Highlights

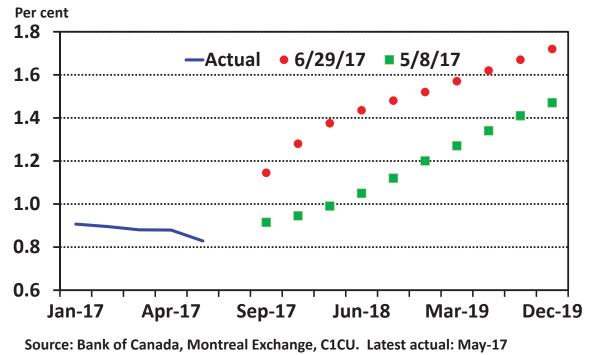
- Dramatic shift in rate expectations due to Bank of Canada comments
- July rate hike coming, followed by September move
- Removal of monetary stimulus gradual thereafter

A dramatic and sudden shift in Canadian rate expectations occurred following a speech on June 12 by the Carolyn Wilkins, Senior Deputy Governor of the Bank of Canada. The speech outlined recent economic gains and contained comments on monetary policy considered that were considered hawkish. Governor Stephen Poloz has reiterated those comments on two occasions thereafter. The Canadian dollar appreciated sharply and long Government of Canada bond yields jumped. Futures markets and forecasters quickly pulled forward a bank rate hike to this year from 2018 with the three-month BA futures pricing one 25 bps increase at the July meeting.

The key comment by Wilkins was: "As growth continues and, ideally, broadens further, governing council will be assessing whether all of the considerable monetary policy stimulus presently in place is still required." Adding fuel to rate expectations the next day was Poloz commenting, "… the interest rate cuts we put in place in 2015 have largely done their work. So that's very reassuring, we're encouraged by the data." He was referring to the bank's two rate cuts in response to the sharp drop in oil prices, which resulted in a brief economic contraction in 2015 and weak growth in 2016.

That the Canadian economy has generated a better data flow since the second quarter of 2016 following the Alberta wildfires, the energy-dependent provincial economies are in better shape, more industries are contributing to growth, and there is less slack in the economy is well documented. A key question is whether this growth resurgence is transitory and prospects are sufficiently positive to warrant a rate hike.

Another aspect is the desire to give the bank more flexibility, or buffer, if rate cuts are needed in the future. After raising the policy rate to its prior 1.00 per cent level, the bank would remain data-dependent



Source: Bank of Canada, Montreal Exchange, C1CU. Latest actual: May-17

and set rates as required, likely a on gradual upward trajectory.

We take a closer look at the Canadian economy and remind ourselves of the bank's policy objective and guideline, which is to target a two per cent inflation rate considering the outlook for overall inflationary pressure and related risks, to set the appropriate stance for monetary policy.

Real GDP growth in Canada has averaged 3.5 per cent annualized since the Alberta wildfires, well above the bank's potential growth estimate of 1.0 to 1.6 per cent. A strong rebound from a shock event is a typical economic pattern and explains some of this faster growth along with federal government tax cuts. The main growth drivers during the last three quarters were personal consumption, exports, and inventories while weakness in business investment and government spending stood out. High growth phases have occurred previously with the last three per cent plus phase in the second half of 2013 and again in 2010 and 2011.

Recent real GDP overstates the strength of Canada's economy. Final domestic demand, real GDP excluding trade and inventories, averaged 2.1 per cent annualized in the last three quarters. This too is above the bank's potential growth estimate.

First quarter 2017 real GDP growth came in at 3.7 per cent annualized, a result that caught the attention of many and was slightly higher than the bank was forecasting. Delving into the details reveals a notable feature – a large inventory buildup amounting to 3.6 percentage points of real GDP growth.

