Laurentian Bank Securities

ECONOMIC RESEARCH AND STRATEGY

BoC Interest Rate Decision – Energy pain and interest rates bite delay the next hike

The Bank of Canada (BoC) left its overnight rate target unchanged at 1.75% this morning.

The BoC is now flexible to the idea of postponing the next hike to much later in 2019 without abandoning its quest for a neutral rate. The most striking passage of the statement is in the last paragraph, where the BoC added the words "over time": "*Governing Council continues to judge that the policy interest rate will need to rise over time into a neutral range to achieve the inflation target.*"

BoC officials came to this conclusion after taking into account several economic developments. Global GDP forecasts were not revised lower across the board even though the flattening of the U.S. yield curve and the tightening in financial conditions were mentioned in the *MPR.* However, the Canadian economic outlook was revised down due to domestic factors. Notably, the BoC recognizes that lower crude oil prices will weigh down on Canadian economic activity in 2019. Indeed, investment in the oil and gas sector is projected to decline by 12% in 2019 (a 1.5% decline was projected in the October *MPR*). Also, softer housing activity is expected to remove 0.1pp from real GDP growth in 2019 as the past increase in interest rates will continue to bite household spending. Altogether, Canadian real GDP growth is projected to slow from 2.0% in 2018 to 1.7% in 2019. This softer pace of economic growth reintroduces excess supply in the economy. According to one calculation from the BoC staff, the output gap is estimated to lie at -0.4% in late 2018, down from about 0.0% a few months ago.

This being said, a gradual strengthening in momentum is expected in business investment and exports excluding the energy sector. Thus, the BoC forecasts real GDP growth to accelerate above potential at 2.1% in 2020. This should be sufficient to bring back CPI inflation close to the 2% target, thus calling for a slightly higher policy rate down the road.

Bottom Line: Even though some market participants have started to talk about rate cuts in North America during the last week, this option will not be on Governor Poloz's table as long as its base case scenario materializes. This being said, in the risks associated to the outlook, the BoC warns that an escalation of trade tensions between the U.S. and China could lead "*to a more severe fallout*". Inversely, an easing in trade tensions could bring the BoC back into a more frequent hiking mode. Finally, the BoC's base-case scenario fits with our current policy rate outlook. We remain confident that the overnight rate target will end 2019 at 2.25% as economic momentum eventually strengthens. The last 25 basis points policy rate occurred in October 2018 and we expect the next one to occur on May 29th at the earliest. We forecast another 25bps hike at the July or September meeting.

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