June 28, 2017

Economics Group

WELLS FARGO SECURITIES

Special Commentary

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With Low Rates Having "Done Their Job," BoC Set to Hike

Executive Summary

After a run of better-than-expected economic indicators and a solid print for GDP growth in Q1, Canada's first step toward monetary policy normalization in the form of an increase in the Bank of Canada's (BoC) overnight rate could come as soon as July. That is not to say that key challenges like an overheated housing market and high consumer debt levels have disappeared. A slightly higher overnight rate does not necessarily make either of those problems worse; in fact, higher short-term interest rates could discourage increased consumer leveraging and the funding available to finance home purchases, even if only marginally.

Faster Growth and Less Spare Capacity

The last time the BoC adjusted its benchmark overnight rate was at its July meeting in 2015 when it cut the overnight rate to 0.50 percent where it has remained subsequently (**Figure 1**). Roughly two weeks from now on July 12, nearly two years to the day later, monetary policy makers will convene in Ottawa and will announce the latest determination on the target level for the overnight rate. Until recently, we expected the BoC to remain on hold, but in this report, we make our case for why we think a quarter point rate hike is now the more likely course of action.

Figure 1

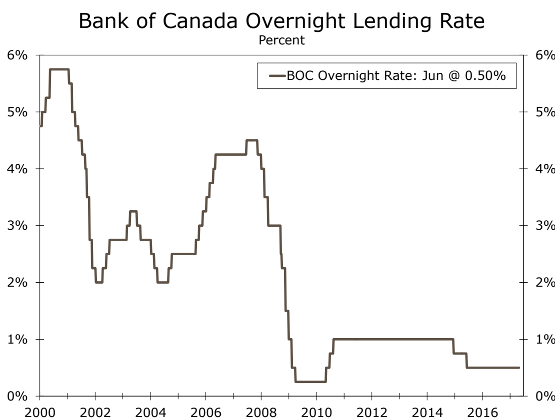
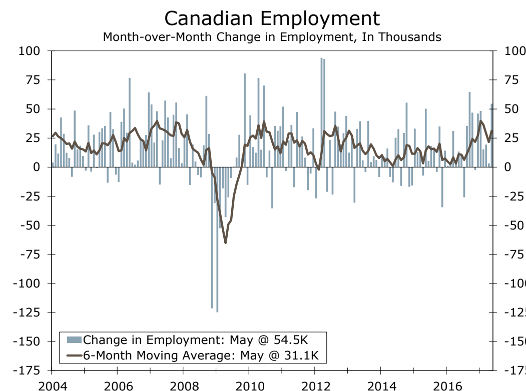


Figure 2



Source: IHS Global Insight and Wells Fargo Securities

Economic indicators have been firming in Canada and consistently coming in ahead of consensus estimates. Recent examples include Q1 productivity figures, April statistics on new home prices and perhaps most demonstrably, the latest jobs report, which showed 77,000 new full-time jobs added for May; enough to offset a mild pullback in part-time hiring and still keep the net change in payrolls north of 50,000 (**Figure 2**).

Faster Growth and "Transitory" Softening in Inflation

Canada's improving economy has, at times, come amid a backdrop of otherwise lackluster growth among other large, developed economies at this mature stage of the global expansion. The 3.7 percent annualized GDP growth rate in Canada in Q1, for example, was the fastest of the G7 economies during that period (**Figure 3**). All major components of domestic demand were additive to GDP growth in Q1, which offset a big drag from trade.

While it is true that CPI inflation has moved away from the BoC's midpoint target of 2.0 percent, the 1.3 percent inflation rate is still comfortably within the 1 to 3 percent range (**Figure 4**).

Figure 3

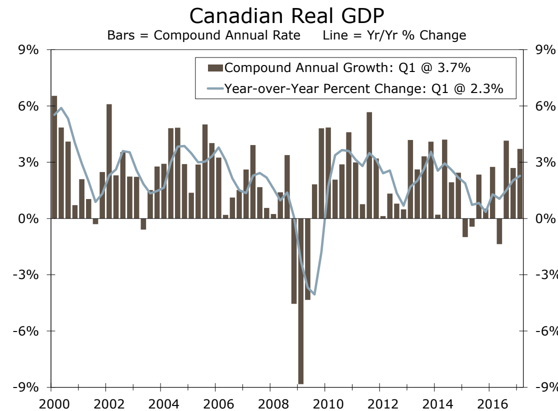
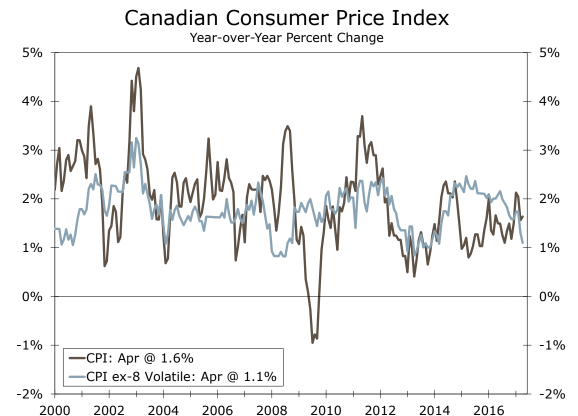


