Is the Loonie Ready to Slide Again?

Description

Over the past decade, the Canadian dollar has moved in a near-perfect inverse relationship with oil prices. When oil prices are above $100 a barrel, the loonie is at its strongest. Whenever the commodity markets stumble, however, things turn sour.

While the latest rally in energy prices has strengthened the loonie to its strongest levels since early 2015, how long will the good times last?

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Another stumble? Not so fast

According to CIBC Capital Markets, the loonie is set to weaken yet again by the end of this year. In its new report, the financial institution stated its belief that the U.S. Fed hike in December will help push the loonie down to $0.74 versus the U.S. dollar from its current level of about $0.77 on the dollar. “With oil prices expected to languish around current levels, look for the loonie to reach the $1.35 (US$0.74) level by the end of the year,” the report said.

Still, that’s a less dramatic fall than its earlier forecasts. In all, things are looking up for the currency. CIBC is calling for the loonie to begin restrengthening by the end of the fourth quarter, solidifying a recovery in 2017.

“With both the central bank south of the border taking an extremely gradual approach to rate hikes and the Canadian economy chewing through the slack that opened up over the past couple of years, the loonie won’t be feeling as much pressure in 2017,” its report said.

With the bank expecting oil prices to average US$66 a barrel next year, a stronger loonie is likely to happen.

What could go wrong?

Over the past decade, oil prices have been the major driver of fluctuations in the loonie. There is, however, one major long-term tailwind that is set for reversal.

In the last 12 months alone, home sales have jumped an astounding 30% over the past year in Vancouver and roughly 15% in Toronto (Canada's biggest market).

According to real estate company Royal LePage, "Demand for expensive luxury homes in the two cities is at the highest on record so far this year." Outside those markets, home prices are still growing by nearly 5% a year. Steeply climbing real estate prices are a major reason why provinces like Ontario, Quebec, and British Columbia have avoided the fates of roiled regions like Alberta and Saskatchewan.

Unfortunately, many analysts now believe that Canada is in its first real estate bubble in decades. An end to the bonanza could be disastrous.

Moody's Corporation (NYSE:MCO) tested a scenario in which house prices fell by 35% in Ontario and British Columbia, and by 25% elsewhere. It estimates that banks would face roughly $18 billion in losses in such a scenario. While its assumptions may appear dramatic, they would only revert Vancouver housing prices to last year's levels and Toronto's prices to where they were just two years ago.

If and when the ongoing housing bubble pops, some people fear that it will do more than just weaken the Canadian dollar. Big-time lenders such as **Royal Bank of Canada** (TSX:RY)(NYSE:RY), **Bank of Montreal** (TSX:BMO)(NYSE:BMO), and **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) may go the way of American banks during the last financial crisis, posting massive losses and watching their stocks sink 50% or more. A weakening loonie may be the least of Canada's problems.

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