Bank of Canada Is Scared: 3 Things to Know

Description

Bank of Canada held rates steady at 0.5%, while cutting its GDP forecast to 1.1% in 2016 and 2% in 2017. The chief concerns were sluggish exports, slowing real estate markets, and nervousness about the U.S. election.

It now believes that the Canadian economy won't reach full capacity until mid-2018. "Recent export data are improving but are not strong enough to make up for ground lost during the first half of 2016," it said, adding there is now "heightened uncertainty" surrounding the Canadian economy.

Here are three things you should know.

1. The loonie will remain weak

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.

A weak Canadian economy will help ensure that the loonie will remain weak versus the U.S. dollar.

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.

2. The housing bubble is over

Due to a new tax, home purchases in Vancouver declined by 26% in August compared with the same month a year earlier. Toronto is likely to follow suit with its own buyer tax. Ottawa has also instituted new rules on mortgages that will likely bring the gangbusters market to a screeching halt.

Canadian Real Estate Association recently trimmed its forecast for 2017, projecting a 0.6% decline in national home sales and a 0.2% drop in prices. In June it had forecast sales to *rise* 0.2% and for prices to *rise* 0.1%.

This reversal could be catastrophic.

3. Oil won't save Canada

For years, the Canadian economy (especially the loonie) has had a strong negative correlation with crude prices. When oil goes up, the Canadian dollar strengthens. When oil falls, it weakens. The same factors significantly impact Canadian employment and income levels.

North American shale projects originally caused oil to fall precipitously from over $100 a barrel. Those same projects will likely keep oil prices low for longer.

According to a recent report from *Bloomberg*, nearly half of the wells located in the Permian Basin and Eagle Ford can remain profitable even when crude prices fall below US$30 a barrel. A whopping 85% can maintain profitability with prices at US$50 or below.

With shale production costs consistently lower than the market expects, don't count on U.S. crude production to continue falling at current prices levels. It's very possible we'll see sustainable oil production growth at or even below US$50 per barrel. That would be bad news for both oil prices, the loonie, and the Canadian economy overall.

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