How Energized is Poloz?

- **No hike is expected this week;**
- **A hike in January is under-priced;**
- **Growth and inflation are tracking the BoC's October forecasts;**
- **But how much more concerned is Poloz toward energy's effects;**
- **And is that enough to negate prior guidance to return toward a neutral rate?**

This week will place a heavy degree of market emphasis upon how the Bank of Canada is reading the shifting tea leaves. That's because up to this point, the BoC has been inclined to guide expectations toward a gradual path of rate hikes and toward a more neutral policy rate. This stance has informed expectations because the BoC has tended to look through fresh developments not only since the October meeting but also since Governor Poloz's speech on November 5th in London and SDG Wilkins' later speech that briefly repeated a bias toward returning to neutral over time. Whether this is still what the BoC believes is a key matter to guide the rates and currency complex. By the time macro data like jobs, trade and productivity growth arrive later in the week, this debate may have already been largely settled.

We expect the Bank of Canada to hold its overnight borrowing rate at 1.75% on Wednesday in a statement-only affair. The week will have the feeling of a fuller BoC meeting, however, because Governor Poloz speaks the next day in Toronto with remarks available at 8:35amET. A press conference will follow at about 9:55amET. The focus will be upon delivering an economic progress report. This year, the BoC committed to delivering such a progress report by a Governing Council member the day after non-MPR statements. This time is Poloz's turn and one should juxtapose that on top of his tendency to offer a December/January surprise over recent years.

Given that the BoC hiked in October and issued a full set of forecasts, this go-around may be focused upon shedding clues toward potential shifts in the forecast bias when the BoC next updates its forecasts on January 9th. The formal staff forecasting exercises should result in briefing Governing Council around the week before Christmas according to their laid-out decision-making process here. There is a lot of new information to incorporate but expect limited direct forecast inferences to be shared just yet.

One piece of new information is the Q3 GDP report and its composition that broadly met if not slightly exceeded BoC expectations but that disappointed in terms of underlying investment (recap here). This evidence limits capacity expansion to the detriment of growth in potential GDP. The USMCA agreement—and its expected implementation sometime in 2019—removed the tail risk of no agreement that may have restrained business investment. The BoC will want to see how its Business Outlook Survey reflects this issue on December 21st.

The second is the impact of the Federal mini-budget and its central focus upon investment incentives (recap here). Among provinces, Quebec has reinforce the Federal policy. This may give the BoC more confidence in the investment outlook.

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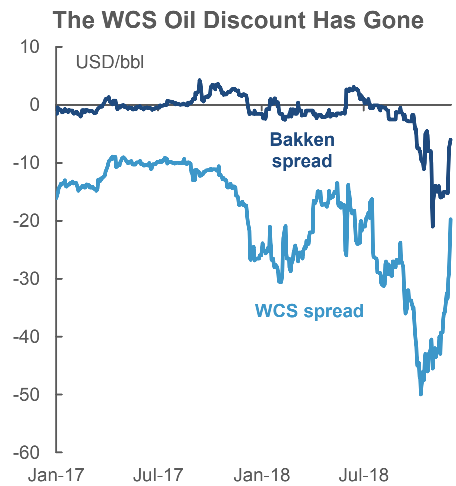
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Third is the impact of one-off announcements like those from GM and others that we think net out to little change to the 2019–2020 GDP forecast. GM—as noted by our autos economist Juan Manuel Herrera—has allocations at its Oshawa plant until the end of 2019 after which it was already on track to drop to about 50,000 vehicles produced in 2020 from about 150,000 this year. The marginal information to some forecasters of eliminating 50,000 units produced in 2020 is small. Also note that it is incorrect to assume this is a 2019 shock that is additive to energy challenges that will be explored in a moment. Further, taking project developments in piecemeal fashion is always dangerous; there have been other more positive investment announcements made recently in Ontario's economy. Regardless, GM is not a consideration for the 2019 forecast.

