Laurentian Bank Securities
ECONOMIC RESEARCH AND STRATEGY

Bank of Canada Decision – September

Very strong confidence in the Canadian economic recovery led BoC officials to increase the overnight rate target by 25 basis points for the second time in eight weeks. The BoC policy rate now stands at 1.00%.

The BoC statement begins with a very upbeat commentary on the broad-based strength in consumer spending, business investment and exports. Overall, stronger-than-expected domestic economic activity was sufficient to look beyond global geopolitical risks and uncertainties related to U.S. trade and fiscal policies. Also, in contrast to our expectation, the BoC did not judge that low CPI inflation justified pausing until at least next October. Instead, the BoC puts faith in the standard argument that above-trend growth leads to higher inflation. The BoC thinks that the small increases in total CPI inflation (from 1.0% to 1.2%) and core inflation measures (from 1.4% to 1.5%) observed between June and July marks the beginning of sustained increase in inflation.

In an attempt to prevent markets from thinking that back-to-back 25 basis points increases in the policy rate imply an aggressive hiking path in the future, the BoC ends its statement with a more dovish commentary: "*Future monetary policy decisions are not predetermined and will be guided by incoming economic data and financial market developments as they inform the outlook for inflation*". One soft spot highlighted is the weak wage inflation observed despite the decline in unemployment. For instance, average hourly earnings (AHE) are up by only 1.3% on a year-over-year basis. A sign of acceleration in this wage measure will facilitate further removal of monetary stimulus in the coming months. Thus, markets should pay attention to the next AHE data point for the month of August which will be reported in Statistics Canada's LFS report on Friday morning.

Also, given the elevated 100% household debt-to-nominal GDP ratio (see the chart below), the BoC states that it will pay close attention "*to the sensitivity of the economy to higher interest rates*". Since the beginning of June for instance, the Canadian 2-year bond yield has increased by more than 70 basis points while the 10-year yield has risen by less than 50 basis points. This led, so far, to a significant flattening of the yield curve. Indeed the yield curve has now flattened close to levels unseen since 2008. Such flattening should be monitored cautiously as this may pressure bank margins and lead to a tightening in credit conditions (see the chart below). The good news is that, as we have yet not seen a significant widening in corporate credit spreads, an imminent economic slowdown seems unlikely. However, we are of the view that future changes in credit spreads need to be monitored closely as a warning signal of economic deterioration.

Finally, it remains to be seen to which extent higher interest payments will reduce discretionary spending and how higher rates will affect housing demand. For Canadians carrying an existing mortgage (based on an average mortgage balance of $235K), we estimate that each 25 basis points increase in rates will raise the average annual mortgage payment by $360. For a new mortgage (based on the Canadian average resale home price of about $500K and a 20% down payment), we evaluate the annual impact of a 25 basis points hike to be $630. The recent Bank of Canada decisions may thus convince more households to remain in the rental market.

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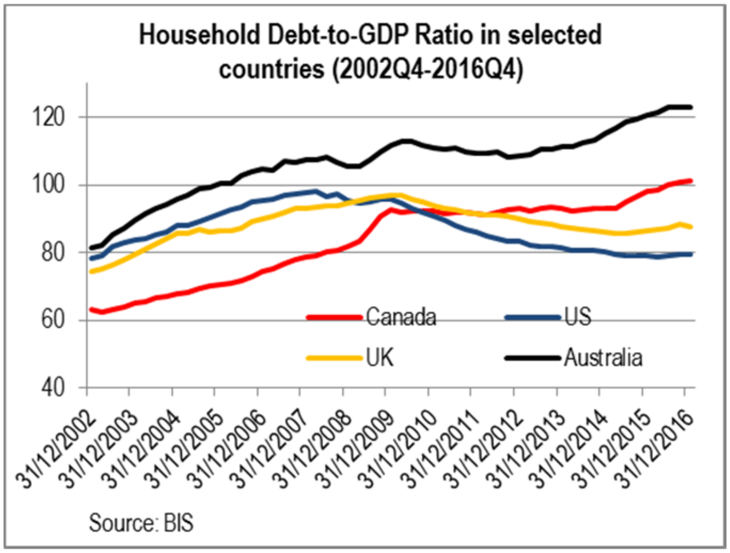

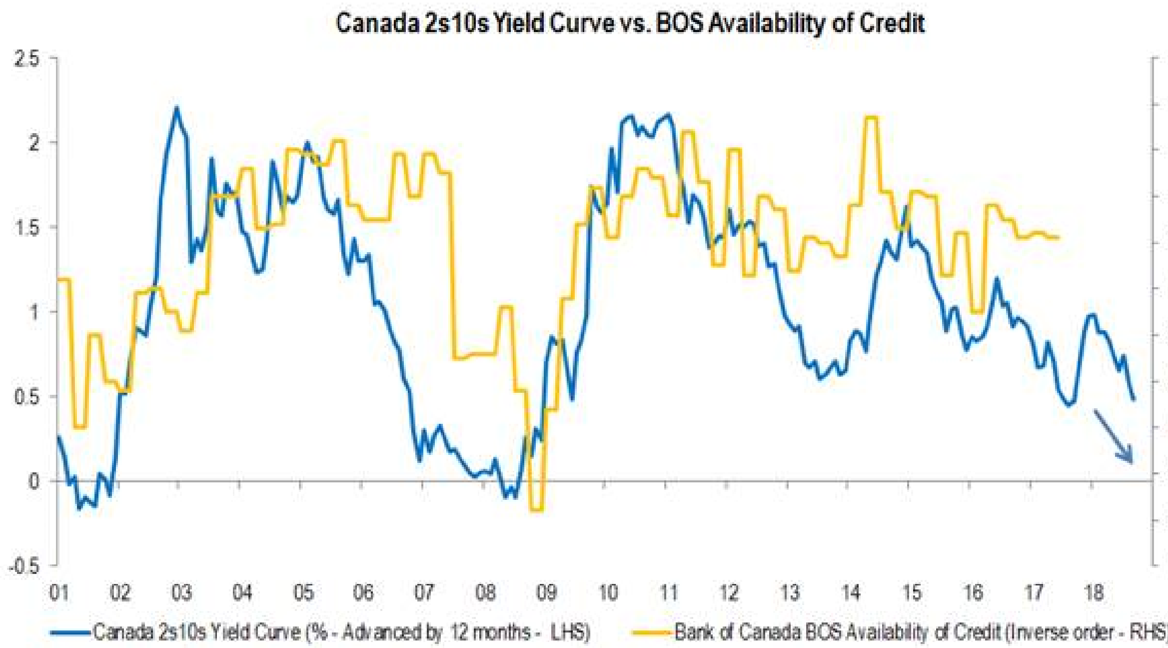

Source: LBS Economic Research & Strategy, Thomson Reuters, Bank of Canada Business Outlook Survey