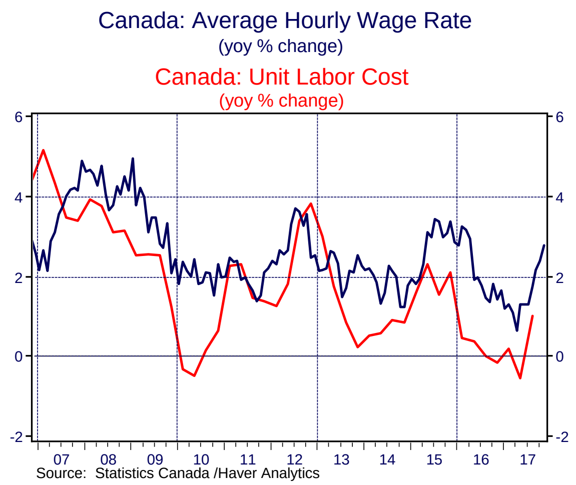
BoC December Decision: Caution on future rate hikes remains intact



The BoC left the overnight rate target unchanged at 1.00% this morning. Our interpretation of the statement is that BoC officials maintain a very prudent tightening bias. "*While higher interest rates will likely be required over time, Governing Council will continue to be cautious, guided by incoming data in assessing the economy's sensitivity to interest rates, the evolution of economic capacity, and the dynamics of both wage growth and inflation*". Basically, the statement echoes Carolyn Wilkins' dovish speech made on November 15th.

Regarding *"the economy's sensitivity to interest rates",* it is too early to precisely assess the magnitude of the impact of last summer's 50 basis points policy rate increase on households' financial situation. There is a fair chance the household debt service-to-disposable income ratio increased slightly for the first time in the current business cycle during the second half of 2017, after being fairly stable near 14% since 2010.

Households will likely be able to partially absorb higher interest rates in 2018, or completely if wage growth surprises consistently on the upside. In this statement, the BoC was right to acknowledge the recent improvement regarding wage inflation. According to the LFS report released last Friday, average hourly earnings in November accelerated to 2.7% on a year-over-year basis, doubling the pace of growth registered last summer (see chart). Still, the cautious BoC does not overreact to the recent strength in some labour market indicators: "*Meanwhile, despite rising employment and participation rates, other indicators point to ongoing – albeit diminishing – slack in the labour market.*" For instance, the October *MPR* referred to subdued growth in unit labour costs (see chart).

Regarding *"the evolution of economic capacity",* the BoC continues to see the economy running close to its potential following last Friday's release of the 2017Q3 GDP report. One progress mentioned by the BoC was the increasing pace of public infrastructure spending and private business investment, contributing to make the recovery more sustainable. At the same time, the GDP historical revisions showed an improved profile for non-residential investment in recent years, implying a higher potential GDP.

Altogether, the Canadian economy appears far from being at risk of overheating. Based on a simple analysis, we find that a smaller-than-usual share of the 173 CPI subcomponents rose above the 2% target in 2017 relative to 2016 (34%, see table below). If this trend continues, it will be difficult for CPI inflation to rise materially in 2018-19. Furthermore, a higher-than-usual share of CPI subcomponents declined in 2017 versus 2016 (38%, see table below).

This apparent broad-based weakness in the CPI could be related in part to two global structural factors that were mentioned in the previous October statement: digitalization and globalisation.

These two global structural forces could restrain inflation in the long run. In the short run, it will take a major positive surprise, such as the removal of NAFTA uncertainty, for the BoC to consider hiking at the January 17th meeting. Thus, at the earliest, we can see the BoC raising its policy rate by 25 basis points at the March 7th meeting. Our year-end 2018 forecast for the overnight rate target is still 1.25%.

Bottom Line: The two 25 basis points policy rates hikes of 2017 can be seen as picking a low hanging fruit. In 2018, increasing the overnight rate target above 1.00% will be a lot more challenging.

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Breakdown of Canadian CPI subcomponents by Price Range Movements
(each item classified by the yoy % price change, expressed as a % share of 173 CPI items)

	below 0%	between 0-1%	between 1-2%	between 2-3%	above 3%
2006	33	10	12	11	35
2007	31	10	11	12	36
2008	23	9	14	18	36
2009	34	13	16	15	22
2010	37	15	17	10	21
2011	23	16	17	14	30
2012	22	13	16	18	31
2013	38	12	17	14	19
2014	31	17	17	11	25
2015	20	14	16	17	33
2016	28	14	16	18	25
2017	38	14	13	13	21
Recent Trend	up	stable	down	down	down

Source: Statistics Canada, LBS Economic Research and Strategy