Fourth is perhaps how Poloz views progress toward implementing the USMCA agreement. I would expect him to either appear to be neutral relative to October or perhaps more encouraged by the ceremonial signing and ongoing negotiations that continue to drive our expectation that a deal with side letter amendments won't be passed by all three countries until well into 2019. During this period, the BoC cannot put monetary policy on hold nor should it.

Fifth is that one should expect Poloz to probably take a similar approach to global trade tensions as he did with NAFTA. The imminent threat of more US tariffs on imported Chinese goods—and retaliation in a variety of forms—has diminished after this weekend. The longer run threat has not disappeared, but Poloz tended to view NAFTA as a risk he would treat as concrete information evolved and so he will probably treat incremental global trade tensions similarly.

Sixth is the biggie. What does the Governor think about the state of Canada's energy market and feedback effects upon the economy and the inflation mandate? I frankly haven't a clue because the BoC has largely evaded the topic since oil prices began to drop around eight weeks ago. But here's what I would suggest with the caveat that there are obviously other potential ways of looking at the issue.

1. Is oil's slide transitory?

I agree with our energy economist Rory Johnston who thinks so but we'll await the OPEC meeting to confirm speculation post-Putin toward a 1 million plus bpd production cut that may bolster global price benchmarks with so far very little of that incorporated into prices. Further, we're already encouraged by the massive compression in Western Canada Select price discounts to WTI (chart 1). In fact, they're pretty much gone with today's large US$11 rally in Western Canada Select and the narrowing of the WTI-WCS discount to under $20 for the first time since July following Alberta's orchestrated production cuts. More compression is possible into 2019 as US refineries return their demand for heavy oil to prior levels, as oil-by-rail works through pipeline bottlenecks and on the path toward the Line 3 pipeline next November. Over time, we could well wind up at the prior $10-15 tights for this spread but a near-term risk would be if OPEC developments widen it again on production cut effects through global benchmarks.

How should the BoC view Alberta's production cuts amounting to 325,000 bpd or about 9% of the six month peak beginning in January and transitioning toward 95,000 bpd once balance has been restored? The January MPR will have to revise down Q1 growth and widen the near-term output gap somewhat. In keeping with their practice to only forecast out two quarters in advance they may also be publicly on the fence on Q2 implications depending upon when they guess Alberta might transition toward softer cuts.

Implied within their forecasts and narrative, however, should be a solid rebound in 2019 Q3/Q4 through oil's effects as production cuts are scaled back and they might also revise up 2020 growth on a temporarily weaker full year of 2019. In addition to the near-term output gap, they should probably care about the smoothed one in future and independent of transitory shocks. A weaker and more front-loaded effect of oil production cuts should mean a stronger and more back-end loaded surge in production as Alberta's imposed cuts abate and possibly get eliminated once Line 3 becomes operational late next year. Further, the terms of trade may improve as prices recover on combined OPEC and Alberta moves and carry trickle down benefits to government revenues, corporate profits and household incomes relative to the alternative. If WCS is durably improving, we could see the exempt smaller producers increase output and the larger players begin to question the need for unchanged cuts. Monetary policy can't do anything about the near-term production hit. It has to see through it and stay on course toward getting to something more neutral than the current -65bps negative real rate that Canada is still running at full capacity in the economy.

2. What is being revealed by little hedging activity?

Enter chart 2. It shows the number of firms that are hedging oil prices this year into next year by the fraction of output they are hedging. We worked with our equity analysts to derive the figures. 'Not much' is the short answer. 'Why' is the next question. One possibility is that the cost of hedging may be too high relative to the implied return expectations. In plain English, oil companies may be anticipating a rise in oil prices and have an asymmetric bias in favour of the return half of the risk-return calculus.

3. Expectations matter:

For years up to the decline in 2014H2, WTI was hanging around $100/bl. The plunge to about a quarter of that over 2014H2–2015H1 was a far bigger shock than the decline from the relatively recent and short-lived spike to US$77 this time. In fact, when it was occurring, many were skeptical it would last. While they've been perhaps vindicated — depending upon how last this correction itself persists—it remains questionable whether firms adjusted investment and hiring plans as prices increased. The point here is that expectations matter in relation to starting points and perhaps this wasn't much of a shock to plans. Clearly that's less true for WCS that fell from nearly US$60 in May to about one-third of that at the low point and still just over half of that prior peak today albeit sharply improving almost as fast as it deteriorated!