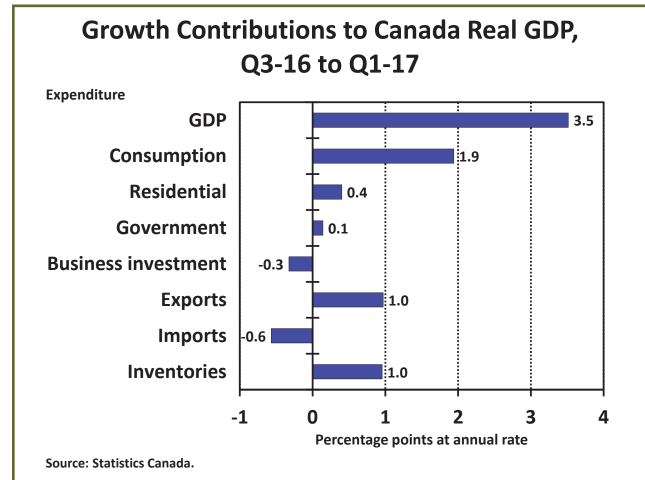
Personal consumption, residential investment, and business investment were significant growth drivers at 4.5 percentage points combined. Exports did not contribute to growth. GDP growth would have been even higher if not for a large increase in imports dragging down growth by 4.3 percentage points.

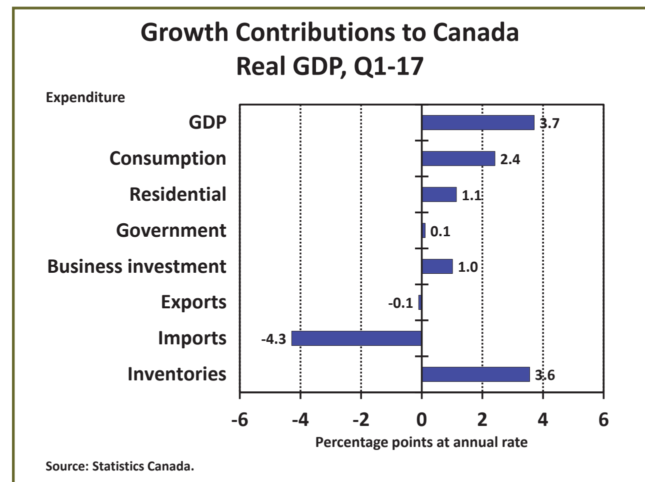
More recent main economic indicators are mostly positive, except for housing sales and starts. National housing sales are being pulled down by Ontario, which is reacting to the province's Fair Housing Plan introduced in April. Manufacturing and wholesale inventories increased in April, and while only a portion of total inventories is captured in GDP, it suggests the potential for less production ahead. However, inventory-to-sales ratios held steady.

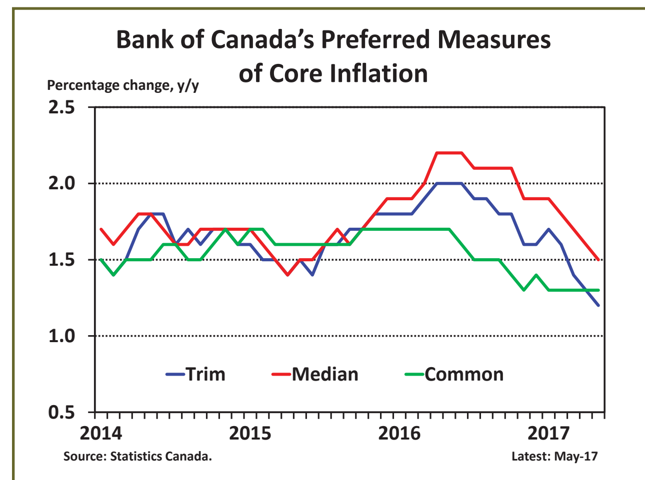
Inflation remains below the bank's target at the low end of its one to three per cent range. Various inflation measures complied by the bank are currently between 1.2 and 1.5 per cent annually. Soft inflation has prevailed since the 2008-09 recession with some above-two per cent phases due to transitory factors. On this front, the bank has no immediate cause to raise interest rates but the bank must be forward-looking because of time lags involved between economic conditions and inflation, usually more than one year. In addition, in the past the bank has raised rates when inflation was below target and could again.

