TD Securities

Bank of Canada Policy Monitor

Rates, FX and Commodities Research

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- We expect that the Bank of Canada will maintain its overnight rate at 0.50% next week.
- A continued rebound in non-energy exports matches the Bank's qualitative narrative of an improving outlook. A very conservative forecast for Q3 real GDP reduces the urgency for the Bank to cut before the end of the year.
- Revised growth forecasts will form the benchmark against which the realization of global risks will determine the likelihood of policy action through 2016.

LOW Q3 GROWTH HURDLE MAKES IT EASY TO WAIT AND SEE

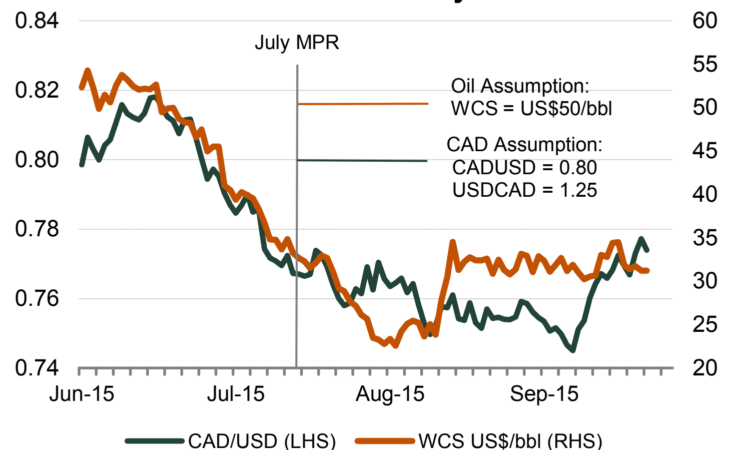
The recent spike in financial market volatility and concern over global growth has prompted many central banks to adopt a wait-and-see approach before deciding on the appropriate policy response. Banks on the hawkish end of the spectrum, such as the Federal Reserve and the Bank of England, have cited growing downside risks that threaten to overcome their stated desire to begin normalizing policy. Central banks that have already acknowledged downside risks, such as the European Central Bank, are prepared to provide more stimulus should those risks be realized. By contrast and in quintessential Canadian fashion, the Bank of Canada stands in the middle of the spectrum following the move to the sidelines in September that balanced ongoing weakness in the energy sector with a nascent upturn in non-energy exports.

The renewed global headwinds that have already dented global confidence and international trade will challenge the Bank's growth narrative. But by virtue of an exceptionally conservative forecast that accompanied the decision in July to cut the overnight rate to 50 basis points, the Bank will have the rare benefit of an upside surprise to warrant keeping policy unchanged next week. Moreover, the updated forecasts to be released with the October Monetary Policy Report (MPR) will become a more realistic benchmark against which the realization of the risks that shroud the outlook will be compared through the end of the year and into 2016.

CAD Doing Its Job

The Canadian dollar continues to absorb the terms of trade shock impacting the wider economy. Heading into the September FAD the price of oil had fallen well below the assumption incorporated into the July MPR but the currency had also weakened substantially. Since September the Bank's own commodity price index has remained more or less unchanged while the Canadian dollar has averaged half a cent weaker than the period between the July cut and the September pause. A closer look at the energy complex reveals a drop in the average price of the Brent crude oil benchmark (-3.3%) whereas both WTI and WCS have rallied (1.9% and 11.0% respectively). This combination is the most beneficial for the Canadian economy, as energy inputs are typically priced in Brent terms while producers receive the price of WCS. In addition to a weaker CAD, longer-maturity domestic interest rates also remain below the levels where the Bank cut in July which helps to counteract the wider deterioration in global financial conditions.

Oil and CAD Both Lagging Assumed Levels from the July MPR



Source: Bank of Canada / Bloomberg

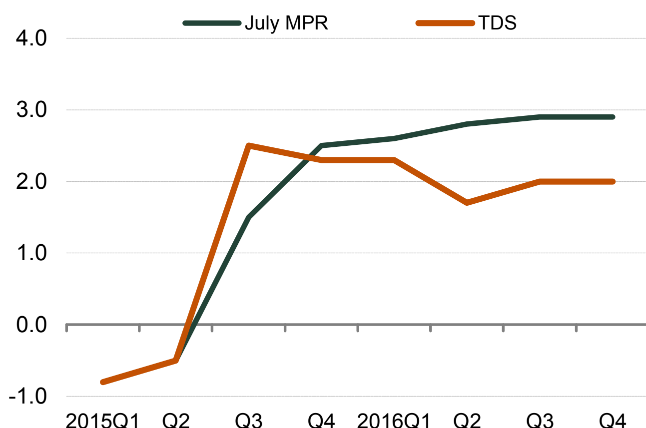
Export Improvement to Battle Darker Global Outlook

