Special Report

Derek Holt (416) 863-7707
derek.holt@scotiabank.com

Dov Zigler (416) 862-3080
dov.zigler@scotiabank.com

Could The BoC Seriously Lag The Fed?

We lay out reasons why we think the Bank of Canada will lag the Federal Reserve in starting to raise rates and will also lag behind in terms of the cumulative pace of hikes over the cycle ahead. What must be simultaneously entertained is the serious risk of an unprecedented lag. This differs sharply from the consensus of economists forecasting both the Fed and the BoC to put through their first hikes generally in tandem as reflected in the March surveys by Bloomberg (chart 1), and we think Canadian rates will outperform US rates over the cycle ahead (i.e., less interest rate risk in Canada).

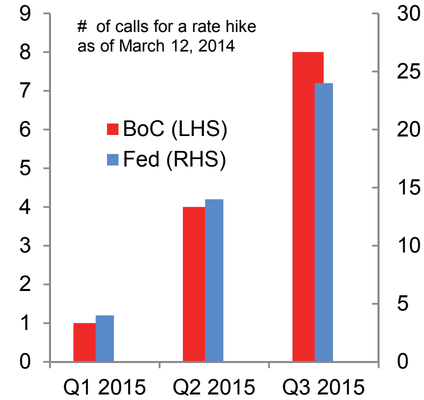
At present, our print forecast is only somewhat different from usually volatile current OIS market pricing that positions Fed hikes starting in 2015Q3 and BoC hikes starting around mid-2015 (chart 2). Scotiabank Economics forecasts that the Federal Reserve will end bond purchases by October of this year and begin to raise the fed funds target by 2015Q2, but with the BoC following two quarters later — and with the fatter tail risk lying in favour of a longer lag relative to the risk of hiking at the same time or ahead of the Fed. We believe such a trading bias should persist as an anchor to relative pricing differentials over time. Where we think the greater scope for market action resides is in terms of the currency. Scotiabank forecasts further currency weakness with USDCAD in the 1.15-1.16 range over the spring and summer.

1. Past Precedent

We will offer reasons as to why history is a limited guide to the cycle ahead, but for now, start by pointing to past precedents. In each of 1999 and 2004, the Federal Reserve began raising interest rates ahead of the BoC and outgunned it on the magnitude of the full cycle's tightening campaign. As chart 3 demonstrates, the Fed began raising the fed funds target rate in June 1999 and the BoC began raising the overnight rate in November. Over the cycle that then ensued, the Fed raised its policy rate by 175bps compared to a cumulative hike of 125bps at the BoC despite a lower starting point at the BoC. In 2004, the Fed began raising rates in June of that year and the BoC waited until September. The Fed raised its policy rate by a cumulative 425bps by the time the dust settled in 2006, and the BoC's cumulative tightening campaign equaled 250bps which left Canada with a lower overnight rate than the US. So in one case the Fed started at a comparable overnight rate and overshot the BoC (1999), and in the other it started at a lower overnight rate after ending a cutting campaign and still ultimately overshot the BoC (2004). **The point is that the BoC has materially lagged the Fed in the past.**

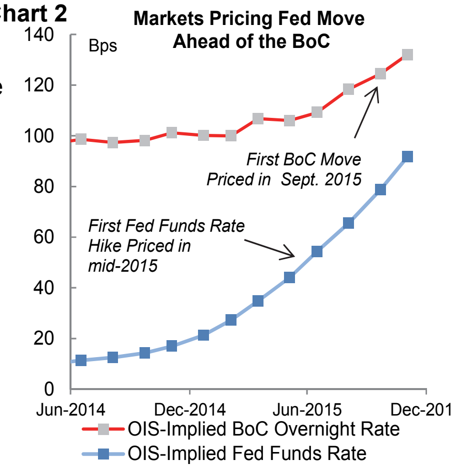
There have been two exceptions over reasonably recent times when the BoC raised rates ahead of the Fed but neither are compelling cases for the

Chart 1 BoC Rate Hikes Generally Expected After Fed



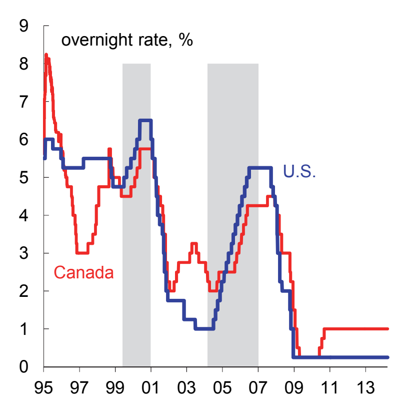
Source: Bloomberg, Scotiabank Economics.

