Talking Points

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The Best Laid Plans...

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...of mice and men, often go awry. Or, in its original Robbie Burns' version, *"The best laid schemes o' mice an' men, gang aft agley"*. Which brings us to that potential Bank of Canada rate hike, which the market now has priced in with a more than 20% chance in July, and with a near certainty by year-end. This is one of the rare instances in the past three years or so that I find myself somewhat less hawkish than the market or the Bank of Canada. And that's because from almost the moment the Bank jolted the markets with its 1-2 hawk-talk combination early last week (Wilkins jabs, Poloz punches), oil prices have been heading due south. And lower oil prices are a serious spanner in the works for the Canadian economy.

Recall that at $43, WTI is now below levels prevailing when the Bank last *cut* rates in January and July 2015. They are down a cool 17% from levels prevailing a wee bit more than four weeks ago, just prior to the OPEC meeting that was greeted with a major thumbs-down from the market. And since the loonie had strengthened in recent weeks—largely due to the Bank's hawkish rhetoric—the Canadian dollar price of oil (about C$57) is at its lowest level since last summer. **At the very least, one would suppose that the Bank would want to ensure that oil prices are not on their way even lower before pulling the trigger on the first rate hike since 2010.**

No doubt, the **economic growth figures make a very compelling case for a rate hike**, **a point we have made often in the first six months of the year**. And this week brought robust readings on both wholesale (+1.0%) and retail trade (+0.8%), following a snappy 1.1% rise in manufacturing sales last week. Together, these point to a respectable monthly GDP result next Friday for April. In turn, this leads to some upside risk for our Q2 call for growth of 2.4%, which will leave GDP up more than 3% in the past four quarters; that's by far and away the fastest growth among the major industrial economies in the past year.

But here's the thing: Q2 ends next Friday, i.e., that's the past. The slide in oil is here and now, and it points to potential trouble again in Q3 and Q4 for Canada. **We cannot stress enough how a stabilization in the oil-driven provinces and sectors has prompted the rebound in national growth in the past year**. Just to pick one example, Alberta retail sales were up 7% y/y in the first four months of the year, compared with a drop of more than 1% in 2016.

Far be it for me to be the skunk at the rate-hike picnic, but **core inflation is sending another strong signal that the Bank can take its time** before moving on rates. The May CPI results came in well below already-low expectations, acting as a heavy antidote to the strength in retail sales. The Bank's old measure of core inflation (CPIX) actually churned out its lowest reading in more than 30 years of records at just under 0.9% y/y (i.e., *below* the old 1%-to-3% comfort zone). Moreover, Canadian headline inflation of 1.3% is now not just the lowest of 2017, but it's below even the Euro Area's pace, and they are still plowing ahead with QE and negative interest rates!

Some pundits are starting to mutter about the Federal Reserve making a policy error by forging ahead with rate hikes. The Economist magazine, for one, frets this week that *"a central bank hell-bent on keeping inflation low and stable risks cutting short a boom with room to run."* One concern is how long-term Treasury yields are receding even as the Fed tightens, flattening the curve (it's now 81 bps for 10s-2s). Well, Canadian 10-year yields are much, much lower at just under 1.5%, with the 10s-2s curve at a slim 58 bps as we speak. Moreover, while overall financial conditions are rip-roaring stateside, Canada's are considerably less robust, with the equity market struggling to stay out of the red so far this year and the currency up in 2017.

Now, **just as one door closes, another opens**—the flip side to the downbeat oil story is that a big prior headache was given a serious dose of relief this week. Warren Buffett, a self-proclaimed bull on Canada, invested directly into equity in Home Capital and provided $2 billion in financing for the company to pay off its costly emergency funding. Accordingly, the stock has more than doubled in a month, and is within 10% of its level before it slid sharply in late April. While we don't believe this one company was ever going to make or break the Canadian housing landscape, at least a more stable backdrop there removes one source of uncertainty from the BoC's decision tree.

In summary, **even to a card-carrying member of the hawkish club, it would make sense for the Bank to stand aside and ensure that the latest sag in oil doesn't persist and/or deepen** before moving on rates. While growth has been a tremendous pleasant upside surprise for Canada this year, inflation is surprising consistently to the downside, reinforcing the message that there's no rush. And, while Home Capital is less of a concern for housing, the 16 measures taken by the Ontario government seem to have effectively calmed the market, also relieving some pressure on the Bank to tighten immediately. In a word, or two, it likely does make sense for the Bank to hike rates this year, but not while oil is careening lower, lest the economy *gang agley*.