Bank of Canada Tightens Financial Conditions On A Lark

- BoC leaves the overnight rate at 1.75% as expected
- The statement tone was slightly more hawkish-neutral than expected
- Did the BoC act prematurely?
- The BoC is signalling that 2% is a ceiling, not a symmetrical target…
- ...such that inflation expectations should remain skewed to 2% and under
- Domestic & global data, global trade policy, and domestic fiscal policy…
- ...will inform potential for another bias shift early into 2020

The Bank of Canada's policy statement leaned more toward the neutral-hawkish end of the spectrum of market expectations (and ours) while leaving the policy rate unchanged at 1.75% as expected. As a result, the BoC's words resulted in tightened financial conditions. The C$ appreciated by half a penny to the greenback and the two year GoC yield increased by almost 4bps. The Canada curve remains inverted with the policy rate set at 1.75%, the two year yield at 1.62% and the 5 year yield at 1.55%.

While they left open some room for monitoring and debate going forward, in general, I find the tone of the statement to be prematurely neutral-hawkish in nature. Domestic data has been deteriorating with weaker GDP growth below most estimates of potential growth and softening high frequency gauges. Adjustments in the softer global economy are ongoing and global trade policy risks remain unsettled. Why the BoC would have tightened financial conditions at this critical juncture amidst so many uncertainties they don't necessarily have better information on than markets is something I find to be a rather curious step. It's a fitting end to entering 2019 hawkishly, taking some time to alter the bias toward a more neutral stance, sounding dovish in the October communications and now tightening conditions. Some of that is justified in a wild year that was disrupted by Trump's trade wars. Nevertheless, investors should remain on guard for another potential bias shift pending developments into the new year.

The neutral/hawkish market interpretation was motivated by the BoC's remark that "There is nascent evidence that the global economy is stabilizing." One could question what this is based upon. Global PMIs, for instance, are mixed and the US ISM readings both deteriorated which matter more to Canada. For now, it's how the BoC interprets developments, but data will inform this bias.

The BoC also repeated that it expects firmer global growth which is a bit rich considering that the October MPR forecast world GDP growth to only slightly improve from 2.9% this year to 3.1% next year. A two-tenths forecast is enough to call it firmer these days?? The BoC also flagged "waning recession concerns" across global markets with the assistance of [foreign] central bank actions.

On inflation, the BoC repeated its expectation that inflation will "track close to the 2 percent target over the next two years." Perhaps, yet the BoC's track record at forecasting inflation leaves room for considerable debate about the outlook.

Further, the BoC's target is supposed to be symmetrical according to its agreement with the Federal government. Hitting 2% core inflation this year for the

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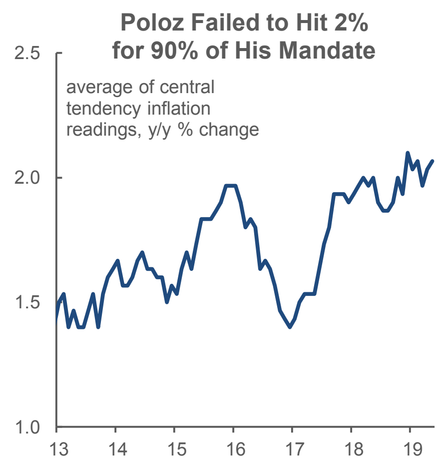
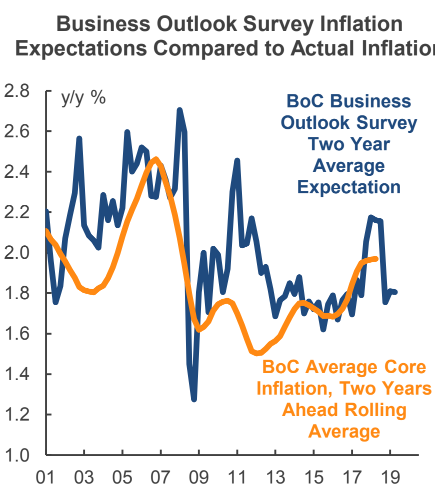


Sources: Scotiabank Economics, Statistics Canada.



Sources: Scotiabank Economics, Bank of Canada.

first time in Governor Poloz's seven year mandate (see chart) and indicating that the central bank is quite content with this is a strong signal to markets to interpret the 2% mid-point of the 1–3% target range as a ceiling. The average of the core inflation measures has been below 2% for 90% of Governor Poloz's mandate that began in June 2013. It's also not just true under Poloz, as the BoC has missed its 2% inflation target by the average of the core measures almost throughout the entire post-GFC period (85% of the time since the start of 2009). That says to me that markets, businesses, employers and consumers are right to expect inflation to be skewed toward 2% and below rather than above target at any point. At this juncture, the BoC is not signalling concern about inflation expectations becoming unmoored from the mid-point of the target range. Going forward, given that a modest amount of slack persists and slack is at risk of widening somewhat in the near term, the risks to the inflation target are skewed more to the downside. Also note that market-based and BOS survey based measures of inflation expectations tilt toward downside risks to the target and all methods of predicting inflation have their pitfalls.

The BoC flagged how consumer spending "expanded moderately, underpinned by stronger wage growth." As argued in the morning note, the higher frequency readings on wage growth are turning south. Year-ago wage growth is holding up, but month-ago seasonally adjusted wage growth is already losing momentum and pointing toward a renewed collapse in wage growth into 2020 which would be consistent with the multi-year oscillating pattern.

The BoC repeated its concluding bias by noting how it "judges it appropriate to maintain the current level of the overnight rate target."

