007. In five year's time, the Canadian dollar recouped all the ground that was lost between 1976 and 2002. Currency movements have remained intense in recent months, with the CAD reaching a low of USD 0.79 in March 2009, followed by a rebound to its current level of USD 0.87-0.88.

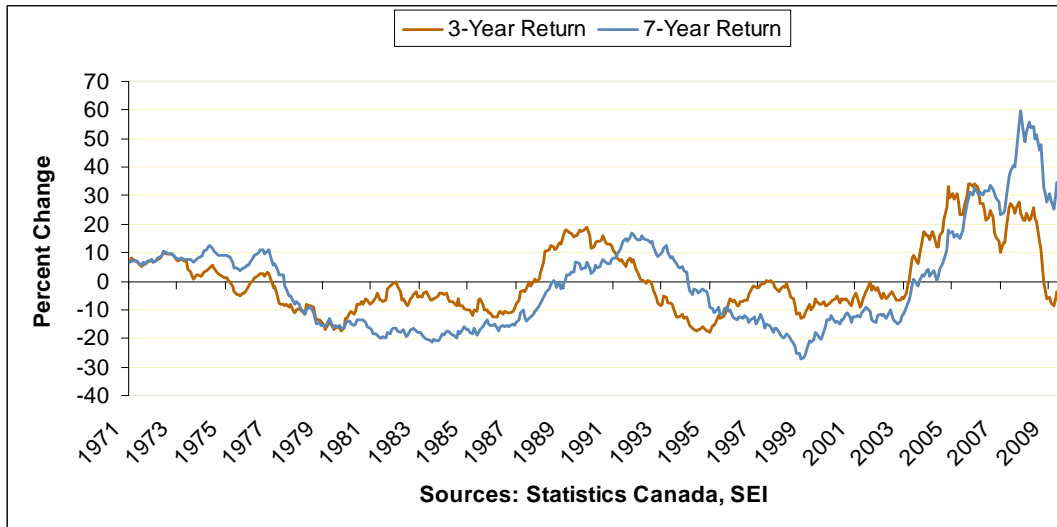
**Exhibit 1: Canadian Dollar Versus U.S. Dollar**



The increasing volatility of the USD/CAD relationship can be seen in Exhibit 2 on the following page, which examines three-year and seven-year rolling returns. Three-year returns exceeded 30% in 2005-2006, but have since turned negative as the currency's plunge in the past year eclipsed the previous two years' gains. Taking a longer perspective, it can be seen that the bull market in the Canadian dollar not only was steep, but also prolonged. Between 2000 and 2007, the currency climbed 60% — a performance far exceeding previous cycles. Interestingly, these ups and downs of the currency have

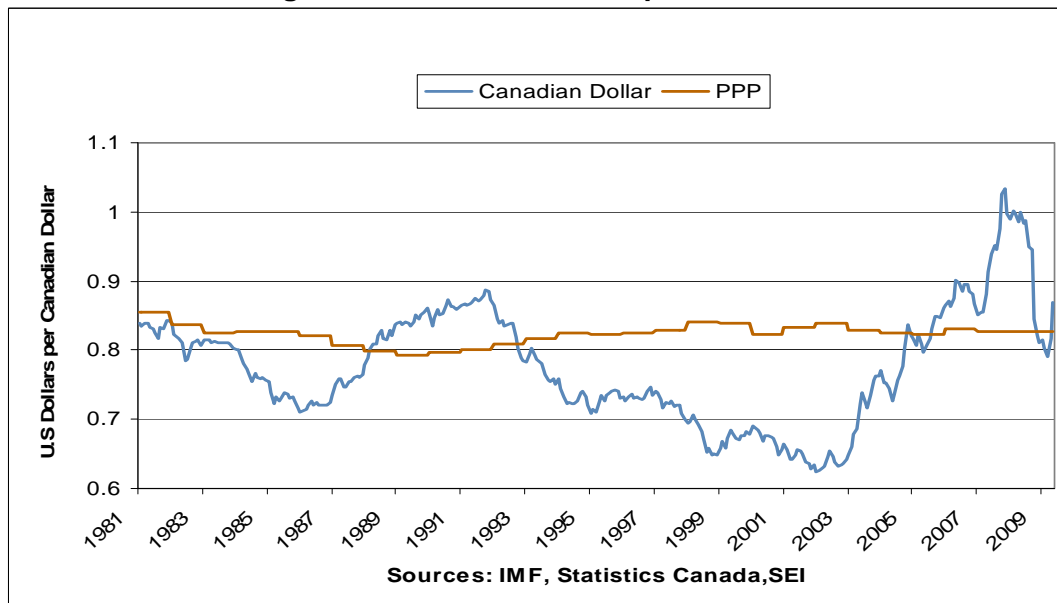
offset each other over time. Since 1970, the average three-year rolling return works out to be just 0.5%. The average seven-year return is slightly negative at -0.8%.

