BoC Preview: The BoC Unplugged

- **No policy rate change is expected at this meeting**
- **The immediate policy bias and forecasts are likely to be little changed**
- **But weak trend growth in final domestic demand suggests all is not well**
- **The Fed's symmetry and expectations debate may be imported**
- **Long anticipated CAD strength could bring the BoC off the sidelines…**
- **...along with multiple risks to the outlook…**
- **...that fiscal policy may not offset**
- **Bond markets have already eased for housing finance…**
- **...but limited policy easing would remove curve inversion, CAD strength…**
- **...while doing little to convince borrowers to go variable**

Wednesday's BoC meeting will offer a full suite of communications including the policy rate decision (10amET), updated forecasts and discussion of risks in the Monetary Policy Report (10amET), and the press conference hosted by Governor Poloz and Senior Deputy Governor Wilkins (11:15amET). The BoC's very limited communications over recent months on the path to the Federal election have elevated uncertainty surrounding how it views the evolution of risks to the outlook.

No Policy Rate Change is Likely at this Meeting

No policy rate change is forecast by Scotia or by consensus. OIS markets assign no material probability of a rate change until easing gets partially priced in well into 2020. The scope for surprise from Governor Poloz is omnipresent across all meetings and the bias has turned gradually more neutral-dovish over the course of the year as escalating US-centric global trade protectionism rewrote the entire global rates complex. Our belief is that the criteria for easing at this juncture have not yet been met but could well be achieved later this year into early next. To that effect, we will be closely evaluating the BoC's reaction function and overall guidance.

Rewritten Statement Likely to Retain a Similar Bias

Hiking in this environment is out of the question and so the obvious risk to market pricing is skewed toward more dovish guidance than markets anticipate. While an MPR statement is usually a full re-write that is focused upon the updated forecasts, the closest hint at a policy bias is likely to involve retaining the concluding paragraph's guidance that includes three main points:

- "Canada's economy is operating close to potential and inflation is on target."

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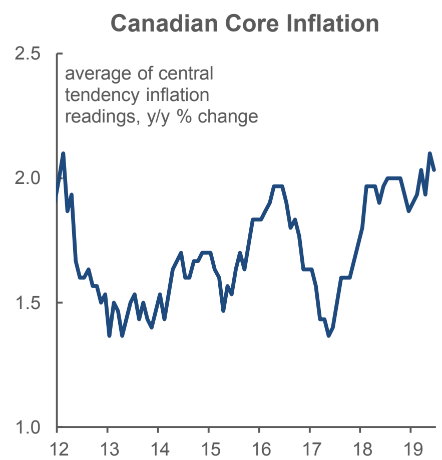
Table 1

	2019	2020	2021
Global Real GDP (%)			
International Monetary Fund	3.0	3.4	--
Bank of Canada	3.0	3.2	3.3
Bloomberg Consensus	3.1	3.1	3.1
Scotiabank Economics	2.9	3.1	3.3
Canadian Real GDP (%)			
Bank of Canada	1.3	1.9	2.0
Bloomberg Consensus	1.5	1.6	1.7
Scotiabank Economics	1.6	1.8	1.9
Canadian CPI Inflation (%)			
Bank of Canada	1.8	1.9	2.0
Bloomberg Consensus	2.0	2.0	1.9
Scotiabank Economics	1.9	2.0	2.2
US Real GDP (%)			
Federal Reserve	2.2	2.0	1.9
Bloomberg Consensus	2.1	1.7	1.8
Scotiabank Economics	2.0	1.5	1.9
US Core PCE Inflation (%)			
Federal Reserve	1.8	1.9	2.0
Bloomberg Consensus	1.8	2.0	2.0
Scotiabank Economics	1.8	1.9	2.0

Note: Forecasts as of October 23rd, 2019
Sources: Scotiabank Economics, IMF, Bank of Canada, Federal Reserve, Bloomberg.

Chart 1



Sources: Scotiabank Economics, Statistics Canada.

- "the current degree of monetary policy stimulus remains appropriate", and
- the conditional data dependency expressed by stating the Bank "will pay particular attention to global developments and their impact on the outlook for Canadian growth and inflation."

