Talking Points

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The latest view on the economy
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Top O' the Market to Ya

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It has not been a kind run for the Canadian dollar, this day, this week, or this year. **The currency finds itself at the absolute back of the pack among the majors in all the longer-term time frames, and is alone in falling notably against the U.S. dollar so far in 2018** (down almost 4%). A soft manufacturing sales read today leaves the loonie floundering at its weakest level since the middle of last year at 76.4 cents ($1.309/US$). The bizarre and somewhat unseemly spectacle of the U.S. and Canada debating over who has a trade deficit with whom simply further fuelled the negative sentiment, which already had a plentiful supply of existing economic fuel stock. (For the record, there are more bilateral measures of trade than you can count on one hand, so while figures don't lie, liars can run riot. We would assert that the big picture is that trade is very well balanced overall between the two countries, given the massive size of the back and forth flows.)

While trade is a weight on the loonie, **the single biggest factor behind this week's latest sag is the shifting outlook on Bank of Canada interest rate policy**. We go into much greater detail on this subject in this week's Focus Feature (attached to this end of this document), but the crux is that the market has been steadily ratcheting down expectations of rate hikes at the very time when it is upgrading the amount of expected Fed tightening this year. For example, this week saw Canadian 2-year bond yields drop 6 bps, even as U.S. yields edged up 3 bps in advance of next week's crucial FOMC meeting.

A combination of a relatively dovish speech this week by Governor Poloz and some soft domestic data (weak home sales, easing household debt, and signs that Q1 GDP is heading for another soft read) just reinforced that theme. The main message from Poloz was that—regardless of the jobless rate and the capacity utilization measures—**there is still plenty of room to let the economy run hot before we seriously risk inflation**. The key quote: *"We cannot know in advance how far the capacity-building process can go, but we have an obligation to allow it to occur."* While the point is debatable, the policy message was not, hitting the loonie and rates with the subtlety of a flying mallet.

On top of that, all commodity currencies slumped a bit this week, partly on concerns over a brewing global trade tiff, as well as supportive U.S. dollar comments from Trump's freshly-minted Chief Economic Advisor, Larry Kudlow. Almost lost beneath the usual round of Washington drama this week (e.g. Rexit), was news that the U.S. slapped an additional 20% tariff on a number of Canadian newsprint producers (total exports to the U.S. of more than $1 billion last year), just the latest in a string of trade actions aimed exclusively at Canada. That latest swipe was entirely overshadowed by louder rumblings that the U.S. is poised to apply some heavy duty tariffs on China, with the reported aim to cut the bilateral deficit by US$100 billion (from $380 billion over the past 12 months). **But it's tough to cite trade as the prime culprit behind the lagging loonie, as the Mexican peso has managed to strengthen this year by more than 5% against the U.S. dollar**, marking a gain on

the cross of almost 9% against the Canadian unit. At 14.3 peso/C$, the cross rate is all the way back to levels prevailing in the week before the 2016 U.S. election.

Notably, the Canadian dollar's latest retreat comes at a time when concerns about rapidly rising U.S. inflation are fading fast. An as-expected read on February CPI and the third drop in a row for retail sales followed last week's mild average hourly earnings result, a trifecta of calming reports. We would point out that the three-month trend on each of wages, headline, and core CPI remains firmly above 3%, but January's extremely hot results have faded. As a result, the 10-year Treasury yield receded a bit further this week to 2.85%, down roughly 10 bps from the 2018 closing high just over three weeks ago (i.e. just prior to the flare-up in trade concerns). Equities also took a small step back this week—albeit after the Nasdaq reached a new high Monday—on the political chaos du jour and the more tangible fears of tariffs on China. Trump's decision to nix the Broadcom/Qualcomm takeover put some serious flesh behind the Administration's increasingly strident protectionist talk.

Looking ahead, it's clearly a challenge to find positive things to say about the Canadian dollar's outlook in this dark trade environment and the rapidly diverging view on North American monetary policy, not to mention the **very real divergence on tax policies**. But we will give it the old college try. First, sentiment is already horrendous on the loonie. Second, despite the headlines, the economic divergence on the ground between Canada and the U.S. is minor, with inflation and job growth actually quite similar over the past year, for example. Third, despite the dire headlines on trade, there are a few specks of optimism on that front (Kudlow thinks it's wrong to go after Canada). Fourth, the ongoing strength in global growth should provide some support for commodity prices. Finally, we suspect the U.S. dollar may ultimately have some even bigger challenges on its hands than the loonie over the medium term, notably a $1 trillion budget deficit. Still, we're far from positive on the Canadian dollar outlook, just not crushingly negative.

