

## Bank of Canada set to keep it loose

We're not expecting the Bank of Canada to follow the Fed with rate cuts just yet. The labour market's stronger than expected, inflation's broadly on target and rates are already lower than in the US. And that will add to further CAD momentum. However, there are some signs of weakness, and a December rate cut can't be ruled out



Bank of Canada  
Governor Stephen  
Poloz

### Times have changed

It's amazing how quickly things can change. At the last Bank of Canada policy meeting in September, the committee decided that *"the current degree of monetary policy stimulus remains appropriate"*. However, it warned that *"escalating trade conflicts and related uncertainty are taking a toll on the global and Canadian economies"*. After that, financial markets were pricing about a 60% chance of a 25bp Bank of Canada rate cut at the 30 October policy meeting, rising to almost an 80% chance of such action by the next one on December 4th.

Today, the implied probabilities are virtually zero for next week and just 10% for December. That's a big change.

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*The labour market is proving to be more resilient than we had thought*

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Certainly, there has been some encouraging news on US-China trade relations. Phase one of the negotiations is being finalised and looks set to result in a postponement of scheduled tariffs in exchange for China purchasing more US agriculture products. We've also had the Federal elections, which saw Canada's Prime Minister Justin Trudeau's Liberal Party lose 20 seats, which left them 13 seats short of a majority. PM Trudeau has indicated he doesn't want a coalition and has suggested the Liberals will run as a minority government that seeks the support of other parties to pass legislation.

On balance, we do not expect any major shifts in fiscal policy. In terms of the economic numbers, the labour market is proving to be more resilient than we had thought. After a subdued May-July period the economy created 81,100 jobs in August with a further 53,700 added to payrolls in September. With the unemployment rate falling to 5.5%, wage growth running at 4.3%YoY and consumer price inflation running broadly in line with target there does indeed seem little to justify a rate cut from the Bank of Canada this month.

Furthermore, the BoC did not raise interest rates as aggressively as the Federal Reserve in the past couple of years with Canadian policy still broadly viewed as mildly accommodative.

## Where the US goes, Canada typically follows

That said, not everything is positive. The latest jobs report showed employment creation was essentially in the public sector with private-sector jobs falling 21,000. The Ivey Purchasing Managers' Index fell into contraction territory while retail sales surprisingly fell 0.1%MoM in August versus expectations of a decent 0.4% gain.

Moreover, the global growth story is looking less positive with evidence spreading of a deceleration in US growth at a time when Europe's economy is stagnant and Asia's is softening. Canada is heavily exposed to these external threats given the Canadian economy is relatively open with trade accounting for more than 30% of economic activity versus little more than 10% for the US. Canada is also more dependent on commodities with mineral extraction and agriculture, representing more than 10% of the economy.

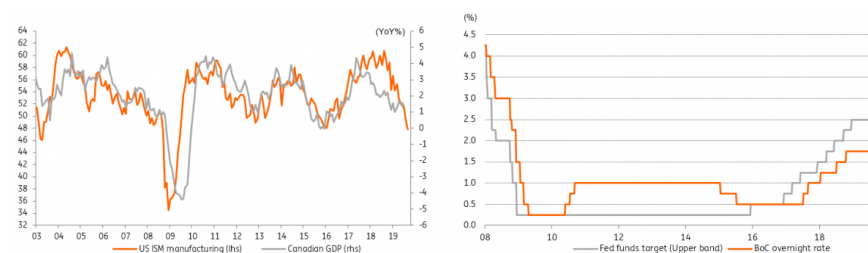
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*The likelihood of a Canadian interest rate cut is greater than the market's pricing in*

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As such, we think the likelihood of a Canadian interest rate cut is greater than that implied by market pricing. After all, the BoC has a tendency to move swiftly after signalling a shift in thinking. Remember back in 2015 when the BoC rapidly changed its tune and cut rates in response to plunging oil prices and the fears for what it might mean for the broader economy? Recall, too, 2017, when it surprised with a September hike after already increasing rates in July. Swift, but modest action seems to be the BoC's mantra. We continue to see a decent chance of a surprise December BoC rate cut.

## US and Canadian comparisons



Source: ING, Bloomberg

### FX: CAD momentum to remain solid

The loonie has recently rediscovered good momentum that was lacking since the summer. Such renewed appetite was evident in the latest CFTC data that show [mounting long positions on CAD](#) in the week 15-22 October by 11% of open interest, making it the biggest long in G10.

For now, this hype on the CAD has few reasons to fade. Market expectations are in line with our view that the Bank of Canada will stay put this week, which ultimately keeps intact what many people might see as the highly attractive carry of the loonie. As a consequence, CAD may well continue to outperform its risk-sensitive peers (AUD, NZD) should global risk sentiment remain supported.

We expect USD/CAD to move below the 1.30 level this week as the unchanged BoC stance remains supportive for CAD momentum while another Fed cut and above all the risk of some weaker-than-expected US payrolls point at USD downside risk. However, we suspect that levels below 1.30 will look increasingly fragile in the coming weeks unless there are more tangible advancements in the US-China trade negotiations. Given the non-negligible risk of trade talks stalling and the BoC cutting rates in December (against market expectations), we stick to a 1.31 end-of-year forecast for USD/CAD.

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