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INVESTMENT SMARTS

Where is the loonie swimming to next?

Keith Richards

I like to cover the Canadian dollar (loonie) and U.S. dollar (USD) in my columns and blogs once in a while—and it's probably time I revisited the subject. When we look at the loonie and its near-term potential movements, it's not as simple as merely looking at its relationship to the U.S. dollar.

The relationship of the USD versus world currencies matters, along with the relationship of the loonie to oil. I have three charts for you today surrounding those relationships. Let's get right to it.

As you can see on the C$ chart (top chart on page 67), the loonie broke its 2008 support earlier this year. Despite the short-termed rally on the currency against the USD, it's clearly on a downward trend. Any questions? No? Thought so. Let's move on.

Stockcharts.com provides a chart of the USD against a basket of predominant world currencies. I've shown this chart, along with the loonie chart above, many times before.

Nothing has changed since my last message. The USD is stalling at exactly where I suggested it would in a blog I posted more than a year ago.

At this point, the USD has some minor downside pressure that could take it to 0.93 "world currency dollars". That's about three cents – or four per cent below current levels.

U.S. dollar weakness, no matter how temporary, does help push the Canadian dollar up on a relative basis. However, we have a unique problem here in Canada. That is, our currency is pretty tied to the price of oil (also known as the "petro-currency" problem). Let's take a look.

Here's a cool chart. (Well, I think it's cool, but I'm a nerd.) The red line is the Canadian dollar versus its U.S. counterpart. The black line is West Texas Intermediate (WTI) crude oil – priced in USD, of course. The pane below shows the mathematical correlation between the two.

The path of these two price charts is tracking quite positively. In particular, the price movements of the two have been near 100 per cent correlated since November 2014 – the only exception being last March, when the correlation very briefly went to neutral. So—if you want to know how the loonie is heading, at least against the USD, then follow oil.

While on the subject of oil, let's take a look at its prospects. WTI crude oil had a sharp rally recently from a low point in the $28 area to over $33. Shortly after that rally, it fell back to $28.

I have been referring to the potential of a rally, or possibly even a bottom on oil over a number of recent blogs and media writings lately.

However, that $28 floor on oil must hold before we can confirm the beginning of a bottom for this commodity.

From a disciplined point of view, we never want to catch the proverbial falling knife of a declining security.

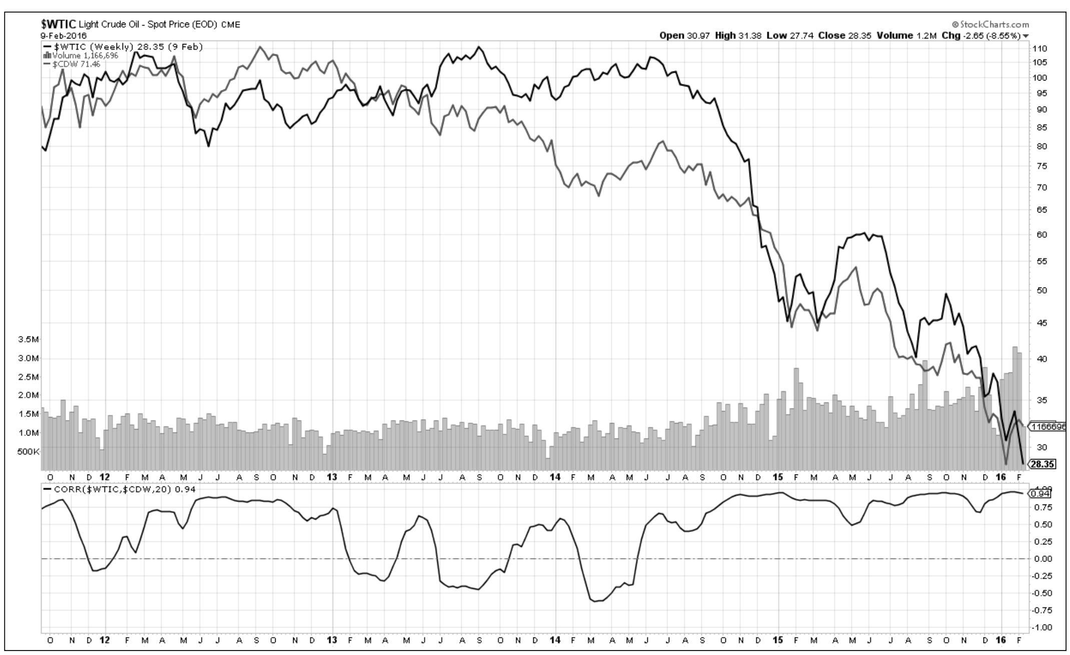
It is best to wait for any stock or security to find a base and ideally, break out of the base before becoming too convinced of "a bottom". At this point, the up-and-down basing action by crude oil is encouraging, but I do not want to jump to the conclusion that now is the time to back up the truck and buy.

There are a few points of caution to observe:

Significant resistance comes in for WTI crude oil at the 10-week moving average. This line coincides with a resistance zone at around $35 to $38 per barrel.

Traditional technical analysis suggests that WTI crude oil is still quite entrenched in a bear market. Lower highs and lows, and a price below the 40-week (200 day) moving average point to this reality, despite some signs of near-termed basing.

Cumulative money flow and



money flow momentum are bearish. This means that serious money has not started moving into WTI oil at this time.

MACD – a momentum indicator constructed out of moving averages - is not showing positive movement at this time. It is a good indicator for longer-terme price movements – and it is not showing positive potential right now.

On the positive side, RSI and stochastics – which are relatively faster moving price momentum studies – suggest an oversold bounce in the price of WTI could continue. Perhaps the stopping point for that bounce will be the above-mentioned $35 to $38 area.

The big trend for the loonie is bearish. The only potential for liberation from this bearish path is oil at this time—and remains so until commodity and currency no longer march in lock-step.

Oil is basing, but hasn't proven to break out yet. If the lows just below $28 can hold for oil, that provides further evidence for a base on oil. The top of the potential base is $38.

My bottom-line prognosis for the loonie

The loonie is going to fly if a breakout through $38 per barrel occurs on WTI crude oil.

Seasonally, oil can move from around February into the spring, so that's encouraging too.

"V" bottoms rarely occur in oversold markets. Thus, the more likely scenario for crude is to bounce up and down for a while before the true bottom can be identified.

As the technical points listed above suggest, I might guess at a temporary lid of $38 for that trading zone. A breakout of some type of complex up-and-down formation, through the $38 lid, would be indicative of a market bottom. Meanwhile, traders looking to play oil should view it as an oversold bounce trade rather than a longer-termed trade until such an occurrence.

If oil falls, you might expect the loonie to continue falling—if it bases, then the loonie might find some support. The USD by itself is neutral to short-termed bearish, which provides some positive potential for stability in our dollar. However, that by itself is not enough to support the Canadian dollar.

What does this mean to Canadian investors and world travellers? I wouldn't use a short-termed rally on the Canadian dollar to bet against the U.S. dollar just yet.

Until and unless we see a definitive breakout through $38 on oil, the loonie will likely remain contained. Until that time, I see no severe downside from a currency perspective, beyond a few percentage points, that would prevent me from holding U.S. stocks.

Similarly, I wouldn't hold off on converting your loonies to U.S. dollars for too long if you plan on travelling. While you may not finesse your currency transaction perfectly, the potential for oil not to break out – and indeed to fall further – has not disappeared.

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