Chart 2 Markets Pricing Fed Move Ahead of the BoC



Source: Scotiabank Fixed Income Strategy (3/25/2014)

Chart 3 Past Precedent



Source: Federal Reserve, Bank of Canada, Bloomberg, Scotiabank Economics.

Scotiabank Economics

Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: (416) 866-6253 Fax: (416) 866-2829
Email: scotia.economics@scotiabank.com

risk of a repeat going forward. The biggest was when the BoC began raising rates in April 2002 and went on to hike its policy rate by a cumulative 125bps before hitting a ceiling in April 2003. This occurred during a period in which the Fed was cutting rates, and the experiment did not end well for the BoC as the overnight rate blew out to a very wide 225bps over the US. The memory of having to retreat as quickly back to the starting point on its policy rate by the Spring of 2004 still hangs over the BoC especially as it took a long time for the BoC to reverse its policy rate in sync with Fed cuts.

The second occasion was when the BoC hiked in June 2010 just before the end of its conditional commitment because inflation was at risk of breaching that commitment amid healthier fundamentals and in order to get off the lower zero bound that was disrupting Canadian money market functioning in the absence of Fed-style programs to alleviate such stresses. Those Fed facilities included the Money Market Investor Funding Facility, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility, and the Term Asset-Backed Securities Loan Facility (TALF). The two central banks opted for different ways of addressing the challenges of operating at the lower zero bound — one did so by getting marginally off of it absent a domestic banking crisis (BoC) and the other opted to smother the effects through offsetting programs (Fed). We judge this period to have been very different than what we face now. Further, it is open to debate as to whether the BoC did the right thing in raising rates in 2010 from a fundamentals perspective and Governor Poloz's policy shifts following ex-Governor Carney clearly indicate a shift in thinking at the BoC. Some believe that the relative fundamentals supported hikes then, while many others believe that the hikes, combined with an arguably too-long hiking bias that over-inflated CAD, were premature as inflation went into a pattern of steadily undershooting BoC forecasts. A prolonged period with an overly tight policy bias may have done damage to the Canadian economy that will take considerable time to reverse.

2. Tighter starting point

Canadian monetary policy is already at a tighter starting point than in the United States and can therefore likely take more time to engineer further tightening than in the US. There are two reasons for this. One is that the overnight rate stands at 1.0% in Canada versus the 0-0.25% fed funds target and has for years since the BoC was the first to commence hikes back in 2010 (chart 3 again). Two is that Canada never pursued quantitative easing and so the exit challenges facing the Bank of Canada are much simpler than those facing the Federal Reserve. What Canada did in order to address funding challenges was to roll out the Insured Mortgage Purchase Program which bought mortgages from lenders through the CMHC and this was funded by the Federal Government through Canada government bond issuance and hence the program was run by the government, not the BoC, and was therefore sterilized.

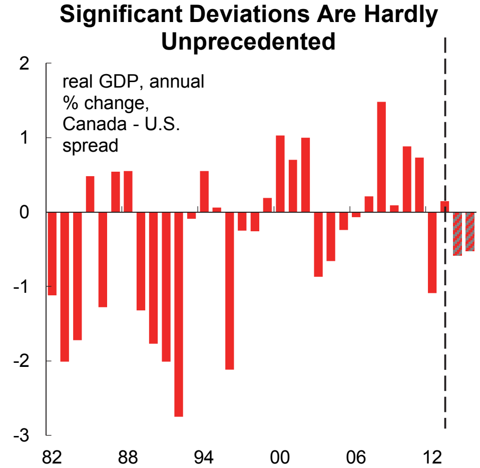
3. Fed tightening will impose tightening on Canada

Against the consensus view that tightening US monetary policy will give the Bank of Canada cover to raise rates via a depreciated Canadian dollar, **we view Fed tapering as imposing net damage upon the Canadian economy and thus the requirement for a more accommodative BoC.** We wrote about this here last Fall, and summarize some of the key points as follows:

- First, it's fairly obvious by now that **CAD depreciation would not be unwelcome to the BoC.** We believe this will continue to be the case and the BoC would be comfortable with a materially weaker currency as opposed to taking steps to offset currency weakening.