4. The energy sector isn't what it was in 2014–15.

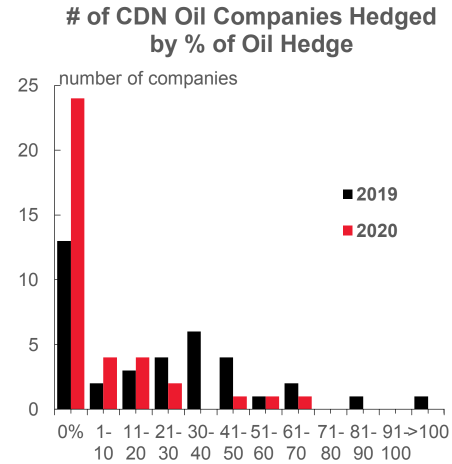
Back then we were at elevated readings across everything going into the price shock. Today we've spent the post-14/15 period adjusting lower and thereby dragging down the sector's relative importance in the economy. The incremental amount of what is at risk to forecasts has adjusted commensurately lower. For example, drilling/exploration activity has largely dried up to about one-third or less of the pace back then and the economy has adjusted (chart 3). There was not any seasonally adjusted response in drilling activity to the improvement in prices prior to late summer. Investment in the oil patch has already corrected to about half what it was just four years ago (chart 4). Say we knock another quarter or half out of that compared to a $2 trillion economy; is that really reason for perma-bears to go cold on everything from growth to the BoC, CAD and the price of Leafs tickets? Also witness charts 5–8 that depict shares of GDP, employment, foreign direct investment and exports represented by energy today. For more on the role of Canada's energy sector in the economy, go here. It is an important, vibrant part of the Canadian economy, but Canada is not, say, Norway by way of the tag I oftentimes sense gets applied by international accounts and how they discount the enormous diversification of the Canadian economy.

5. Other automatic stabilizers have adjusted unlike 2014.

One of these stabilizers is the currency. USDCAD was at about 1.10 back when the 2014 shock hit but is at 1.32 now and hasn't really done much in response to oil with the plethora of other driving factors (USD strength, NAFTA headline volatility, etc.). Lower oil and depreciated CAD that is in no small part due to USD strength benefit other parts of the economy (Ontario, Quebec, etc.).

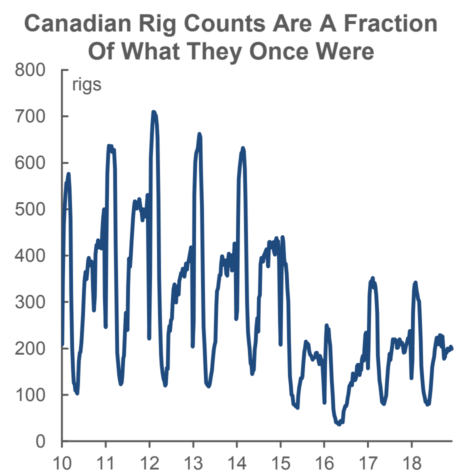
6. Leakage effects

Chart 2



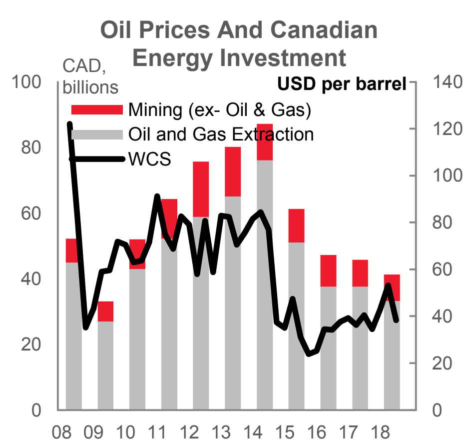
Sources: Scotiabank Economics, Scotiabank Equity Research.

Chart 3



Sources: Scotiabank Economics, Baker hughes inc.

