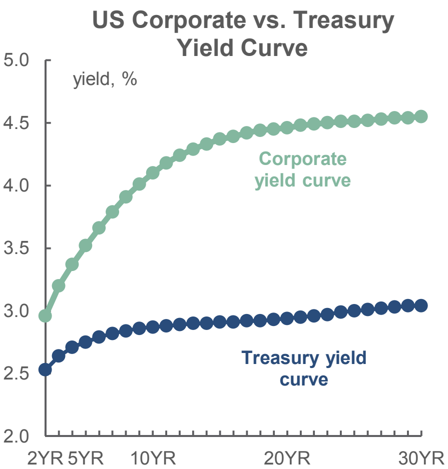
The Door Is Open To Expedited BoC Hikes

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

- **The BoC hiked its policy rate by 25bps as fully anticipated by markets and most forecasters including Scotia.** The bias to the overall set of communications was more hawkish than markets expected at the margin and it leaves the door open to considering two more rate hikes before year-end relative to our present forecast for one more hike. I think the rates market got that more than the currency following the full suite of communications, but there may be room for adding to nearer-term rate hike expectations. That bias will be informed by the evolution of data and trade policy risks into US mid-terms but at this point it is feasible that the BoC goes again in September with little priced in OIS markets at present that are pricing about half of another hike by the October meeting which should also enjoy higher probability of a follow-up hike. It is also unclear whether expedited near-term hikes alter the longer-run end point or simply bring it forward. The press conference is over and all communications risk is probably done for the day.
- **Key is that there were several forecast upgrades that were marginally more hawkish in nature.**
    - **US growth was raised to 3.1% this year (2.7% prior April forecast) and next year's forecast was lowered to 2.5% (2.7% prior) largely reflecting more front-loaded momentum**. World growth was left unchanged at 3.8% this year and lowered a tick to a still solid 3.5% next year.
    - **Raising the US outlook enabled the BoC to raise its Canadian GDP growth forecast** by a tick to 2.2% next year (2.1% prior) and 1.9% in 2020 (1.8% prior) while leaving this year's forecast unchanged at 2% while simply playing with the quarterly distribution of 2018 growth. As US stimulus hits, there will be leakage into Canada through Canadian exports. The BoC's real gross domestic income forecast was raised more materially than its real GDP outlook to 2.6% from 2.5% previously for this year, 2.3% from 1.9% next year, and 2.0% from 1.8% in 2020.
    - **Within the quarterly break-down, the BoC went to the high end of the present consensus for Q2 GDP growth and pegs it at an upwardly revised 2.8%** (2.5% prior). I'm a bit surprised by the fact the BoC is taking the upper end of the forecast range which is near-term hawkish. Governor Poloz repeated how this follows nailing the Q1 GDP forecast that landed at 1.4% (after revising lower from the BoC's January forecast). On net, Q1 and Q2 average out to about 2% growth over 2018H1 which is marginally above the unchanged estimates of potential growth (ie: the noninflationary speed limit to growth).
    - The inflation forecast was raised a tick to 2.4% this year (2.3 prior), 2.2% in 2019 (2.1 prior) and left at 2.1% in 2020. The BoC does not forecast its core measures.
- **Also key is that the BoC is largely looking through trade tensions and their effects on growth. On this, there are three points:**
    - **The BoC argues that higher oil prices offset increased trade tensions as "the incremental drag on projected GDP [ed. of**



Sources: Scotiabank Economics, US Treasury.

trade tensions] roughly balances the positive impact of higher oil prices." That is a symmetrical bias to oil market developments to the bias exhibited in the other direction when the BoC cut in January 2015 on the back of commodity worries and is consistent with our expectations. The BoC argues that the risks to oil prices are roughly balanced at current price levels and their forecasts always incorporate a random walk approach to oil prices by using the recent average spot prices. This has been one of our key arguments in that an improvement in the terms of trade (higher export relative to import prices) and the knock-on effects into domestic incomes through households, profits and government revenues improves the outlook for the Canadian economy especially into 2020–21 when three pipelines will probably become operational (TransMountain, Line 3 and Keystone XL as the third Keystone leg). More pipelines buoy the upstream investment climate over this horizon.

