A Hawkish Hike for the Bank of Canada

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The Canadian economy has been undeniably strong this year, experiencing strong job creation, robust GDP growth and solid Business Outlook Survey results indicating positive business sentiment. This strong economic data along with recent hawkish statements from various members of the Bank of Canada (BoC) led the market to price in a rate hike for this month. On Wednesday, the BoC met these market expectations by raising the target overnight interest rate by 25 basis points to 0.75%. Although the market was broadly expecting an increase, it is notable as it marks the first rate hike in roughly seven years.

Diving into the statement

One of the major arguments against tightening policy is that inflation is actively falling, and for an inflation-targeting central bank, it seemed like a peculiar time to raise rates. However, the Bank targets inflation in the future, not today. In its statement, the BoC indicated that it expects inflation to be near 2% by 2018. They explained away inflation worries by stating that this recent decline is transitory in nature, briefly distorted by grocery competition, electricity rebates and automobile prices.

The statement was more hawkish than many, ourselves included, had anticipated. The BoC's assessment is that growth in Canada has broadened across industries and regions, leading to a more sustainable Canadian growth picture. The central bank has upgraded its growth forecasts for 2017 from 2.6% to 2.8% as a result. The economy was described as being "robust" with a significant amount of economic slack absorbed, and the output gap is now expected to be closed by the end of 2017 rather than sometime in the first half of 2018. This is a significant shift, since an economy operating at full potential by the end of this year arguably justifies notably higher interest rates.

Despite an aversion to forward-looking statements, the announcement hinted strongly at further rate increases. While further actions are explicitly data dependent, it is important to note that the simple act of mentioning the possibility of further tightening is a bold stance in itself given the central bank's previous aversion to forward-looking statements. Canadian government bond yields and the loonie rose after the hike on speculation that the BoC will raise rates again later this year.

Risks we continue to monitor

While the Canadian economy is certainly strong right now, we are cautious over the medium term due to several risks. These include the prospect of a growing competitiveness wedge between Canada and the U.S. and an overextended housing market. The competitive gaps for Canada centre around the potential impact of new tariffs (particularly as it relates to softwood lumber, the dairy industry and steel), stricter environmental laws in Canada relative to the U.S., the impact of changes to both corporate and personal tax rates, and tighter labour laws in several provinces.

Fears about a housing market collapse have also been at the forefront for many investors. Recent regulations in Ontario have brought on some signs of cooling, similar to Vancouver just one year ago. However, despite more stringent lending requirements and declining sales volumes in major cities like Toronto, we don't believe the housing market is on the verge of collapse, particularly as important drivers like higher unemployment and rapidly rising lending rates are not currently in place. That said, even a minor slowdown in activity would weigh on GDP growth relative to prior years, so it is important to monitor housing activity to understand its influence on growth and future rate hike expectations.

Insights

The key debate going into this meeting was whether rate hikes should be viewed as purely an unwinding of the oil-shock-induced special stimulus from 2015 (with two 25 basis point hikes followed by a pause) or instead as the start of a bigger tightening cycle. Until today, the BoC speeches argued for the former; however, this announcement argues for the latter. We cannot assume this is a two-and-done situation anymore. We budget for a minimum of one further hike this year and are inclined to pencil in further tightening for 2018.

The actions taken by the BoC need to be viewed at least as a cog in a synchronized, coordinated tightening effort among major central banks. We have argued for some time now that the developed world has passed peak monetary stimulus. Even as some other central banks allow their balance sheets to grow a bit further, the pace is already beginning to slow. We do not expect a particularly fast or unified movement from other central banks but the winds are certainly beginning to shift. In turn, this underpins the gradual shift higher in bond yields globally.

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