Despite trade uncertainty, Bank of Canada raises rates

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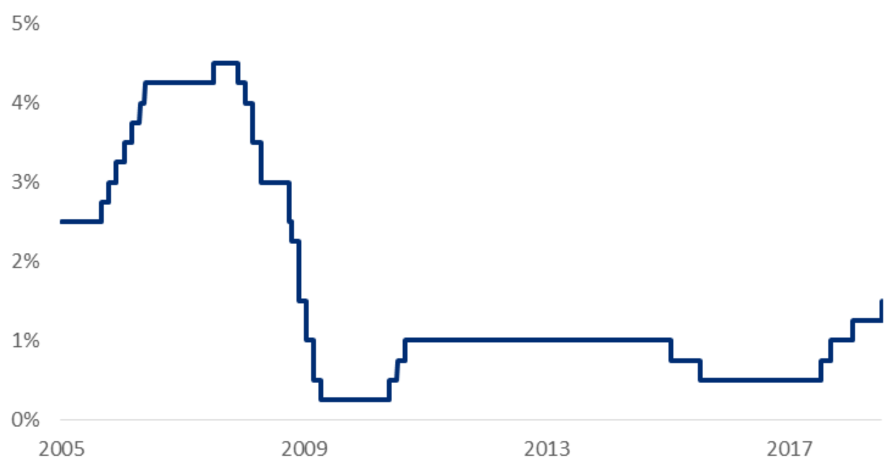
On July 11, Stephen Poloz and the data-dependent Bank of Canada (BoC) elected to raise its benchmark overnight rate to 1.5%, the highest level in nearly a decade. The decision was in line with market expectations that factored in the high likelihood of a rate increase as recent economic data indicates the Canadian economy has been growing steadily, lessening the case that low rates are required to stimulate further growth.

Why the hike?

After April GDP growth was contained to 0.1% and May inflation was in line with the BoC's forecast at 2.2%, the market was split 50-50 on whether the BoC would raise rates. However, results from the Business Outlook Survey and a strong June employment report led the BoC to determine that higher interest rates were warranted.

The BoC's Business Outlook Survey involves reaching out to senior management of approximately 100 firms to gather opinions on the current state of their business and their forward-looking views on economic activity. The recent Q2 report saw increases in the number of firms experiencing difficulties meeting new demand and facing labour shortages, signs that the economy may be bumping up against its long-run capacity.

Rising rates remain below historical levels



Source: Bloomberg, RBC GAM. Data as of January 1, 2005 – July 11, 2018.

The June employment report painted a healthy picture of the Canadian economy as 31,800 jobs were added, more than offsetting modest declines in the preceding two months. Despite job gains, the unemployment rate rose to 6% (still near multi-decade lows), as more individuals showed confidence in the labour market and started to look for work. Year-over-year wage growth of 3.5% was also noted in the report. While this is a slightly distorted figure with recent minimum-wage increases in Ontario and British Columbia, wage growth alongside gas prices and newly imposed tariffs led the BoC to increase its inflation forecast to 2.4% for 2018 – further support for the rate increase.

Remaining dovish

Looking forward, a number of concerns facing the Canadian economy suggest that there may be less tightening in the coming year, including a protectionist drag, competitiveness challenges and a slowing housing sector.

On the protectionist front, NAFTA negotiations took a turn for the worse in June with the U.S. extending steel and aluminum tariffs to Canada and Mexico, prompting both to strike back with retaliatory measures of their own. As deadlines are missed and little progress has been made on the auto file and proposed sunset clause, we believe the odds of a new NAFTA deal, in one form or another, currently sit at just 50%. At this point, all we know is that the current uncertainty is problematic, reducing Canadian GDP materially.

From a competitiveness standpoint, the Canadian economy faces a number of challenges compared with the United States, including higher taxes, tougher labour laws and environmental regulations (e.g., carbon taxes). The business community appears to be acknowledging Canada’s diminished competitiveness with surveys indicating business investment will decline in 2018 for the fourth consecutive year.

The Canadian housing market also poses a considerable threat, in part because it now accounts for a larger share of growth than it has and also because serious economic problems have historically spawned from a country’s housing sector. To date, we have seen early signs of this segment of the economy slowing, with a mix of rising mortgage rates and targeted government measures making their way into the market. On top of this, Canadian consumers will feel the impact of interest-rate hikes more today, when household debt-to-income ratios are at elevated levels, than in the past.

In their remarks, the BoC downplayed the risk of a recession, attributing the flattening yield curve to a strong appetite for long-term bonds and reiterating the adage that expansions don’t die of old age. However, in addition to addressing inflation and concerns the Canadian economy may be overheating, this hike provides the BoC with the added ability to cut rates down the road if these risks start to materially impact the Canadian economy.

For now, though, the Bank of Canada is clearly focused on raising rates, and the market now prices in a greater than 60% chance of a further rate increase before the end of 2018. The question is whether the aforementioned challenges will manifest and preclude further tightening.

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