The BoC's Hawkish Turn Is About More Than Just One Word

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- **While the Bank of Canada raised its overnight borrowing rate by 25bps to 1.75% and delivered the fifth hike in the cycle as universally expected, it accompanied this with a generally more hawkish stance that signals an expedited hike path from this point forward in keeping with guidance provided into the communications.** The BoC may have also laid out some of the criteria for potentially turning more upbeat on growth and hawkish on rates in future and we could see a development in this regard in the fairly near term (hint: Morneau's Fall statement, see below). The Canadian dollar has appreciated by nearly a full cent and the two-year Canada yield jumped by 4–5bps. What makes the rate movement all the more powerful is that it is occurring on a day when the US Treasury front-end is materially dearer, with the US 2 year yield down by about 4bps for a relative underperformance of 8–9bps so far today.
- **To interpret the BoC as having turned more hawkish relies upon much more than the deletion of a single word,** but let's start with that issue while nevertheless doing so with the understanding that dwelling too much on this one word risks missing the rest of the overall hawkish turn. Indeed, by making such a big deal out of it, the BoC risked having markets lose sight of a broader set of underlying messages while simultaneously providing confusing messaging on the significance of deleting gradual. What follows lays out numerous examples of a more hawkish turn, followed by comments about other important considerations including a possible December hike catalyst and the BoC's forecast revisions.
- **The surprise to markets came with the deleted reference to raising borrowing costs at a 'gradual' pace in the statement.** In the opening remarks to the press conference and throughout the conference, both Governor Poloz and especially the high profile given to SDG Wilkins in this press conference went out of their way to say that this was meant to allow for more flexibility in future decisions and that the result could either be a faster or slower pace of hikes in future. The deletion of 'gradual' was intended, they say, "to avoid the impression that we are following a preordained, mechanical rate path."
- **I don't find that to be entirely tenable.** At a minimum, it's naïve to assume that markets would just shrug their shoulders at the deletion of the word given how powerful it has become in the lexicon of global central bankers. For example, the Fed's communications folks know full well that deleting reference to 'gradual' would spook bond markets everywhere, and the BoC's Governing Council presumably knows that. In any event, 'gradual' seemed to be working for the BoC to describe only a two-hike path this year before today and worked for their slow path and it could have also worked for an expedited path. An example is that the Fed has defined 'gradual' as essentially one hike per calendar quarter which is faster than the BoC has acted especially combining this with the rate equivalent effects of the Fed's balance sheet unwinding. If 'gradual' worked to give the BoC flexibility to date, then why did it feel it needed more two-tailed flexibility by deleting it?
- **Second, Governor Poloz remarked that "we are being stimulative at a time when the economy doesn't appear to need it."** The BoC is again emphasizing the curiousity of having a negative real policy rate given the

operating characteristics of the overall economy. I personally take that as a catch-up signal relative to where the real neutral rate should be at this time in the cycle and hence this reinforces dropping 'gradual'. I've been emphasizing for a long time now how Canada should not be keeping company with other negative real rate economies like the Eurozone, UK and Japan.

- Third, reinforcing the push toward a positive real rate is a step along the path to **the BoC's explicit guidance today that "the policy interest rate will need to rise to a neutral stance to achieve the inflation target."** Note that the BoC continues to define the neutral rate as a range from 2.5% to 3.5% with a 3% mid-point that is similar to the Fed's.
- **Fourth, the BoC removed some negative judgement related to the USMCA deal that was struck on September 30th** but noted that it did not remove all of the negative judgement because of other trade policy uncertainties and because the USMCA has yet to be ratified and probably won't be until well into 2019. Implementation risks continue to exist.
- **Fifth, I would also point to the extent to which the BoC went out of its way to balance the risks against the perennial bears in the spectrum of voices who have spent years if not decades portending the imminent demise of the Canadian consumer and housing markets.** Note the following quote:
    - ◊ "While the focus of many commentators tends to be on the downside risks, it is also possible that strong consumer confidence builds on solid job and income growth, and leads to greater-than-expected consumption. We will also pay close attention to global trade policy developments and their implications for the inflation outlook. Again, we need to bear in mind that this risk is two-sided."