While it's exceedingly tough to shut out the 24-hour news cycle emanating from Washington, there are some important elections coming at investors elsewhere in the world. And, no, we are not referring to this Sunday's presidential election in Russia—with Putin holding 70% approval ratings, it holds all the drama of whether the Leafs will make the playoffs this year. (Sidebar, they are already in as of yesterday… and there was much rejoicing.) For Canadians, there are votes in the two biggest provinces, first in Ontario on June 7, then in Quebec likely on October 1. The latter will see the ruling Liberals try to fend off a pro-business party (the CAQ), and this week saw the government decide to shift $10 billion from the Generations Fund to pay down debt, with expectations that the budget later this month will be mildly stimulative.

The Ontario campaign is bound to produce a much sharper distinction on the economic vision, with the new Progressive Conservative leader Doug Ford pledging to cut taxes and the size of the government. Meantime, the ruling Liberals have taken the unusual step of aiming to run deficits of as much as 1% of GDP, even with a record debt load (and near-record as a share of GDP) and at this advanced stage of the business cycle. But, there's no monopoly on "unusual" pledges—one of Ford's first stated priorities is to axe the foreign buyers' tax on homes in Toronto. How that

can possibly be a top priority, especially given very compelling evidence that said tax played a huge role in deflating the Toronto housing bubble in the past year, is a mystery.

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Rate Outlook Reset: New Theory of Relativity

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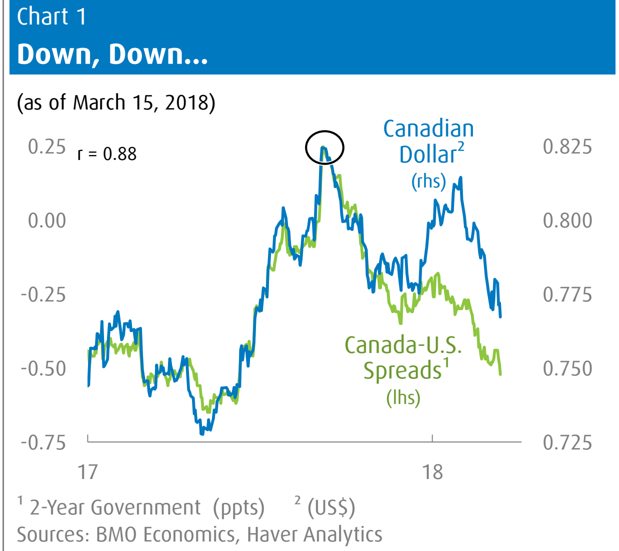
It's amazing how the North American interest rate outlook has shifted in little more than six months. Casting back to last September, the Bank of Canada had just hiked rates in successive meetings—to the surprise of some—lifting short-term rates above their U.S. counterparts, and pushing the Canadian dollar to a two-year high above 82.5 cents. Almost to the day, Canada's relative outlook versus the U.S. has been in retreat from those heady conditions, with both spreads and the currency sinking steadily since then (*Chart 1*). **We believe that even with that big adjustment of the past six months, there is still room to run—i.e. the odds are tilted to the Fed doing more than the market expects and the Bank of Canada doing less.**

The profound change in fiscal policy is the primary factor for the **upside risk on U.S. monetary policy** in the past six months—a massive dollop of both tax cuts and new spending, poised to add roughly 1 percent to GDP this year alone. Markets are now priced for three U.S. rate hikes in 2018, matching both last year's outcome and the latest FOMC expectation (from the December dot plot). But that latest Fed view pre-dated both the fiscal stimulus and the new Chair, Jerome Powell. We suspect that there is a good chance the FOMC's rate projection will shift higher in next week's forecast, with the tax plan details in hand, and with a somewhat more hawkish cast in command. Our official view is that the Fed will hike each quarter this year, with the first 25 bp move coming next week.

