Bank of Canada puts wind under Loonie's wings

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The loonie has soared over the past few months and many are wondering why and where it could go from here?

The Canadian dollar rose from 74 cents US at the start of the year to about 80 cents today.

The reason for this move is the Bank of Canada has shifted to a more hawkish stance, meaning they want to raise interest rates. Higher interest rates put upward pressure on the Canadian dollar, as it makes our bonds more attractive to foreign investors. In order for foreign investors to buy our bonds (denominated in Canadian dollars) they must purchase Canadian dollars first, which puts upward pressure on the domestic currency.

This pivot from our central bank towards more of a tightening bias reflects confidence in our economy – and that's a good thing. The extreme monetary measures enacted in the wake of the oil collapse are no longer necessary and Canadian industries have now recovered from the fallout. That's precisely why the Bank of Canada raised its overnight rate on July 12 for the first time since September 2010. Governor Stephen Poloz of the Bank of Canada, said "since April, we have also seen further evidence of a broadening of growth in Canada. Along with stronger-than-expected growth, this has bolstered governing council's confidence in the outlook for the economy and inflation."

Canada's central bank unexpectedly cut the overnight rate twice in 2015 from one per cent to 0.5 per cent. It was a rough time economically because of the energy crash and Canada was in recession. No longer. Another rate hike of 0.25 per cent at the next meeting in October would complete the roundtrip back to one per cent. From that point, further rate increases would likely be more gradual.

The overnight rate is the benchmark for everything else in the economy, so the ripple effects are widely felt. The follow through to your pocket book from the Bank of Canada's rate hike, for example, was almost immediate as all of the big banks raised their prime lending rates. Mortgage payments can also be affected. Those with a variable rate mortgage will have to pay more as the interest portion of the loan is based off the prime rate. Those with fixed rate mortgages will be unaffected until the mortgage comes up for renewal. At that point, a higher rate on their mortgage is likely.

The stronger Canadian dollar will weigh on the performance of your foreign investments as well. But there are also many benefits to investing outside of Canada, especially in the U.S., where markets are broader and offer investors more opportunities than in Canada. There are simply certain stocks you can't get exposure to by staying within your own borders. Another benefit to your portfolio is the fact that the U.S. dollar tends to rally during periods of uncertainty and market corrections. This acts as an indirect hedge, as it insulates your portfolio during substantial market sell-offs.

The Canadian dollar has had a big run in a short period of time and will probably now cool off. The next rate hike is widely expected at this point and probably won't come as a surprise to the market. Oil and other commodities are always the wild card and a rebound could push the loonie even higher, but this is not currently expected. It's also worth noting that the US dollar has fallen significantly against most major currencies this year. As the U.S. Fed continues to hike rates (likely in December), the U.S. dollar weakness globally should cease, capping further upside in the Canadian dollar.

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