    And on rate hike effects on household indebtedness:

    - ◊ "We understand that this can be difficult, particularly for those who are highly indebted. At the same time, employment and incomes continue to grow, which can help to cushion the adjustment process. Further, the quality of new debt is improving and housing activity is moderating to a more sustainable level. All of this is making the economy more resilient, and reduces the chances of painful outcomes for many people further down the road. The rule changes also appear to have helped take the wind out of the sails of speculators in some markets, which reduces the pressure on housing affordability. Overall, while financial system vulnerabilities are still elevated, the fact that they have stabilized and edged down in a number of respects is positive."
- **Sixth, Governor Poloz was asked if the move toward a neutral policy rate implied that was a cap on rates this cycle and he responded by bluntly saying "I wouldn't describe it that way."** The Fed has a 50bps overshoot of its neutral rate estimate in the dot plot, and **the Governor's remark today implies that the door is open to an overshoot of the neutral rate on this side of the border.**
- **Seventh, the BoC sounds more hawkish on prospective wage growth,** now saying "it is projected to pick up in the coming quarters." That's important, because it indicates that they are guided by stronger wage inputs to the inflation outlook in a Phillips curve sense.

BoC Forecast Revisions:

- World GDP growth was left broadly intact at 3.8% in 2018 (unchanged), 3.4% in 2019 (down a tick) and 3.4% in 2020 (unchanged).
- **Note that the BoC lowered its inflation forecasts, but treat this with care.** The CPI forecast is unchanged at 2.4% in 2018, but it was lowered to 2.0% from 2.2% in 2019 and revised down a tick to 2% in 2020. **They may have revised it down not because they are more dovish on inflation, but more so because they are more hawkish on rates and working through the consequences to growth and inflation in the BoC's model projections.** Removing/reducing NAFTA trade uncertainty causes them to emphasize the overshoot on CPI inflation that they were showing in the July forecasts and to lean against that prior interpretation more aggressively with an expedited path to neutral. Previously, recall that Poloz was somewhat ambivalent toward the NAFTA uncertainty implications to inflation, saying it could translate into higher prices. Well that's gone, and they're leaning more against it on rates.
- On growth forecasts, the BoC revised up Q3 GDP to 1.8% (1.5% prior) which we had generally expected. There still might be upside. Q4 GDP is forecast at 2.3% which implies a moderate acceleration into year-end and to above-potential growth that places further strain upon capacity pressures. GDP was revised up a tick in 2018 to 2.1%, down a tick in 2019 to 2.1%, and unchanged at 1.9% in 2020. It's possible they simply adjusted the intertemporal path of GDP growth to raise a tick and then lower a tick into 2019, but this would also be reinforced by an implied faster pace of rate hikes.

Other Important Considerations:

- **What could be a possible catalyst to a December rate hike in addition to data?** One factor could be if Finance Minister Morneau addresses the corporate tax differential with the US by offered more favourable tax treatment of investment. **That could give the BoC reason to remove more negative judgement on the investment forecast after they retained some of it due to 'competitiveness challenges.'** This would give the BoC greater conviction that investment is carrying the baton on future growth and that the rotation of the sources of growth toward investment and exports relative to housing and consumption is underway

- **How do we square the circle the full set of communications** that a) removed 'gradual', b) stated the economy doesn't need this much stimulus or a negative real rate as emphasized by the Governor in the press conference, c) that headwinds facing the outlook have come down, d) that every meeting is 'live' as Poloz emphasized in the press conference, but e) they could go at either a faster or slower rate hike pace and simply want more flexibility? Maybe they genuinely believe it gives them more flexibility, but I'm doubtful. Alternatively, **it could be that they don't want markets to bring too many rate hikes forward too quickly to the point to which it short circuits their implied path.** The BoC wants to be in control of markets and there's no better way to blow a narrative than for markets to go too far. That interpretation suggests they are indeed more hawkish, but they don't want markets to go too far in believing them at this point.

- **Why was deleting 'gradual' a surprise to everyone at least this early? With good reasons.** Recall that Governor Poloz said on September 27th that the "The bank will continue to follow a gradual approach to raising interest rates, and remain dependent on incoming data and other sources of information to guide our decisions." The Bank had been emphasizing multiple reasons for proceeding gradually yet just three weeks later the only material development has been the USMCA. On that point, Poloz had previously indicated that the BoC would lag any positive NAFTA developments in the removal of negative forecast judgement related to trade frictions and wait for the data to inform such a bias; well, they waited a whole three weeks to take a major step in this direction. Some negative judgement is yet to be removed, but I can't help but think that the BoC took this step much sooner than it had indicated would happen and would have known the market consequences.

- **The BoC also flagged the "large-scale investment projects, such as the LNG Canada project…"** that we figure adds around a couple of tenths to GDP growth in 2020 but the BoC surprised us in not raising its GDP forecast for that year despite this development. There are many possible explanations for doing so, but one is that perhaps the BoC offset the effects through a higher implied rate profile that restrains future growth somewhat as an offset.

- Clients should watch for the usual media interviews this afternoon into this evening.

