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5 Minutes for Business

The Loonie Takes Flight, but for How Long?

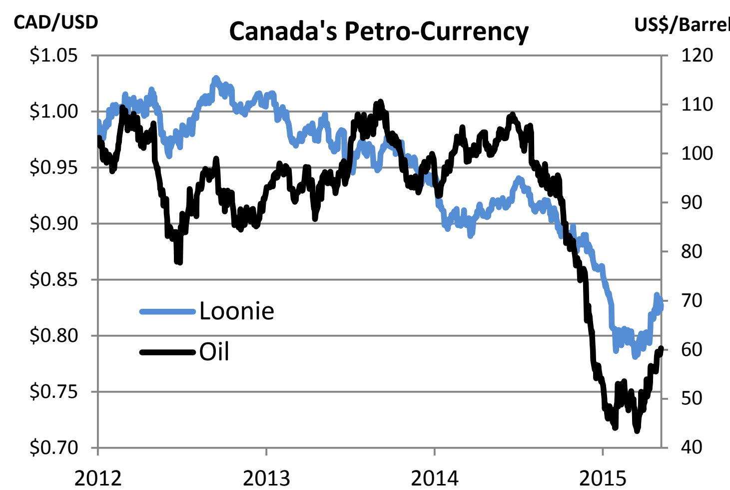
May 19, 2015

Can you guess which currency had the biggest percentage rise since March 2015? That's right! It's our loonie, which surged 7% from 78 cents two months ago to 83 cents today, a stellar performance for a tired bird. So is the loonie set to soar or is this a temporary bounce? And why is it so volatile?

The Canadian dollar is often called a 'petro-currency' because oil prices are the biggest factor in its price movements. Remember the fear in February when Citibank predicted that oil would drop to $20 a barrel? At the time, oil inventories soared as production overshot consumption. But now we are starting to see demand pick up as consumers take advantage of cheap gas and warm summer weather while production growth slows. So the fear has faded, with oil in the $60 a barrel range, pushing the dollar higher.

The second factor was disappointing U.S. GDP in the first quarter with growth essentially flat at 0.2%. An unusually harsh winter was tough, but the strong U.S. dollar hammered American exports with a 7.2% decline. There is no need to worry: the U.S. job market is performing well with 223,000 jobs created in April, and wages are rising because of higher-paying positions in business services and construction. Nevertheless, this means the expected rise in U.S. interest rates will likely be pushed back to the end of 2015. A weaker U.S. dollar puts less pressure on the loonie.

As we look ahead, the loonie will hit turbulence because it's being pulled in two different directions. Firstly, we expect that rising demand will push oil prices back up to $65 a barrel, but not beyond. We have seen a sharp slowdown in U.S. production from shale, but U.S. producers simply capped the wells and they can turn them back on very easily. So any increase in oil prices beyond a certain range will be met with a boom of production that will push prices back down.



Secondly, despite healthier oil prices, Canada's economic performance is still expected to be soft, and the loonie will take a big hit on May 29 when Statistics Canada announces the Q1 GDP. With exports, business investment and inventories all expected to contract in the first quarter as the downturn in oil finally shows up in the real economy, Canada's total GDP will almost certainly shrink, causing fears of recession. We're confident these effects are temporary and that stronger performance in manufacturing and services will partly offset weakness from energy later on. We expect Canada's GDP to grow 1.9% in 2015.

This all means the loonie's strength will be short-lived. As the lift from oil prices tapers off, the dollar will be pulled down by slower growth in Canada and rising interest rates in the U.S., which will attract investors away from Canadian securities. This means our loon will flap around, eventually perching at an average of 80 cents in 2015 before improving to 83 cents next year.

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