A key driver of inflation is wages, which remain subdued due to labour market slack, notwithstanding recent large employment gains. Current slack in the labour market is high at a 6.7 per cent unemployment rate in May and 9.3 per cent including discouraged searchers, a waiting group, and a portion of involuntary part-timers. This broader unemployment rate measure was above 12 per cent in 2009. Wages are a lagging indicator given structural conditions such as annual increases. The widespread impact of wages on inflation is more problematic for central bankers than energy or food prices because it can become entrenched and more difficult to contain.

The latest assessment of economic slack comes from the bank's output gap analysis in its April Monetary Policy Report (MPR). A new forecast and assessment will be released in its July report. The bank's projection for the output gap (potential GDP minus actual GDP) calls for it to close in the second quarter of 2018. Previously, the bank saw the output gap closing in the third quarter. This advance was due to a higher 2017 GDP growth forecast (2.6 vs. 2.1) and a reduction in potential output growth to a midpoint of 1.3 per cent from 1.5 per cent. If potential output growth were left unchanged at 1.5 per cent, the output gap would not close until late 2018.







Potential GDP is a theoretical concept, not measurable, but it is important because monetary policy-makers use the output gap to determine whether the economy needs more or less monetary stimulus. The bank reports potential growth in a range because of measurement uncertainty. Current ranges are 1.0 to 1.6 per cent in 2017, 1.1 to 1.7 per cent in 2018, and 1.1 to 1.9 per cent in 2019. There is a cyclical component to potential GDP growth, which is currently at a trough. The bank does not rigidly set rates based

on the output gap only, it is one guidepost among several.

The bank's Labour Market Indicator suggests that the workforce remains underutilized, more than the actual unemployment rate indicates. With subdued growth in labour costs and core inflation below two per cent, there could be more excess slack in the economy than the midpoint output gap suggests.

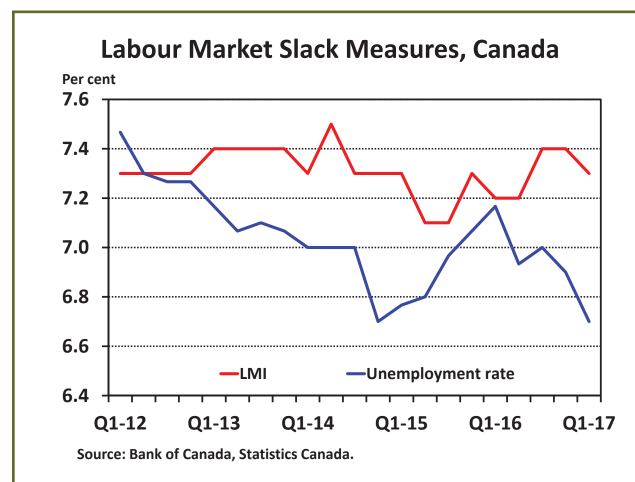
The governor has often stated that a sustained increase in exports and business investment is needed before monetary stimulus should be removed. Recent data shows exports leveling out and business investment down about 20 per cent since the oil price collapse. Energy exports are expanding and holding up total exports, but excluding energy, total exports are down. In addition, exports excluding motor vehicles and parts are even lower. Non-energy and non-auto exports are the lowest since mid-2014.

With oil prices below $50 US amid an uncertain outlook, no major increase in energy investment spending is likely. The last Statistics Canada survey indicated a 2.3 per cent increase in 2017 investment intentions driven by conventional oil and gas with non-conventional (oilsands) down significantly. This survey was taken when WTI hovered around $50 US and the Canadian dollar 75 US cents. Currently, WTI is around $45 US and the dollar 77 US cents, which are less supportive for new investment. The futures market is pricing WTI less than $50 US through 2019, while the consensus forecast is less than $55 US through 2018.

The bank has correctly concluded that "the adjustment to lower oil prices is now largely behind us." However, there are lingering impacts of the oil price collapse such as still high unemployment and excess physical capacity in some oil-dependent provincial economies, low current and future capital investment spending, and low prices. Some of the recent increase in energy exports and production is due to prior investments in production capacity being completed.

The recent rise in CAD will come into consideration by the bank. The US-CAD exchange rate is around 77 US cents, up from 73 US cents in early May. However, this higher level is in line with values seen earlier and should not cause the bank much concern. The CAD's rise is related to USD weakness and higher Canadian rate expectations despite low oil prices.

More importantly, the bank will consider global growth prospects, which have improved this year. Most recent data are the preliminary or flash PMI survey results for June. The U.S. flash PMI slowed



from May but remained well above the 50-expansion mark. A similar slowing played out in the flash Eurozone Composite and Japan Manufacturing PMIs. Leading economic indicators for key economies from the OECD and others point to ongoing growth in the near term.

Annual U.S. economic growth through 2019 is seen in the 2.0 to 2.5 per cent range with China slowing to 6.0 per cent in 2019. European Union growth prospects have improved recently and forecasts call for near two per cent annual growth. Global growth is bolstered by the economies of Brazil and Russia exiting recessions and faster growth in South Asia, notably from India.

The main risks for the next global economic recession are geopolitical and trade policy. Substantial financial imbalances causing a recession are not present and are unlikely to unfold under tighter financial regulations in effect since the Great Financial Crisis. Economic imbalances due to high debt levels, excessive investment spending, and speculative activity are not widespread and are limited to certain countries and sectors, which have received some attention by policymakers.

Canada's growth prospects are fairly positive but are expected to slow in the near term. The April industry GDP release supports this view, along with less support from the temporary growth drivers in the first quarter. The bank's projection is 2.5 per cent annualized real GDP growth in the second quarter and an implied 2.1 per cent average in the second half. After 2017's 2.6 per cent growth, the bank sees 1.9 and 1.8 per cent in 2018 and 2019, respectively.

The bank has CPI inflation rising to 2.0 per cent by the end of 2017, which appears high given recent low readings. This forecast will be adjusted down in the July MPR with the inflation trajectory remaining upward from here.

Economic Forecast – Canada								
	2016 Q4	2017 Q1	2017 Q2	2017 Q3	2016	2017	2018	2019
Real GDP, % annualized	2.8	3.7	2.5	2.0	1.5	2.7	2.0	2.2
Unemployment Rate, %	6.9	6.7	6.6	6.5	7.0	6.5	6.3	6.1
Total CPI, % y/y	1.4	1.9	1.6	1.7	1.4	1.7	1.9	2.1

Source: Statistics Canada, Central 1 Credit Union. Shaded values are forecasts.

This forecast is slightly more positive at 2.7 per cent growth in 2017 with a similar 2.5 per cent expectation for the second quarter and slower second half. CPI inflation looks to remain below two per cent through 2018.

The bank's communications have not telegraphed the dramatic shift in rate expectations until most recently. At the April rate announcement, the end of the oil price shock was acknowledged as were temporary factors boosting first-quarter growth and lacklustre exports and business investment. "In short, the economy is not yet firing on all cylinders." The May rate announcement concluded," ... the current degree of monetary stimulus is appropriate …"

Some of this shift can be explained by stronger GDP data than previously estimated, not only in the bank's forecast, but also to upward revisions in underlying data compiled by Statistics Canada released on May 31. The bank, along with all forecasters, is data-dependent.

In a rare statement, higher potential output growth was mentioned in the bank's April MPR as an inflation risk. The report stated: "Uncertainty associated with the bank's estimate of potential output is large. The current level of potential output could be higher than estimated, resulting in more excess supply and less inflationary pressure than currently assessed." The July MPR will likely not change the bank's potential output estimates because it is on an annual reassessment schedule. In this opinion, potential output growth is higher than currently estimated.

The case for raising the policy rate this year is compelling based on the bank's most recent communications, GDP data, and the bank's estimate of potential output. Factor in the bank's prior history of raising an ultra-low policy rate to create a buffer, as in the year following the financial crisis, and conditions are set for a policy rate increase. The futures market has got it right.

The next questions are by how much and how fast? A 25-bps increase in the overnight target rate to 0.75 per cent at the July 12 meeting is a near certainty. Only very negative economic or geopolitical news released prior to the meeting could delay the move. The bank appears keen on returning to the pre-oil shock policy rate of 1.00 per cent so another 25-bps increase is expected at the September meeting. Thereafter, the removal of monetary stimulus will be gradual and data-dependent.

Higher T-bill rates and bond yields have occurred in anticipation of the bank's move in July. Lending and deposit rates will follow shortly. The move to normalize interest rates shifts the yield curve upward resulting in a slightly steeper curve. Normalization will take four to five years, possibly longer, with the policy rate between 2.5 to 3.0 per cent. The bank will aim to raise rates at a speed the economy can accommodate, otherwise it may cause a slowdown prompting lower rates.

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Target Overnight Rate Forecast	
Meeting Date	(Per cent)
May 24, 2017	0.50 (a)
July 12	0.75
Sep. 6	1.00
Oct. 25	1.00
Dec. 6	1.00
Jan. 2018	1.00
Mar.	1.00
Apr.	1.00
June	1.00
July	1.25
Sep.	1.25
Oct.	1.25
Dec.	1.25
Jan. 2019	1.25
Mar.	1.25

Source: Bank of Canada, Central 1 Credit Union. (a) actual

Interest Rate Forecast									
	2017 Q1a	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
Target Overnight Rate	0.50	0.50	0.75	1.00	1.00	1.00	1.25	1.25	1.25
Prime Rate	2.70	2.70	2.95	3.20	3.20	3.20	3.45	3.45	3.45
1-mo. T-Bill	0.43	0.50	0.65	0.90	0.95	0.95	1.15	1.20	1.20
3-mo. T-Bill	0.47	0.55	0.75	1.00	1.00	1.00	1.25	1.25	1.25
6-mo. T-Bill	0.52	0.60	0.85	1.10	1.05	1.05	1.30	1.30	1.30
1-year T-Bill	0.61	0.70	0.95	1.20	1.15	1.15	1.40	1.40	1.40
2-year GoC Bond	0.77	0.75	1.10	1.30	1.25	1.25	1.50	1.50	1.50
3-year GoC Bond	0.90	0.85	1.15	1.35	1.30	1.30	1.55	1.55	1.55
5-year GoC Bond	1.14	1.05	1.40	1.60	1.55	1.55	1.85	1.80	1.90
10-year GoC Bond	1.71	1.50	1.80	2.00	1.90	1.95	2.25	2.20	2.30

Source: Bank of Canada, Central 1 Credit Union. Note: Quarterly average based on daily data. a = actual, all others forecast.

Deposit Rate Forecast									
	2017 Q1a	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
1-year GIC	0.73	0.75	0.80	0.95	0.95	0.95	1.20	1.20	1.25
3-year GIC	1.08	1.00	1.00	1.20	1.20	1.20	1.40	1.40	1.40
5-year GIC	1.30	1.10	1.20	1.35	1.35	1.35	1.55	1.55	1.65

Source: Bank of Canada, Central 1 Credit Union. Note: Quarterly average based on weekly data. a = actual, all others forecast. Non-redeemable semi-annual rates from Bank of Canada based on typical rate (mode) at six major banks.

Mortgage Rate Forecast									
	2017 Q1a	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
1-year Mortgage	3.14	3.15	3.35	3.55	3.55	3.55	3.75	3.75	3.75
3-year Mortgage	3.39	3.40	3.60	3.75	3.75	3.75	3.95	3.95	3.95
5-year Mortgage	4.64	4.65	4.80	4.95	4.95	4.95	5.15	5.15	5.25

Source: Bank of Canada, Central 1 Credit Union. Note: Quarterly average based on weekly data. a = actual, all others forecast. Posted fixed term rates from Bank of Canada rates based on typical rate (mode) at six major banks.