- Please see the attached statement comparison with the usual caveat that MPR statements are usually full re-writes that lessen the significance of following word for word changes.

RELEASE DATE: OCTOBER 24, 2018

The Bank of Canada today increased its target for the overnight rate to 1 ¾ per cent. The Bank Rate is correspondingly 2 per cent and the deposit rate is 1 ½ per cent.

The global economic outlook remains solid. The US economy is especially robust and is expected to moderate over the projection horizon, as forecast in the Bank's July *Monetary Policy Report* (MPR). The new US-Mexico-Canada Agreement (USMCA) will reduce trade policy uncertainty in North America, which has been an important curb on business confidence and investment. However, trade conflict, particularly between the United States and China, is weighing on global growth and commodity prices. Financial market volatility has resurfaced and some emerging markets are under stress but, overall, global financial conditions remain accommodative.

The Canadian economy continues to operate close to its potential and the composition of growth is more balanced. Despite some quarterly fluctuations, growth is expected to average about 2 per cent over the second half of 2018. Real GDP is projected to grow by 2.1 per cent this year and next before slowing to 1.9 per cent in 2020.

The projections for business investment and exports have been revised up, reflecting the USMCA and the recently-approved liquid natural gas project in British Columbia. Still, investment and exports will be dampened by the recent decline in commodity prices, as well as **ongoing competitiveness challenges and limited transportation capacity.** The Bank will be monitoring the extent to which the USMCA leads to more confidence and business investment in Canada.

Household spending is expected to continue growing at a healthy pace, underpinned by solid employment income growth. Households are adjusting their spending as expected in response to higher interest rates and housing market policies. In this context, household credit growth continues to moderate and housing activity across Canada is stabilizing. As a result, household vulnerabilities are edging lower in a number of respects, although they remain elevated.

CPI inflation dropped to 2.2 per cent in September, in large part because the summer spike in airfares was reversed. Other temporary factors pushing up inflation, such as past increases in gasoline prices and minimum wages, should fade in early 2019. Inflation is then expected to remain close to the 2 per cent target through the end of 2020. The Bank's core measures of inflation all remain around 2 per cent, consistent with an economy that is operating at capacity. Wage growth remains moderate, ***although it is projected to pick up in the coming quarters***, consistent with the Bank's latest *Business Outlook Survey*.

Given all of these factors, Governing Council agrees that ***the policy interest rate will need to rise to a neutral stance to achieve the inflation target. In determining the appropriate pace of rate increases, Governing Council will continue to take into account how the economy is adjusting to higher interest rates, given the elevated level of household debt.*** In addition, we will pay close attention to global trade policy developments and their implications for the inflation outlook.

RELEASE DATE: SEPTEMBER 5, 2018

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

CPI inflation moved up to 3 per cent in July. This was higher than expected, in large part because of a jump in the airfare component of the consumer price index. The Bank expects CPI inflation to move back towards 2 per cent in early 2019, as the effects of past increases in gasoline prices dissipate. The Bank's core measures of inflation remain firmly around 2 per cent, consistent with an economy that has been operating near capacity for some time. Wage growth remains moderate.

Recent data on the global economy have been consistent with the Bank's July *Monetary Policy Report* (MPR) projections. The US economy is particularly robust, with strong consumer spending and business investment. Elevated trade tensions remain a key risk to the global outlook and are pulling some commodity prices lower. Meanwhile, financial stresses have intensified in certain emerging market economies, but with limited spillovers to other countries.

The Canadian economy is evolving closely in line with the Bank's July projection for growth to average near potential. Following growth of 1.4 per cent in the first quarter, GDP rebounded by 2.9 per cent in the second quarter, as the Bank had forecast. GDP growth is expected to slow temporarily in the third quarter, mainly because of further fluctuations in energy production and exports.

While uncertainty about trade policies continues to weigh on businesses, the rotation of demand towards business investment and exports is proceeding. Despite choppiness in the data, both business investment and exports have been growing solidly for several quarters. Meanwhile, activity in the housing market is beginning to stabilize as households adjust to higher interest rates and changes in housing policies. Continuing gains in employment and labour income are helping to support consumption. As past interest rate increases work their way through the economy, credit growth has moderated and the household debt-to-income ratio is beginning to edge down.

Recent data reinforce Governing Council's assessment that higher interest rates will be warranted to achieve the inflation target. We will continue to take a gradual approach, guided by incoming data. In particular, the Bank continues to gauge the economy's reaction to higher interest rates. The Bank is also monitoring closely the course of NAFTA negotiations and other trade policy developments, and their impact on the inflation outlook