BoC’s Poloz Reaffirms The Next Move Is Up, Lays Out The Criteria

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- Governor Poloz’s speech was a blend of forward guidance that is consistent with past communications and a retrospective defence of policies Ottawa enacted in response to the 2014–15 energy shock. The main takeaway is that he reaffirmed the temporary interruption of the rate hike cycle but is uncertain about the length of the pause period that we think will have the BoC returning with hikes in H2.
- Market reactions were fairly minor. The yield on Canada 2s is still higher on the day and with no real post-speech reaction. On CAD, it had rallied coming into the week and so maybe the mild quarter-cent post-speech depreciation to the USD is just unwinding some of the earlier positioning to still leave a hawkish currency effect in anticipation of the speech intact. Recall that CAD had appreciated by about one cent from the close on Friday to late yesterday.
- There is little new information to the BoC narrative out of this one. Anyone expecting a first half pause got that reinforced. Anyone expecting a return to rate hikes also got what they needed out of it with H2 still a reasonable bet for two hikes in 2019.
- **One mildly new piece of information was that he could have responded to the Fed and left the door more open to being 'flexible' and hence a more ambiguous direction of rate risks. He did not.** There is nothing to suggest that the next move is anything but up. In that regard, "the path to neutral" is the key in that it's not implying a path away from neutral.
- Second is that he spelled out a little more clearly what he needs to see to hike again. They are as follows and with more detail provided later in this note.
    - Housing stability. We may get that this Spring in my view.
    - Investment improvement. Poloz thinks we may get that this year.
    - Trade policy certainty. He spoke of MOUs between the US and China and possibly seeing a deal. If we get trade deals and stability, he'd be more comfortable hiking.
- For purposes of informing opinions on the BoC’s next moves and timing them, the most salient quote is the following:

    “We judge that we will need to move our policy rate up into a neutral range over time, to a point where it is not stimulating or constraining economic growth. However, the path back to that neutral range is highly uncertain. We will watch the data as they come in, and use judgment to deal with the uncertainties and manage the associated risks.”

- This is not new information. Each of the comments about the need to move toward neutral, doing so “over time,” being data dependent and the messaging on numerous uncertainties was communicated in the statement, press conference and MPR last month. So was Poloz’s comment in today’s audience Q&A that he expects a temporary slowdown with an inference toward improved prospects going forward.

- In the wake of the Fed's communications so far this year, the incremental information is that it's different on this side of the border. Cuts are out of the question with the hand the BoC has been dealt thus far in favour of a strong bias toward the next move being up unlike the Fed's 'flexible' approach. How so**? If Poloz wanted to leave the door open to easing in future, he might not have referenced "the path back to that neutral range" and left it more open in terms of direction or by connoting a greater sense of flexibility.** One distinction to the Fed is that the BoC's neutral rate range of 2.5% to 3.5% may be identical to the Fed's, but unlike the Fed the BoC remains 75bps beneath the lower limit of that range. The BoC will revisit potential growth and neutral rate ranges in the April MPR but it's highly unlikely they'd change guidance that the policy rate is still well below whatever their present neutral rate guess may be at that time. That guess is likely to prudently remain a range versus a point estimate.
- **Poloz's three main areas of uncertainty that have held back further rate hikes are now expanded upon.** None of them should really be treated as new information to markets. Housing is the first one and he concludes "more data will help us better understand" the market which is a nod to monitoring the Spring housing market in particular by way of the next likely big test. Poloz expands upon housing as follows:

  "One important uncertainty that we are dealing with today is the impact of higher interest rates on highly indebted Canadians. Rising interest rates will mean these people will have to spend more of their income servicing debt, leaving less for other goods and services. **Clearly, given these elevated levels of debt, raising rates will have more of an impact on the overall economy than in the past. This is one reason why we have been gradual in our approach to raising interest rates."**

  "Housing markets are adjusting not only to higher interest rates, but also to new mortgage guidelines and rules aimed directly at cooling certain housing markets. Given the unique situation, we are monitoring the impacts carefully."
- Poloz also notes that business investment is the other source of uncertainty including the quote below. What's missing, however, is a discussion of how this feeds back upon their inflation mandate including the impact upon potential growth, capacity and hence inflation risk.