Figure 4



Source: IHS Global Insight and Wells Fargo Securities

In reference to the softer inflation readings earlier this month, Carolyn Wilkins, senior deputy governor at the BoC said that slower inflation dynamics were "transitory" and offered a somewhat more optimistic outlook on the Canadian economy.

In our view, Wilkins' comments on June 12 helped set expectations for an eventual tightening of policy and higher short-term interest rates. As we indicated in the webinar we hosted the day after the Wilkins' comments (June 13), we will be watching the communications from BoC officials closely.

The initial hawkishness expressed by the deputy governor was underscored by additional remarks in a recent televised interview in which BoC Governor Poloz said that two years of low rates had "done their job," and that excess slack was being absorbed steadily. While risks in the housing market and consumer credit remain, we think a rate increase in July is now more likely than the BoC remaining on hold.

Although a 25-bp move is not likely to have a significant or immediate effect on household debt levels or home prices, higher short-term interest rates could discourage increased consumer leveraging as well as the funding available to finance home purchases, even if only marginally.

Financial markets have been paying attention to the language from BoC policymakers as well. In **Figure 5** on the next page, we have plotted the "expected" level for the overnight lending rate in Canada based on overnight index swap futures. The horizontal axis is numbered "1st" through "6th" indicating the number of BoC meetings out, while the vertical axis plots the expected level of the overnight rate at that time of those meetings.

While we do not hold out these financial market measures as a firm indication of precisely where interest rates will necessarily be at a given meeting, they are useful in gauging how rate expectations are evolving, particularly in terms of weighing the effect of BoC policymaker statements. The two lines we have plotted in Figure 5 indicate where those expectations were prior to the hawkish BoC comments earlier this month and where they are today.

Figure 4

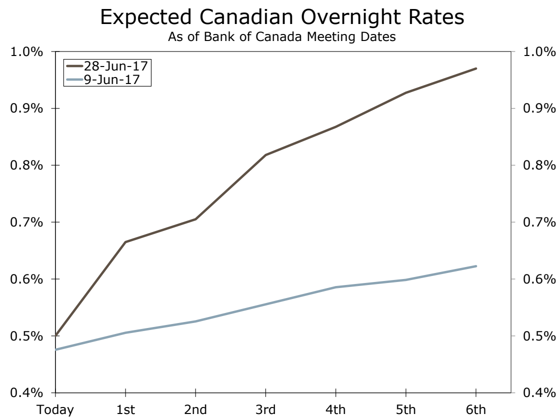
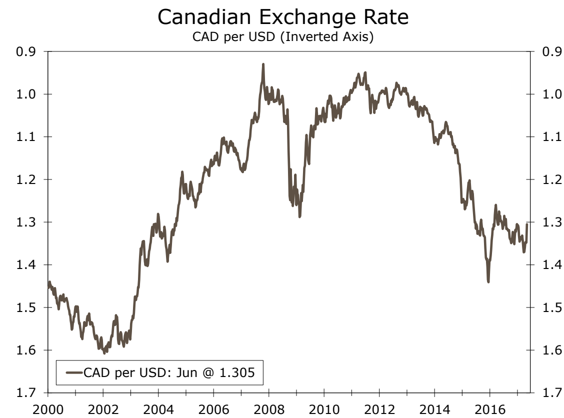


Figure 5



Source: IHS Global Insight and Wells Fargo Securities

Implications for the Canadian Dollar

In our view, markets have already partly reacted to evolving Canadian policymakers' communication. Since the shift in the BoC's tone earlier this month and with the Canadian dollar short positioning extended, the Canadian dollar has strengthened by 3 percent versus the greenback, while Canadian two-year government bond yields rose 30 bps, narrowing the interest rate spread between the United States and Canada. A July rate hike by the BoC would reinforce our outlook for Canadian dollar strength over time as the relative monetary policy stances between the United States and Canada begin to converge.

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