- **Second, the BoC has only marginally increased its estimate of the cumulative effect of trade policy uncertainty and US tariffs announced to date.** They now say "The dampening effects associated with trade policy uncertainty and the implemented US tariffs subtract about 2/3 per cent from the level of GDP by the end of 2020." That cumulative effect is fairly modest and most of it was incorporated in the April MPR. The Governor continues to emphasize how policy is data dependent and that hypothetical trade policy scenarios cannot guide immediate policy which I think is the right thing to do.
- **Third, the BoC's estimated direct trade hit to Canada from the US steel and aluminum tariffs is a total wash.** They figure that exports from Canada to the US will be down 0.4% due to the steel tariff and an extra 0.2% due to the aluminum tariff by 2018Q4, but imports to Canada are also forecast to be down (all else constant) 0.6% due to reciprocal tariffs. We had a small negative effect on balance and so despite saying in the BoC's statement that "this effect is now judged to be larger, given mounting trade tensions" it nets out to even less of a concern to the BoC in terms of the net trade account than it was by our estimates. That is a bit more hawkish than expected.

- **On housing, the BoC says "Recent data suggest housing markets are beginning to stabilize following a weak start to 2018."** When asked in the press conference if this is viewed as positive—presumably in the context of the BoC's prior stability concerns—the Governor said 'yes.' That is not new per se as the BoC has for some time indicated expectations for firming housing market activity over 2018H2 but it reinforces the point.
- **It's worth drawing additional attention to the C$ reference which is somewhat hawkish.** The BoC says "Meanwhile, oil prices have risen. Yet, the Canadian dollar is lower, reflecting broad-based US dollar strength and concerns about trade actions." That signals a willingness to view some of it as being incrementally stimulative to Canada on net as external USD influences drive some of the CAD weakening, while some of it reflects an increased uncertainty premium. I think that's reasonable but it goes against viewing the BoC as being comfortable with where the currency sits at 1.312 at present in favour of something perhaps less stimulative.
- **Some may question the BoC's soft Q3 GDP forecast of 1.5% SAAR for Canada but this is explainable**. It at least partly reflects the Syncrude problems in addition to the Q2 burst of oil production following transitory disruptions in Q1. Indeed the BoC states "Because the strength of export growth in the first two quarters mainly reflected a faster-than-expected rebound in oil exports after temporary pipeline shutdowns in late 2017, export growth in the third quarter is expected to slow." Our estimate is that around 1/4% gets knocked off Q3 GDP growth due to Syncrude's problems and then reversed to +1/4% in Q4. The BoC may be a little more bearish on the Q3 effect and possibly more upbeat on the reversal effect thereafter but I can't tell that part because under Poloz they only publish quarterly SAAR projections out one quarter (to Q3 in this year). Overall, the message is to look through the Q3 growth softening.
- **In addition to trade concerns, a relatively dovish nod came from the wage reference.** The BoC is reinforcing its belief that the wage common metric is preferred by citing wage growth of 2.3%. Recall that wage common is an adjusted composition of wages drawn from the payrolls survey and a tiny weight upon the Labour Force Survey's measure of wage growth for permanent employees that used to be the preferred gauge. My personal belief is that this still underestimates wage growth in Canada.
- **The Governor once again fully dismissed the importance attached to the Federal Reserve outlook in terms of conditioning the BoC's policy stance. That's likely appropriate in the moment for today's decision, but it remains unclear over time.** There is likely a limit to independent monetary policy through the currency that I think still exists.
- **On NAFTA, I think the Governor's messaging needs clarification or at least to be more fully repeated**. Poloz said in the press conference that the trade policy risks could evaporate if a NAFTA deal is struck. Does that mean he would instantly turn

more bullish on Canada and hence more rate hawkish? I doubt it, as he has previously said they would not remove negative forecast judgement immediately if a NAFTA deal is struck. But is he signalling something different now? Removing negative judgement with a lag would be an asymmetric policy bias given they were fairly quick to introduce negative judgement.

- During the press conference, the Governor was asked if he was concerned about the flattening yield curve and what it may portend. **He categorically said "I don't interpret the flattening of the yield curve as a warning sign as we would in more normal times."** The Governor gave popular arguments for why (e.g. long-end demand, global CBs, etc.) but the broad message is that this central bank sees nothing in the bond market that would suggest caution attached to future policy decisions. Personally I think he's right on that. He also doesn't dispute why the bond market is behaving this way and said "I wake up every morning thinking the market is certainly right" which is likely contestable to many market participants and is curious given he has surprised markets with some past policy decisions. See this morning's *Daily Points* for further colour on yield curve signals by flagging the competing signals in the corporate bond market. Another chart is offered below.
- During the press conference, the Governor flagged that monetary policy is unsuited to address protectionism and was somewhat ambivalent toward what direction monpol would take in the face of an escalation of trade protectionism. He emphasized the growth versus inflation risks and concluded that how monetary policy behaves depends upon the circumstances. **The takeaway is not to assume that monetary policy would ease or turn neutral should trade tensions escalate as it would depend upon the overall growth and inflation effects.**
- **Please see the attached statement comparison.** As always, an MPR statement essentially involves a full forecast-driven re-write.
- **The press conference is over and the opening statement is here.** There will be knock-on media interviews conducted after the dust settles as per the recent custom but I think we've gotten as much as we're likely to out of the communications provided to this point.
- The full Monetary Policy Report is available **here**.