Chart 4

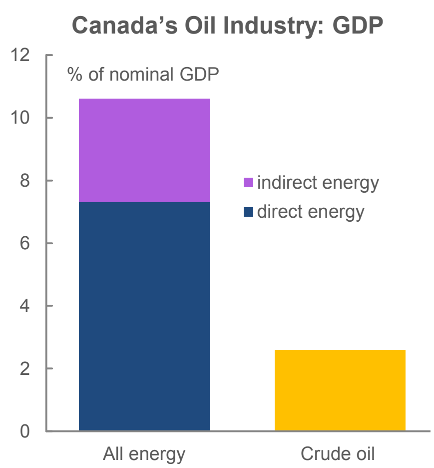


Sources: Scotiabank Economics, Statistics Canada, Bloomberg.
* Preliminary Data. WCS Q4 quarter-to-date avg.

There is a vibrant debate over the full supply chain effects of lower oil this time around and how much is leaking out to the US refineries. Oil companies with upgraders and refineries, for example, aren't complaining about cheap feeder costs and there have been just such major investments coming on line in the wake of the prior investment boom. That's a big reason why even now the industry is divided toward the concept of mandated production cuts. There would be more trouble for the economy if lower input costs weren't benefiting margins in key parts of the energy sector where heavy investments were made. Also note the evidence in the latest trade figures that displayed weakness in oil imports due to substitution toward domestic production. From a GDP accounting sense, that's a plus that implies less import leakage out of the economy.

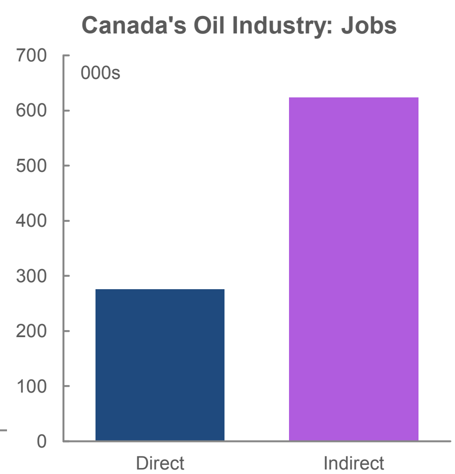
Scotiabank Economics will release a fresh forecast update once we hear from Governor Poloz and are witness to what Thursday's OPEC meeting may deliver.

Chart 5



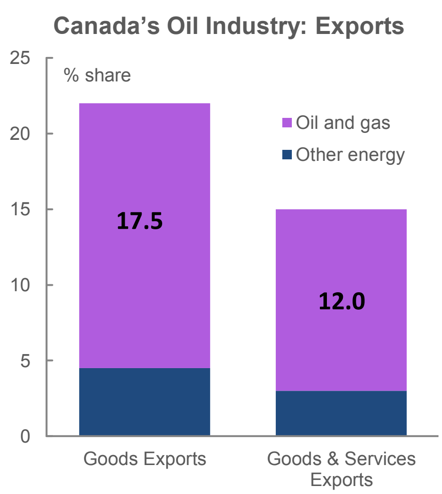
Sources: Scotiabank Economics, Statistics Canada.

Chart 6



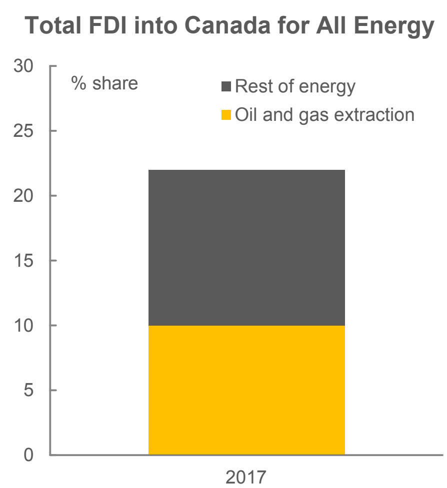
Sources: Scotiabank Economics, Statistics Canada.

Chart 7



Sources: Scotiabank Economics, Statistics Canada

Chart 8



Sources: Scotiabank Economics, Statistics Canada.