More Trouble for the Loonie? U.S. Inflation Is Rising

Description

The loonie has been under a lot of pressure.

For years, the currency has had a strong negative correlation with crude prices. When oil goes up, the Canadian dollar strengthens. When oil falls, it weakens. With experts warning of another oil supply glut, prices could fall yet again, disrupting the loonie's recent strength.

Falling oil prices would be devastating, but there's an even bigger issue to worry about.

Rising U.S. interest rates are a killer

Typically, currencies with higher interest rates tend to have stronger values versus those with lower borrowing rates. That's why the current situation–the U.S. is raising rates, while Canada is lowering them–is such a headwind.

The Bank of Canada's key lending rate stands at 0.5% after it cut the figure twice earlier this year. Meanwhile, the U.S. raised rates to 0.5% last December.

According to **Goldman Sachs Group Inc.** (NYSE:GS) analyst Jan Hatzius, "The chance of a rate hike by year-end is 80%." His new report called the latest payroll report "just enough" for the U.S. Federal Reserve to raise rates this month.

Canada may continue to keep rates low

The loonie could be relieved of a lot of pressure if the Bank of Canada decided to start raising rates alongside the U.S. That's not going to happen though.

This summer Statistics Canada reported that the debt-to-disposable-income ratio for the average Canadian is 165%–near record highs. Up to one million Canadian borrowers may not be able to absorb the increase in their monthly payments if interest rates rise by just one full percentage point.

Real estate prices are also starting to peak, removing a major advantage that numerous Canadian cities have benefited from during the oil collapse.

Typically, interest rates don't start to rise until the economy has gained solid footing. Canada's economic transition, however, could take some time.

David McKay, the CEO of **Royal Bank of Canada** (TSX:RY)(NYSE:RY), believes it could take 15 years for Canada to "reinvent itself" after its manufacturing and service sectors began to shrink following the 2009 financial crash.

The U.S. now has more reasons to raise rates

Raising rates is a major tool in fighting off inflation. By increasing borrowing costs, the government can artificially manipulate the money supply and economic activity. On September 16 the market received some news that upped the incentive for higher U.S. rates.

The August Core Inflation Rate for the U.S. came in at +0.3%. That compares with expectations of +0.2% and +0.0% the prior month.

While that may not seem like much, it results in a nearly 4% annualized inflation rate–much higher than the market was ready for.

If you're worried about the strength of the loonie, things won't be looking better anytime soon.

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Author
rvanzo