**Exhibit 2: Canadian Dollar Versus U.S. Dollar Rolling Returns**



We believe that it makes sense that there would be a strong tendency to return to the mean. The Canadian economy is closely intertwined with that of its southern neighbour. The U.S. absorbs 78% of Canada’s exported goods and is the source of more than half of Canada’s imports. Purchasing Power Parity<sup>1</sup> for the Canadian dollar equals USD 0.83, as seen in Exhibit 3. The current spot price is about 5% above that (the spot price was nearly equal to the PPP value in April). Obviously, it is a rare occurrence when spot prices are near a currency’s PPP value. But severe overshoots and undershoots will eventually be corrected as price differences between identical products and services in different countries are arbitrated away.

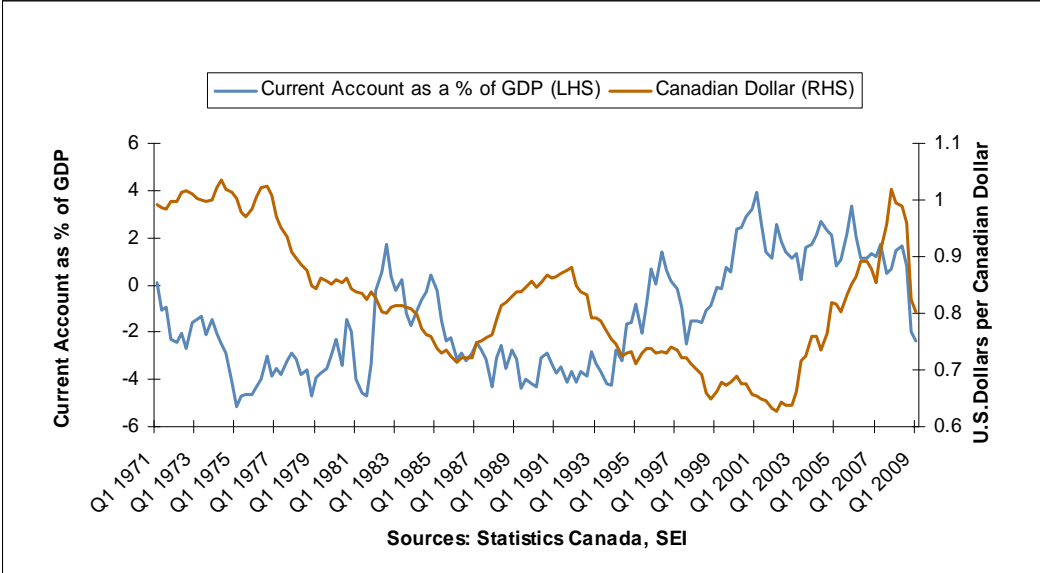
**Exhibit 3: Purchasing Power Parities Versus Spot**



<sup>1</sup> PPP is an estimate of the amount of adjustment needed on the exchange rate between countries in order for the respective currencies to be equivalent.

Exhibit 4 highlights the relationship between Canada’s current account and movements in the currency. Historically, a strong Canadian dollar generally led to poorer trade performance. This, in turn, could put downward pressure on the Canadian currency, as exporters selling into Canada recycle their proceeds back into their home currency. In recent years, the Canadian current account remained in surplus despite the sharp appreciation of the currency against the U.S. dollar. Beginning last fall, however, the global recession and the collapse in commodity prices resulted in a sharp deterioration in both the Canadian currency and the current account position.