Chart 4

Significant Deviations Are Hardly Unprecedented



Source: Bloomberg, Statistics Canada, BEA,

- Second, tapering has and is likely to continue to put **upward pressure upon global bond yields and Canadian borrowing costs at a time when the mature Canadian household cycle doesn't need a rate shock.** The US might be able to afford higher fixed mortgage rates as it unleashes pent-up demand in the household sector, but Canada cannot.

- Third, tapering would probably continue to pull capital into the US and raise the cost of company financing on the margin in such a fashion as to **restrain the already disappointing Canadian investment cycle.**

- Fourth, **Fed tapering could weaken commodity prices or cap the gains as has already occurred** in favour of USD-oriented flows and thus further restrain Canadian growth and investment.

- Fifth, while Fed tapering presumably requires improving US economic fundamentals, **the economic improvement in the US may well continue to fail to trickle over into Canada** by virtue of the fact that Canada has lost so much export competitiveness over time. We'll expand upon this in a moment.

4. Canada to underperform US growth

In no small part because the two main engines of the Canadian economy lie at all-time record highs, we forecast growth to underperform the US where those same two key sectors are at an earlier growth phase. Chart 4 shows the modest underperformance of the Canadian economy that we are formally forecasting relative to the US and how the prior period of significant outperformance over US growth has come to an end.

Those two sectors are households and resources. Resource sector investment lies at record heights and, while the volume of activity is expected to remain high, growth is looking toppish (chart 5). This casts doubt upon the hopes for an investment-led growth cycle. Further, our regular readers know our views on how Canada lies at all-time record highs across everything in the household sector in contrast to the US (with one such variable illustrated in chart 6). This puts greater odds on US macro outperformance through unleashing pent-up demand in an improving economy relative to no such prospects in Canada. At the same time, fiscal drag on US GDP growth is being reined in and this too should prove to be more constructive to US growth relative to Canada than over prior years.

Finally, while we forecast a gradual improvement in exports keyed off of currency depreciation, this is by no means certain. Chart 7 shows that history may be a guide to how currency depreciation will turn around the export picture, but there are reasons to temper future expectations. Indeed, such expectations have been routinely delayed over recent years. One reason for this is that Canada has lost an enormous amount of competitiveness in the US imports market to countries with materially lower unit labour costs (productivity adjusted wages), and particularly within the key NAFTA setting (chart 8). This is coupled with slower growth prospects in the energy sector than would be the case in the absence of rapid US development of its own energy sector alongside similar plans in Mexico. Such supply-side changes that make Canada a little less special than it once thought itself to be come at a time of record exposure to the energy sector that represents about one-quarter of total exports (double that of the early 2000s) and record resource investment as noted above.

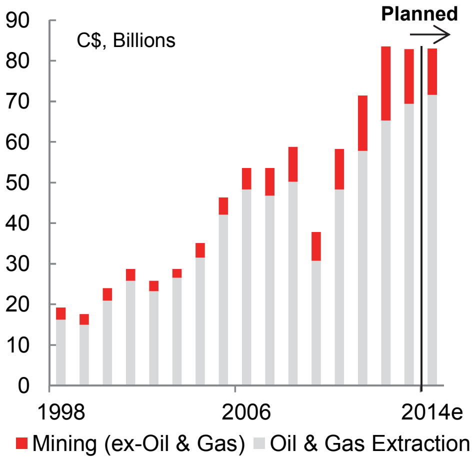
5. Global spare capacity trumps domestic output gaps

There are at least two counter-points to the view that because Canada has less spare capacity than the US this might be thought of as the country facing greater inflation risk and hence the risk of sooner and bigger rate increases.

