BoC: See You "Within A Few Months"?

CONTACTS

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

- The Bank of Canada's broad suite of communications (here, here and here) **reinforced our expectations for a return to raising the policy rate as soon as Spring or Summer.** Even with competing external headlines throughout the delivery period, the overall tone led to a modest rise in short-term Canada bond yields including a 2bps rise in two year yields relative to the US, while the C$ has appreciated by about two-thirds of a cent to the US so far this year and about a quarter of a cent post-10am.
- **The BoC sees inflation returning to "around the 2 per cent target by late 2019"** after operating below that "through much of 2019." While more spare capacity is judged to exist at this point, the BoC sounds confident about the inflation forecast "as these transitory effects unwind and excess capacity is absorbed." Indeed, Poloz spelled out in the press conference that "the deviation from full capacity will be temporary and not long enough to have a material effect upon inflation."
- In terms of timing this narrative and associated rate risks, I thought that what was most striking was Poloz's assertion in the press conference that **"our belief is that the economy will be back to where it was a few months ago within a few months."** He could have indicated it will take longer than that and done so by, say, sounding more negative about the energy sector's influences or external challenges, but chose to describe a view that the economy remains close to "home" defined as full capacity accompanied by labour shortages.
- **The BoC repeated that "the policy interest rate will need to rise over time into a neutral range to achieve the inflation target."** The one difference is the insertion of "over time" that Poloz explained to be meant to "inject a degree of ambiguity or delay by being less close to home than we were three months ago." In other words, it just reaffirms near-term pause language and also somewhat states the obvious that the process will indeed occur over time.
- When pressed to define the neutral rate, **he repeated the prior guidance that they wish to get back toward a positive real rate: "neutral would not be an interest rate that is still negative in real terms."** He also repeated reference to 2.5–3.5% as the neutral rate range and while he noted that the April MPR will do its once a year reassessment of potential and the neutral rate, he did not guide expectations for material changes.
- Overall, **this is a narrative about a temporarily interrupted path toward rate hikes, certainly not an abandoned path** by any stretch as markets and some elements within consensus went too far in that direction. The path toward that outcome requires a substantial number of elements to go right but the underlying forecast details broadly back up the narrative.
- On such details, the BoC estimates that **the output gap ended 2018 in a range of -1.0% to 0%** versus the prior assumption that it was between -0.5% and +0.5%. That means about **½% of GDP by way of greater slack than was previously being estimated**. Downward revisions to prior years of GDP growth plus lowered forecasts for 2018Q4 and 2019Q1 GDP growth open up this slack. An implied rapid rebound closes it off.

- **The BoC left the broad ranges for its potential GDP growth forecasts unchanged but indicated that the average of 1.9% potential growth over 2019–2020 is "slightly below" estimates in the October MPR.** It is unclear how that is the case if they left the ranges unchanged unless a) they are leaning slightly lower within those ranges, or b) they are speaking to second decimal points. The BoC needs to spell out its potential growth estimates more clearly versus speaking to ranges and yet still signalling it is leaning in a particular direction. They cautioned that fresh estimates for potential GDP growth will be released in the April MPR.
- **GDP growth was lowered for 2019 (1.7%, 2.1% prior) and raised for 2020 (2.1%, 1.9% prior) as roughly anticipated.**
- **The composition of growth was slightly altered.** In weighted contribution terms, consumers are forecast to drive 1.0% of GDP growth (1.2% prior) in 2019 and 1.0% in 2020 (1.1% prior). Housing is also expected to be less beneficial to growth, dragging a weighted 0.1% off GDP (+0.1% previously) in 2019 but then adding 0.1% in 2020 (0 previously). Exports are forecast to add 1% to GDP in 2019 (0.9% previously) and 0.8% in 2020 (0.7% previously). **Overall, the rotation of the sources of growth toward investment and exports remains intact in the forecasts with only a little less contribution by consumers.**
- **On the impact of lower oil prices, they are saying it is about one-quarter as large as in 2014–15** and a cumulative hit to the LEVEL of GDP of 0.5% by the end of 2020. That's roughly similar to our estimate.
- For quarterly GDP forecasts, the BoC only goes out two quarters and revised down Q4 to 1.3% (2.3% prior) and came in at just 0.8% for Q1. The fact that full year GDP growth in 2019 was revised down three-tenths to 1.7% bakes in a substantial recovery from Q2 onward.
- Inflation-adjusted gross domestic income is forecast to take the bulk of the hit this year. They revised that growth forecast down to 0.9% (2.0% prior) and offset a bit of that by raising the 2020 forecast to 2.2% (2.0% prior).
- **Headline CPI inflation was revised down a tick for last year to 2.3%, three-tenths to 1.7% for 2019 and left unchanged at 2% for next year. Again, however, note the guidance that inflation is expected to return to 2% by the end of this year which is buried in the annual math.**
- Which leads to the bottom line conclusion. **If growth rebounds, shuts off spare capacity, and returns inflation to the target inside of one year from now, then given lagged influences of monetary policy changes, it is reasonable to conclude that embedded within such forecasts are implied rate hikes sooner than markets have been anticipating.** There is a perfectly broad range of reasonable hike expectations, but either way I find that we're talking multiple hikes. Governor Poloz would not have sunk so much effort into how the narrative is only temporarily interrupted with the economy back "home" within the year or even "months" if his only aim was to signal one and done. 2–3 hikes begins to be a more serious consideration. Our global forecast update will be released later this week.
- **As an aside, I don't see consumer bankruptcies the same way as the Governor** and was somewhat surprised by how the Governor is viewing bankruptcies given the importance of tracking how they are responding to higher rates and other developments. Poloz says consumer bankruptcies have gone up. They have not. Total insolvencies have risen because proposals have gone up, and they are a very different animal compared to going bankrupt. Bankruptcies are still toward record lows. See yesterday's note here.
- Please see the attached statement comparison albeit that being an MPR statement entailed a full re-write compared to the December statement.

