BoC Interest Rate Decision – October: Aiming for a "Neutral" Rate

The Bank of Canada (BoC) increased its overnight rate target from 1.50% to 1.75% this morning. Financial markets were surprised by the hawkish statement relative to the September decision. If the *MPR* outlook projecting above-potential economic growth materialises, the BoC thinks it will be appropriate to increase its policy rate closer to a "neutral stance" sooner than later. In other words, the BoC wants to end the long period during which monetary policy provided a tailwind to economic growth as it believes the economy no longer needs it. The neutral rate's estimates range between 2.50% and 3.50% according to various research papers, with 3.00% often used as a mid-point. The BoC is not as aggressive as some FOMC members looking to move the U.S. policy rate into restrictive territory; that is above the neutral rate, although we cannot rule out this outcome in the medium-term.

Markets were generally of the view that the BoC was not going to hike twice in back-to-back monetary policy decisions. This is no longer true. The BoC seems to have redefined their "gradual approach" to mean that tightening every second meeting might be insufficient to prevent inflation from accelerating. BoC officials thus appear more worried than this summer about falling behind the curve, a profound shift in the market's mindset in our view. This means that, if the current positive economic momentum holds and geopolitical and trade tensions do not generate excessive market jitters, another hike at the December 5th meeting cannot be ruled out and might in fact be expected. As of this writing, the probability of such an outcome was about 30% as reflected in the pricing of Canadian interest rate swaps. The 2-year and 5-year yield on Government of Canada bonds were also up by a few basis points on the news. Although markets were surprised this morning by the more pressing necessity of bringing back the policy rate to a neutral level, the timing of such an event remains elusive. It will depend on whether the data surpasses expectations or disappoints. BoC's Senior Deputy Governor, Carolyn Wilkins stressed in the press conference, that it was possible that the policy rate rises a bit faster or slower. Notably, the BoC mentioned that it will continue to closely monitor how the economy reacts to higher interest rates. Put simply, the BoC acknowledges that it is still data-dependent and pointed out that, since the market gets access to the same information as the BoC, "it should not be that difficult" to infer what the BoC is going to do as the high-frequency data gets published.

Bottom Line: The proactive BoC does not want to be perceived by market participants as being on auto-pilot when it comes to the pace of monetary tightening. We earlier forecast a 25 basis points policy rate increase in 2019Q1 followed by another one in 2019Q3. Today's upbeat tone from the BoC opens to the door for one additional hike in December 2018 and three hikes for the entire 2019 if the current expansion does not hit any major incident. Inversely, it is possible that the tightening cycle could end abruptly if economic activity turns south as a result, for instance, of households having difficulties absorbing higher rates. We also see growing signs that the global economy is moving closer to the late stages of the business cycle. Notably, a geopolitically triggered economic slowdown is a growing market concern. With the U.S. threatening to increase tariffs to 25% on over $500 billion worth of Chinese goods and services as soon as January 2019, trade uncertainty is still, unsurprisingly, the top risk surrounding the *MPR* outlook. All in all, the BoC, similarly to the Fed, may find it more challenging than it let on today to get back to a neutral stance within the next 12 to 18 months.

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