  "A second area of intense interest is the outlook for business investment, which has been less robust than our models indicated for the past couple of years, mainly due to uncertainty about the future of the North American Free Trade Agreement. Although uncertainty remains around ratification of the new Canada-United States-Mexico Agreement, **we expect investment spending to regain momentum in 2019**, especially in light of the government's new accelerated capital depreciation rules. However, we must acknowledge that the future of the global trade environment is highly uncertain right now."
- During the press conference, Poloz said that the BoC has built into its forecast that some of the investment uncertainty will reduce with the signing of CUSMA and the new tax incentives for investment in the non-energy sector and that **this is "confirmed for me with the conversations I'm having"** as a likely tip on the anecdotes the BoC is gathering from the business community.
- Poloz goes on to state what is largely obvious on trade as his third risk:

  "However, we must acknowledge that the future of the global trade environment is highly uncertain right now."
- **Each of these three risks could turn in either direction**. Our view, however, is that housing stabilizes this year and gently strengthens, investment in cap-ex rises on pent-up post-NAFTA demand, capacity pressures and tax incentives, and trade policy settles down into a Presidential election year stateside and the campaigning that is already starting.
- Separately, however, I can't help but think that at least a couple of pages in this speech read like a quasi-political defense of Ottawa's policy response over the 2014–15 period. Poloz patted himself on the back for the 2015 rate cuts and expanded upon this by noting that "Both macroprudential and fiscal policies were also put in place, and this produced better outcomes." A counter argument might have been that part of the reason we're in a soft patch on drivers like consumption and housing is that cyclical fine-tuning through rate cuts and fiscal transfers including through the enormous increase in child benefit transfers that counted on T4s and mortgage applications and was spent on-line and in stores resulted in brought-forward consumption and housing demand and played a role in overheating conditions. That episode may have overheated housing and consumption and drove the BoC to then tighten more than they might otherwise have done before hitting pause as momentum was lost. Responding with cuts and transfers to a transitory terms of trade shock will always resurrect the rules over discretion debate in monetary policy. My personal belief is that a more cautious interpretation of this past stimulus response should hang in the air through the course of events this year both in terms of fiscal and monetary policy.

- Additional elaborations on special topics include the following.

Energy sector effects

In the press conference, Poloz noted that by the April MPR, he'll be able to give a clearer sense of the oil picture. He repeated that the rebound in oil prices gives confidence to their narrative that the economy is going through a 'temporary' two quarter slowdown mainly due to energy market developments.

Temporary slowdown

When asked in the press conference whether he was a global outlier among central bankers in speaking of the need to get back to neutral Poloz said that while the situation varies from country to country, every central bank is data dependent and that **'What we're saying is that our moderation is a temporary one and so if we get more traction on investment and exports with inflation on target then it would be less necessary for interest rates to be as stimulative."**

B20 and Housing

When asked about whether B20 should be scaled back, I appreciated the Governor's response. For starters, he noted it's still early just one year later, but more importantly he observed that the pressures on affordability were more dangerous with bidding wars before B20 than it is with stress testing that has cooled that activity (notwithstanding the possibility it might have cooled on its own). Therefore he's arguing it's not as clear cut as saying do away with B20 or scale it back and housing will become more affordable. The inference is that if one eliminates or scales back B20 then frothy bidding wars could return. That's the comparative statics of a good economist speaking in my opinion. Poloz also noted that the underwriting quality of the mortgages has improved a lot which improved the risks surrounding the process of policy rate normalization effect into future mortgage renewals. Poloz concluded "Every month we're getting into a more resilient and more stable environment for the stock of debt." Poloz also went on to note that the response of housing to B20 is taking "a little more" time than expected, with emphasis upon "a little." He also noted that housing starts remain strong which indicates strong underlying fundamentals demand for housing including demographics.

- The full speech is available here.
- I would watch for additional media advisories on follow-up press interviews today or this evening. Sometimes they've added new twists. The first one will appear in Le Devoir.