3 Reasons the Bank of Canada Is Likely to Be Accommodating — for Now

Description

The Bank of Canada's recent rate hike to 0.75% from 0.5% has sparked a bull run on the Canadian dollar; the CAD/USD exchange rate topped $0.80 for the first time in more than a year. A strengthening Canadian economy along with expectations of additional rate hikes are the key drivers of the Canadian dollar rally, and analysts and investors are looking for guidance as to which direction the exchange rate will go moving forward, as a changing currency exchange rate affects various Canadian industries differently.

Investors in sectors such as utilities or REITs have seen the impact of the changing CAD/USD exchange rate of late. Largely considered to be bond proxies, these equities tend to react to fluctuations in interest rates, and therefore the Canadian dollar, in similar ways. Companies such as **Algonquin Power & Utilities Corp.** (TSX:AQN)(NYSE:AQN) are prime examples of how companies with excellent growth prospects and earnings-per-share growth can fall in value, as investors seek to put their money in industries that will not be affected by any future rate hikes.

Assessing the likelihood of additional rate hikes should be the principle job of an investor considering utilities or REITs in today's environment. A bet one way or the other could move the needle, so to speak, for a portfolio; long-term investors generally stay away from speculation, and I tend to agree. I do, however, believe that many of the interest rate concerns investors have regarding REITs or utilities are overblown for the following reasons (which have been supported by analysis done by the International Monetary Fund).

First off, the Canadian housing market now makes up the largest component of Canadian GDP. Any sort of housing downturn (or recession) would seriously impact the ability of the Canadian federal and provincial governments to meet budgetary goals. The government of B.C. now receives more tax income from housing than the Alberta government receives from the oil and gas sector. Raising rates too quickly or too much is a risk that the Bank of Canada simply can't take.

Secondly, the oil and gas sector in Alberta is still hurting, as companies operating in the Albertan oil sands continue to lose their competitive position to shale oil producers in North America due to the respective cost of extraction and selling price differences relating to Alberta oil production. Raising rates has the effect of increasing borrowing costs for Canada's oil companies — something which may not be the most prudent thing to do, as some companies are fighting for their lives at the moment.

Lastly, U.S. protectionist policies stemming from the new Trump administration stand to impact Canada's export sector. During the most recent period of low rates, Canada's export sector has seen some improvement. Some analysts have suggested that exports may just now be coming out of a "J curve" which would mean long-sought-after growth in a sector that has declined over the years. Additional rate cuts would serve to halt this momentum and may further exacerbate export-related issues stemming from U.S. protectionism.

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Date
2025/08/03
Date Created
2017/07/26
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