BoC Preview: Guidance Required

As Governor Poloz moves into his first experience leading a hiking cycle, the privilege to date of bouncing along a rate bottom that afforded the luxury of being loathe to provide forward guidance will be pressured to transition toward more sophisticated central bank communications with markets whether expressed or implied. The speed of market adjustments with two year yields up 40bps and the C$ up 5 cents versus the USD since just before the Wilkins speech on June 12th is a sign of a rate tantrum by markets that were caught flat-footed by the BoC's desire to suddenly spring a surprise and wondering where to next. Further surprises would not be welcomed by either markets or—more importantly—households and businesses. The risk of more such market action to come through a further pile-on into a modest market requires some handholding.

With our expected hike next week largely baked into markets, the greater question mark is whether the BoC is speaking to a script that simply implies taking back the insurance provided through two rate cuts in 2015—or going further than that. The case for simply sterilizing the two prior cuts and flat-lining for a period of time at an overnight rate of 1% may be rooted in Poloz's references to: a) how those cuts have done their job (even if they only heated up housing), and b) that the oil shock's effects are over—to imply just removing oil-related emergency stimulus. That may be the safe thing for Poloz to do.

But the case for raising rates by more than the consensus call for 50bps in hikes and by perhaps more than the markets have priced is the direction toward which Scotia Economics continues to lean. Whether that guidance arrives next week or in subsequent meetings is uncertain given how quickly the BoC's reaction function has changed and uncertainty over data-dependent arguments going forward. Note that OIS markets have priced two hikes by the end of this year and have not priced most of a third hike until Q3 of next year. Our house forecast is for three hikes (July, October and 2018Q1) before flat-lining. That is as aggressive as we are prepared to go in our print forecast at this point, but **we judge the risk to our rate forecast through to the end of 2018 as more skewed toward greater than three hikes rather than fewer** and with that the risk to the curve and CAD remains greater in our view over time than is currently priced. As previously argued, if we let our Scotiabank Global Macroeconomic Model speak unfiltered through reliance upon an output gap and augmented Phillips curve approach, then a full 100bps of tightening is recommended by the end of 2018 that would leave the policy rate at a still-low 1.5%. Chart 2 shows our inflation forecast using the augmented Phillips curve model.

Canada has already closed spare capacity by the BoC's traditional or "extended multivariate" output gap definition and the average of this measure and its newer "integrated framework" output gap is expected to shut later this year. If that happens, then 2018 could well bring about Poloz's recent guidance that inflation should be "well into an uptrend" by 2018H1. So should wage pressures given tightening markets, evidence of a recent bottoming, and big minimum wage hikes by Ontario and Alberta. Given monetary policy lags, it's plausible that the central bank already views itself as on-the-mark at best, if not slightly behind the inflation curve through maintaining emergency levels of stimulus just 6-12 months ahead of Poloz's inflation guidance.

Several risks are overstated. CAD is one (here). NAFTA has not been torn up. A border tax is D.O.A. An imported bond shock on deficit-financed US stimulus has not occurred. Soft present core inflation is less of a caution at the BoC's emergency rates than at the Fed which is up 100bps. There is more evidence that exports and investment can fill in for housing. Toronto housing is stumbling, but this is likely temporary while Vancouver is on the mend and elsewhere is resilient (chart 3). And job gains support consumers.

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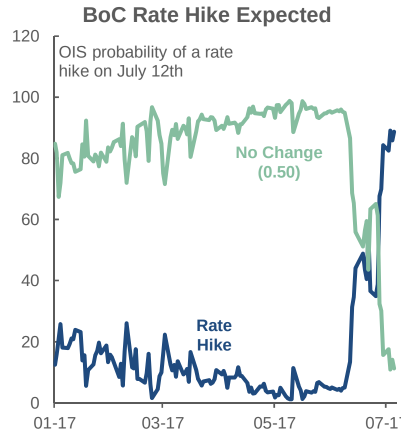
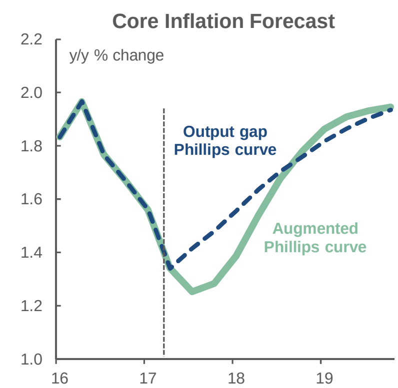
Chart 1



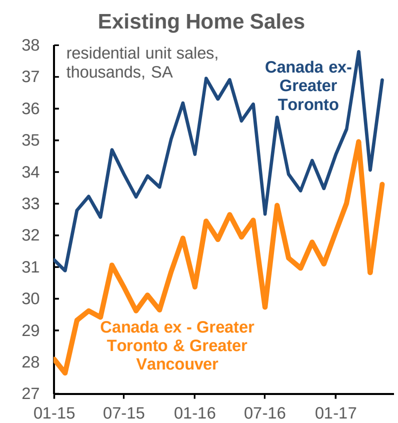
Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

Chart 3



Sources: Scotiabank Economics, CREA.