Canada: Did the Markets React Exaggeratedly to Stephen Poloz’s Speech?

The highly anticipated speech by Bank of Canada (BoC) Governor, Stephen Poloz, provided very little guidance on the BoC’s future course of action. He argued that monetary easing in 2015 was no longer necessary and stated that there was no predetermined trajectory for interest rates “from here.” Many market participants felt that this single sentence was all they needed to know. Canadian short-term yields fell, as did the Canadian dollar. The derivatives’ markets pared down hiking expectations.

Yet, the speech had a reasonable amount of nuance. Stephen Poloz noted that the expansion was “more broadly based and self-sustaining,” and recalled the importance of an economy operating at a state of full capacity for the inflation outlook. He, in fact, said that the evolution of economic capacity was the most important issue the BoC would be tracking. Recall that the BoC estimates the output gap (as per the conventional measure) to have been closed as of Q2. He said that this situation reinforced the BoC’s expectation for inflation to converge to the 2% target over time. The BoC in fact expects inflation to exceed its target two years from now.

Despite these not-so-dovish precisions, Stephen Poloz did not show the same level of determination as Deputy Governor Carolyn Wilkins in June, who stunned markets by declaring that the BoC was considering withdrawing some of the “considerable” degree of monetary stimulus. Stephen Poloz’s speech of yesterday rather played the uncertainty card at will. Some passages for instance stated that “the appropriate path for interest rates is very difficult to know,” or that “we need to keep updating our understanding of the economy in real time.”

Markets quickly labeled the speech as dovish, and Stephen Poloz certainly left an impression of caution, even of hesitation. He omitted to mention that the current degree of stimulus was “considerable,” as had been done in the press release of September 6, and as Carolyn Wilkins had stated in June. The fact that he explicitly linked the two latest hikes to the two cuts of 2015 could also lend itself to the interpretation that these were “special-case” hikes, that need be distinguished from the rest of the normalization, which will hinge to a greater extent on the pre-existing considerations of high household debt, currency volatility, or further enlightenment on the underlying dynamics of inflation.

IMPLICATIONS

It is important to correctly interpret the meaning of “no predetermined path.” This comment does not imply that an increase in October is to be ruled out at this stage. As far as the actions of the central banks are concerned, too often markets tend to interpret a failure to commit as a commitment to fail. In our opinion, the BoC mostly insists that decisions will not be rushed, but in fact made at the last minute, with as much information in hand as possible. This implies that a probability of less than 30% of a rate hike in October, as currently discounted in markets, seems complacent. There is still nearly a month before the next meeting, and several important economic statistics to scrutinize. As such, one cannot rule out that markets will have to redo their calculations, as has often been the case in 2017!