Economic Flash!

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Bank of Canada: “I’ll Be Back”

The Bank of Canada took itself out of the rate hike game today, and it isn’t quite sure about when it will be coming back off the sidelines. But at the same time, it’s sticking to its guns that interest rates are too low to be sustainable, and that at some point, they will be climbing into the 2.5% to 3.5% range the Bank judges as “neutral”. So Governor Poloz’s message to markets is “I’ll be back”, but rate hikes are now coming “over time” as opposed to in the here and now. That’s a slightly more hawkish message for financial markets that, prior to this announcement, were not even pricing in one full quarter point hike in 2019.

We continue to question the ability of the economy to sustain growth near potential at interest rates significantly higher than those currently in place. The drop in oil production, as well as global growth concerns surrounding a China-US tariff war, are cited by the Bank as reasons for the economy to underperform in the near term. But even before the Q4 drop in crude oil prices, the Canadian economy had only been growing at a 2.1% real pace in the four quarters to Q3. That’s not meaningfully above the non-inflationary potential pace that the Bank is trying to achieve, and that’s with overnight rates having averaged only 1.25% over that period.

The Bank’s more optimistic take will have it return with rate hikes on the first sign of good news. In its forecast, it sees that coming in Q2 as we get past the biggest negatives from oil production cuts, setting us up for a rate hike near mid-year (late Q2, or perhaps now more likely, July). But if, as we expect, neither growth nor inflation get that heated thereafter, the Bank could again be back on the sidelines for the rest of 2019, and in a globally slowing climate in 2020, remain there for another year.

As we expected, the statement justifying today’s stand-pat decision came alongside a marking down in projected Canadian GDP growth. If anything, the Bank of Canada’s forecasts for Q4 2018 and particularly Q1 2019 look to be on the low side, averaging only about 1% over that period. For 2019 as a whole, GDP growth is now seen as coming in at 1.7%, a reasonable judgement in our view, down from 2.1% in the October projection. A rebound to 2.1% in 2020 would represent a two-tick upward revision in their forecast, but that’s presumably based on a slower track for interest rate hikes than what underpinned the October call.

We share the view that the worst times for the energy sector in terms of production restraint will pass after a quarter or two, although capital spending plans will be pared back this year. Indeed, the Bank’s base case assumes that WTI will stay at $50, while we see it gradually moving higher over the coming year. But we question the ability of the Canadian economy to grow above potential in the face of substantial further rate hikes, the lagged impacts of prior hikes, and the inevitable slowing in US growth in 2020 as fiscal stimulus comes to an end and the American economy reaches full capacity. To get any momentum in exports in that environment, the Canadian dollar will have to stay no stronger than its recent range, and that in itself could be a barrier to more than a single hike if the Fed only has a quarter point in store this year.

Other than the one-time dip in inflation from cheaper gasoline, the Bank hasn't changed its view on price pressures. The Bank's output gap measure now shows just a touch of slack, but it sees that as confined to energy producing provinces. As a result, headline inflation will be back at 2% in 2020.

It notes that soft wages at the national level have mostly been reflecting wage trends in energy producing provinces, although wages really don't look heated elsewhere if one removes the one-time impacts of large minimum wage hikes that kicked in last year.

Market Implications

Short term yields ticked up very slightly after the statement, and the Canadian dollar showed a small gain, but both effects were promptly reversed. While we're more dovish on the Bank than consensus forecasts, even one rate hike would be negative for the front end of the yield curve, and along with an oil price recovery, allow for at least a temporary Canadian dollar rally. But, as noted, if that's a one and done move for rates, we would see the Canadian dollar remaining generally range-bound for the year as a whole.