Who let the hawks out?

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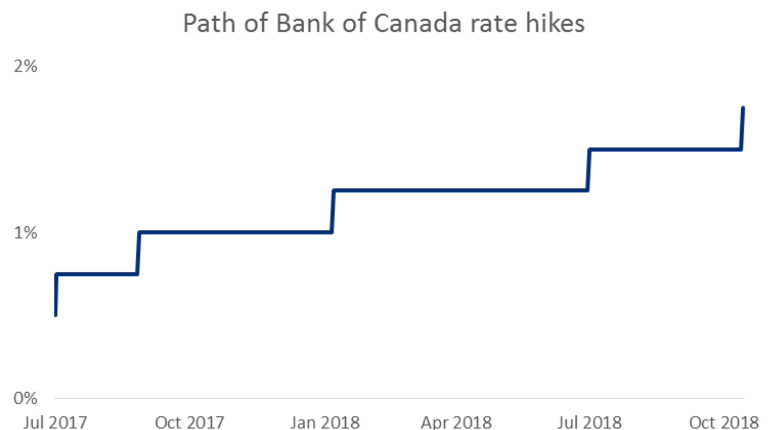
For the third time this year and fifth since July 2017, the Bank of Canada (BoC) elected to raise its benchmark overnight rate, increasing it from 1.50% to 1.75%. The October announcement came as little surprise to market participants who priced in a 90% probability of a hike leading up to the decision. With the increase coming through as expected, investors were paying close attention to the wording used by the BoC to gain further insights on the future course of rate increases.

Hawkish tone

The statement was arguably a little more hawkish than markets anticipated. This can be attributed to the BoC removing the use of the word "gradual" to describe the pace of future rate increases and the simultaneous addition of an explicit commitment to raise the policy rate to a "neutral stance". The shift in tone suggests an increased commitment to pushing ahead with further rate hikes, and that the default plan is to continue lifting rates until they are somewhere in the Bank's 2.5% to 3.5% estimate of a neutral rate. If delivered, that means three to seven additional rate increases from here.



Source: RBC GAM. Bloomberg. July 11, 2017 to October 24, 2018

Tight economy supported hike

The decision from the BoC was arguably the correct course of action given the tight Canadian economy as the unemployment rate dipped to 5.9% after strong employment numbers were announced in September. In addition, the latest Business Outlook Survey – a key guide underpinning BoC decisions – indicated businesses expect solid sales growth and anticipated difficulty meeting demand under the tightest economic conditions in a decade. The fact that the interviews were conducted before the U.S.M.C.A. agreement was reached suggests the business community may now be even more upbeat.

In the face of tighter labour markets, it's interesting to note that we have yet to see significant moves in wages. However, the Bank of Canada indicates that "wage growth … is projected to pick up in the coming quarters", and we concur. This could keep inflation at or above the Bank's 2.0% inflation target.

Recent developments

In the time since the BoC's last rate hike in July, there have been a number of encouraging developments. The global economic backdrop remains decent and U.S. growth is especially crisp. The new U.S.M.C.A has helpfully reduced trade uncertainty in North America. However, despite this North American progress, international protectionism remains a significant risk to the global economy with substantial uncertainties revolving around U.S.-China negotiations, along with residual drags related to U.S. tariffs on Canadian steel and aluminum.

Vulnerabilities related to the Canadian housing sector have edged lower as borrowing has slowed due to a combination of higher interest rates and stricter mortgage lending rules. However, despite these developments, the Canadian housing sector remains a threat to financial stability given high household debt levels.

Areas for caution

In addition to the mounting trade tensions, there are a number of other concerns clouding the economic outlook. A number of emerging-market nations are under stress from slowing Chinese demand, rising protectionism, a rising U.S. dollar and higher U.S. rates. Moreover, the financial market volatility that rattled investors in February and March of this year appears to be back as bond yields press higher.

Closer to home, the Canadian energy sector has not benefited from the broader rise in energy prices as the price for Western Canadian Select (WCS) oil is currently suffering a nearly $50 discount to the U.S. price due to persistent transportation bottlenecks plus a witch's brew of temporary factors.

Outlook moving forward

Taking the above in balance, it seems likely the BoC will continue its tightening journey at its next major meeting in January. The BoC's default plan is likely to continue tightening on a quarterly basis until such point as economic conditions no longer support such moves. We highlight the risk that it is not able to move quite so quickly given the prospect of slower global growth and the reality of competitiveness challenges in 2019.

As the BoC moves forward it will be important to maintain a watchful eye on the ability of Canadians to cope with higher interest rates and how the economy reacts to global trade tensions. For investors, it's important to keep in mind that if the neutral rate sits at approximately 3% - considerably ahead of the current policy rate of 1.75% - the implications are not quite as large as the bond market has already priced in a sizeable chunk of this future tightening.

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