CAPITAL MARKETS RESEARCH

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Special Report: Slightly More Dovish BoC Likely As Spare Capacity Grows

We think the BoC is likely to come across somewhat more dovishly tomorrow when it simultaneously releases the policy statement and Monetary Policy Report at 10amET and follows up with Governor Carney's second last MPR press conference at 11:15amET. Because of its vague nature that we think primarily serves to guide against rate cut expectations, the BoC is likely to retain intact its rate guidance that stipulates that "modest" rate hikes are "likely" "over time", but that "the timing and degree of any such withdrawal will be weighed carefully against global and domestic developments, including the evolution of imbalances in the household sector."

Downward Forecast Revisions

At a minimum, the BoC has to acknowledge that Canadian economic growth has again disappointed its expectations. We are currently tracking about 1.2% annualized 2012Q4 growth compared to the BoC's last forecast in October for 2.5% Q4 growth. Scotia Economics is forecasting 1.9% 2013Q1 growth compared to the BoC's 2.6%, and 2% in Q2 compared to the BoC's 2.6% such that we think the BoC would be justified in lowering its near-term growth assumptions. The BoC may signal some relief that the so called fiscal cliff has been averted in the US, but will probably stick to a warning about protracted uncertainty stemming from the March 1st sequester, mid-February to early-March debt ceiling, and the March 27th expiration of the Continuing Resolution that risks a partial U.S. government shutdown. At the same time, it may signal somewhat greater encouragement toward near-term growth in China's economy and US housing markets.

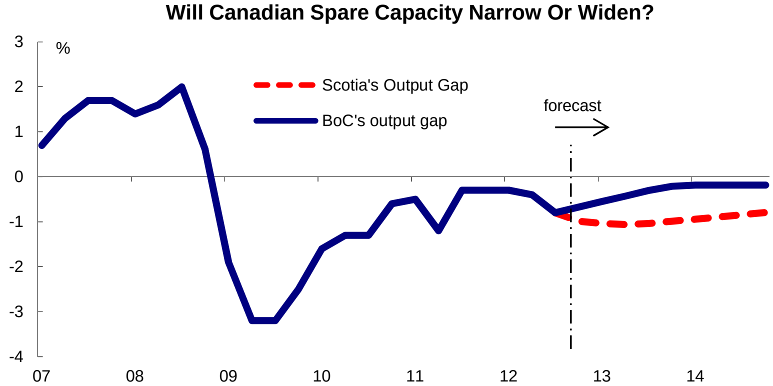
Still Persistent Slack In Job Markets

While the BoC may also signal some encouragement toward recent Canadian job growth, soft growth in aggregate hours worked over recent months is an important offset. The BoC has tended to emphasize that the unemployment rate remains above full employment levels that might prompt greater wage pressures, and that slack exists in terms of the optimality of employment conditions. Examples of this include the significant number of individuals who are working part-time but that would rather be working full-time, and the fact that the labour force participation rate remains a full percentage point below its pre-crisis peak and toward the low end of readings over the past decade. Further, caution is warranted toward future job growth given that more recent job gains have occurred in an environment of very little broad economic growth.

Modest, But Persistent Spare Capacity

The broad implication to growth disappointments is more important in that Canada's spare capacity continues to rise as growth disappoints and that should help to keep inflation pressures at bay. We figure that the output gap equaled about 1% of GDP as at the end of 2012 and that it will remain at or slightly below this level pretty much straight through to the end of 2014 (red line in chart 1). A widening output gap is consistent with what we had forecast in our piece "BoC On Hold For A Long Time Yet, As Spare Capacity Grows" on August 1st last year

Will Canadian Spare Capacity Narrow Or Widen?



Source: Bank of Canada, Statistics Canada, Scotiabank Economics.

