Canadian Rates Outlook 2020–21

- **The Bank of Canada is forecast to cut twice in 2020.**
- **Canadian inflation risks are tilted lower.**
- **Mild curve steepening forecast.**

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BANK OF CANADA—EASING IS COMPATIBLE WITH INFLATION GOALS

Two rate cuts are forecast in 2020 with our current placement anticipating them to occur in the first half of the year after which the overnight rate is expected to hold at 1.25%. Chart 1 shows our yield curve projections. The crux of the argument that follows is that to ease monetary policy would not be inconsistent with inflation presently being on target.

- A significant part of the reason that inflation landed on the 2% target in 2019 had to do with a series of idiosyncratic drivers that may prove to be transitory and that have nothing to do with economy-wide slack or the lack thereof;
- As slack nevertheless widens, this should marginally combine with the reversal of these more dominant temporary factors to put renewed downside pressure on inflation in 2020;
- From a risk management standpoint, the BoC should err on the side of easing when downside risks to inflation surface given its weak track record at forecasting inflation;
- The way the BoC has implemented policy measures suggests to economists, markets and businesses that 2% is an inflation ceiling as opposed to a symmetrical target implemented in what the BoC used to describe more commonly as a flexible inflation targeting framework. This tendency to act like it's a ceiling risks unmooring full-cycle inflation expectations—with some supporting evidence—and poses greater vulnerability to future shocks.

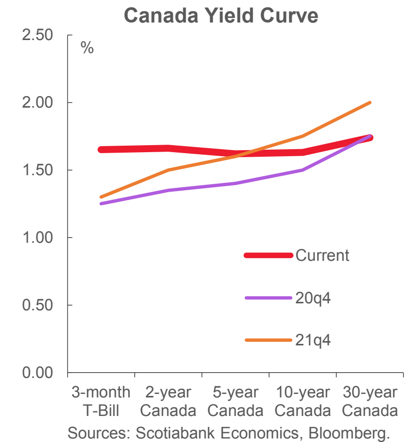
Secondary to the inflation argument for easing are four other matters that are addressed below. Amidst shaken consumer confidence due to financial stress and a weakened jobs trend, rate cuts could re-inject fresh confidence.

A. Inflation's Transitory and Idiosyncratic Drivers

The BoC has tended to argue that inflation around 2% is a signal that the economy is running at or very near full capacity. An alternative explanation is that inflation is being driven by a variety of idiosyncratic factors that may be transitory and that have nothing to do with slack or the lack thereof.

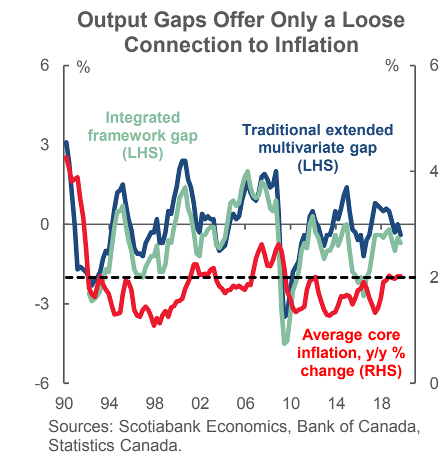
For starters, the connection between 'core' inflation and output gaps is tenuous at best. Chart 2 shows the BoC's two output gap measures and the average of the three 'core' measures of inflation. There is a broad connection over time but it is too strong a statement that if inflation is on target then it must be that spare capacity has been eroded. That's particularly since estimating potential growth is highly imprecise and hence so are slack estimates.