One is that for a country like Canada that is more reliant upon trade than the huge domestic US economy and that is a price-taker across most of what it exports with the exception of a handful of commodities, speaking of domestic spare capacity as an

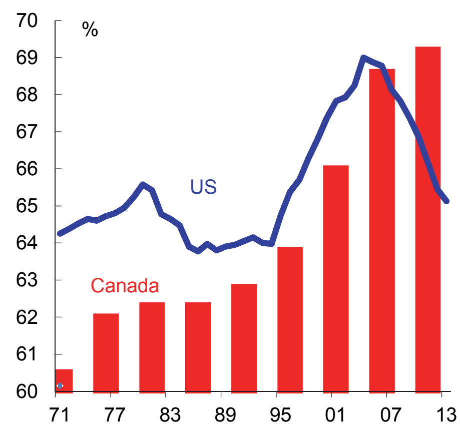
Chart 5

Natural Resources Investment:
Capex Peaking Out?



Source: Scotiabank Economics, Statistics Canada

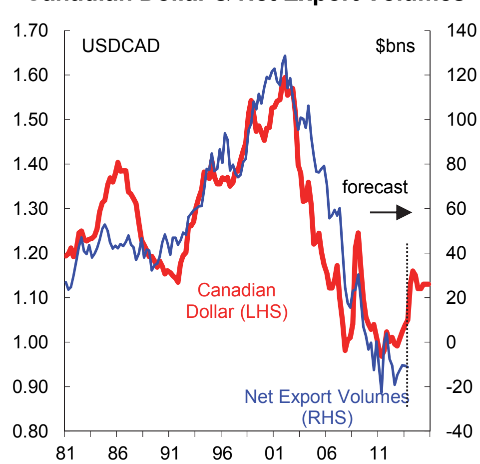
Chart 6 Home Ownership Rates



Source: US Census Bureau, Statistics Canada, Scotiabank Economics.

Chart 7

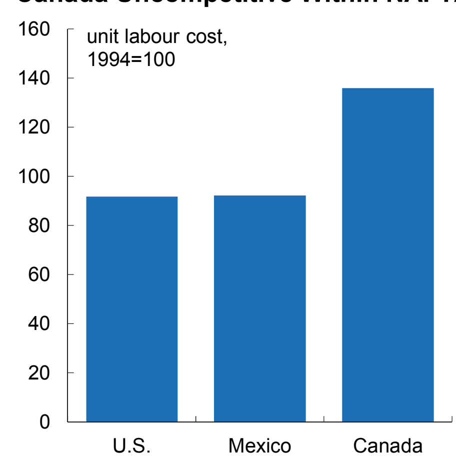
Canadian Dollar & Net Export Volumes



Source: Statistics Canada, Scotiabank Economics.

Chart 8

Canada Uncompetitive Within NAFTA



Source: OECD, Scotiabank Economics.

influence upon domestic inflation significantly misses the point. At a minimum, the definition of spare capacity should be broadened to encompass spare capacity across Canada's trading partners (chart 9). If Canada's main trading partners have lots of disinflationary spare capacity then Canada is likely to continue to import such disinflationary pressures. Most of them do, and particularly the key economies of the United States and Eurozone.

Second is that even when defined in terms of just domestic output gaps, what matters is what happens beyond the point of eliminating spare capacity across the Canadian economy. We're fans of what was the main point to Governor Poloz's recent speech: that even after it closes, the output gap is likely to remain at balance for an extended period (chart 10). That is because the BoC forecasts that the economy's non-inflationary speed limit (i.e., potential growth) will roughly match muted actual GDP growth expectations. If that's true, then the BoC's 2% inflation target may not be at risk of being sustainably breached for years into the future as the economy fails to trip into material excess demand. **Highly accommodative monetary policy may be required for an extended period yet just in order to keep inflation up around the 2% target and avoid slipping back into excess supply over the longer run.** Of course, a third counter-point could well be that output gaps are, at the very best, a loose guide for inflation risks and often only by booting out of CPI random special factors and regulated prices whether doing so or not is appropriate. Different starting points on estimating the size of the output gap now are an added but more minor complication with the formal BoC estimate around 1% being on the low side of the BoC's thinking on the range and also below the IMF's estimate for Canada.