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and this is one reason why we have been consistently more dovish in our BoC expectations than consensus. Indeed, spare capacity would be supportive of no rate hikes at any time within the 2013-14 forecast horizon. While the gap is modest, it stands in contrast to the BoC's forecast over much of 2012 that spare capacity would steadily and consistently close off quarter-after-quarter into late 2012 and then become eliminated by the end of 2013. The BoC might therefore follow up a near-term forecast downgrade with delaying the projected point at which spare capacity is closed off, and thereby moderate the path toward returning to its 2% inflation target. Even if we're wrong, it is difficult to forecast a material enough degree of excess aggregate demand that could put upward pressure upon inflation over our forecast horizon enough to challenge the BoC's inflation target. True, output gaps are highly imprecise readings and they are hardly the sole predictor of inflation risks, but the BoC has long emphasized spare capacity considerations in its policy framework and one might have cause for concern should such a framework get totally discarded. With spare capacity persisting (indeed slightly rising) while headline inflation has fallen to 0.8% y/y or near zero after taking account of the BoC's own half-point estimate of the CPI's inflation measurement bias, it may be fair to argue that by sticking to a relatively hawkish bias the BoC is reacting in asymmetric fashion to missing its inflation target if interpreted in a strict near-term sense. Next week's inflation reading is likely to remain soft at about 1% y/y or slightly higher, as year-ago base effects put upward pressure upon the reading before those same base effects turn the other way again in the next month's report.

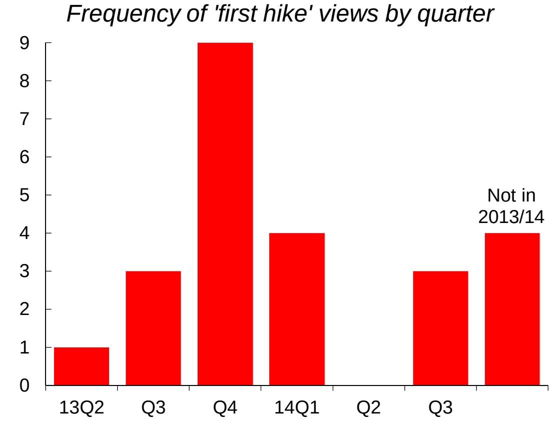
Inflation may bounce higher in future on soft base effects and that may explain some of the BoC's caution as opposed to over-emphasizing current inflation readings, but persistent and growing spare capacity coupled with a strong currency should help keep a lid on any upside risks while growth has been very lacklustre throughout the past year and likely well into 2013 at a minimum. We think Canadian GDP growth will lag behind the US partly as Canadian households are at structural peaks across virtually every variable in contrast to the likelihood that the US unleashes pent-up housing demand, and as the quest for US energy independence may pose a greater challenge to Canadian energy exports into the US than previously.

So why the possible asymmetric policy response to performance on inflation readings? The BoC to date has been focused upon housing excesses and looks through near-term inflation measures in favour of the influences of financial stability considerations upon its inflation target over a longer period of time. A fair debate in that regard, however, concerns the dramatic cooling in new condo sales volumes, softer resale figures, and the weakest household credit growth environment since the very weak 1990s. A consideration in this regard entails whether this is temporary softness like what we saw in the depths of the crisis before housing volumes surged again, or whether the weakness is more permanent this time around as regulatory conditions affecting housing finance have sharply tightened and the country cannot count upon another secular decline in interest rates as characterized the policy and market response to the crisis. Such is the nature of the two-tailed balanced risks to the household sector that the BoC is likely to continue emphasizing in contrast to its earlier stricter concerns that were focused upon the rising debt-to-income ratio.

What Consensus Thinks & Where We Think The Risk Lies On A BoC Call

Bloomberg's latest consensus survey of BoC calls pulled forward the median call for the resumption of rate hikes into 2012Q4. We offer a few reasons to be careful while assessing this survey. For one, at 24 shops, it's much larger than we had thought the number of shops doing serious Canada work to be so we think the sample is somewhat diluted. If we stick with the five major domestic banks, then the consensus is skewed toward early 2014. The Bloomberg consensus is also biased toward short-term views, since by the time one goes out five quarters from now, ten forecasters drop out and the sample shrinks down to 14. The median can also mask important details in the descriptive statistics for the sample of opinion. One is the large dispersion of views (chart 2). One shop expects the BoC to hike next quarter just as Governor Carney is handing the baton over to his successor, and we wish the call good luck. At the opposite end, four shops are not forecasting rate moves in 2013-14. In some cases that's because they stop their forecasts before the end of 2014, and in others it is because they predict a 1% o/n rate to the end of 2014.

Diverse BoC Views
Frequency of 'first hike' views by quarter



Source: Bloomberg, Scotiabank Economics.

Scotiabank Economics print forecast is currently in the 2014Q1 camp. In assessing risks to this baseline view, I increasingly like a story that puts the fat tail risk on a BoC hold throughout 2013-14 since I think Canada will face spare capacity throughout the forecast horizon, and because the threat of rate hikes to cool housing is being rapidly taken care of as per the evidence of a housing correction and the coolest household debt growth since weakness of the 1990s.