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CANADA

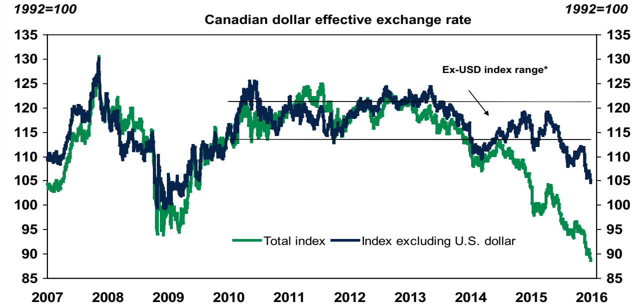
Despite the weak economy, the Bank of Canada can afford to be patient

Will the Bank of Canada (BoC) cut rates on January 20th? Currently, markets price in about a 25% chance of a cut at the Bank's next meeting, which will be accompanied by the release of the Monetary Policy Report and a press conference by the Governor. Three conditions make the rate cut case fairly compelling. First, there is the economic data. December delivered an assortment of disappointing high-frequency numbers. Trade, manufacturing, wholesale sales, CPI, and real GDP were among the prominent monthly indicators failing to meet consensus expectations. Even though the trade balance and employment estimates received in January managed to exceed consensus forecasts, details within those reports were far from reassuring. For instance, the 22,800 increase in employment largely originated from the volatile self-employment category and was concentrated in Ontario and Québec, whereas the bulk of other provinces saw declines. Meanwhile, the December housing starts report received yesterday lengthened the list of disappointing estimates.

A second argument to cut rates lies in the forward-looking signals. The BoC's Business Outlook Survey released yesterday revealed preoccupying signals on business investment and hiring intentions. In the latter case, this means that labour market slack will continue to increase, putting even more widening pressure on the BoC's integrated measure of the output gap, which considers excess capacity in the job market.

And of course third, there is the continued descent in crude oil. The price of the West Texas Intermediate barrel is testing the $30 US level. The Western Canada Select barrel trades at close to $16 US (small consolation: this represents $22 in Canadian dollars!). Seeing as the Bank of Canada cut rates by surprise about a year ago in response to crude oil dynamics, it is not unreasonable to assume that oil prices are a part of the Bank's reaction function.

It is only very recently that the depreciation of the Canadian dollar against currencies other than the U.S. dollar gained momentum



Between 2010 and 2015, one standard deviation around the mean
Source : Bank of Canada and Desjardins, Economic Studies

Implications: So will the Bank deliver an ease next Wednesday? We do not believe so. Governor Poloz's speech of January 7 made the case that a commitment to a floating currency is probably the best policy tool currently, and that otherwise patience is of the order. He might be right. One of the reasons the weaker Canadian dollar has not delivered as much benefit as hoped for so far, lies in the fact that it was just one out of the many currencies depreciating against the U.S. dollar. It did not meaningfully cheapen against the other currencies until very recently. The ex-USD effective Canadian dollar index only broke from its 5-year range last July. History will be the judge as to whether this is the ultimate impetus to a substantial and sustainable recovery in net exports, but for now it affords the BoC a bit of time, not least with the federal government set to lay out its own stimulus initiatives this spring.

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