Bank of Canada Policy Announcement

Oil Slick Drives BoC Caution

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The Bank of Canada left policy rates unchanged at 1.75% as expected. The tone of the statement was **clearly more dovish than expected**, with C$ off a full penny and the two-year yields rallying 7 bps.

Key quotes…

Oil…The huge decline in oil since the October MPR was highlighted, and "*in light of these developments and associated cutbacks in production, activity in Canada's energy sector will likely be materially weaker than expected*." The latter is consistent with the downgrade of our GDP growth outlook at the start of the week to account for the Alberta production cuts. So expect a meaningful cut to the BoC's Q4 growth call of 2.3% and Q1 to be introduced at a low level.

Domestic economy…With respect to the broader economy, the recent softer data (e.g. weak September GDP) "*suggest less momentum going into the fourth quarter*." The drop in Q3 business investment was highlighted, but the BoC still expects a rebound due to the USMCA, accelerated depreciation and capacity constraints. This is where the Business Outlook Survey out on December 21 could loom large.

Inflation…While core inflation continues to track around 2%, headline inflation "*at 2.4 percent in October, is just above target but is expected to ease in coming months by more than the Bank had previously forecast, due to lower gasoline prices*." In the same paragraph, the BoC says that the downward revisions to historical GDP that were part of the Q3 release "*together with recent macroeconomic developments, indicate there may be additional room for non-inflationary growth*." That's as clear as it gets that there's no rush to get to neutral.

Path to neutral…The one hawkish part of the statement was the reiteration that the "*Governing Council continues to judge that the policy interest rate will need to rise into a neutral range to achieve the inflation target*." So the end goal remains intact, but "*the appropriate pace of rate increases will depend on a number of factors…the effect of higher interest rates on consumption and housing, and global trade policy developments. The persistence of the oil price shock, the evolution of business investment, and the Bank's assessment of the economy's capacity...*" The addition of oil and business investment makes the timing of future hikes more uncertain.

Credit/housing…This only got a small mention as it has clearly taken a back seat to oil and other issues.

U.S.-China trade worries…Still an issue for the BoC, but upside and downside risks were noted post-G20.

Key Takeaway: While the Bank reiterated its desire to get policy rates to neutral, the path to neutral is clearly more uncertain than just a couple of months ago. Looking ahead to January, the BoC will likely **need to be convinced <u>to</u> hike** (rather than not to hike), so we'll need to see a solid run of data and oil prices at a minimum hanging in there. We'd put the odds of a January hike at 50/50 at best right now. Don't forget we'll hear from Governor Poloz tomorrow, and we'll see if the appropriate message was received.