Chart 1



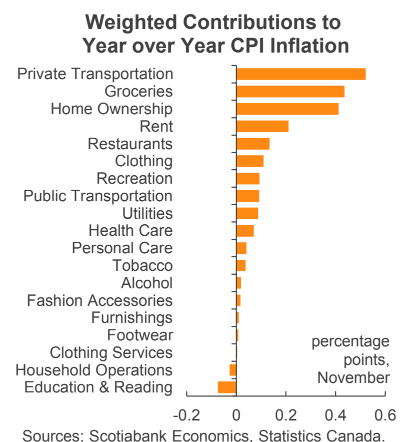
Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bank of Canada, Statistics Canada.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Secondly, chart 3 shows the main drivers of annual CPI inflation as a segue into discussing potentially idiosyncratic drivers. Autos, gasoline, groceries, and home ownership costs including house prices and mortgage interest are the top drivers of inflation. Each of them potentially has little to nothing to do with broad slack conditions and much more to do with industry-specific drivers.

Take grocery prices for example. On a weighted contribution to overall CPI inflation basis, groceries rank as the second biggest driver. This annual report explains sources of food price pressures in terms of idiosyncratic factors like African swine fever's impact upon global pork supply, the impact of trade war frictions on supply chains, the impact on vegetable prices of E.Coli outbreaks and the impact of supply chain disruptions on beef prices. Whether such effects on grocery prices are transitory or not is uncertain, but they have little to do with broad economy-wide capacity pressures.

Or take the impact of past depreciation in the Canadian dollar on auto prices (chart 4) which has contributed to the biggest weighted contribution to overall CPI inflation. There is a one year lagged effect between changes in the dollar and auto prices when new models are introduced; as CAD appreciated this past year, there should be less auto price inflation in 2020.

Chart 4

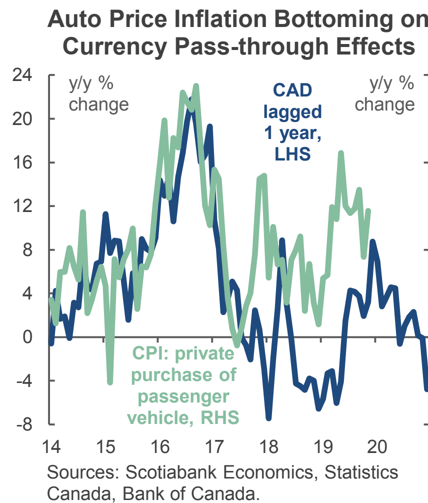


Chart 5

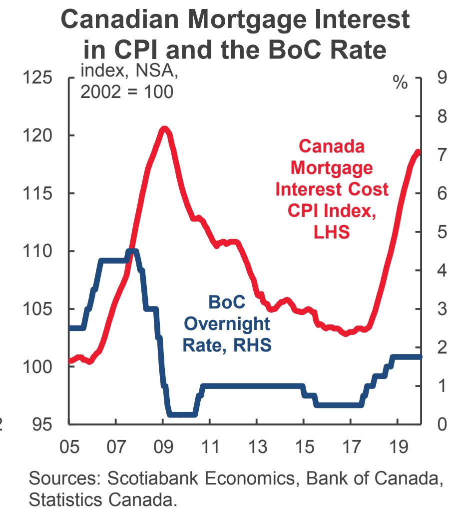


Chart 6

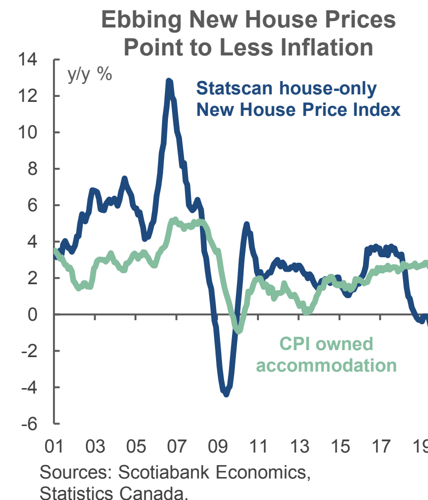
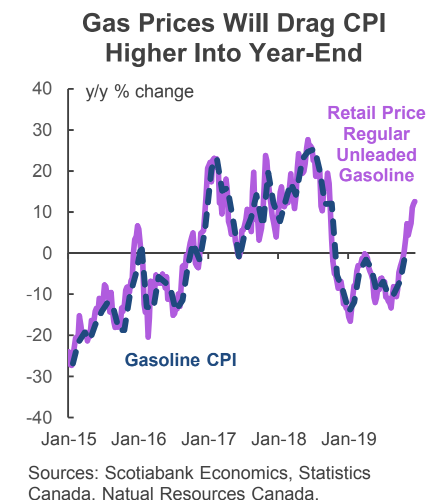


Chart 7



Or take the impacts of past rate hikes by the BoC on mortgage interest costs (chart 5) and the likelihood that this factor drops out as a driver of rising home ownership costs in 2020.

Further, the replacement cost component of the owned accommodation portion of shelter costs in CPI is driven by the 'house only' part of StatsCan's new house price index. As the latter has seen an abrupt ebbing in the pace of increase over the past year, the historical lagged effects point to downside risks to the owned accommodation part of CPI into 2020 (chart 6). Note that house price contributions to Canadian CPI are derived from builder prices and not resale prices.

The same transitory idiosyncratic argument may be true for gas price inflation this year off of low prior base effects but pending further evaluation of risks to energy markets that are discussed later (chart 7).

The large weighted roles played by several idiosyncratic drivers of inflation are probably not adequately filtered out by the 'core' measures of inflation. For instance, the latest month-ago change in the trimmed mean CPI gauge included several of these arguably idiosyncratic components (chart 8). They likely combine to play a significant role in driving inflation to the BoC's target. If they weaken, which is quite plausible, then achieving the BoC's 2% inflation target may itself be a transitory accomplishment.

B. Canada Is Building Slack Again

What reinforces downside risk to inflation is the possibility that as transitory drivers diminish, widening slack in the economy could sap pricing power. Economic growth over the second half of 2019 averaged below the BoC's estimate of potential growth that is required to soak up production inputs and preserve stable inflation. Our forecast is for GDP growth to equal about 1.5% in 2020 with possible downside risk which would ride roughly in tandem to potential growth or below it such that, at a minimum, widened slack by the end of 2019 persists over 2020. Household finances are strained and manufacturers and wholesalers have the highest inventory bloat since the 2009 recession which portends slowing production growth and likely slowing hiring activity with it.

C. Restoring Credibility to a Symmetrical Inflation Target

In a risk management sense, the BoC should place greater emphasis upon downside risks—like the ones discussed thus far—than upside risks to inflation given it has perennially over-predicted inflation in the past.

Enter chart 9. A very well established pattern is that the BoC constantly forecasts a return to 2% inflation within its projection period but almost never achieves it. Each dotted line shows the inflation forecast contained within successive Monetary Policy Reports over the years. The solid line is the actual trend in inflation. Note that average 'core' inflation fell below the 2% inflation target during 90% of the months during Governor Poloz's term as Governor. **If one's forecast bias has been to persistently predict inflation to be too high, then adopting a more cautious policy stance has merit.**

D. Inflation Expectations

A potentially dangerous unmooring of inflation expectations is occurring in Canada and it may be time for the BoC to return to emphasizing the flexible inflation targeting approach that it utilized toward the start of the decade. This may be a direct offshoot of the BoC's inability to sustainably achieve 2% inflation. Over Governor Poloz's term, average core inflation has run at about 1.7% y/y which is identical to the average over the slightly longer post-recession period since 2010. Just as inflation arrived at the 2% inflation target, the BoC has rung the all clear and declared the economy 'home', defined as a point at which supply and demand are balanced, slack has disappeared and stable prices are evident.

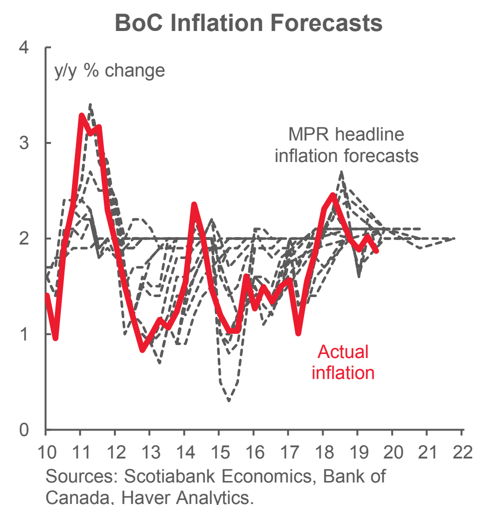
How do measures of inflation expectations behave in light of this approach? All measures of inflation expectations have their pros and cons, but they all suggest that the BoC's inflation target range is skewed to the lower 1–2% half of its 1–3% band. Bond market measures are below 2% (chart 10). Businesses don't believe 2% will be hit (chart 11). The consensus of private sector economists is the most optimistic, but a) it may suffer from the same inflation over-forecasting bias as the BoC, and b) the Bloomberg consensus only projects 1.9–2.0% inflation over 2020–21 and nothing higher.

Now here lies the rub. When the Bank speaks of having returned to 'home' and signals that it is content with inflation at 2%, it implicitly signals to markets, households and businesses that 2% is a ceiling. By corollary, **it comes to be believed that average inflation over the cycle is being targeted at something materially**

Chart 8

Sources: Scotiabank Economics, Statistics Canada.
Red bars denote categories included in trimmed mean CPI.

Chart 9



Sources: Scotiabank Economics, Bank of Canada, Haver Analytics.

below 2%. This can mean that businesses, consumers and governments start to believe that wage- and price-setting exercises over the full cycle should be something below a 2% inflation and overall cost of living estimate. Measures of inflation expectations would appear to confirm this.

Does it matter? Probably. The lower inflation gets, the less of an unanticipated shock to the economy it takes to get deflation which is the worst overall scenario for the economy in that businesses and consumers put off spending plans in anticipation of lower prices in a self-fulfilling and damaging feedback loop.

Downside risks to inflation, a poor track record at forecasting it and potentially unmoored inflation expectations combine to counsel an easing bias.

E. Other Considerations

The crux of the easing argument is rooted in the inflation targeting framework, but other arguments are also briefly addressed.

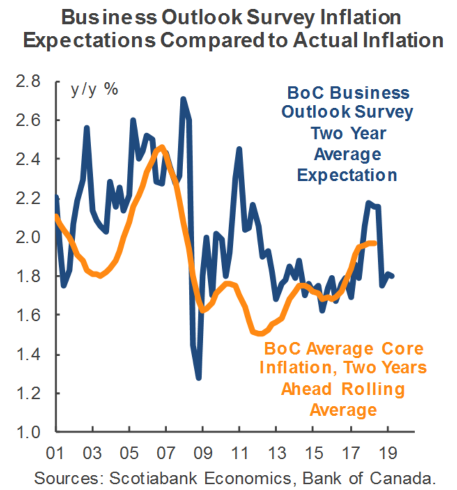
F. (i) A Softening Job Market

If job growth faces downside risk then that's a significant risk to the strained consumer sector and housing markets. In turn, this may merit easier financial conditions.

Chart 10

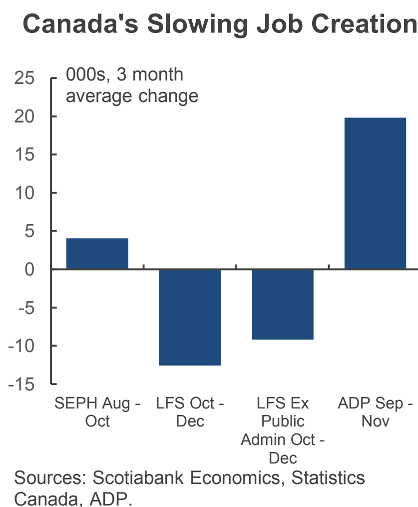
Sources: Scotiabank Economics, Bloomberg.

Chart 11



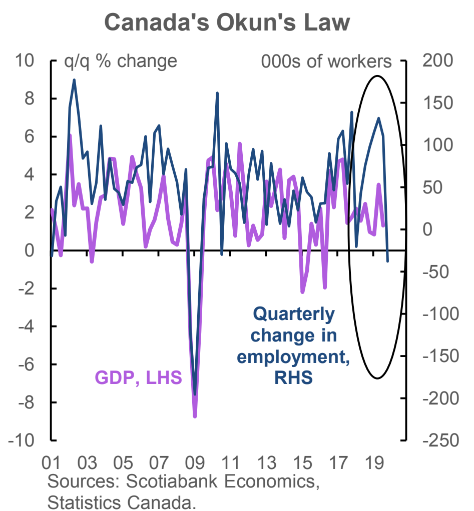
Sources: Scotiabank Economics, Bank of Canada.

Chart 12



Sources: Scotiabank Economics, Statistics Canada, ADP.

Chart 13

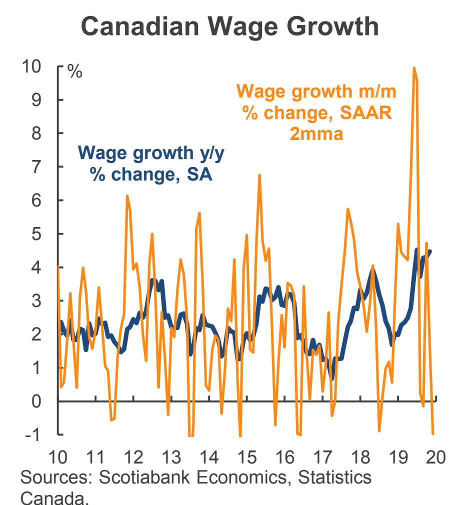


Sources: Scotiabank Economics, Statistics Canada.

There is no doubt that Canada's job market has been on a tear since mid-2016 when job growth began to accelerate. It has performed more strongly than the US job market over this time. More recent trends across the three main measures of job growth are nevertheless indicating somewhat greater caution on average (chart 12). It's feasible that job growth overshot what should have occurred in the context of soft trend growth in GDP over recent years and that the historical connections between the two measures will weaken job markets. This relationship is referred to as Okun's 'law' which posits that the historical connection between GDP growth and job growth is dragging job growth downward (chart 13).

A similar argument may hold in terms of wage growth. A weak pace of wage growth a year ago played a significant role in driving an overshoot of wage growth at present. Month-over-month gains were nevertheless quite strong over the middle of 2019 but may have since settled back down (chart 14). If monthly gains have slowed then when tacked onto this past year's strong gains, the pace of wage growth may abruptly slow in 2020. More disconcerting is that wage gains at the present rate are not backed by productivity gains casts doubt on the sustainability of wage pressures.

Chart 14



Sources: Scotiabank Economics, Statistics Canada.

F. (ii) What Fiscal Stimulus?

If there is a sense that fiscal stimulus can take over from monetary policy into 2020 then such beliefs should arguably be put to rest.

For one thing, incremental Federal fiscal stimulus has been focused upon a small increase in the Basic Personal Amount as a small tax cut. We estimate the incremental effect on economic growth to be small—at around a tenth of a percentage point into 2020 or less—and transitory (chart 15). Go here for more.

For another, this small amount of Federal stimulus is offset by near-universal fiscal consolidation across provincial governments and by an increase in Canada Pension Plan premiums that took effect at the beginning of 2020.

Third, Canada is projected to run deficits of 1.2% of GDP in FY20 and FY21 before they gradually diminish in subsequent years. Almost a third of this is not stimulatory, and is instead due to actuarial accounting for pension obligations. Recession risk would materially widen deficits given the Finance Department's estimate that each 1% shock to nominal GDP adds $5 billion to the deficit. Peak-to-trough NGDP growth involved a swing of eight percentage points in the early 1990s, over 10% in the early 2000s and about 15% in 2008–09. The federal government is not likely to materially pre-spend fiscal room much further as it could well expose the country to downside risk to its AAA credit rating—which the Finance Minister is explicitly mandated to protect—and risk pro-cyclical future belt-tightening that by practical necessity would focus upon the middle class.

Last, perhaps unlike some other parts of the world, Canada has room to act with monetary policy as a first line of defense relative to fiscal policy. In fact, many economists—likely including those at the BoC—believe that fiscal policy is likely to prove more powerful when the policy rate is toward the lower bound. Politically, it may also be unfeasible for the Federal Government to launch material fiscal stimulus without the BoC leading the way.

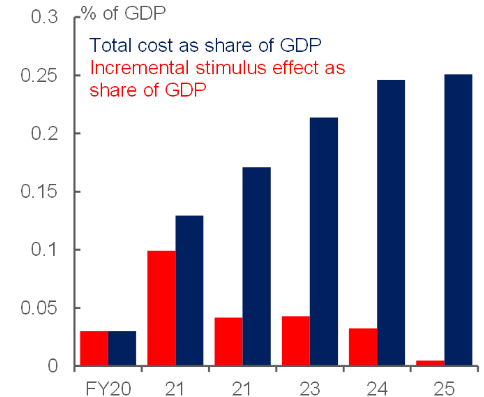
F. (iii) Household Debt and Stability Risks

Financial stability risks attached to easing are arguably exceeded by stability risks attached to having led households toward a low rate environment only to suddenly stop by not addressing downside risks to growth and inflation. The household saving rate sits at about 1%, and hence a fraction of what it is in the US while debt payments are at a cyclically elevated share of household incomes versus the historic lows in the US.

As a result of strained finances, Canada has been stuck in a soft trend growth environment for retail sales and broader consumption for about the past two years. Retailers have borne the brunt of this adjustment (chart 16).

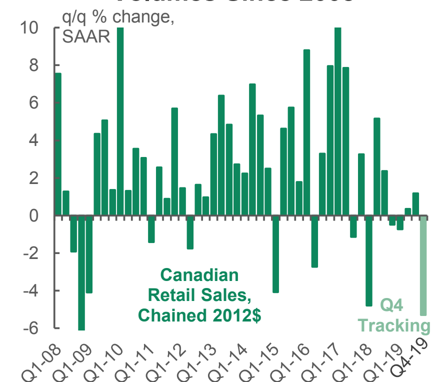
Furthermore, growth in existing home sales may have passed its peak. Sales were rising at a 1.5–3.5% monthly seasonally adjusted pace from April through to August. Over the three most recent months, sales growth has slowed to a crawl at 0.4% m/m on average even as year-ago growth rates remain elevated. Further, there was never an upswing in new home sales and absorptions as all of the arguably temporary upswing in housing was in the resale market. That in turn could have been driven by the maturation of the B20 dampening effect on home sales in 2018 that posed a soft jumping-off point for sales

Chart 15



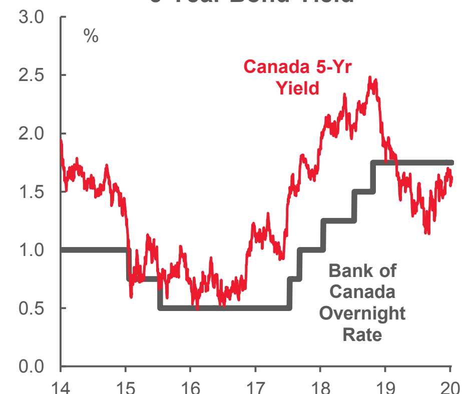
Sources: Scotiabank Economics, Finance Canada..

Chart 16



Sources: Scotiabank Economics, Statistics Canada.

Chart 17



Sources: Scotiabank Economics, Bank of Canada, Bloomberg.

and prices this year, and also by the bond market rally that drove fixed borrowing costs consistently lower before they increased after August. Both effects are arguably mature.

Last, chart 17 repeats an argument I've previously used. Easing back in 2015 flattened the entire term structure of rates and pushed through fixed and variable rate mortgages into housing markets. This past year, Canada imported a positive bond shock derived from market-driven actions as well as actions by the Federal Reserve and ECB. That motivated the earlier pick-up in home sales. The curve nevertheless remains inverted with a policy rate at 1.75% and the 5 year GoC yield under 1.6%. **Easing today may simply remove this inverted kink, ease businesses' working capital financing requirements and push back on an appreciating C$ over the past year.** The horse has arguably left the barn in terms of appetite for fixed rate mortgages that comprise over three-quarters of all mortgage debt in Canada and therefore it's unlikely that modest easing would spark a flood back into variable rate mortgages.

F. (iv) Iran and Oil

As uncertainty remains high, do higher oil prices stemming from US-Iran developments change the BoC picture? Not at this point. It's possible in future, but not in a way that is favourable to the outlook versus imposing an added downside risk to the overall Canadian economy and possibly reinforcing an easing bias. There are several supporting points.

1. The WTI moves so far are modest (+$8 off the early October levels, only back to April 2019 levels). Brent is a similar picture that matters to the east coast projects that sell into the northeastern US and with that price back up to April levels and US$10 higher than October. Western Canada Select—a proxy for Alberta's heavy crude—has barely budged by comparison.

2. Any more material rise in oil prices would have to be sustained. It's not clear how next steps would impact oil prices over our full forecast horizon and hence whether any gains would be transitory or longer-lived. For instance, who knows where we go from here, but for reference purposes the Gulf War popped oil prices higher for less than six months.

3. It depends upon the nature of a potential oil shock. One that is driven by demand that supports oil prices in a sharply improving world economy could be constructive to the Canadian outlook in that the energy regions benefit but the improving world picture is a favourable offset to the regions that use more expensive oil (e.g. Ontario, Quebec).

   But an oil price shock led by tensions in the Middle East may be more of a supply shock with prices that could benefit Alberta and the east coast but offer a negative shock to central Canada absent a material pick-up in world growth. Shutting the Suez, for example, would hardly be favourable to the world economy, let alone Ontario and Quebec especially if accompanied by further appreciation in the partially petro-driven Canadian dollar. Heavily indebted Canadian consumers would no doubt just love higher home heating and gasoline costs and so it's the starting position on finances to when the shock is imposed that matters.

4. Further, Alberta's ability to get product out of the ground and to market is constrained and so any further gains in oil prices would be mostly a price effect with relatively little flow-through to cap-ex.

Table 1

Scotiabank Economics' Canada Yield Curve Forecast

	2019	2020				2021			
	(end of quarter, %)								
Canada	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Prime Rate	3.95	3.70	3.45	3.45	3.45	3.45	3.45	3.45	3.45
3-month T-bill	1.66	1.55	1.25	1.25	1.25	1.25	1.25	1.25	1.30
2-year Canada	1.69	1.50	1.35	1.30	1.35	1.40	1.45	1.45	1.50
5-year Canada	1.68	1.45	1.35	1.35	1.40	1.45	1.50	1.55	1.60
10-year Canada	1.70	1.55	1.45	1.50	1.50	1.55	1.60	1.70	1.75
30-year Canada	1.76	1.65	1.60	1.65	1.75	1.80	1.85	1.95	2.00

Sources: Scotiabank Economics, Bloomberg.

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