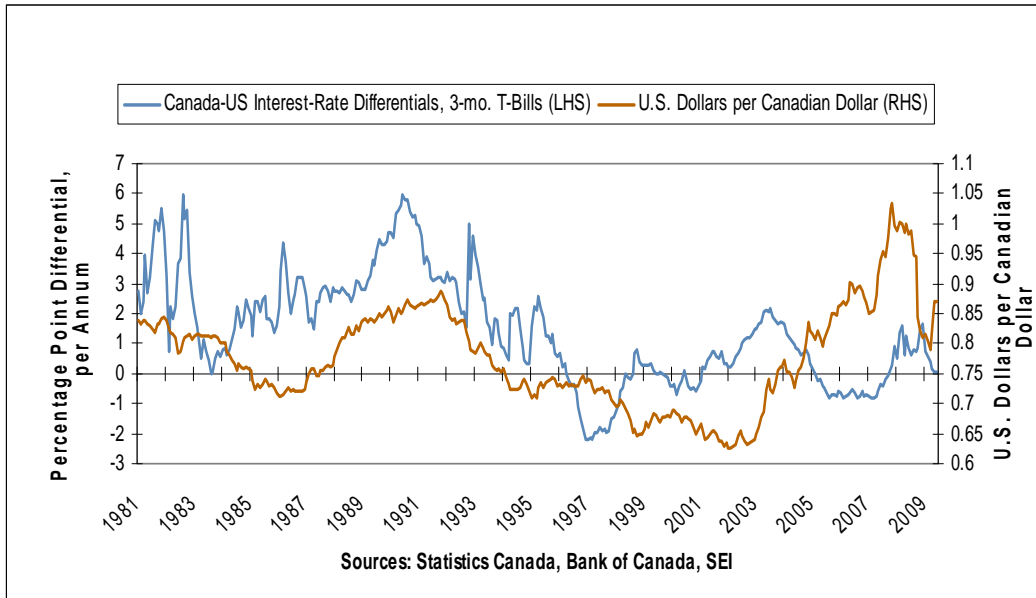
**Exhibit 4: Canadian Current Account Versus the Canadian Dollar**



**Not Much Difference in Differentials**

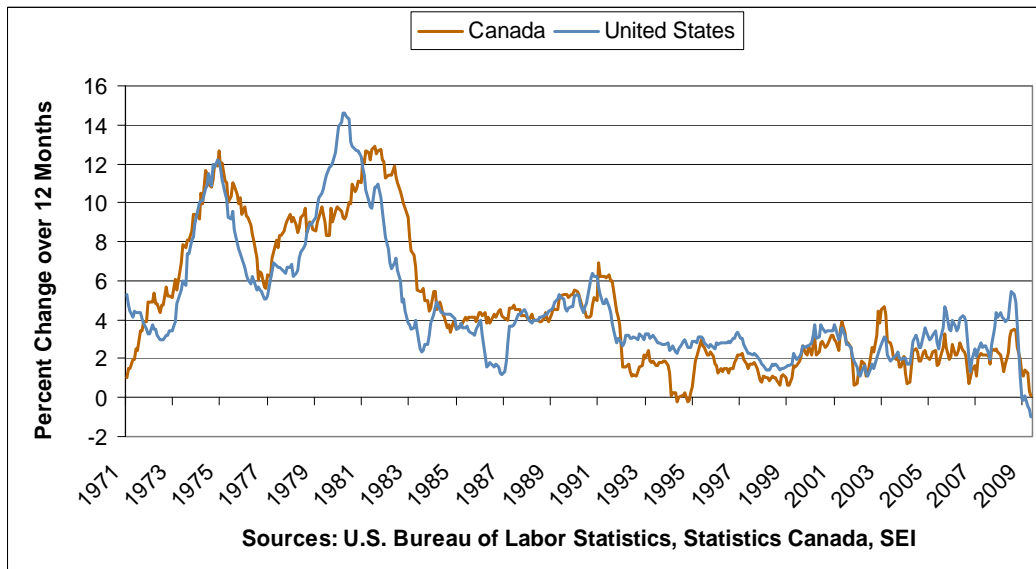
Interest rate policy is another key driver of currency rates. If a country raises its interest rates, currency prices will tend to strengthen as those relatively higher interest rates attract foreign investors. Exhibit 5 on the following page tracks the difference in yields between the Canadian and U.S. three-month Treasury-Bill (T-Bill) rates since 1980. Although there appears to be periods of positive correlation — i.e. the Canadian dollar appreciates (depreciates) as Canadian interest rates rise (fall) versus U.S. rates — during the 1990s and the early 2000s, recent experience is decidedly mixed. We do not believe that interest rates are a strong influence at the current time. First, there is no differential. T-Bill rates are only 25 basis points in both countries. Although the Bank of Canada is not explicitly pursuing a quantitative easing policy, it has expanded its balance sheet and has permitted short-term rates to fall to U.S. levels. It’s our view that rates in both countries will remain low for a prolonged period.