6. CAD pass-through as an inflation risk

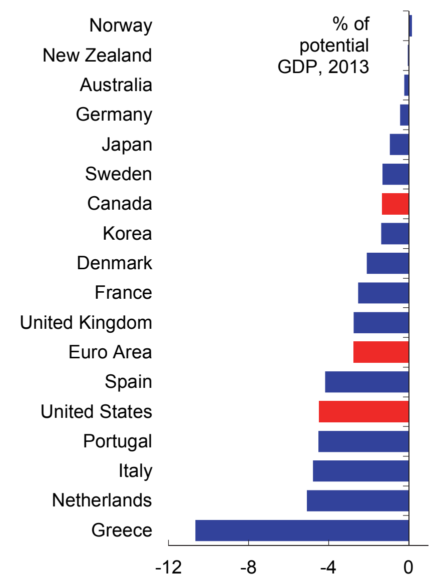
An upside risk to the inflation outlook could come from the depreciation of the C$. This might negate the risk of later BoC tightening so it's worth exploring. CAD has depreciated by 15% against the USD since September 2012. The weaker currency may lead to higher inflation if the depreciation is sustained. While we think that the depreciation will stick or even accelerate as the BoC charts a dovish course and the Fed continues to move towards monetary policy normalization, we offer caveats on going too far with the pass-through argument.

First, evidence on pass-through effects is mixed, and that evidence has significantly diminished over time and across countries. The BoC estimates that for every 10% trade-weighted depreciation of the C$, there is a corresponding increase to core inflation of 30bps in the first year following the drop and 50bps in the second year, as reflected in chart 11. That would point to CPI upside — and cumulatively bring inflation close to the BoC's 2% target — over the next couple of years if not sooner given we're a year-and-a-half into the CAD depreciation trend already.

So a risk here is that headline inflation could potentially be more responsive in the near term. Upsides are already showing up in the import price data as the weakening of the C$ is not exactly new — the depreciation has been happening since the Fall of 2012 and the lagged relationship between depreciation and inflation would imply that some pass-through should start to show up soon. The inflation numbers for February contained tangible signs that the weaker C$ is filtering into the broader economy in categories that don't count as 'core' prices: vacation costs, which are heavily influenced by airfares, foreign hotel prices, and other factors that are directly contingent on the C$, were up much more than is usual for February. These are nevertheless modest shares of the CPI basket. The point is that the inflation upside from the weaker CAD could start to factor

Chart 9

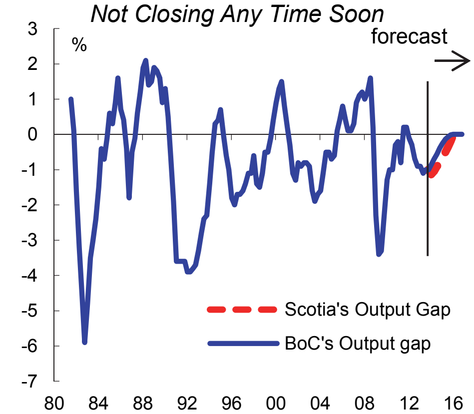
Output Gaps



Source: IMF, Scotiabank Economics.

Chart 10 **Canada's Output Gap:**

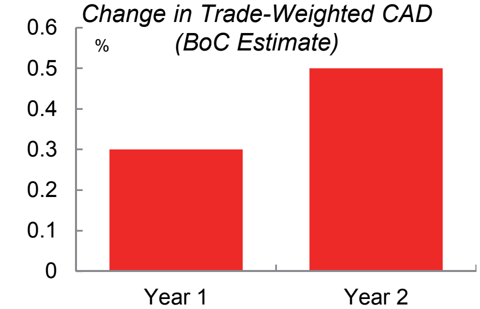
Not Closing Any Time Soon



Source: Bank of Canada, Statistics Canada, Scotiabank Economics

Chart 11 **USDCAD Impacts Core CPI**

CPI Pass Through from 10% Change in Trade-Weighted CAD (BoC Estimate)



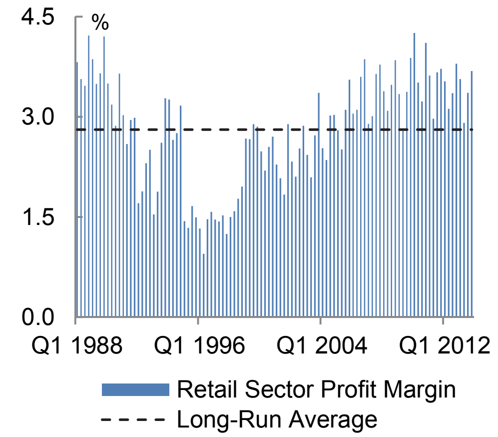
Source: Scotiabank Economics, Bank of Canada into the BoC's forecast in the months to come, particularly if the increase in import costs is sustained.