On the dovish/neutral side of the picture, or alternatively labelled "how the bias could shift again", the BoC continues to acknowledge that "ongoing trade conflicts and related uncertainty are still weighing on global economic activity, and remain the biggest source of risks to the outlook." Fair enough. The BoC went on to note "Future interest rate decisions will be guided by the Bank's continuing assessment of the adverse impact of trade conflicts against the sources of resilience in the Canadian economy— notably consumer spending and housing activity." This makes it fairly clear that the BoC needs to see weaker consumer and housing data before becoming more concerned. Whether housing's rebound this year has solid underpinnings or rests upon transitory drivers and whether the surge in job and wage gains this year will carry over into 2020 or rests upon equally temporary factors will no doubt be parts of this debate.

The final remark that the BoC will incorporate fiscal policy developments into its January MPR is not unexpected. A Fall statement is expected after Parliament reconvenes tomorrow and at some point before the holiday season. At issue remains judging potential fiscal stimulus in terms of a) magnitude, b) the degree of transitory versus permanent effects, and c) the timing of when stimulus hits.

Overall, while we expected a neutral bias today, the BoC went one step further than had been anticipated by tightening financial conditions absent improving domestic data, absent tangible trade policy developments and amidst ongoing evidence of adjustments to a weaker global economy. Perhaps the BoC's bias is informed by the Fed's signal that a material shock would be required to motivate additional easing, and apparently by stock markets given the nod to financial market developments. Time will tell whether this was an appropriate thing to do, but data, domestic fiscal and global trade policy developments and market conditions will further test this bias alongside the reality of shifting BoC communications.

Please see the attached statement comparison, albeit of limited use given the typically full re-write following a previous MPR statement.

Bank of Canada Deputy Governor Tim Lane will deliver an Economic Progress Report tomorrow morning at 8amET followed by a press conference. My first question would be how seriously the BoC treats the symmetry requirement to its inflation mandate and why, against the backdrop of the evidence presented above. A second question could be how seriously they view financial stability as a companion monetary policy goal relative to the tools at the disposal of the Federal government and its agencies.

RELEASE DATE: DECEMBER 4, 2019

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

The Bank's October projection for global economic growth appears to be intact. There is nascent evidence that the global economy is stabilizing, with growth still expected to edge higher over the next couple of years. Financial markets have been supported by central bank actions and **waning recession concerns**, while being buffeted by news on the trade front. Indeed, **ongoing trade conflicts and related uncertainty are still weighing on global economic activity, and remain the biggest source of risk to the outlook.** In this context, commodity prices and the Canadian dollar have remained relatively stable.

Growth in Canada slowed in the third quarter of 2019 to 1.3 percent, as expected. Consumer spending expanded moderately, underpinned by stronger wage growth. Housing investment was also a source of strength, supported by population growth and low mortgage rates. The Bank continues to monitor the evolution of financial vulnerabilities related to the household sector. As expected, exports contracted, driven by non-energy commodities. However, investment spending unexpectedly showed strong growth, notably in transportation equipment and engineering projects. **The Bank will be assessing the extent to which this points to renewed momentum in investment.**

CPI inflation in Canada remains at target, and measures of core inflation are around 2 percent, consistent with an economy operating near capacity. Inflation will increase temporarily in the coming months due to year-over-year movements in gasoline prices. **The Bank continues to expect inflation to track close to the 2 percent target over the next two years.**

Based on developments since October, Governing Council judges it appropriate to maintain the current level of the overnight rate target. **Future interest rate decisions will be guided by the Bank's continuing assessment of the adverse impact of trade conflicts against the sources of resilience in the Canadian economy—notably consumer spending and housing activity. Fiscal policy developments will also figure into the Bank's updated outlook in January.**

RELEASE DATE: OCTOBER 30, 2019

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

The outlook for the global economy has weakened further since the Bank's July *Monetary Policy Report (*MPR*)*. Ongoing trade conflicts and uncertainty are restraining business investment, trade, and global growth. A growing number of countries have responded with monetary and other policy measures to support their economies. Still, global growth is expected to slow to around 3 percent this year before edging up over the next two years. Canada has not been immune to these developments. Commodity prices have fallen amid concerns about global demand. Despite this, the Canada-US exchange rate is still near its July level, and the Canadian dollar has strengthened against other currencies.

Growth in Canada is expected to slow in the second half of this year to a rate below its potential. This reflects the uncertainty associated with trade conflicts, continuing adjustment in the energy sector, and the unwinding of temporary factors that boosted growth in the second quarter. Business investment and exports are likely to contract before expanding again in 2020 and 2021. At the same time, government spending and lower borrowing rates are supporting domestic demand, and activity in the services sector remains robust. Employment is showing continuing strength and wage growth is picking up, although with some variation among regions. Consumer spending has been choppy, but will be supported by solid income growth. Meanwhile, housing activity is picking up in most markets. The Bank continues to monitor the evolution of financial vulnerabilities in light of lower mortgage rates and past changes to housing market policies.

The Bank projects real GDP will grow by 1.5 percent this year, 1.7 percent in 2020 and 1.8 percent in 2021. This implies that the current modest output gap will narrow over the projection horizon. Measures of inflation are all around 2 percent. CPI inflation likely will dip temporarily in 2020 as the effect of a previous spike in energy prices fades. Overall, the Bank expects inflation to track close to the 2 percent target over the projection horizon.

All things considered, Governing Council judges it appropriate to maintain the current level of the overnight rate target. Governing Council is mindful that the resilience of Canada's economy will be increasingly tested as trade conflicts and uncertainty persist. In considering the appropriate path for monetary policy, the Bank will be monitoring the extent to which the global slowdown spreads beyond manufacturing and investment. In this context, it will pay close attention to the sources of resilience in the Canadian economy—notably consumer spending and housing activity—as well as to fiscal policy developments.