The **more nuanced shift is in the Bank of Canada outlook**. Two-year yields are in fact slightly higher than six months ago, owing to January's rate hike, but have stagnated since that point. Last week's Statement and this week's speech by the Governor gave no sense that the Bank is prepared to tighten again soon; we have believed for some time that policy will remain on hold until at least the second half of the year, with 50 bps of hikes in H2. Here are five reasons to believe the risks are now tilted to the downside for even that mild outlook on future BoC moves:

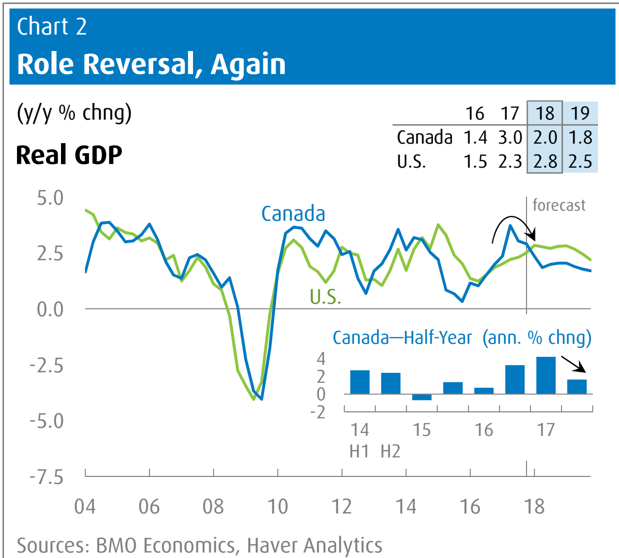
1. **GDP Growth:** For a "particularly" data-dependent Bank, the argument for a flatter tightening profile can start and end with the big cooldown in GDP since mid-2017. Growth slowed to a meagre 1.6% annual rate in the second half of last year, from 4.2% in H1, a much more forceful braking than expected (*Chart 2*). From a bigger picture view, Canada and the U.S. are effectively trading places in the growth tables this year, with the U.S. expected to quicken to nearly 3% GDP while Canada cools closer to 2%.

Chart 1
Down, Down...



[1] 2-Year Government (ppts) [2] (US$)
Sources: BMO Economics, Haver Analytics

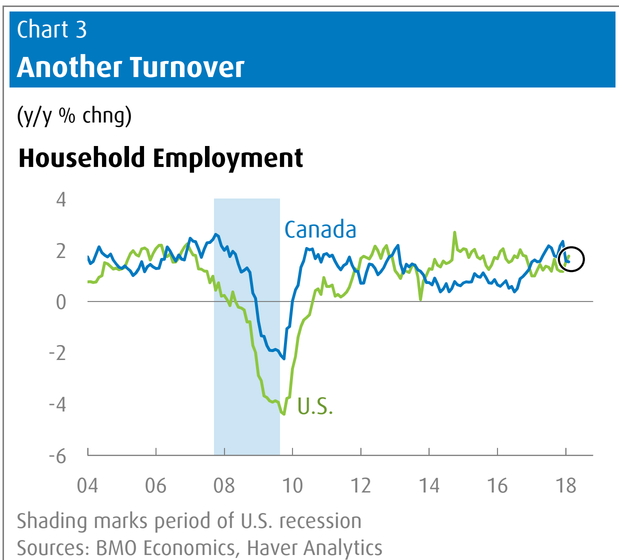
Chart 2
Role Reversal, Again



	16	17	18	19
Canada	1.4	3.0	2.0	1.8
U.S.	1.5	2.3	2.8	2.5

Sources: BMO Economics, Haver Analytics

Chart 3
Another Turnover



Shading marks period of U.S. recession
Sources: BMO Economics, Haver Analytics

2. **Employment:** After a surge last year, Canadian job growth has simmered down notably and is now growing slower than both U.S. measures on a year-over-year basis (*Chart 3*). Moreover, there is Governor Poloz' longstanding view that there is still plenty of untapped slack in the labour market, and his statement this week that *"we have an obligation to allow"* the capacity-building process to stretch to the limit.

3. **Housing:** The Bank was always going to wait to better assess how the new OSFI mortgage rules and initial rate hikes affected the housing market. With two months in hand, it increasingly looks like the rule changes and rate hikes *have* had a significant effect. The previously red-hot Toronto market has especially slowed to a crawl, with price gains screeching to a halt, and sales across the broader Ontario market sliding (*Chart 4*).