Recent comments from Governor Poloz at the IMF meetings in Peru continue to paint a reasonably optimistic outlook despite growing concerns expressed in other quarters. While the Governor is likely to echo this view in his press conference, the message from the accompanying MPR is likely to be more downbeat. Relative to July, we see scope for the Bank to revise down its forecast for 2016 global growth from 3.6% to 3.4% and for 2017 to be cut from 3.7% to 3.5%. On a country basis, the Bank is likely too upbeat on the outlook for the United States and China and we would expect growth over the next two years to also be pared back by at least 0.2% in each year.

Closer to home, the crux of the argument of why we see the Bank remaining on the sidelines next week is the tracking for Q3 real GDP growth that is a full percentage point ahead of the 1.5% that was forecast back in the July MPR. The prudence bordering on pessimism is entirely understandable as the forecast was presented before there was any evidence to suggest that non-energy export had shown any sign of responding to either firming external demand or the sharp depreciation in the currency. The tone of the Bank's communication since July has placed a lot of emphasis (and tremendous relief) on this improvement. The latest edition of the Bank's Business Outlook Survey (BOS) also provides qualitative confirmation of the improvement in non-energy exports. The balance of opinion for future sales increased to +16 and the accompanying commentary noted that firms exporting to the United States had become more optimistic.

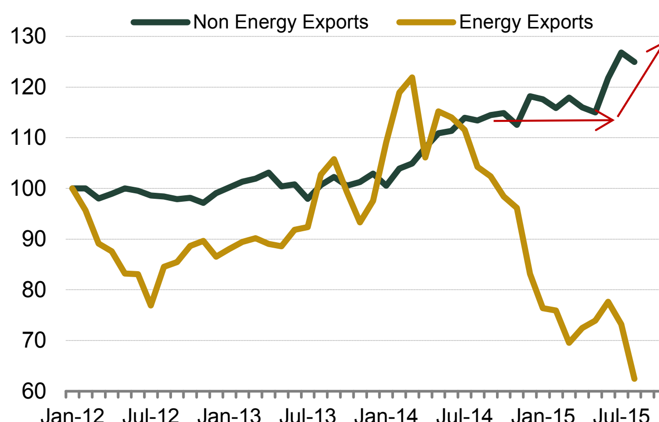
Q3 GDP data will be released early in December (just ahead of the Bank's last FAD of the year) so in the interim the Bank will have the opportunity to raise its July forecast. Our forecast is for Q3 growth to come in at 2.5% annualized (our current tracking is also broadly consistent with this forecast). Our Q4 growth forecast is for a deceleration to 2.3% versus the Bank at 2.5%. We would not be surprised to see some activity pulled forward, especially in appreciation of a softer global outlook over the balance of the year and into 2016. We anticipate that 2016 growth may be cut by as much as 0.3% to 2.0%. While the Bank is wildly too optimistic in expecting 2.6% growth in 2017, it is a sufficiently distant horizon to not influence the near-term outlook for monetary policy.

Q3 Real GDP Stronger Than Forecast But Expect Downward Revisions Later



Source: Bank of Canada / TD Economics

Non-Energy Exports Compensating for Renewed Energy Weakness



* Index: Jan 2012 = 100
Source: Statistics Canada / Haver Analytics, TDS

Note that the evolution of economic data relative to what was forecast matters tremendously given the Bank's new approach to measuring underlying inflation. Instead of relying on core CPI as an operational guide, the Bank estimates underlying inflation as a function of its output gap which in turn will be impacted both by the evolution of real GDP versus what was forecast and changes to potential output. On the former, we expect that the upwards revision to Q3 will translate to less near-term slack. On the latter, the forecast for potential output will likely be revised lower amid reduced investment in the commodity sector. This will also narrow the output gap and potentially raise the Bank's estimate of the underlying rate of inflation in the economy.

Bottom Line

The main message from the Bank is expected to blend relief that exports have rebounded with concern over a darkening global outlook. The tremendous uncertainty surrounding global events and the transmission of any prospective shock to the Canadian economy supports a wait-and-see stance next week. Moreover, we would view the forecasts presented in the MPR as a new benchmark against which the flow of data will determine the likelihood of additional policy stimulus early in 2016.

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