The Canadian Dollar Is Rising: Should You Run From Rail and Manufacturing Stocks?

Description

The Canadian dollar finished at $0.82 on September 14 as it continued to test its momentum following a second rate hike by the Bank of Canada on September 6. Strong Canadian GDP and job numbers have injected optimism into the broader economy, but headwinds remain for key sectors. With the next round of NAFTA negotiations set for late September in Ottawa, Canadian manufacturers will be forced to sweat out another few days.

Canadian Pacific Railway Limited (TSX:CP)(NYSE:CP) has faced significant headwinds in 2017 as the Canadian dollar has risen. The stock is up 1.1% in 2017 as of September 14 but is down 7% since the first interest rate hike by the Bank of Canada on July 12. This is in spite of second-quarter results released on July 19 that showed revenues grow 13% to $1.64 billion and net income climb 46% to $480 million.

Canadian National Railway Company (TSX:CNR)(NYSE:CNI) stock is now 7.5% since the July 12 rate hike but is still up 9.1% on the year. Again, this is after second-quarter results released on July 25 showed a significant improvement from the previous year. Net income increased 20% to $1 billion, and revenues experienced 17% growth to $3.3 billion. CEO Luc Jobin was enthusiastic about the remaining 2017 outlook, but added, "…volume comparisons in the second half of the year will be more challenging, and the strengthening of the Canadian dollar will constitute a headwind."

It is not just Canadian rail stocks that have faced challenges due to the rising dollar. **CAE Inc.** (TSX:CAE)(NYSE:CAE), a Montreal-based manufacturer of simulation and other technologies to airlines, has also faced pressure. The stock is up 5.5% in 2017 and 9.6% year over year. However, since the July 12 rate hike, the share price has declined 12.5%.

The company released its fiscal first-quarter results for 2018 on August 10. It posted revenue of $698.9 million compared to $651.6 million in fiscal Q1 2017. CAE also reported profit of $97.8 million compared to $89 million in the previous period. Analysts expect CAE to post improved earnings in the final three quarters of fiscal 2018.

With all three of these companies demonstrating solid earnings, does it make sense to bet on them as the Canadian dollar rises? Or will the dollar cool off in the remaining months of 2017?

The current $0.82 valuation puts the Canadian dollar right around its historical average. Analysts at **Royal Bank of Canada** expect the Canadian dollar to slow as the U.S. dollar's underperformance dissipates. However, analysts also forecast a third and final rate hike from the Bank of Canada in October.

When it announced the rate hike on September 6, the Bank of Canada stressed caution in its notes. I am skeptical that a third rate hike will be forthcoming next month. If the central bank stands pat, the Canadian dollar could weaken as we head into 2018. That would make these underperforming stocks an enticing buy.

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Author
aocallaghan