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# CANADA

## Bank of Canada vs. markets : is there some form of misunderstanding?

The election of Donald Trump brings headaches to Bank of Canada officials (BoC). While the direct impact on the North American economy remains to be defined, the effect on financial markets has been strong, and carries on. In the United States, stock markets, Treasury yields and the currency have skyrocketed. The first variable has an important positive influence on confidence indicators, but the latter two are more likely to hinder growth. The U.S. economy does look sturdy enough to tolerate these headwinds, and it will have additional support coming in the form of an expansionary fiscal policy.

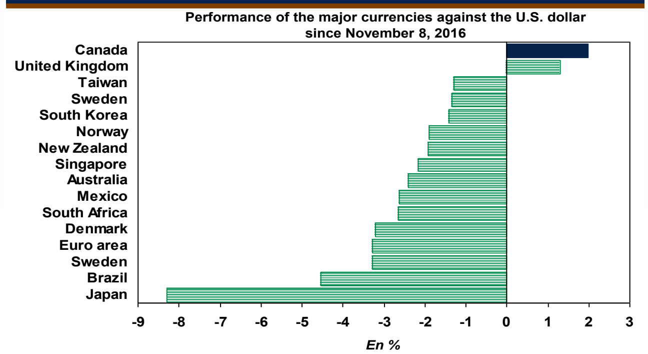
In Canada, despite a marked rebound in growth in the third quarter, the economy remains much more fragile, as the impact of the recent oil shock continues to be felt. New rules restricting access to homeownership entail additional risks. Even if a soft landing is expected, the spectacular bursting of the U.S. housing bubble about a decade ago is not without causing a bit of anxiety on this side of the border. The economy therefore still very much depends on accommodative financial conditions.

Nonetheless, following Trump's victory, Canadian bond yields rose and mortgage rates followed suit. Meanwhile, the strength of the U.S. dollar since the election has been much highlighted but the reality is that the Canadian dollar has been even stronger. It is in fact the strongest currency since the election.

The interplay of monetary policy expectations appears to be the main explanation. In the United States, derivatives markets have begun to expect the Fed to be less hesitant to raise rates. This adjustment was justified, in a context where just recently, markets expected virtually no tightening over the next three years. This seemed most abnormal in a context where even the most dovish Fed officials have signed off to policy normalization

Far from being in this state of mind, the BoC admitted to having actively discussed lowering its policy rates at its meeting of last October. In its press release of December 7,

**The election of Donald Trump has propelled the loonie**




* As of November 9, 2016.
Sources: Bloomberg and Desjardins, Economic Studies

it recalled the considerable excess slack prevailing in Canada, expressed disappointment at business investment and seemed to minimize the rebound in growth in the third quarter. Despite a BoC that obviously still harbours many doubts, markets are now anticipating a significant probability that it will walk in the Fed's footsteps and lift rates as soon as early 2018. In other words, markets do not seem to adhere to the thesis that monetary policies will diverge for a long time. Yet, in a speech given no earlier than November 29, BoC Governor Stephen Poloz insisted that all the ingredients of monetary policy divergence remained in place.

**Implications:** Rather than adjusting to the warnings of Governor Stephen Poloz, markets are inviting him to toast to Donald Trump. Will they come to reason, or will the BoC need to make a splash to assert its credibility? Let us not forget that Mr. Poloz already has a surprise rate cut to his record. However it unfolds, Canadian short-term yields and the loonie appear vulnerable to a reversal.

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