

Special Commentary

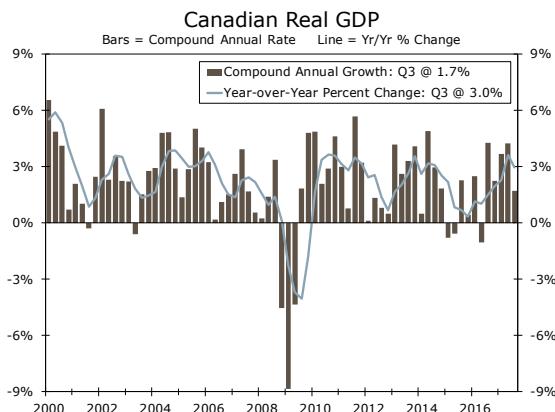
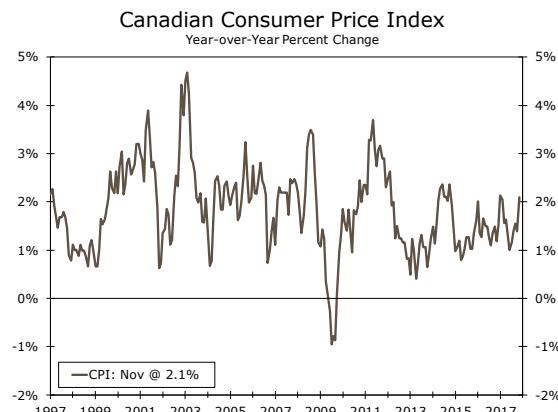
Tim Quinlan, Senior Economist
tim.quinlan@wellsfargo.com • (704) 410-3283
 Ariana Vaisey, Economic Analyst
ariana.b.vaisey@wellsfargo.com • (704) 410-1309

The Bank of Canada Hikes Rates

At its first scheduled policy announcement of 2018, the Bank of Canada (BoC) increased its overnight target lending rate 25 bps to 1.25 percent. With this increase, the BoC has lifted the overnight rate above where it was in 2015 when oil price declines caused it to cut rates twice that year. In this special report we break down the statement from the Bank of Canada and consider the likely monetary policy path for the year ahead. In short, the inflation backdrop should be adequate to justify further rate hikes, but an over-leveraged consumer and lingering worries about NAFTA will be among the key hurdles between the BOC and an untrammelled path to higher short-term interest rates in Canada.

Strong Overall Economic Backdrop

Canadian GDP grew at the fastest quarter-over-quarter pace of any G7 economy in the first two quarters of 2017, reflecting less of a drag from energy-related spending as oil prices rebounded, but has since slowed (Figure 1). Real GDP expanded in Q3 at just a 1.7 percent annualized pace, down from a breakneck 4.3 percent in Q2. Flat month-over-month GDP growth in October disappointed expectations and gave pause to market participants anticipating a short-term rate hike.

Figure 1**Figure 2**

The BoC has lifted the overnight rate above where it was in 2015 when oil price declines caused it to cut rates twice that year.

Source: Statistics Canada and Wells Fargo Securities

However, other data have indicated underlying economic strength. Retail sales are on pace to end 2017 at one of the fastest growth rates in recent memory. Consumer price index (CPI) inflation came in at 2.1 percent in November, just above the midpoint of the BoC's 1-3 percent target range (Figure 2). Most encouragingly, Canada's unemployment rate sank 0.2 percentage points to 5.7 percent, the lowest in 40 years (Figure 3). The BoC highlighted close to target inflation and stronger-than-expected consumption and residential investment, "reflecting strong employment growth," in its policy statement announcing today's rate hike.

Expectations for a rate hike at the January meeting jumped on the day of the employment report and financial markets began to price in a higher rate environment. Those expectations were warranted as evidenced by today's rate hike, but there are a few hurdles that stand in the way for

Together we'll go far



the BoC this year. We highlight these risks and will be following up on these themes throughout the year.

The Balancing Act Facing Poloz

BoC Governor Stephen Poloz now has to weigh staying his hand, potentially stoking higher inflation as the labor market overheats but lending support to GDP growth, or using further rate hikes to cool down the economy. Adding to hawks' concerns are recent minimum wage hikes, such as Ontario's increase to \$14 an hour as of January 1, up from \$11.60 previously – a 21 percent jump. Some Ontario Tim Hortons locations have already raised prices on their breakfast menu this year, which may signal broader price changes to come.

Admittedly, core measures of inflation are a bit lower than the headline at present, but all are moving in a decidedly upward trajectory (Figure 4). For the BoC, as with other central banks around the world, low unemployment has not led to meaningfully higher inflation as it has in prior cycles, although we could be at an inflection point on that front.