4. **Household debt:** The BoC has been focusing directly on the growth in household credit, specifically citing a recent moderate slowdown in the latest Statement (*Chart 5*). Note that credit is still rising at a 5.5% y/y clip, well above anyone's estimate of underlying disposable income growth—so the debt/income ratio is likely to resume climbing, even after fading a bit in Q4 from a record high (to 170%). Still, the slower growth track seems to be enough to sideline this issue for the moment.

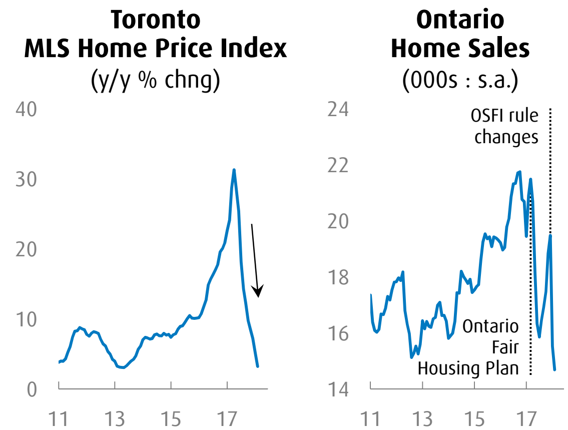
5. **Trade outlook:** Canada may have been exempted from the U.S. steel and aluminum tariffs—for now—but the issue simply reinforces the point of how vulnerable the Canadian economy is in particular to U.S. protectionism. Despite Ottawa's best efforts to diversify, exports of goods and services to the U.S. still account for 22% of Canadian GDP. Plus, and disconcertingly, even before the NAFTA negotiations kicked into high gear, Canadian trade trends were struggling (*Chart 6*), with net exports chopping 2 percentage points off growth in the past four quarters, after adding to growth in the four prior years.

A counterpoint to the list: fiscal policy. Ottawa's budget unveiled plans to spend all of its new-found revenue, and now Ontario is planning to dip back into the red by up to 1% of GDP at this late stage in the economic cycle (and after a drawn-out effort to balance). Still, compared with the U.S., net fiscal stimulus will be milder (likely under 0.5% of GDP, pending Ontario and Quebec budgets later this month, and provincial elections later this year), so the needed monetary response will also be presumably milder.

The Bottom Line: The risks to North American monetary policy are lopsided, with the U.S. at clear risk of doing more tightening than the market expects and Canada to do less. In turn, expect the Canadian dollar to stay mostly on the defensive through 2018, with its main support a broadly weaker U.S. dollar itself.

Chart 4

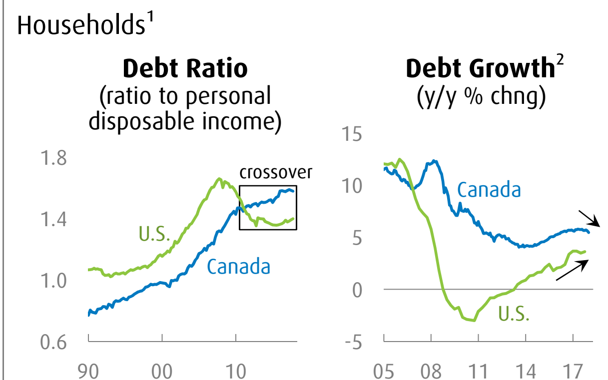
The Big Chill



Sources: BMO Economics, Haver Analytics

Chart 5

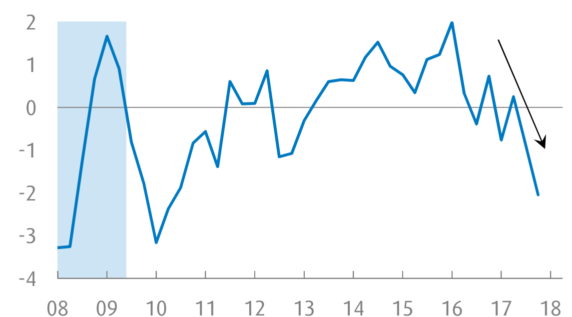
Still Borrowing, After All These Fears



[1] Households, nonprofits and unincorporated businesses
[2] Consumer credit and residential mortgages only
Sources: BMO Economics, Haver Analytics

Chart 6

Canadian Trade: Orange Crush



Shading marks period of Canadian recession
Sources: BMO Economics, Haver Analytics

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