Public Sector Debt

FICC Strategy

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Quick Hit – BoC resistance is futile (or is it?)

By Warren Lovely/Taylor Schleich

The US Federal Reserve stands on the cusp of a fresh monetary policy easing cycle, the first since 2007-08 and only the fifth in the past quarter century. As remarkable as it may be that the US monetary policy authority feels compelled to act whilst America's jobless rate sits at a 50-year low, cuts are all but a done deal. Indeed, in the face of slower growth and subdued inflation, monetary policy makers are loosening things up in many corners of the globe. Here, we explore whether the Bank of Canada can (or should) buck this easing trend. Or is Canadian resistance in the face of such a coordinated effort unwise and ultimately futile? The following table explores either side of the debate, signaling (via a green checkmark) which argument *FICC Strategy* tends to find most persuasive.

	Why the Bank of Canada should resist cutting	Why the Bank of Canada should follow the Fed lower
Policy independence	"Just because your friends jump off a bridge [or cut rates], doesn't mean you have to?" Every kid has heard a variation of this admonishment from their parents, and some may be inclined to apply this type of thinking to central bank policy. Canada is its own country after all, and our economy can (and often does) move to the beat of a different drum. We've explored disconnects in Canadian-US real GDP and FDD growth and they're non-trivial. Along the same line, recent North American economic data have tended to surprise in different directions, generally topping expectations in Canada and missing the mark in the US. More than industry/sectoral make-up, there are fundamental differences in Canada-US demographic trends, social policy priorities and general government fiscal posture (among other things) that could (at least theoretically) allow for monetary policy divergence.	We've nothing against principled stands, but no one is questioning the Bank of Canada's independence. Poloz doesn't take orders from Powell, even if the latter has been pressured by one Donald J. Trump. Fact is, the US, China, Japan, Europe and Australia favour easier policy because growth has slowed and/or inflation has failed to arrive as expected. What are other forward-looking central banks seeing that the BoC is not? Can Canada's small-open-economy really prove immune to a more anemic global backdrop? Judging from long-term correlations, Canada's not had a lot of success bucking global growth trends. That's probably why Canada's official policy rate has tended to move up and down with the crowd, and why the BoC has participated in every FOMC easing cycle (albeit sometimes with a lag) since the o/n target became Canada's main monetary policy instrument in the mid-1990s.
Relative policy rates	There's another school of thought, derivative of the above, focused on *relative* policy rates. With the Fed having outgunned the BoC on the way *up*, the upper bound of the US overnight target band is (for the moment) 75 bps higher than in Canada. The burden of easing must surely rests more squarely on Powell than it does on Poloz, or so the thinking goes. In other words, the BoC can simply sit back and let the Fed bring its policy rate more in line with where it sits north of the border. You might think of this as a way of (indirectly) importing looser policy in Canada (i.e., Fed cuts bolster the US outlook, allowing Canadian exporters to piggyback on marginal demand). Sounds good on paper but...	Relative interest rates exert significant influence over currency valuations. Full stop. So there's an understandable worry that leaning against the global monetary policy easing could trigger a stronger C\$... particularly since a degree of BoC easing is already priced in. Analysis by our FX strategy colleague, Sandra Kagango, suggests that driving the Canada-US 2-year interest rate differential (currently -35 bps) to zero could take CAD as far as 1.24 (i.e., ~4% stronger than current levels), *all else equal*. In light of Canada's complicated investment/export outlook (due in part to tax competitiveness worries and geopolitical uncertainty), currency appreciation linked primarily to relative policy settings could well jeopardize growth and the longer-term productivity picture.
Inflation	As it stands, Canadian core inflation is running right on top of the BoC's 2% target. Our *Economics* colleagues would highlight even greater pressure/heat on a shorter-term, seasonally adjusted basis. As for the US, one of the Fed's preferred measures—the core PCE deflator—is up just 1.6% year-on-year. Nor does it appear that Canadian inflation expectations have eroded like they have stateside. Meantime, Canadian wage growth looks to have picked up, with average hourly earnings for permanent workers advancing ~3% year-on-year. For an inflation-targeting BoC, these are non-trivial considerations.	While BoC's three core inflation measures averaged 2% (as of June), the measure with the best empirical fit with the output gap (CPI-Common) just happens to be the tamest (at 1.8%). We no longer use CPIX as a policy guideposts, but that former core measure averaged 1.7% during the first half. As for wages, competitive pressures may blunt the ability of firms to pass on higher costs to consumers. Overall, if you're looking for justification to cut in Canada, there isn't a lot to seize on here. But should trend growth hold below potential (see below), a wider output gap might open the door to BoC easing down the road.
Growth	Adopting the glass-is-half-full approach, Canada looks to be moving past earlier weakness in GDP growth. (Mind you, the bar's set pretty low when comparing to the 0.3% average annualized growth eked out in 2018:Q4-2019:Q1.) Second quarter forecasts will be fine-tuned tomorrow (once we see May GDP), but at this point Q2 should deliver at least 2% growth (AR). No question, healthy labour markets arm consumers with legitimate fire power. Meanwhile, Canada's so-called "positive fundamentals" are seeing certain housing markets regain some footing. Indeed, real residential construction activity should contribute positively to Q2 growth (after racking up 7 declines in the prior 8 quarters).	Growth may have bounced back in Q2, but on a trend basis, Canada's expansion is running well shy of the non-inflationary speed limit. Without being too swayed by global anxieties, it's not too hard to envision a scenario where lukewarm Canadian growth extends into 2020 (even allowing for a prospective LNG construction pop). Housing regained a heartbeat in Q2, but broad measures of interest-sensitive demand are hardly setting the world on fire. After a spring-time bounce, business sentiment has been shaken a bit. There's also fiscal restraint in a couple major provinces to factor in, which could well neutralize stimulus from Ottawa and some other provincial jurisdictions.
Household behaviour	For years, an unprecedented (and rising) level of Canadian household indebtedness has been flagged as a serious concern/vulnerability. It was one of those domestic risk factors you simply couldn't look away from. Higher interest rates, alongside a series of tougher macroprudential measures and select provincial tax changes, have been credited with taming this risky behavior, bending the curve on household debt growth lower. Undoing earlier rate hikes (even partially) would presumably encourage Canadians to leverage back up. Do we really want that? After all, as the BoC put it in July's *Monetary Policy Report*: "the vulnerabilities associated with indebtedness would be exacerbated if the additional spending were financed by more borrowing. This would worsen the impact of an adverse shock in the longer term".	As perverse as it sounds, pulling trend growth back up to potential in the near-term might just require going back to household debt/housing well via lower rates. Given the anticipatory nature of markets, we've already seen posted mortgage rates move lower. Modest BoC easing might not drag 5-year fixed rates much lower (underlying yields are ultra-lean after all), but failing to cut might undo/reverse some of the mortgage interest rate relief we've recently enjoyed. And what of those healthy labour markets and sturdy bank capitalization levels everyone crows about? Surely they diminish the threat of marginal mortgage debt... particularly since tough macropru policies continue to substitute for higher rates. While hardly the sole consideration, lower rates could likewise encourage developers/builders to bring much-needed housing supply to key markets, potentially alleviating affordability concerns.

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Geopolitical	Far from a becalmed geopolitical backdrop, a particularly acute source of concern to Canada was seemingly defused with last year's successful negotiation of the United States-Mexico-Canada Agreement (USMCA). While not-yet-ratified, you'll have no trouble finding key members of US administration touting the benefits of the deal. And it's fair to say that the new deal eased business anxiety across Canada. In the extended wake of that agreement, the US stood down on steel/aluminum tariffs (allowing Canada to end its own retaliatory measures). Trump and Trudeau even managed a reasonably constructive bilateral meeting a few weeks back, identifying common ground across a host of important areas. To some, this is evidence of calmer heads (or at least common sense) prevailing, as the economic fallout from a serious disruption to such a highly integrated North American trading relationship would have been severe.	When it comes to the USMCA, successful negotiation is not to be confused with legislative ratification. While Mexico has approved the deal, and Canada stands ready to do the same, Democratic objections over labour, environment and patent protections just saw the US Congress punt ratification to at least September (earliest). So a degree of uncertainty lives on. Elsewhere, Brexit fears continue to weigh on sentiment. To some, the rise of Boris Johnson in the UK increases the risk of a messy divorce (i.e., a hard Brexit), a view endorsed by some currency traders judging from where cable has slumped to. Stay tuned. Moving on, a China-US trade spat has had a tangible impact on trade/investment flows around the world. While a temporary truce was struck at the G-20 meetings last month, this heavyweight dispute may be far from over. Canada finds itself caught up in this feud too; just ask our farmers. Add in simmering worries over potential US tariffs on European and Japanese automakers and its little wonder that a *Global Economic Policy Uncertainty Index* is so darn elevated. While far from a perfect solution, easier monetary policy is one way of combatting geopolitical dysfunction. ✓
Cdn election	Canadians will be headed to the polls for a federal election on October 21st. Public opinion polls generally point to a tight race and we've no interest in making a bold political prediction here. Let's just say that advanced economy central bankers generally prefer to avoid even the appearance of political meddling, and are thus loathe to change rates in/around elections (absent a legitimate economic/financial crisis of course). There's something to be said for this line of thinking, which would be consistent with staying on hold until at least the votes are counted.	We've no doubt that Poloz has little interest in injecting himself into this fall's vote. And there's hardly a raging crisis that warrants such a swift pivot to lower rates. So even if the Fed follows a July cut with another move lower in September, October 30th would presumably be the earliest the Bank of Canada would think to join in. In the grand scheme of things, this unofficial election-related BoC blackout might just burn off around the time the case for (or potential benefits of) modest monetary stimulus becomes clear(er).

NA

Bottom Line: As the above discussion is meant to demonstrate, the Bank of Canada's reaction function to a looming FOMC easing cycle is hardly clear cut. You'll find various analyst/commentators and market practitioners camped out on either side of the "stand your ground" vs "follow the Fed" debate. We won't pretend to have all the answers, nor are we interested in disparaging alternative viewpoints. Ultimately, much will depend on how far and how fast Powell and Company end up moving. If the US and global backdrop warrants 75-100 bps of cumulative FOMC easing via a handful of cuts through next spring—our internal base case and a view largely embraced by rates traders—it could prove increasingly difficult for the Bank of Canada to resist its own modest easing cycle. In such a scenario, 50 bps of BoC easing, starting as early as October, might be a reasonable assumption. The partial, if not complete convergence in Canada-US overnight target rates we then anticipate might be consistent with a somewhat stronger loonie, *ceteris paribus*. But that lower Canadian policy rate setting would serve to re-steepen Canada's yield curve, extending the life of today's somewhat tired expansion.

Note: The views expressed here are those of FICC Strategy. For those interested, we're happy to share our comprehensive analysis of past FOMC easing cycles, which provides a primarily Canada-US perspective on what we've typically observed across rates, credit, currency and commodity markets. Contact your NBCFM Sales representative for a copy.

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