RELEASE DATE: JULY 11, 2018

The Bank of Canada today increased its target for the overnight rate to 1 ½ per cent. The Bank Rate is correspondingly 1 ¾ per cent and the deposit rate is 1 ¼ per cent.

The Bank expects the global economy to grow by about 3 ¾ per cent in 2018 and 3 ½ per cent in 2019, in line with the April *Monetary Policy Report* (MPR). The US economy is proving stronger than expected, reinforcing market expectations of higher policy rates and pushing up the US dollar. This is contributing to financial stresses in some emerging market economies. Meanwhile, oil prices have risen. **Yet, the Canadian dollar is lower, reflecting broad-based US dollar strength and concerns about trade actions. The possibility of more trade protectionism is the most important threat to global prospects.**

Canada's economy continues to operate close to its capacity and **the composition of growth is shifting**. **Temporary factors are causing volatility in quarterly growth rates**: the Bank projects a pick-up to 2.8 per cent in the second quarter and a moderation to 1.5 per cent in the third. Household spending is being dampened by higher interest rates and tighter mortgage lending guidelines. Recent data suggest housing markets are beginning to stabilize following a weak start to 2018. Meanwhile, exports are being buoyed by strong global demand and higher commodity prices. **Business investment is growing in response to solid demand growth and capacity pressures, although trade tensions are weighing on investment in some sectors**. Overall, **the Bank still expects average growth of close to 2 per cent over 2018-2020**.

CPI and the Bank's core measures of inflation remain near 2 per cent, consistent with an economy operating close to capacity. **CPI inflation is expected to edge up further to about 2.5 per cent before settling back to 2 per cent by the second half of 2019. The Bank estimates that underlying wage growth is running at about 2.3 per cent,** slower than would be expected in a labour market with no slack.

As in April, the projection incorporates an estimate of the impact of trade uncertainty on Canadian investment and exports. **This effect is now judged to be larger, given mounting trade tensions.**

The July projection also incorporates the estimated impact of tariffs on steel and aluminum recently imposed by the United States, as well as the countermeasures enacted by Canada. Although there will be difficult adjustments for some industries and their workers, **the effect of these measures on Canadian growth and inflation is expected to be modest**.

Governing Council expects that higher interest rates will be warranted to keep inflation near target and will continue to take a gradual approach, guided by incoming data. **In particular, the Bank is monitoring the economy's adjustment to higher interest rates and the evolution of capacity and wage pressures, as well as the response of companies and consumers to trade actions.**

RELEASE DATE: MAY 30, 2018

The Bank of Canada today maintained its target for the overnight rate at 1¼ per cent. The Bank Rate is correspondingly 1½ per cent and the deposit rate is 1 per cent.

Global economic activity remains broadly on track with the Bank's April Monetary Policy Report (MPR) forecast. Recent data point to some upside to the outlook for the US economy. At the same time, ongoing uncertainty about trade policies is dampening global business investment and stresses are developing in some emerging market economies. Global oil prices have been higher than assumed in April, in part reflecting geopolitical developments.

Inflation in Canada has been close to the 2 per cent target and will likely be a bit higher in the near term than forecast in April, largely because of recent increases in gasoline prices. Core measures of inflation remain near 2 per cent, consistent with an economy operating close to potential. As usual, the Bank will look through the transitory impact of fluctuations in gasoline prices.

In Canada, economic data since the April MPR have, on balance, supported the Bank's outlook for growth around 2 per cent in the first half of 2018. Activity in the first quarter appears to have been a little stronger than projected. Exports of goods were more robust than forecast, and data on imports of machinery and equipment suggest continued recovery in investment. Housing resale activity has remained soft into the second quarter, as the housing market continues to adjust to new mortgage guidelines and higher borrowing rates. Going forward, solid labour income growth supports the expectation that housing activity will pick up and consumption will continue to contribute importantly to growth in 2018.

Overall, developments since April further reinforce Governing Council's view that higher interest rates will be warranted to keep inflation near target. Governing Council will take a gradual approach to policy adjustments, guided by incoming data. In particular, the Bank will continue to assess the economy's sensitivity to interest rate movements and the evolution of economic capacity.