Figure 3

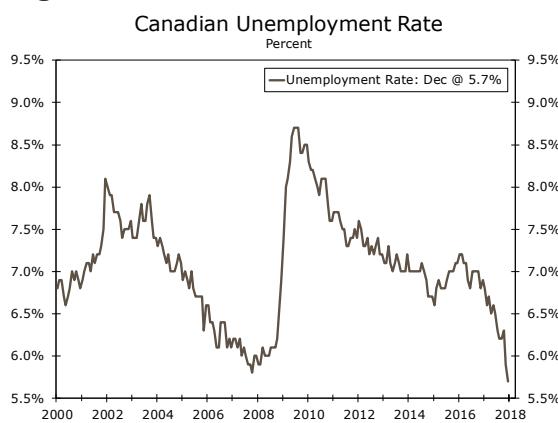
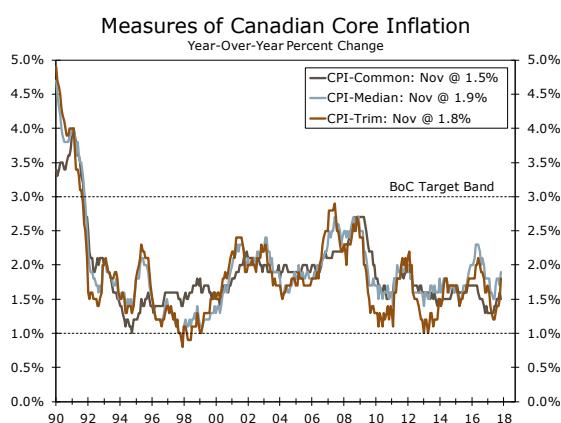


Figure 4



Source: Statistics Canada and Wells Fargo Securities

At the same time, the effect of 2017's two quarter-point rate hikes is already being felt by Canadian households. Even before the BoC's rate decision today, a number of Canadian banks already raised benchmark mortgage rates, citing BoC rate changes among factors.

Given high levels of household indebtedness in Canada, it bears closely monitoring the impact of higher rates on the Canadian consumer. Canada's household debt to GDP ratio reached 97.0 percent in Q3, and household debt levels lead the OECD on a per capita basis. Consumers, enjoying a buoyant job market and rising home values, have boosted GDP growth in the past year but this does not look to be sustainable, especially with continued rate hikes. In its press release today, the BoC called out interest rates and new mortgage guidelines as factors likely to weigh on consumption and residential investment looking forward, which was a new addition from the December press release.

Concerns about a United States withdrawal from NAFTA still linger, with mixed signals from the White House. This risk may also prompt the BoC to hold off rate hikes given the potential negative economic effects of higher tariffs with Canada's largest trading partner. Specifically, the accompanying statement from the BoC today stated "uncertainty about the future of NAFTA is weighing increasingly on the outlook, the Bank has incorporated into its projection additional negative judgement on business investment and trade."

We have been (and remain) on the low-end of the consensus expectation for short-term rates in Canada. Our forecast of 1.50 percent for the overnight rate at year-end means that there is only scope for one more rate hike this year. Until the December jobs report hit the wire, we thought the timing of the first rate hike would actually be in March. The BoC has shown itself to be willing to move quickly based on economic data, with its September and January rate hikes following

Given high levels of household indebtedness in Canada, it bears closely monitoring the effect of higher rates on the Canadian consumer.

unexpectedly strong GDP and employment growth, respectively. These moves have resulted in a relatively fast pace of tightening since the summer, outpacing the Federal Reserve. However, we expect the BoC to move more slowly in the months ahead, especially given the concerns we have highlighted. At this point, we are maintaining our call for one more quarter-point rate hike by the BoC in the second half of 2018, while acknowledging upside risk to our forecast.

Wells Fargo Securities Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Jamie Feik	Economist	(704) 410-3291	jamie.feik@wellsfargo.com
Erik Nelson	Currency Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@wellsfargo.com
Harry Pershing	Economic Analyst	(704) 410-3034	harry.pershing@wellsfargo.com
Hank Carmichael	Economic Analyst	(704) 410-3059	john.h.carmichael@wellsfargo.com
Ariana Vaisey	Economic Analyst	(704) 410-1309	ariana.b.vaisey@wellsfargo.com
Abigail Kinnaman	Economic Analyst	(704) 410-1570	abigail.kinnaman@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

Wells Fargo Securities Economics Group publications are produced by Wells Fargo Securities, LLC, a U.S. broker-dealer registered with the U.S. Securities and Exchange Commission, the Financial Industry Regulatory Authority, and the Securities Investor Protection Corp. Wells Fargo Securities, LLC, distributes these publications directly and through subsidiaries including, but not limited to, Wells Fargo & Company, Wells Fargo Bank N.A., Wells Fargo Clearing Services, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Asia Limited and Wells Fargo Securities (Japan) Co. Limited. Wells Fargo Securities, LLC, is registered with the Commodities Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. Wells Fargo Bank, N.A. is registered with the Commodities Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC, and Wells Fargo Bank, N.A. are generally engaged in the trading of futures and derivative products, any of which may be discussed within this publication. Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC's research analysts receive compensation that is based upon and impacted by the overall profitability and revenue of the firm which includes, but is not limited to investment banking revenue. The information and opinions herein are for general information use only. Wells Fargo Securities, LLC does not guarantee their accuracy or completeness, nor does Wells Fargo Securities, LLC assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only and are not intended as an offer or solicitation with respect to the purchase or sales of any security or as personalized investment advice. Wells Fargo Securities, LLC is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company © 2018 Wells Fargo Securities, LLC.

Important Information for Non-U.S. Recipients

For recipients in the EEA, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority. The content of this report has been approved by WFSIL a regulated person under the Act. For purposes of the U.K. Financial Conduct Authority's rules, this report constitutes impartial investment research. WFSIL does not deal with retail clients as defined in the Markets in Financial Instruments Directive 2007. The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. This report is not intended for, and should not be relied upon by, retail clients. This document and any other materials accompanying this document (collectively, the "Materials") are provided for general informational purposes only.

SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE