Forecast Update: Trade Risks Should Prompt Bank of Canada To Cut Rates by 50 Basis Points

- **We now assume the US-China trade war will persist for the remainder of the Trump Presidency. This represents a substantial increase in risk relative to our previous assessments, as can be seen in the market reaction over the last two weeks.**
- **Some central banks are responding to signs of weakness, others in anticipation of damage to come.**
- **We now believe the Bank of Canada will follow those that cut rates to insure against potential damage. While, in our view, domestic conditions don't warrant a rate cut given inflation is at target, real policy rates are already negative, the housing market is strengthening, and wage growth is very strong, the balance of risks to the inflation outlook is shifting. A risk management approach to managing inflation can justify a 50 basis points reduction in the Bank of Canada's policy rate.**
- **We anticipate the first 25 basis points cut to take place on October 30 (with odds of a September cut nearly 50/50), followed by a second cut early in the first quarter of 2020.**
- **Coordinated action by major economy central banks is possible and could lead to an inter-meeting cut by the BoC. With limited monetary firepower in many major economies, coordinated action could be a force multiplier, and would dispel notions that central banks are undertaking competitive devaluations.**

Downside risks are materializing. With mounting evidence that the trade war between China and the US will persist through President Trump's first term, and strong indications that the conflict and the resulting costs will escalate, the global outlook is deteriorating rapidly. Moreover, negative risks to the outlook have increased markedly in recent weeks.

It is against this background that global equity and bond markets have reacted violently to trade developments and other indications of global weakness. Central banks in a number of countries have eased policy. Some in response to real-time evidence of economic weakness, others in anticipation of damage to come.

For much of the year, we believed the Bank of Canada would not need to lower its rates. That was based on the now clearly optimistic assumption that there would be a truce or resolution to the trade war, but it also reflected the view that the Canadian economy remained fundamentally healthy, given the phenomenal job growth seen so far this year, a solid turnaround in housing markets, inflation right on the Bank of Canada's two percent target, and negative real interest rates in Canada. The latter factors stand in sharp contrast to the situation in the US, where real policy interest rates are positive and core PCE inflation is meaningfully below the Fed's 2% objective.

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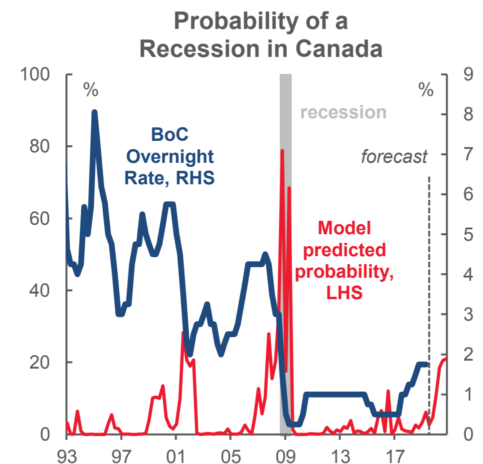
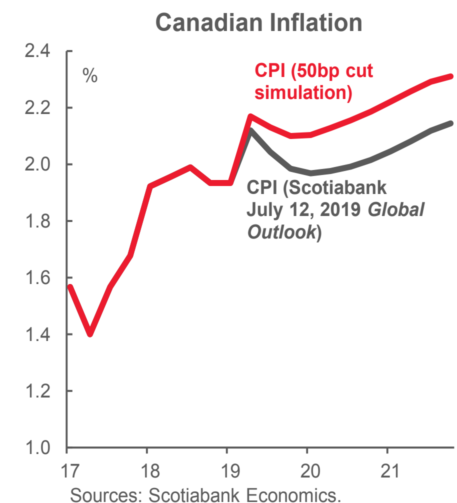
Chart 1



Sources: Scotiabank Economics, Haver Analytics.

Chart 2



Sources: Scotiabank Economics.

Given the evolution of risks, we now think the Bank of Canada should take some insurance and cut rates by 50 basis points by the end of 2020Q1. Were Canada an island, cut off from the rest of the world, such a move would not be necessary. As Governor Poloz has indicated a number of times, he considers the implementation of monetary policy within a risk management framework as have previous Governors. Risks to the Canadian economy are on the rise. Dependent as it is on international trade, Canada cannot be immune to the rising tide of protectionism. The darkening outlook for other exporters drives this point home: consider that the German economy contracted in 2019Q2.

A demonstration of this risk management approach over the inflation targeting history is apparent in chart 1, which indicates that when the probability of a recession in Canada rises to the 10% level or so, the Bank of Canada has always cut. It is evident that the balance of risks to growth has shifted, and that as a consequence the risks of lower inflation are now greater. Our gauge of recession probabilities, which uses the yield curve and consumer confidence, points to a 20% risk of recession in Canada by the end of next year, well above the level associated with interest rate cuts in the past. An interest rate cut is required to balance risks to the inflation outlook.

Cutting rates comes with risks. There are clear indications that the housing market is strengthening on the back of falling mortgage rates and strong population, employment and wage growth. Rate cuts would put upward pressure on home prices in some markets and encourage households to borrow. With household indebtedness already high, and with the Governor having spoken at length about the risks associated with high household debt, rate cuts could increase financial stability risks. Inflation currently seems glued to the Bank's 2% target, but the strength of the job market is leading to strong wage gains. Average hourly wages are rising at the highest pace in 10 years and, with low productivity, this has the potential to generate higher inflation.

If the downside risks fail to materialize, a 50 basis point cut would lead to a minor overshoot of the BoC's target, with inflation hitting a peak of 2.3% in early 2021 (chart 2). That, to us, is a small price to pay for an insurance policy given the deteriorating global environment. In keeping with the risk management approach, Governor Poloz can quickly undo these cuts if the dark clouds part or if it becomes evident that Canadian financial stability is at risk.

On timing, we believe the Bank will cut rates at the October 30 meeting, but the odds are near even that it cuts on September 4. Much will depend on the evolution of risks over the next couple of weeks. Amplification of the trade rhetoric and continued reaction in financial markets could push the BoC to move in September. Arguing for an October cut is the release of Q2 GDP in late September, which is on track to rise by about 3%, well above the 2.3% forecast by the BoC in the July *Monetary Policy Report*. Also key will be the August print for the labour market, which will indicate whether the fall in jobs observed in July is a sign of a cooling labour market, while also revealing if wage gains are accelerating further.

An inter-meeting cut is possible and may well be desirable. With limited monetary firepower in most advanced economies, and with the need for policy stimulus becoming increasingly evident at the global level, **there is a possibility that leading central banks engage in coordinated monetary easing.** Such a move would reassure markets, but also act as a force multiplier to any individual country's effort. Moreover, with President Trump likely to complain that any country that is cutting rates is trying to manipulate its currency, a coordinated move would make it clear that countries are not engaging in expansionary monetary policy to gain competitive advantage. It would also be an opportunity for policymakers to implicitly express in a coordinated fashion their concern about the damage caused by the ongoing trade tensions. Of course, there is the possibility that the positive impulse provided by additional monetary easing would prompt President Trump to take an even more aggressive stance on trade and in so doing undermine the efforts of global central banks to counter the impacts of trade actions.

Please note that only the interest rate forecasts have been updated in this table. The economic forecasts have not been updated since our July 12, 2019 outlook and are presented for reference only. They will be updated in our September forecast update.

Quarterly Canadian Forecasts	2018	2019				2020			
	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic									
Real GDP (q/q ann. % change)	0.3	0.4	2.5	1.5	2.3	2.4	2.0	1.5	1.7
Real GDP (y/y % change)	1.6	1.3	1.3	1.2	1.7	2.2	2.0	2.0	1.9
Consumer prices (y/y % change)	2.0	1.6	2.1	1.8	1.9	2.1	2.1	2.0	1.9
Avg. of new core CPIs (y/y % change)	1.9	1.9	2.1	2.0	2.0	2.0	2.0	2.0	2.0
Financial									
Canadian Dollar (USDCAD)	1.36	1.33	1.31	1.31	1.28	1.28	1.28	1.25	1.25
Canadian Dollar (CADUSD)	0.73	0.75	0.76	0.76	0.78	0.78	0.78	0.80	0.80
Bank of Canada Overnight Rate (%)	1.75	1.75	1.75	1.75	1.50	1.25	1.25	1.25	1.25
3-month T-bill (%)	1.65	1.67	1.65	1.60	1.40	1.25	1.25	1.25	1.25
2-year Canada (%)	1.86	1.55	1.47	1.30	1.20	1.20	1.25	1.25	1.25
5-year Canada (%)	1.89	1.52	1.39	1.20	1.25	1.25	1.30	1.35	1.40
10-year Canada (%)	1.97	1.62	1.46	1.20	1.25	1.35	1.40	1.45	1.50
30-year Canada (%)	2.18	1.89	1.68	1.40	1.45	1.55	1.60	1.65	1.70

Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

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