Poloz and Canadian Trade

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

An assessment of Canada's latest trade figures and Governor Poloz's speech follows. The broad takeaway is that while the story could change rapidly in either direction and BoC guidance remains that rates will need to rise to neutral over time, there is a very high bar to raising the policy rate at all in 2019Q1. This is a prudent step at this juncture and with OPEC plus Russia signalling no traction toward an agreement and in light of fresh information surrounding global trade tensions, geopolitical risks and domestic data revisions stretching back years in time. It would be insensible at this point to write off further hikes in 2019 and to materially alter longer run rate forecasts given the ongoing possibility that energy market conditions and trade tensions could both materially improve into 2019Q1. Governor Poloz altered his guidance appropriately here in my opinion as the speed of developments has been disconcerting of late. We will be issuing a global forecast update tomorrow.

POLOZ GUIDES TOWARD SIGNIFICANT REVISIONS IN THE JANUARY MPR

- Bank of Canada Governor Stephen Poloz's speech reinforced yesterday's incrementally dovish statement (speech here). The broad message is that higher rates are coming, just not for some time. That is a somewhat unusual turn given Governor Poloz has traditionally loathed forward rate guidance. Regardless, the BoC is setting a *very* high bar against a Q1 hike.

- Key passages from Poloz's speech are cited below. Overall, the BoC is working toward incorporating these points in fresh forecasts that will be released in the January MPR which was to be expected. The net outcome is likely to be a little more slack than previously assumed and a little less inflation pressure as risks to growth get skewed more to the downside. This would be consistent with modestly delaying our rates outlook.

- **On US-China trade tensions as the major risk:**

  > "First, there have been growing concerns of a global economic slowdown. I would note that our forecasts were already calling for a moderation of economic growth in 2019–20, but this would only bring us to a sustainable growth track and would not be cause for concern. Nevertheless, the main risk we see to that outlook today is ongoing trade tensions between the United States and other countries, particularly China."

- **On how trade wars would be cause for rate hikes:**

  > "Rising tariffs will slow economic growth and reduce productivity on both sides, and will raise inflation risks besides—a combination we used to call stagflation. This combination is particularly challenging for monetary policy, since it forces a trade-off between cushioning economic growth through lower interest rates and containing inflation risk with higher interest rates. Because the effects on the economy would likely prove to be structural, rather than cyclical, I have to believe that containing inflation risks would become paramount in an outright trade war."

- **On two-sided risks to protectionism**, however, Poloz notes one cannot "focus only on the worse-case scenario." They are not going toward the trade war conclusion at this juncture but Poloz's quote above was meant to convey the direction of risks to monetary policy.

- **On oil's effect**, Poloz stated:

  "Much of Governing Council's discussion was focused on oil. Global oil prices are well below our forecast assumptions made in our October MPR, primarily due to supply forces. There is also an important overlay of worry about moderating global economic growth, given heightened trade tensions, with implications for future oil demand."

- Poloz also said the January MPR will incorporate the results of **"special targeted visits to players in the energy sector"** by January. "We'll have a lot more information to understand the most important new shock." The inference is also that the upcoming Business Outlook Survey and its sample period may be insufficient and/or lagging developments that they wish to supplement with a greater focus upon consultations with the energy sector. On what he hopes to glean from such discussions, Poloz emphasized spending and investment plans plus differences in the outlook for Canadian heavy versus light oil prices.

- **On pending forecast revisions:**

  "While we did not prepare a completely new economic forecast for yesterday's decision, we will do so between now and our next decision in January. It is already clear that a painful adjustment is developing for Western Canada, and there will be a meaningful impact on the Canadian macroeconomy. That said, given the consolidation that has taken place in the energy sector since 2014, the net effects of lower oil prices on the Canadian economy as a whole, dollar for dollar, should be smaller than they were in 2015."

- **On differences between the oil shock of 2014–15 and today,** Poloz flagged how CAD was rising back then as oil was tanking, thereby complicating non-energy sector adjustments through feedback effects of the decline in the outlook for the energy sector. He is saying it's different now as lower oil prices and CAD depreciation boost other parts of the economy.

- **On data disappointments,** Poloz also noted that data since the October MPR has been disappointing, though that may be debatable. GDP was marginally above BoC expectations (2% versus 1.8%) for Q3 but investment disappointed their expectations. This morning's trade figures (see below) are obviously new information but lean more toward the positive side of the picture.

