Special Report

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CAD Traders Are Inviting A Dovish Bank Of Canada

- **Export growth continues to disappoint amid renewed resilience in the Canadian Dollar.**

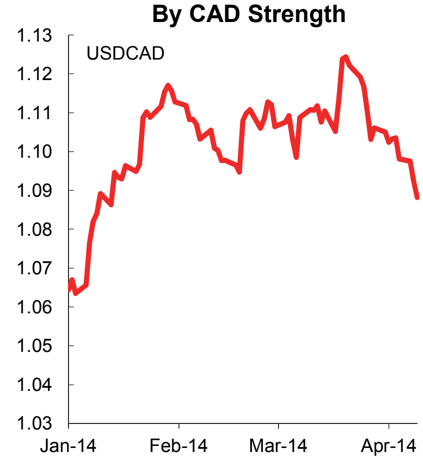
Against some expectations that slightly firmer Q1 inflation figures will motivate a more hawkish turn by the Bank of Canada next week, we think that the latest rate statement, the full forecast update within the April 16th Monetary Policy Report, and the ensuing press conference to be held by Governor Poloz and Senior Deputy Governor Tiff Macklem (unfortunately his last) will turn out to be dovish and CAD negative in nature, all else equal.

If The Recent Objective Was To Depreciate CAD, Then The BoC Hasn't Been Successful

CAD is even stronger than it was back on January 22nd (chart 1) when the BoC said on page 10 of the MPR that "Despite depreciating in recent months, the Canadian dollar remains strong and will continue to post competitiveness challenges for Canada's non-commodity exports." If CAD was too strong then, and it's even stronger now, then don't look to the BoC to sound hawkish and further fan CAD strength. One might quip that if talking down the currency has been a major implicit goal to BoC communications this year, then it has not succeeded given that the currency is stronger than it was around the January MPR. We just don't see the BoC as being interested in a policy bias that would add to CAD strength next week.

Chart 1

BoC Is Probably Frustrated By CAD Strength



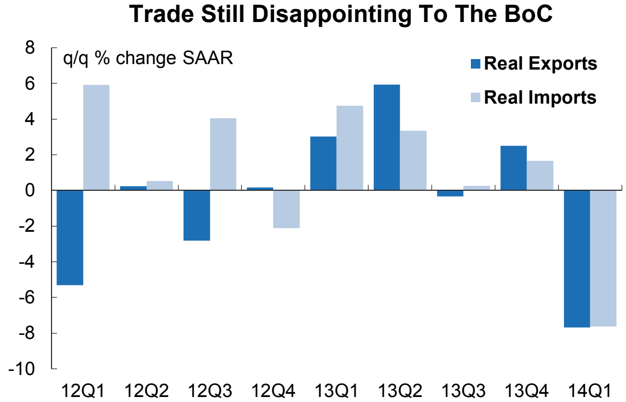
Source: Bloomberg, Scotiabank Economics.

A Bleaker Perspective On Trade

Ouch! The first quarter is shaping up to be absolutely ugly for Canadian trade. As chart 2 shows, export and import volumes are simultaneously suffering a massive decline — without even taking into account the strike at Vancouver's port because we don't have March data yet. Net trade might not have a big overall drag effect on GDP because exports and imports are equally weak. This is related to the goal of depreciating the currency as a means of improving export competitiveness given the BoC's forecast for a rotation of growth drivers away from the frothy household sector and toward investment and exports. That's still not working, and CAD is a part of it while a massive loss of cost competitiveness in comparison to the US and Mexico — among many others — is a deep-seated challenge.

Chart 2

Trade Still Disappointing To The BoC



Source: Statistics Canada, Scotiabank Economics.

Downward Growth Revisions

The BoC has to revise near-term growth lower and is unlikely to offset that by revising future growth a whole lot higher. 2014Q1 growth is tracking at around 1% in seasonally adjusted and annualized terms. The BoC had

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forecast 2.5% growth in the January MPR and so they are likely to have to take growth down by at least a full percentage point. They had already been forecasting reasonably solid growth from Q2 onward at about a 2.5% quarterly pace over the rest of the year, so it's unlikely the BoC will materially raise post-Q1 forecasts. As a consequence, the estimate of the output gap is likely to turn out to be a little larger, and its closure still not forecast for *at least* two more years.

The BoC might acknowledge slower U.S. growth in Q1 and the likelihood of a U.S. growth rebound in Q2 and beyond that could pull Canada along with it. Mitigating that upside pull could be some pushback from lower Chinese external demand.

About-Face?

Recall that Governor Poloz gave an uber-dovish speech on March 18th and hence two weeks following the last statement and the BoC is unlikely to take an incrementally more hawkish turn just one month later. The result of that speech knocked USDCAD back by about a couple of cents. Poloz's message was that once the output gap closes within roughly a two-year period, the economy is unlikely to trip into excess demand that would challenge the BoC's inflation target. Since then, however, USDCAD has fully reversed and then some through a roughly 3.5 cent appreciation in the currency off the post-speech highs.

Don't Sweat Inflation Adjustments

While it's true that the BoC has to raise its inflation forecast for Q1, the BoC has already stated as much so it won't be a surprise and it is unlikely to materially alter a dovish post-Q1 inflation forecast profile. 2014Q1 headline CPI inflation is tracking at about 1.3% in seasonally adjusted and annualized rates over Q4, and that compares to the BoC's 0.9% forecast way back in the last MPR on January 22nd. In the BoC's last formal forecast in January it had projected 1.2% inflation in Q2 and 1.4% in Q3 while ending the year at 1.5% in Q4. We don't see any need to materially raise Q2-onward inflation rates despite not hitting the exact bottom that had been forecast in Q1. The BoC already referenced inflation coming in a little higher than expected in Q1 in the March 5th statement when they stated "...although recent readings were slightly higher than expected." They are unlikely to strengthen that further and will simply reinforce it by raising the Q1 inflation forecast with perhaps minor alterations thereafter. Further, we don't see clear warning signals for future inflation (see pp.5-7 here and our article titled Could The BoC Seriously Lag The Fed?). Addressing the risk of import price inflation is unlikely in our view because it would more explicitly open the door to allegations that the BoC is attempting to weaken the currency as a way of returning inflation back to the 2% target, and perhaps because its effects are highly uncertain which is something we addressed in more detail in those earlier articles cited above.

Finally, we would look to the last sentence of the rate statement in March being retained in such fashion as to continue to maintain dovish ambiguity over the next eventual rate move. That sentence reads as follows: "The timing and direction of the next change to the policy rate will depend on how new information influences this balance of risks."