Forecast Tweaks

The BoC might not change its forecasts a great deal. Global growth forecasts may be downgraded somewhat. Recall that in its July MPR, the BoC forecast world GDP to grow by 3.2% in 2020 and 3.3% in 2021. The September statement noted that world trade and investment "is weighing more heavily on global economic momentum than the Bank had projected" in July.

That said, the BoC is not really out of line with what most are forecasting for world growth. See table 1 for a comparison of current IMF, Bloomberg Consensus and Scotia Economics' forecasts to what the Federal Reserve forecast in September and what the BoC last forecast way back in July. The BoC's July forecasts for inflation are broadly in line with consensus views next year, although Scotia is toward the upper end into 2021.

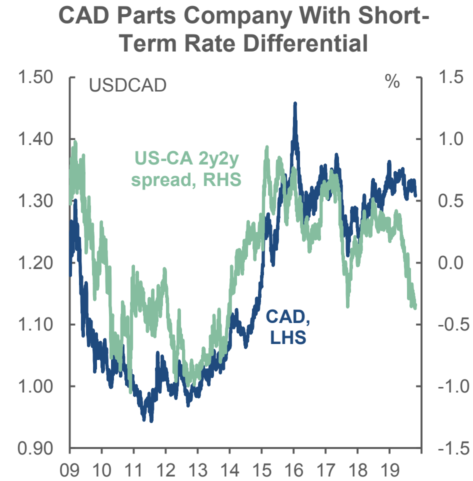
Importing the Fed's Influences

Directly or—more likely—indirectly, the BoC could well import the policy influences of a Fed-style debate on inflation.

Canadian core inflation is presently on target at the mid-point of the 1–3% policy target range, but on a monthly year-ago basis since 2012, it has spent 90% of the time running beneath this target (chart 1). **Years of undershooting its prime objective and forward-looking uncertainties may counsel a prolonged period of allowing inflation to rise above 2% and thus working the range.** At issue is the credibility of the policy framework not when judged in the context of the experience since the 1990s but more rooted in the post-crisis period during which global inflation has been under downward pressure virtually everywhere across major markets.

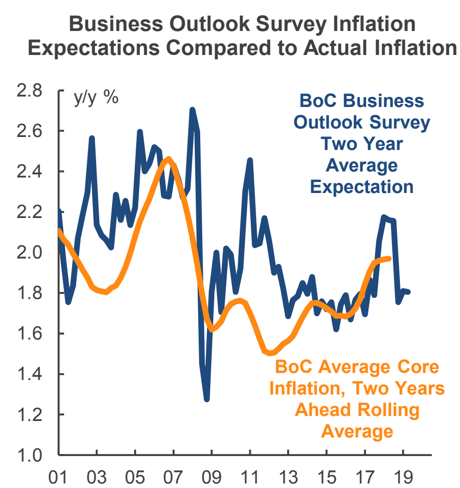
Indeed, the Fed is conducting a thorough review of its policy apparatus that is likely to culminate in a shift toward targeting average inflation of 2% over a period of time in order to demonstrate the symmetry of the target. If doing so means further Fed easing—we forecast two more rate cuts including this week's — then such an emphasis could more significantly restore the connection between the C$ and the Canada-US short-term rate differential (chart 2). There is a realistic degree of policy contingency upon our Fed views (here). As the Fed cuts on top of the BoC and perhaps below, hot money flows may be more incentivized toward the C$. The BoC does not target the currency, and talk of MCI or Type 1 or Type 2 influences has long since passed, but appreciating from 1.36 on a USDCAD basis at the start of the year toward something in the 1.20s could impose an unwanted deterioration of trade competitiveness for a country that competes heavily on price. By corollary, that would be could an imported downside risk to growth through tightly integrated North American capital markets. **This would frustrate the BoC's desired rotation of the sources of growth toward trade and investment especially with energy investment likely to remain weak, potentially dampen overall growth, and put at least temporary downside pressure on its inflation target.**

Chart 2



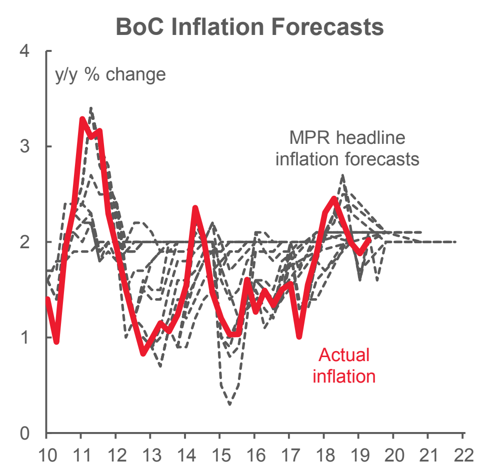
Sources: Scotiabank Economics, Bloomberg.