### Exhibit 5: Interest-Rate Differentials Versus the Canadian Dollar



Inflation differentials can also determine currency values. The higher the inflation rate, the weaker a currency tends to be, as inflation erodes the purchasing power of that currency. Canadian and U.S. consumer-price inflation trends track closely with each other, however, as seen in Exhibit 6. It's hard to make the case that inflation rates are a driving force in the U.S./Canadian currency relationship. Inflation rates for both countries have stayed in a relatively narrow range since the 1990s. Although U.S. inflation tended to run slightly ahead of Canada's during the 2003-2007 expansion, the situation has reversed in recent months, with the U.S. experiencing mild deflation.

### Exhibit 6: CPI Inflation

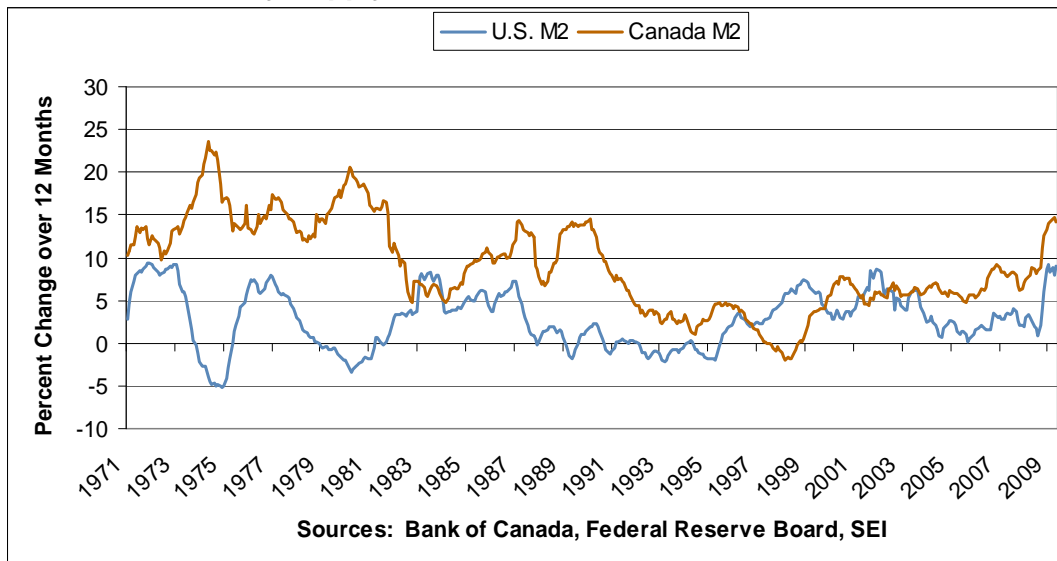


Despite the weak U.S. economy and the absence of a near-term inflationary threat, many observers fear that U.S. deficit spending and quantitative easing will eventually result in a major inflation problem and a severe weakening of the American dollar. We think these concerns are overwrought, especially over a timeframe as short as the next couple of years. Although the extraordinary dislocations in the financial system have eased, the de-leveraging of the private sector continues. There is no reason to

believe that government deficit financing will spawn near-term inflation pressures or crowd out private-sector investment as recovery gets underway. On the contrary, deficit spending and aggressive monetary easing probably prevented an even steeper downturn than the one that has been endured (see our analysis in the recent paper *This Is Not Your Grandfather's Depression*).

