Laurentian Bank Securities
ECONOMIC RESEARCH AND STRATEGY

BoC Decision: BoC hints about the possibility of raising its policy rate above 1.00%

BoC officials turn their recent hawkish remarks into action. They increased the overnight rate target from 0.50% to 0.75%. This marks the first rate hike since former Bank of Canada governor Mark Carney's brief tightening cycle in mid-2010. Investors are now fully accepting the BoC's intention to remove the 50bps cut triggered by the 2015 oil shock. Combined with an economy likely to expand above trend, this should facilitate the rapid removal of another 25bps at the October 25th meeting, if not earlier at the September 6th meeting. Barring any economic disaster, we now see an increasing probability that the policy rate will be at 1.00% this fall.

Furthermore, the BoC is opening the door to the possibility of raising its policy rate above 1.00% without affirming it is going to follow through. "*Governing Council judges that the current outlook warrants today's withdrawal of some of the monetary policy stimulus in the economy. Future adjustments to the target for the overnight rate will be guided by incoming data as they inform the Bank's inflation outlook, keeping in mind continued uncertainty and financial system vulnerabilities*".

Without guiding the markets toward a gradual tightening cycle like the Federal Reserve, hinting about the possibility of raising the policy rate above 1.00% makes today's statement slightly more hawkish than market expectations. This intention is supported by an output gap now projected to close faster than previously anticipated (around the end of 2017 rather than in the first half of 2018 in the April *Monetary Policy Report*). Also, the possibility of embarking on a traditional hiking process is based on the view that CPI inflation will return closer to the 2% target by mid-2018. The BoC sees the current softness in core inflation as temporary but nonetheless revised down its inflation forecast in 2017 (from 1.9% to 1.6%) and 2018 (from 2.0% to 1.8%) before inflation increases to 2.1% in 2019. The BoC is attributing most of this softness to a few CPI items: food price competition, electricity rebates in Ontario and the impact of the CAD appreciation on auto prices. A more sustained weakness in inflation could in the cards in our view, as nearly 30% of the CPI components have been declining on a year-over-year basis. Also, some other developments could prevent the BoC from heading into an aggressive tightening cycle: stronger CAD, higher global longer term rates, lower crude oil prices, the beginning of a cooling down in GTA housing market and the gradual adjustment of indebted households to slightly higher rates.

Finally, the broadening global recovery is also supportive for the Canadian outlook. This being said, the BoC does not take into account any fiscal stimulus coming from Washington: "*the prospects of expansionary US fiscal policy are less clear than they appeared in April, given delays in decision-making processes. Consequently, the fiscal stimulus assumed in the January and April forecasts has been removed*". Any positive developments on that front would reinforce further rate hike expectations for 2018, which for now might appear premature.

Bottom Line: The BoC hit the markets' sweet spot today by hiking its policy rate by 25bps and hinting about the possibility of raising it above 1.00% in the medium-term. Altogether, we forecast the overnight rate target to end 2017 at 1.00%. As for 2018, for now, there are too many moving parts that could influence the Canadian outlook to firmly forecast further hikes. In the absence of a U.S. fiscal stimulus later this year, these might appear premature.

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