Chart 3



Sources: Scotiabank Economics, Bank of Canada.

Chart 4

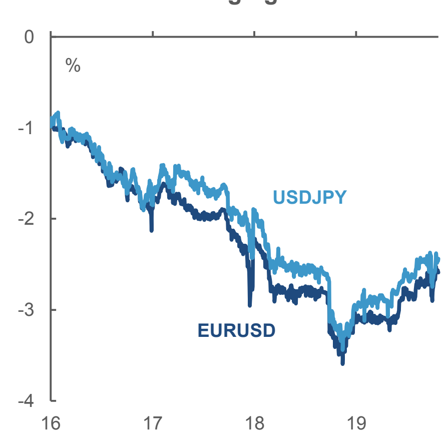


Sources: Scotiabank Economics, Bank of Canada, Haver Analytics.

Inflation is also expected to remain weak and below target. These are by no means perfect measures—especially in Canada—but market-based inflation breakevens derived from real return bonds are around 1¼%, while the BoC's Business Outlook Survey indicates that two-thirds of businesses expect inflation to run in the lower half of the BoC's 1–3% policy target range. As chart 3 demonstrates, business expectations derived from this survey arguably do a better job at nailing turning points in actual inflation than the BoC's inflation forecasts drawn from MPRs over the years (chart 4).

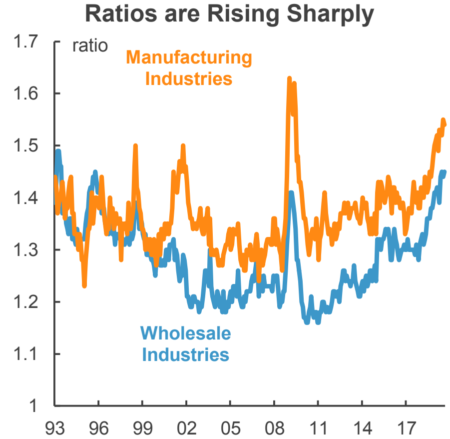
If expectations are becoming unmoored, then this should be of concern to the BoC and yet, to date, there has been no dialogue that has broached the topic the Federal Reserve views as key to its own policy bias. To repeat the earlier point, it's feasible that the BoC gets dragged along by the Fed to explicitly or implicitly hold its own dialogue regarding the importance of a symmetrical inflation target (tolerating upsides as much as downsides over time that average out) and the role of expectations. This could be a mechanism toward applying some of its own easing.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

Chart 6



Sources: Scotiabank Economics, Statistics Canada.

Plenty to Worry About

During the press conference, the risk may lie in terms of emphasizing uncertainties hanging over the outlook that may inform possible criteria for easing policy. There is no shortage of reasons for being cautious toward the outlook, in keeping with our continued forecast for a return to easing as soon as the December meeting.

For one thing**, the list of major forward-looking uncertainties surrounding geopolitical and policy-related events remains very long and we have a guarded bias toward them.** Brexit, US-EU auto tariffs, US-China trade negotiations, the November 21st expiration of the Continuing Resolution to fund the US government, and impeachment proceedings are among the considerations.

Second, **forward-looking market risks remain high.** We think short-term funding market pressures will return by quarter-end and pressure the apparatus the Fed has been putting in place to address the strains. They may be manageable with greater infrastructure now in place through overnight and term repos plus the possible introduction of a Standing Repo Facility with a rate just above a 'normal' repo rate. The fourth quarter is also typically a time when dollar funding demands spike and take up currency hedging costs and currency basis within a covered interest rate parity framework (chart 5). The effects can be destabilizing to bond and currency markets with spillover effects into equities as we've often seen toward year-end in a more balance sheet constrained world that prevents full arbitrage of strains between spot versus forward exchange rates and cross border interest rate differentials. These risks could unfold in the context of relatively high equity valuations.