- **On housing**, the BoC says they are looking at the broad evidence as indicating stabilization:

  "While recent data from the housing sector have been softer than expected, we believe this is the result of a significant adjustment in new construction from single dwellings to multiples, and this adjustment has prolonged the slowdown in housing construction that began earlier this year. Population and employment growth, and therefore fundamental demand for housing, remain strong. Credit growth has also steadied, and all of this supports our view that the market is stabilizing."

- **On investment**, Poloz stated:

  "announced tax changes will lead to a further strengthening in investment. This would also suggest continued growth in exports, which have been supported by strong foreign demand, but constrained by tight capacity."

- **On the possibility of cutting again as the BoC did in January 2015**, Poloz offered "no comment" but went on to say they have to do their work to understand the shock better but that this time is unlike 2014–15 and that we are starting from a different base this time. By the latter point, he is likely referencing the collapse in oil investment that occurred after 2014–15, much lower drilling activity etc.

- **On the neutral policy rate**, nothing in the speech, Q&A or press conference indicated changed thinking regarding the neutral rate range:

  "…we continue to judge that the policy interest rate will need to rise into a neutral range—somewhere in the neighbourhood of 2.5 to 3.5 per cent—in order to achieve the inflation target."

- **On the impact of GDP revisions on estimated spare capacity:**

  "The level of GDP today is now believed to be nearly 1 per cent lower than previously thought. The effect of this revision on the inflation outlook will depend on how much of that shift is in demand and how much is in supply or economic capacity, and therefore how our estimates of the gap between the two are affected. We will say more about this in our January MPR, once our analysis is complete."

- In the audience Q&A, Governor Poloz **appeared to alter his thinking on the significance of the flat yield curve.** He has previously largely dismissed it as driven by factors that were more specific to QE policies, issuance and bond market developments. Today he said the flattening yield curve is reason to be cautious.

Canadian Trade Supports Q4 GDP, Investment

Canada, International Merchandise Trade balance (CAD billions), October:

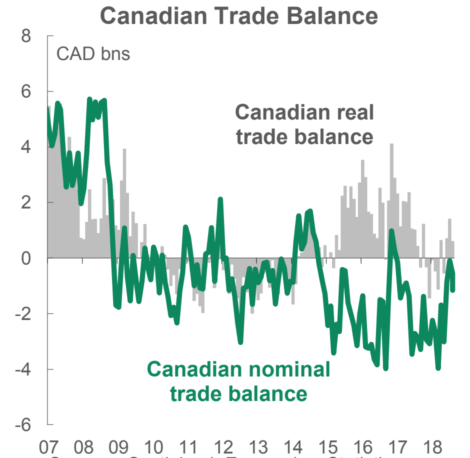
Actual: -1.17

Scotia: -0.3

Consensus: -0.73

Prior: -0.89 (revised from: -0.42)

- While the dollar value of the trade deficit widened by more than expected, the composition was constructive to Q4 GDP. That's because a strong rise in export volumes and flat import volumes will be positive to GDP but these effects were overwhelmed by the already known fall in oil prices. A caution is that when energy market developments are changing rapidly, the first pass at trade figures will be subject to potentially material revisions given past issues with incomplete surveys; this was a factor in the downward revision to September exports and may continue to be.
- Export volumes were up 1.2% m/m. Import volumes were flat.
- Exports volumes are tracking a gain of about 2% q/q SAAR in Q4 after falling by about 1½% in Q3. Caution should surround this mild rebound given distortions like Syncrude and auto industry maintenance. Import volumes are tracking flat so far in Q4 after plunging by about 8% in Q3. Net trade is shaping up to be a mildly positive contributor to Q4 GDP growth so far. Nikita Perevalov's 'nowcast' model estimates growth at 1.6% q/q SAAR in Q4. That would imply a downward forecast revision by the BoC that had previously forecast Q4 growth of 2.3%.



Sources: Scotiabank Economics, Statistics Canada.

- Note that the value of exports of crude oil fell 16.2% m/m and played the dominant role in driving headline exports lower.
- In value terms, exports were up in 7 of 11 sectors. They fell in energy products (-12.4% m/m), forestry products and building materials (-2.1%), metal and non-metallic mineral products (-0.9%) and industrial machinery and parts (-0.6%). There were strong gains elsewhere including autos (+4.4% m/m), agriculture/fishing (+4.8%), metal ores and non-metallic minerals (+2.4%), chemicals/plastics (+2.2%), electrical parts/equip (+3.6%) and consumer goods (+1.8%).
- The value of imports fell 0.6% m/m with seven of eleven categories pushing lower. Notably, imports of industrial machinery and equipment were up by 1.5% which is positive to the investment picture since around two-thirds of capital goods tend to get imported.

This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a “call to action” or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with “Global Banking and Markets”, is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.