However, apart from uncertainty over the estimates of pass-through, there are qualitative arguments of relevance to why pass-through might not be as great in this cycle. One is that the effects of CAD depreciation on import prices could be absorbed more heavily within high margins in the retail sector (chart 12) at a mature point in the household cycle.

Secondly, how sustained any CAD depreciation effects on inflation may prove to be depends upon how much further the currency continues to depreciate. If its depreciation is nearing an end then pass-through effects could represent a one-time level adjustment to CPI and not something for the BoC to point to as cause for altering its longer-run inflation outlook. If a one-time adjustment is all that materializes, the BoC could counsel looking through it.

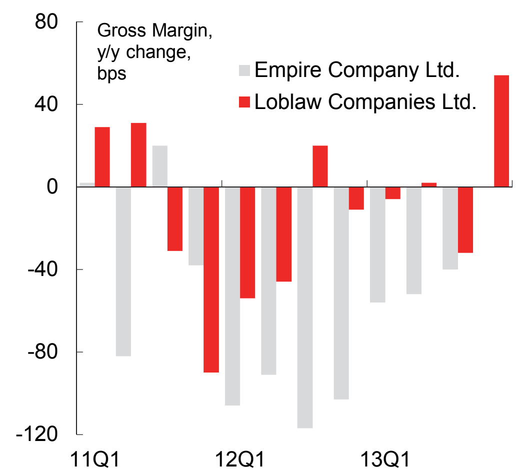
Third, while CAD pass-through could represent first-round inflationary effects, the second-round effects could be more interesting. If pass-through of higher import prices into prices paid by consumers occurs against the backdrop of ongoing weakness in personal income growth and in the context of tightening credit conditions at a mature point in the lending cycle that is being reinforced by stricter macroprudential rules, then the second-round effects could be disinflationary. That could arise as households balance their budgets by spending more in the short-term upon essentials and spending less on discretionary items either now or in the second-round adjustments. If the BoC were to witness continued softness in income growth then it could well be inclined to look through temporary upsides to inflation via the currency.

Chart 12 Retail Sector Net Income Margin Within Historical Norms



Source: Scotiabank Economics, Statisics Canada

Chart 13 Grocery Retailer Gross Margins Have Had a Tough Two Years



Source: Scotiabank GBM

7. Can Retail Margins Absorb CAD Depreciation?

Another factor that may help to explain low inflation in Canada is retail price competition. From a broader economy-wide perspective, the evidence drawn from retailers' margins continues to be fairly modest. Operating expenses as a share of operating revenues have fallen slightly and boosted margins over recent quarters, but not by a big amount (see chart 12 again).

Company-by-company numbers can sometimes be a little more convincing. For example, bottom-up data show an ongoing retail price war in the grocery sector resulting in gross margin compression. The cause here is that the major Canadian grocery chains have all been expanding, and simultaneously, major US-based grocery chains have been seeking growth opportunities in Canada over the past few years. The result has been deep discounting and gross margin compression in the Canadian grocery sector at least as reflected by the individual Canadian grocery retailer gross margins that are publicly disseminated (see chart 13) — which translates into lower inflation at food stores which make up more than 10% of the CPI.

The BoC has flagged retail price competition as a factor in low CPI, singling it out as one of the principal causes of CPI undershooting (the BoC's March 5 statement reads: "Excess supply in the economy and competition in the retail sector will likely keep inflation well below the 2 per cent target this year"). We wouldn't push this argument too far, but as the charts show, the retail price battle in Canada is real, and is reflected in soft same-store sales at major Canadian grocery chains.

Conclusion

Our broad conclusion is that Canadian rates are forecast to outperform US rates with US yields moving higher relative to Canada across the curve over time and at the same time as further forecast depreciation in the Canadian dollar while carry increasingly favours flows into the US. This may well not be fully priced into the relative curves given arguments behind why relative central bank policies may be entering entirely uncharted waters.

For Scotiabank Economics' full global macroeconomic and financial market forecasts including for Canada, go [here.](#)