Bank of Canada Decision – Firmly on Hold but Lots of Moving Parts

The Bank of Canada (BoC) left its overnight rate unchanged at 0.50%, as unanimously expected by markets participants.

The recent improvement in domestic economic conditions led the BoC to substantially revise up its Canadian real GDP forecasts for 2017 (from 2.1% to 2.6%) and leave 2018 virtually unchanged (from 2.0% to 1.9%). Combined with slightly lower potential growth estimates, the BoC sees the output gap closing in the first half of 2018, a bit earlier than previously estimated last January (mid-2018). But the faster pace of shrinking unused capacity is not sufficient to move the needle on the policy rate anytime soon. We fully agree with the two following key sentences of the statement:

- "*While the recent rebound in GDP is encouraging, it is too early to conclude that the economy is on a sustainable growth path*".
- "*The Bank's Governing Council acknowledges the strength of recent data, some of which is temporary, and is mindful of the significant uncertainties weighing on the outlook*"

Indeed, risks to the outlook highlighted in the *Monetary Policy Report* (*MPR*) indicate there are a lot of moving parts that could lead to a deterioration of the Canadian economy. For the BoC, the most important source of uncertainty is the "*prospect of a notable shift toward protectionist global trade policies*". Countervailing duties on Canadian softwood lumber products could be announced by the U.S. as early as April 24, while NAFTA renegotiations which could lead to a new free trade agreement are expected to begin later this year.

In our view, financial conditions are also slightly less accommodative as a stronger CAD, higher long-term interest rates in the US will weigh on Canadian growth. The BoC does not seem overly concerned for now about the U.S. economy, stating that most of the weakness in 2017Q1 was driven by "*a weather-related decline in the consumption of utilities*". In contrast to the BoC, we are somewhat more worried by the recent soft patch of U.S. economic releases. More precisely, a tightening in U.S. lending standards for consumer loans has weakened the growth of motor vehicle sales since the beginning of 2017. This could potentially become a new cyclical headwind for Canadian exports and business investment. Moreover, the BoC's base case scenario includes a positive contribution of 0.5pp to U.S. real GDP growth by mid-2019 from Trump's anticipated fiscal stimulus. Unfortunately, the tug of war between the White House and Congress over health care suggests that it may prove difficult to enact growth-friendly policies, such as broad-based U.S. tax reforms.

There are also some domestic-based risks to the outlook. For instance, the full-fledge impact of last year's tightening in mortgage rules by the federal government on housing demand is not fully known at this stage, a point acknowledged in the *MPR*. In addition, the Ontario government will soon announce targeted policies to curb speculative activities that could lead to further adjustments in the housing sector. On that front, the BoC has clearly raised a red flag, stating that "*Price growth in the GTA has accelerated and seems to have entered a phase in which speculation is playing a larger role*".

Altogether, there are a lot of moving parts that could lead to a deterioration of the Canadian outlook. We find upbeat the BoC's 2.6% real GDP growth forecast for 2017 (our own forecast calls for 2.3% real GDP growth this year - see our detailed Canadian economic forecasts at www.vmbl.ca). Granted, markets have been hoping for the best lately, chewing on some constructive economic releases. If the pace of economic growth continues to surpass potential, the set of three core inflation measures used by the BoC would logically pick up and trend towards 2%. This outcome would lead BoC officials to discuss the possibility of raising the policy rate. But, in our view, such a discussion is premature because the positive build-up in economic momentum still has to cross several hurdles. Canadian economic growth needs to become more broad-based in the medium-term (two-thirds of real GDP growth in 2017 is expected to come from household spending). Exports and business investment must contribute more positively to economic growth, a challenging situation due to the considerable uncertainty regarding tax and trade U.S. policies. This was the main message from the BoC today.

In summary, the BoC is firmly on hold at the moment. However, a negative shock could occur in 6-12 months from now, enough to bring back the possibility of a rate cut on the front burner. Until some of the considerable uncertainty clouding the outlook is removed, it is difficult for us to see if the BoC will be able to hike its policy rate in the medium term. Thus, we continue to forecast the overnight rate target to end 2017 and, most likely 2018, at 0.50%.

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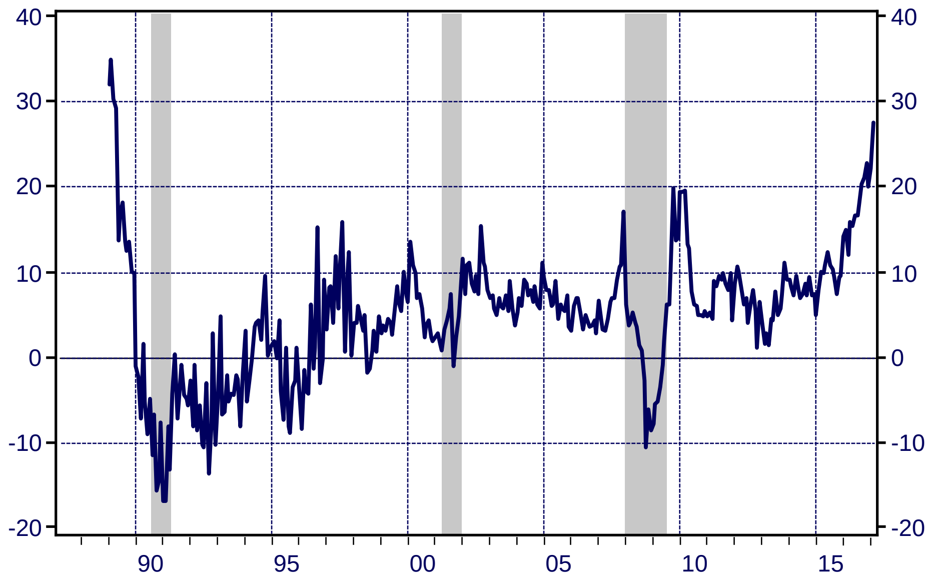
Average Resale Price: GTA Housing Market

(yoy % change)



Source: The Canadian Real Estate Association /Haver Analytics

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