Although bank reserves in the U.S. have quadrupled, the money supply, as measured by M2<sup>2</sup>, has accelerated rather modestly. Growth in Canadian M2 has actually been faster in recent years — as seen in Exhibit 7 — reflecting the relative strength of Canada's banking system. Eventually, serious consideration will need to be given to unwinding the stimulus that has been put into place in the United States. But that time is not now. In a financial crisis that results in a contraction of private-sector debt, it pays to err on the side of easing. Labour and product markets will need to tighten up considerably before inflation becomes a problem. At this point, industrial capacity is deeply depressed and unemployment is well above the level that could engender a sustainable rise in prices. Given an output gap that exceeds 6% of U.S. Gross Domestic Product (GDP), we see little chance that government deficit spending will result in a major gain in either interest rates or inflation over the next one or two years.

**Exhibit 7: M2 Money Supply Canada Versus U.S.**



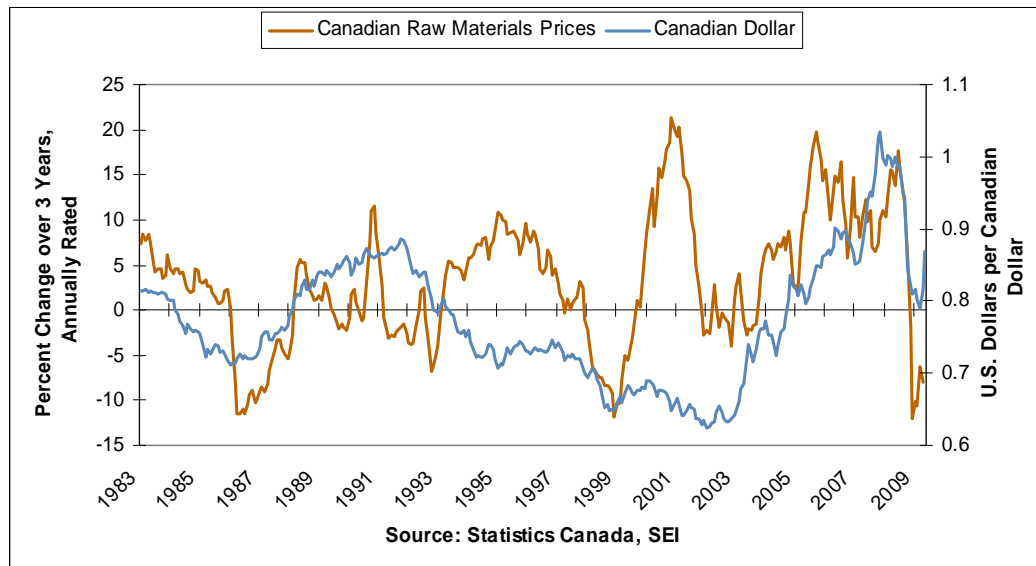
### Keeping an Eye on Commodities

With more than 60% of Canada's merchandise exports composed of energy, agricultural, forestry and industrial goods and materials, it's not surprising that Canada is looked upon as a "commodity country," not unlike Australia. The country's currency moved higher in tandem with commodity prices during the last cyclical expansion and collapsed with those prices during the global downturn, as seen in Exhibit 8 on the following page. The revival in commodity prices in recent months has coincided with the Canadian dollar's turnaround as well. However, prior to 2003, there appeared to be a much looser correlation between the currency and commodity prices. Commodity prices, for example, rose sharply in the 1999-2000 period, with little reaction in the currency. During the mid-1990s, the Canadian dollar actually declined sharply despite steady gains in raw materials prices, as political concerns surrounding

<sup>2</sup> M2 is a measure of the money supply, that includes M1 (defined as all coins, currency, traveller's checks, checking account balances, NOW accounts, automatic transfer service accounts, and balances in credit unions held by the public) and assets in savings deposits, small-denomination time deposits (time deposits in amounts of less than \$100,000); and balances in retail money market mutual funds.

the separatist movement in Quebec were a major preoccupation for investors at the time. Although renewed commodity price strength should lead to a stronger Canadian currency, it has not always been the case.