RELEASE DATE: JANUARY 9, 2019

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

The global economic expansion continues to moderate, with growth forecast to slow to 3.4 per cent in 2019 from 3.7 per cent in 2018. In particular, growth in the United States remains solid but is expected to slow to a more sustainable pace through 2019. However, there are increasing signs that the US-China trade conflict is weighing on global demand and commodity prices.

Global benchmark prices for oil have been about 25 per cent lower than assumed in the October *Monetary Policy Report* (MPR). The lower prices primarily reflect sustained increases in US oil supply and, more recently, increased worries about global demand. These worries among market participants have also been reflected in bond and equity markets.

The drop in global oil prices has a material impact on the Canadian outlook, resulting in lower terms of trade and national income. As well, transportation constraints and rising production have combined to push up oil inventories in the west and exert even more downward pressure on Canadian benchmark prices. While price differentials have narrowed in recent weeks following announced mandatory production cuts in Alberta, investment in Canada's oil sector is projected to weaken further.

These developments are occurring in the context of a Canadian economy that has been performing well overall. Growth has been running close to potential, employment growth has been strong and unemployment is at a 40-year low. Looking ahead, exports and non-energy investment are projected to grow solidly, supported by foreign demand, the CUSMA, the lower Canadian dollar, and federal tax measures targeted at investment.

Meanwhile, consumption spending and housing investment have been weaker than expected as housing markets adjust to municipal and provincial measures, changes to mortgage guidelines, and higher interest rates. Household spending will be dampened further by slow growth in oil-producing provinces. The Bank will continue to monitor these adjustments.

The Bank projects real GDP will grow by 1.7 per cent in 2019, 0.4 percentage points slower than the October outlook. This revised forecast reflects a temporary slowing in the fourth quarter of 2018 and the first quarter of 2019. This will open up a modest amount of excess capacity, primarily in oil-producing regions. Nevertheless, indicators of demand should start to show renewed momentum in early 2019, leading to above-potential growth of 2.1 per cent in 2020.

Core inflation measures remain clustered close to 2 per cent. As expected, CPI inflation eased to 1.7% in November, due to lower gasoline prices. CPI inflation is projected to edge further down and be below 2 per cent through much of 2019, owing mainly to lower gasoline prices. On the other hand, the lower level of the Canadian dollar will exert some upward pressure on inflation. As these transitory effects unwind and excess capacity is absorbed, inflation will return to around the 2 per cent target by late 2019.

Weighing all of these factors, Governing Council continues to judge that the policy interest rate will need to rise over time into a neutral range to achieve the inflation target. The appropriate pace of rate increases will depend on how the outlook evolves, with a particular focus on developments in oil markets, the Canadian housing market, and global trade policy.

RELEASE DATE: DECEMBER 5, 2018

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

The global economic expansion is moderating largely as expected, but *signs are emerging that trade conflicts are weighing more heavily on global demand.* Recent encouraging developments at the G20 meetings are a reminder that *there are upside as well as downside risks around trade policy.* Growth in major advanced economies has slowed, although activity in the United States remains above potential.

Oil prices have fallen sharply since the October *Monetary Policy Report* (MPR), reflecting a combination of geopolitical developments, uncertainty about global growth prospects, and expansion of U.S. shale oil production. Benchmarks for western Canadian oil – both heavy and, more recently, light – have been pulled down even further by transportation constraints and a buildup of inventories. In light of these developments and associated cutbacks in production, *activity in Canada's energy sector will likely be materially weaker than expected.*

The Canadian economy as a whole grew in line with the Bank's projection in the third quarter, although data suggest *less momentum going into the fourth quarter.* Business investment fell in the third quarter, in large part due to heightened trade uncertainty during the summer. Business investment outside the energy sector is expected to strengthen with the signing of the USMCA, new federal government tax measures, and ongoing capacity constraints. Along with strong foreign demand, this increase in productive capacity should support continued growth in exports.

Household credit and regional housing markets appear to be stabilizing following a significant slowdown in recent quarters. The Bank continues to monitor the impact on both builders and buyers of tighter mortgage rules, regional housing policy changes, and higher interest rates.

Inflation has been evolving as expected and the Bank's core measures are all tracking 2 per cent, consistent with an economy that has been operating close to its capacity. CPI inflation, at 2.4 per cent in October, is just above target but is expected to ease in coming months by more than the Bank had previously forecast, due to lower gasoline prices. *Downward historical revisions by Statistics Canada to GDP, together with recent macroeconomic developments, indicate there may be additional room for non-inflationary growth*. The Bank will reassess all of these factors in its new projection for the January MPR.

Weighing all of these developments, Governing Council continues to judge that the policy interest rate will need to rise into a neutral range to achieve the inflation target. The appropriate pace of rate increases will depend on a number of factors. These include the effect of higher interest rates on consumption and housing, and global trade policy developments.

The persistence of the oil price shock, the evolution of business investment, and the Bank's assessment of the economy's capacity will also factor importantly into our decisions about the future stance of monetary policy.

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.