



Bank of Canada Cuts Rates to Blunt Effects of Lower Oil

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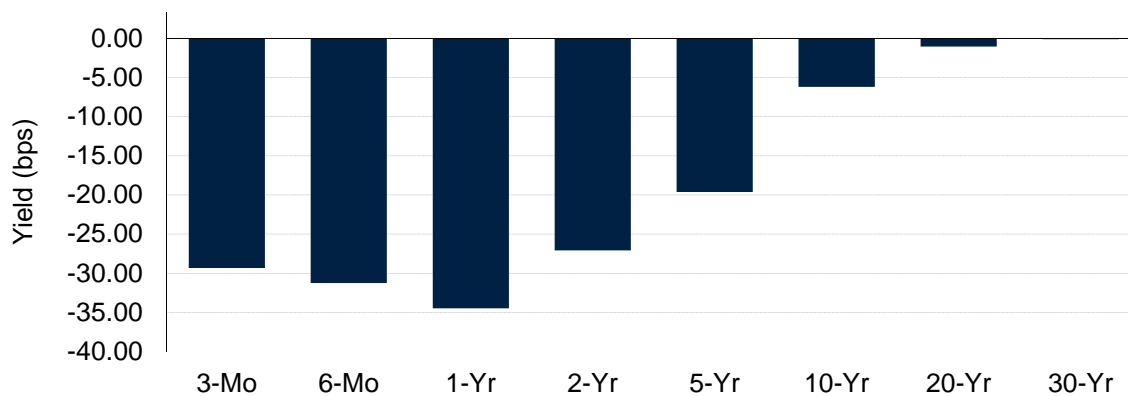
The Bank of Canada (BoC) unexpectedly lowered its overnight rate target by 25 basis points (bps) to 0.75% on Wednesday January 21, in response to the challenges that lower oil prices pose for near-term growth and inflation in Canada. BoC Governor Stephen Poloz characterized the rate cut as “insurance” for the economy given how the slide in oil prices is likely to affect investment in energy-related sectors of the economy and also push inflation even further below a level the central bank is comfortable with.

While the oil price drop likely represents a headwind for the Canadian economy, the BoC recognized that it could take steps to stimulate other parts of the Canadian economy in order to offset the expected slowdown in the oil patch. By reducing rates, the BoC hopes to provide a further boost to the nascent recovery in Canadian manufacturing. That recovery has already been helped by the oil and natural gas declines, which are significant input costs, and the sharp decline in the loonie over the past year, which has helped to make Canadian exports more competitive in the U.S. and global markets. The rate reduction aims to take this a step further as it not only has pushed the loonie even lower, but it has also lowered the cost of borrowing for Canadian businesses, which should help to stimulate investment. Further, with the Federal Reserve preparing to potentially hike interest rates sometime this year, and the Bank of Canada considering further accommodation, we believe pressure on the Canadian dollar could linger in the near term.

The reduction in interest rates and the Canadian dollar represents challenges and opportunities for investors, in our opinion. The BoC’s rate cut makes an already-challenging investment environment in fixed income even tougher. Yet, this is a reminder that having a disciplined approach to investing is critical for investors looking to meet income needs and maintain the benefits of portfolio diversification. For equities, lower rates generally lend support to valuation multiples, but the benefits vary by sector. Telecom services providers, utilities, and REITs are likely to be most positively impacted, in our opinion. At the other end of the spectrum, a prolonged period of lower interest rates would present a significant challenge for life insurance companies. A weaker Canadian dollar would also have a positive impact on the earnings of Canadian companies that derive a significant proportion of their revenues outside of Canada and/or price goods in U.S. dollars (e.g., forest products). Overall, the challenges posed by lower oil prices continue to suggest that global diversification remains key for Canadian investors.

Government Bond Yields Have Fallen Considerably Since the Announcement

Government of Canada Yield Change Post-Statement



Source - Bloomberg, RBC Wealth Management; Priced as of 11 a.m. ET 1/21/15

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