A dovish hike for the Bank of Canada

After a year of strong economic data, capped off by a positive Business Outlook Survey and a string of strong employment reports, the Bank of Canada (BoC) elected to hike its overnight rate to 1.25% – the highest level since the financial crisis. The latest move officially signals that the BoC is in tightening mode after two rate hikes in 2017 acted to unwind the stimulus delivered in response to the oil shock in 2015.

How the market reacted

With strong economic and labour statistics rounding out 2017, the market pegged the likelihood of the BoC raising the overnight rate to 1.25% at over 90% in the days leading up to the meeting.

Investors were keeping a close eye on the announcement, particularly with respect to the central bank's language surrounding the prospect of future interest-rate hikes. This is of heightened interest, given that the BoC has been hard to read recently with messages in December about the Canadian economy reaching its potential while also lagging the United States by a few years as a result of the oil shock in 2015.

Despite raising its estimate of the Canadian economy's potential growth rate to 1.6% from 1.5%, coupled with positive fundamentals supporting the economy, uncertainty about the future of NAFTA is a large concern for the central bank. With this in mind, the BoC indicated future rate hikes will be warranted over time; however, some degree of stimulus is likely required to keep the economy operating close to potential and to keep inflation on target. The market reacted to the dovish tone of this statement with slightly lower bond yields across the curve.

Key highlights:

- The market was convinced the BoC would raise rates leading into the decision with a 90% probability of a move priced into the market.
- The move is being deemed dovish, signaling the BoC will remain cautious in considering future policy adjustments guided by incoming data.
- Looking forward, the market anticipates further rate hikes in 2018 with the consensus estimate of two more increases. We anticipate the BoC will take a more cautious approach as a number of headwinds may begin to mount for the Canadian economy.

Outlook for the Canadian dollar

The Canadian dollar's recent strength has been driven by the BoC's turn towards a tightening bias. Our view is that, over the medium term, there are headwinds facing the Canadian economy that may restrict the loonie's ability to continue appreciating from the BoC's tighter stance. These risks include:

- Protectionism and uncertainty surrounding the future of NAFTA.
- Whether Canadian competitiveness can keep pace as U.S. tax cuts work their way through.
- Increasingly tougher labour laws in Ontario and Alberta, particularly as effects of the significant increases in minimum wage are felt.
- Stricter environmental standards in Canada, including carbon levies.
- Oil and the extent to which rising U.S. shale production will contain prices over the medium term.

These headwinds could considerably reduce the impact of business investment and exports, which the BoC expects to contribute to growth. Furthermore, consumption and the housing market are expected to play smaller roles in generating growth as the implications of higher interest rates and new mortgage rules play out.

In today's currency markets, we see that growth is having a much larger influence as countries experiencing faster growth are likely to see their currencies outperform. If this trend continues in the future, we anticipate the above constraints will make it difficult for the Canadian dollar to strengthen further moving forward.

What's our outlook for future rate hikes?

It remains to be seen how quickly the BoC will raise rates from here and where they will eventually settle. Markets are anticipating three rate hikes in 2018, which would bring the overnight rate up to 1.75%. The BoC is seeking to accomplish a balance between gradually bringing interest rates back to normal levels amid strong growth and employment without triggering a slowdown. We do expect more rate hikes, though perhaps at a slower pace than the market anticipates. The BoC's new language – specifically, that continued monetary stimulus will likely be required to keep the economy operating close to potential and inflation on target – is supportive of our view.

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