



The Bank of Canada Hikes Rates: Part Deux

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After a summer of strong economic data, capped off by last week's 4.5% GDP print, the Bank of Canada (BoC) decided to hike rates yet again, moving to a 1.0% overnight rate and completely unwinding the extraordinary stimulus delivered in response to the oil shock in 2015. We would note though that the BoC hasn't revised its future growth expectations higher. Instead, this hike reflects both global and Canadian growth that has been better than expected, bringing the economy closer to its potential. We thought that the odds of a rate hike were higher than the market expected, but it was certainly not set in stone. Indeed, the immediate strength in the Canadian dollar (CAD) and increase in bond yields on the back of this move are a reflection of mixed market expectations.

Why has the market reacted?

While it was not implausible that a rate change would occur, only about half of market participants expected it at today's meeting. The balance expected a hike in October, when more data would have been made available and the BoC was scheduled to release its updated monetary policy report. The recent strength of the CAD, which is up approximately 10% off its spring lows, was expected to be a moderating factor in the decision, leading market participants towards the view that perhaps the BoC would hold steady at this meeting.

As such, the decision to hike rates today rather than waiting until October is being deemed a "hawkish" move. However, in our view, the language used to portray future decisions was more moderate. To us, this implies less certainty about future rate increases than there was at the time of the first hike in July, though we do expect more rate hikes to come.

Has the outlook for the Canadian dollar now changed?

The recent appreciation of the loonie has been driven by the BoC's sharp turn towards a tightening bias, and our view is that over the medium-term there are a number of headwinds facing the Canadian economy. These are expected to moderate the long-term upside potential for the currency, and include:

- Protectionism and the risk that NAFTA renegotiations may result in an unfavourable outcome for Canada
- A growing divide between taxation in Canada and the U.S.
- Increasingly tougher labour laws in Ontario and Alberta, particularly as minimum wage increases come into effect
- Stricter environmental standards in Canada
- Higher electricity costs in Ontario, further impacting competitiveness amongst manufacturers
- Oil and the extent to which rising U.S. shale production will contain prices over the medium-term

While the BoC is counting on stronger exports and higher corporate investments, these headwinds could considerably dampen those prospects.

Key Highlights:

- The market was mixed around whether a hike would occur today or in October.
- The move is being deemed hawkish as a function of their decision to hike today rather than because of any specific language around future decisions. To us, this implies less certainty about future rate increases.
- Looking forward, we think October is a possibility for the next round of hikes, but it would require further significant economic strength in the near-term. A more likely scenario is a December hike at the earliest.

Meanwhile, the BoC acknowledges that the consumer is unlikely to be the engine of future growth, expecting a levelling off in spending. However, we believe that cumulative measures taken over the past several years to limit the excessive risk-taking in the Canadian housing market, combined with higher interest rates, are much more likely to cool household spending. While we can't know with certainty that this is the end of CAD strength in the short term, we believe it already provides good medium- and long-term opportunities at current levels.

What's our outlook for future rate hikes?

Despite the BoC now fully unwinding the stimulus that was delivered in 2015, we expect more rate hikes to come, though perhaps at a slower pace than the market is currently anticipating. This is driven by the recent strength in the Canadian dollar and the BoC's expectation that growth will slow in the second half of the year. As well, the BoC acknowledged that inflation is still low, recognizing a number of risks around geopolitics, tariffs and the strength of the Canadian dollar. In its statement, the BoC specifically mentioned that further decisions are "not predetermined," which we view as a more dovish tone than that taken in July. Meanwhile, this rate hike, combined with the one in July, should help to slow growth over the next 18 months.

As we look forward, October is certainly a possibility for the next round of increases, though it would likely require further significant economic strength in the near-term. As well, the U.S. Federal Reserve is hiking at a pace of roughly four increases per year, and to us it would be quite aggressive for the BoC to hike at a pace of eight increases per year – despite their historical tendency to move fairly expediently when in motion. As such, our view is that the next hike is more likely to come in December at the earliest.

Publication Date: September 6, 2017

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