### Exhibit 8: Commodities Versus The Canadian Dollar



Fundamental considerations argue for at least a breather in the commodity-price run-up. The economic outlook is uncertain, and there remains a great deal of slack in the energy and industrial goods markets. Additionally, there is a distinct possibility that Chinese demand for oil and other industrial commodities will pull back, following the significant build-up in inventories seen to date. Insofar as the Canadian dollar remains tied to the performance of commodities, there may be additional currency weakness in the months immediately ahead. A move back down to the USD 0.83-0.84 level is possible, given the potential for a broad consolidation in the global markets of the sharp gains achieved in the March-May period. A move back to or below the March lows in the CAD would be associated with a more serious relapse in global markets than we currently expect.

Over the longer run, commodities are expected to remain quite volatile, responding to perceived shortage situations, gyrations in demand from China and other developing nations and investor speculation. It's our view that global growth will return in the years ahead, but the rate of gain will likely be muted compared to the past decade. The damage to the world's financial system will take years to repair. The U.S. consumer will not be the engine of growth that it had been, although the prospects for emerging economies remain positive. All the same, talk of the resumption of a secular bull market in commodities seems premature at best. Given this scenario, the 12-18 month outlook for the Canadian dollar appears moderately positive, although it wouldn't justify a return to parity against the USD.

### Conclusions

The USD/CAD relationship has been a volatile one since the breakdown of the Bretton Woods currency arrangement in the early 1970s. The volatility and unpredictability has become even more intense in recent years, as the Canadian currency appreciated rapidly against the background of soaring commodity prices, then fell back steeply as global recession hurt demand for commodities and the U.S. currency benefited from its status as a safe haven.

Ironically, the currency relationship has mean-reverted to long-term averages. The Canadian dollar is currently close to its Purchasing Power Parity value and about 10% above its 30-year average and

median readings. Even in this more volatile financial environment, hedging doesn't appear to be a critical issue for investors with medium- and long-term horizons. Indeed, un-hedged positions may be optimal, since exposure to the USD provides a diversifying component. In the past year, for example, un-hedged Canadian investors benefited from dollar strength as the equity markets collapsed. The symbiotic economic relationship between the U.S. and Canada should continue to provide a long-term anchor around which the currency will fluctuate.

We think a case can be made for tactical hedging, although very recent experience underscores the unpredictability of short-term relationships. Especially at this time, when the currency relationship is close to its long-run average, there is no compelling indication that the Canadian dollar is undervalued or overvalued. The bullish investment thesis on the Canadian dollar essentially revolves around the following expectations: (1) commodity prices are in a secular bull market; (2) investors will continue to view the Canadian dollar as a "commodity currency;" and (3) U.S. economic fundamentals deteriorate as a result of excessive fiscal and monetary stimulus, thereby leading to a sharp and sustained devaluation of the U.S. dollar. None of these assumptions are guaranteed to be correct, and there is little evidence to suggest that they will be proved true over the next year or two.

The rebound in the Canadian dollar since March reflects the easing of the global financial crisis and an improvement in investors' risk appetite. It has coincided with the rally in stocks, commodities and other assets on the riskier side of the asset spectrum. We view this as merely a normalization of investment flows following the previous panic into the safest of investments, namely, T-bills and the U.S. dollar. This rally has ebbed in recent weeks, however. Currency volatility will likely remain a headache for Canadian investors, but a sustainable trend may not materialize until the global economy shows more convincing signs of sustained recovery.

*Index returns are for illustrative purposes only and do not represent actual fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.*

*This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the funds or any stock in particular nor should it be construed as a recommendation to purchase or sell a security, including futures contracts.*

*There are risks involved with investing, including loss of principal. Diversification may not protect against market risk.*

*Information contained herein that is based on external sources is believed to be reliable, but is not guaranteed by SEI, may be incomplete or may change without notice.*

*SEI Investments Canada Company, a wholly owned subsidiary of SEI Investments Company, is the Manager of the SEI Funds in Canada.*

*Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Mutual fund securities are not covered by the Canada Deposit Insurance Corporation or any other government deposit insurer.*

*The information contained herein is for general information purposes only and is not intended to constitute legal, tax, accounting, securities, or investment advice, nor an opinion regarding the appropriateness of any investment. You should not act or rely on the information contained herein without obtaining specific legal, tax, accounting and investment advice from an investment professional.*