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An analysis of the latest economic data

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Bank of Canada Policy Announcement and Monetary Policy Report

Bank, Interrupted

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The **Bank of Canada kept interest rates unchanged** today at 1.75%, as was universally expected, following three rate hikes in 2018. If there was any surprise in today's messaging—and there weren't many big ones—it was that the Bank **sounded a tad more committed to further rate hikes** down the line than the market was likely expecting. Market reaction was quite muted, however, with only a mild temporary strengthening in the Canadian dollar (also supported by the ongoing recovery in oil and risk assets, generally). The key takeaway is that **we remain comfortable with our call of two rate hikes later this year**, with the first possibly in Q2 and the second in Q4 (after October's Federal Election).

The **main theme** in today's announcement and MPR was **oil**, with the Bank even elevating crude prices to being **the number one "*particular focus*" on when to hike rates next**. There was also a **very detailed special Box in the MPR** on the various impacts and assumptions around lower oil prices, with perhaps the most notable conclusion that **energy sector capital spending will drop 12% this year** (versus an October assumption of -1.5%). All told, the drop in oil since the summer would shave 0.5 percentage points from GDP by 2020, estimated to be one-quarter of the impact of the 2014-16 drop (which prompted 50 bps of rate cuts). Their forecasts are based on the assumption of WTI prices around \$50 (versus just over \$52 as we speak) and just \$30 for WCS (a bit above \$40 now thanks to a recent spike). The attached table has the Bank's new forecast and compares it to ours and their prior outlook—the biggest change was a 4 ticks slice in the 2019 GDP outlook to 1.7%, which is basically in line with us (officially at 1.8%, but close enough).

Some key comments from the Bank:

➢ *"The global economic expansion continues to moderate, with growth forecast to slow to 3.4 per cent in 2019 from 3.7 per cent in 2018."* Curiously, the Bank actually did not change their global economic outlook for 2019/20 one iota in the past three months, despite all the Q4 financial market volatility, sticking doggedly to 3.4%. Brave call, given the run of weak numbers from both China and Europe, of late.

Bank of Canada's Base-Case Projections

	2018				2019				2020				Average		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	18	19	20
Real GDP (% chng : a.r.)															
Oct-18 MPR	1.4	2.9	1.8	2.3									2.1	2.1	1.9
Jan-19 MPR		**2.9**	**2.0**	**1.3**	**0.8**								**2.0**	**1.7**	**2.1**
BMO CM	1.7	2.9	2.0	1.5	1.0	2.5	2.2	1.9	1.6	1.6	1.6	1.5	2.1	1.8	1.7
CPI Inflation (y/y % chng)															
Oct-18 MPR	2.1	2.3	2.7	2.3				2.0				2.0	2.4	2.0	2.0
Jan-19 MPR		**2.3**	**2.7**	**2.0**	**1.7**			**2.0**				**2.0**	**2.3**	**1.7**	**2.0**
BMO CM	2.1	2.3	2.7	1.9	1.4	1.7	1.6	2.0	2.1	2.1	2.0	2.0	2.2	1.7	2.1

➢ *"Meanwhile, consumption spending and housing investment have been weaker than expected as housing markets adjust to municipal and provincial measures, changes to mortgage guidelines, and higher interest rates. Household spending will be dampened further by slow growth in oil-producing provinces. The Bank will continue to monitor these adjustments*." The Bank suggests that the Canadian economy has been *"performing well overall",* but then highlights the emerging weakness in domestic spending. In fact, the entire chop in 2019's growth outlook (from 2.1% to 1.7%) is due to lower domestic demand (from 2.0% to just 1.3%), with each of consumer spending, housing and business investment downgraded.

➢ *"This revised forecast reflects a temporary slowing in the fourth quarter of 2018 and the first quarter of 2019. This will open up a modest amount of excess capacity, primarily in oil-producing regions. Nevertheless, indicators of demand should start to show renewed momentum in early 2019, leading to above-potential growth of 2.1 per cent in 2020."* One key change in their forecast assumptions is that they now believe that the output gap had re-opened to 0.5% of GDP by Q4 (versus a middle point of no gap in the October forecast), driving home the point that they can now be quite patient and deliberate before hiking rates again.

But having said that…the final word was …

➢ *"Weighing all of these factors, Governing Council continues to judge that the policy interest rate will need to rise over time into a neutral range to achieve the inflation target. The appropriate pace of rate increases will depend on how the outlook evolves, with a* ***particular focus on developments in <u>oil markets</u>****, the* ***<u>Canadian housing market</u>****, and* ***<u>global trade policy</u>****."* (Emphasis ours.) If oil stabilizes, or even recovers further, the housing market stays on its soft-landing path, and there is some sort of semi-positive resolution to the US/China trade talks, the Bank looks plenty comfortable restarting the rate-hike process. By the next MPR (April 24th), we should have some clarity on US/China trade (and perhaps even the USMCA), as well as a better bead on housing and oil markets. But, that meeting is likely the earliest possible that the Bank could even consider hiking.

In the Governor's press conference, there was no major divergence from the initial message, but the overall impression seemed a bit more cautious (along with memorable metaphors on Gretzky and beer). Most notably, Poloz sounded some concern on the housing front, in that it was taking longer than expected to stabilize. Reinforcing the point that the pause may last longer than many expect was his remark that "*it will take time for us to get what we need out of the data*". Again, the overriding message was rate hikes when necessary, but not necessarily rate hikes any time soon.