Canada's bloated upstream manufacturing and wholesale inventories may portend downside risk to employment and production going forward (chart 6). Perhaps a very strong year for job growth was all brought forward because of a) over-production that went into inventories, b) companies not investing in machinery and equipment versus addressing capacity constraints by adding employees, and c) productivity growth being sacrificed. On the latter point, the acceleration of real wage growth is not rooted in what has to be the long-run driver which is productivity.

Little Help Coming

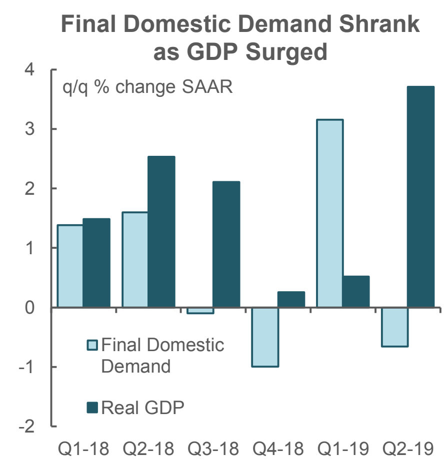
Fiscal stimulus is unlikely to be a substitute for monetary stimulus and the BoC probably wouldn't incorporate any such effects until they became more highly anticipated. A post-election budget could implement the Liberal platform and introduce stimulus, but by the time a new budget is passed and impacts the economy it might be next Spring/Summer. Further, the amount of stimulus is likely to be small and in the low tenths of percentage points of GDP, while the effects on growth (not levels) are likely to prove transitory.

Misplaced concerns

On the concern that easing could reignite housing market imbalances, I think that's misplaced or at least exaggerated.

That's partly because **the bond market has already taken mortgage rates there and not due to BoC easing bets as Canada imported a positive external bond market shock.** Over roughly the past year, the yield on the 5 year Government of Canada bond has fallen from about 2 ½% to a low of 1.13% in early September before drifting back up to over 1.6% now. The catalyst has been rising concern about the global economy and foreign central bank easing, particularly by the Fed and the ECB. This bond rally moved through fixed rate mortgages and ignited some borrowing and housing market activity. OIS markets only have a fraction of a quarter point rate cut priced into 2020 and so the bond rally has not been driven by BoC easing bets so much as it has been driven by carry into higher-yielding Canadian bonds compared to many other markets.

Chart 7



Sources: Scotiabank Economics, Statistics Canada.

Limited easing probably wouldn't cause enough incentive to go variable relative to fixed in this bond market environment. By not easing monetary policy, however, the BoC is arguably forcing an inverted curve and hoping for such bond market conditions to go away which is doubtful. By corollary, not easing and thus maintaining pressure on short-term rates is contributing to the currency appreciation since earlier this summer and to greater pressure on short-term financing of working capital financing requirements across businesses. Not easing while the Fed potentially continues to ease and dives on top or beneath the BoC's policy rate could well drive added currency strength.

A Strong Economy? Not so Fast

Beyond such arguments, the domestic economy offers a mixed picture. There has only been one decent quarter for growth in the past three that are in the books with Q3 tracking softly around 1½% after a temporarily distorted growth spurt in Q2. Average growth over the four quarters to 2019Q3 is running at the low end of the BoC's estimated potential growth range of 1.5–2.1% for 2019 and 1.3–2.1% for 2020. There are no assurances that actual growth will keep up with potential growth such that the durability of operating close to the closure of spare capacity is not assured. Trend growth in retail sales volumes has been weak. Wage growth has picked up, but lacks underlying productivity gains to ensure sustainability, with little in the tank by way of a saving rate of just over 1% and debt payments as a share of disposable income that is reaching cycle highs. Business investment in machinery and equipment has also been soft.

In all, final domestic demand that takes consumption, business investment, government spending and housing investment—and therefore strips out inventories and net trade from GDP—has posted very little trend growth for multiple quarters (chart 7). This is a major reason why it's misleading to argue that the domestic data has been solid especially if bloated upstream inventories add downside risk and trade-related risks into a slowing US and global economy continue to mount.

For more on our rates forecasts, go here.