

Canada: We're looking for a rate cut in October

Canada's economy performed well in 2Q19, but it is heavily exposed to global growth and trade, which hints at weaker activity ahead. The central bank has acted swiftly before and we think they could use next week's meeting to lay the groundwork for an October interest rate cut. CAD is likely to stay on the back foot, but the long-term outlook remains positive



Bank of Canada
Governor, Stephen
Poloz

Some encouragement on the domestic front...

At the July monetary policy meeting, the Bank of Canada suggested there was little prospect of any near-term policy change. Officials highlighted the improvements to the domestic story we've seen since the weakness in 4Q18 and 1Q19 with the economy described as growing at potential. Today's 2Q GDP report underlined that strength with the economy growing by a very robust 3.7% annualised versus the 3% consensus figure. It is this decent domestic performance that has so far left the BoC reluctant to follow the crowd of other central banks signalling dovish intentions. We

think that will change at the next policy meeting on September 4.

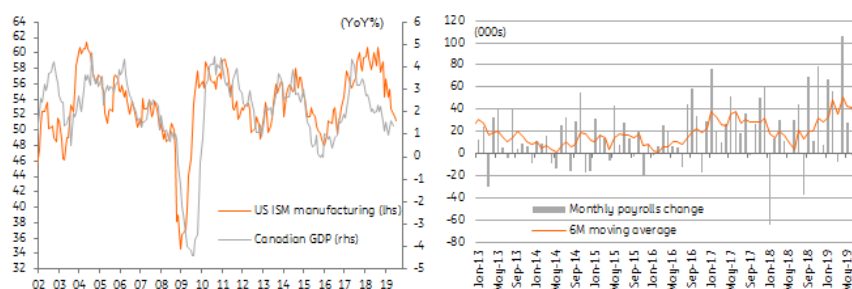
After all, if you dig a little deeper into the GDP we find the growth story isn't as positive as the headline suggests. Exports contributed hugely by growing 13.4%, largely due to the re-starting of oil fields whereas consumer spending grew just 0.5% annualised - the slowest since 2012 - despite healthy income gains. Non-residential business investment actually contracted 16% annualised while residential investment rose for the first time in six quarters.

... is increasingly being offset by a weaker global backdrop

Looking back at the July policy meeting, the BoC also recognised the threat posed by global trade tensions, which in turn risks curbing manufacturing activity, weakening investment and dampening commodity prices. These trade tensions have escalated in recent weeks while the global slowdown shows little sign of abating. Together with a softer tone seen in US manufacturing data, the newsflow all points in the direction of fading Canadian economic momentum. In any case, the surge in export growth due to oil seen today is not sustainable.

The Canadian economy is relatively open with trade accounting for more than 30% of economic activity versus little more than 10% for the US. It is also more dependent on commodities for a significant proportion of its output with mineral extraction and agriculture representing more than 10% of the economy. Given these exposures and with little prospect of an imminent easing in trade and global growth concerns we expect that Bank of Canada to use next week's policy announcement to pave the way for a rate cut in 4Q19.

Softer US manufacturing and weaker Canadian payrolls point to BoC rate cut



Source: Macrobond, ING

The BoC likes surprises

These expectations will build if we see a further slowdown in labour hiring. Canada has already experienced two consecutive months of falling payrolls and, with business confidence coming under pressure given the global backdrop, we may see more losses in the months ahead. A rate cut at next week's meeting is an outside possibility, but the imminent federal election (October 21st) and election campaigning getting into full swing make that doubtful. At the moment the market is pricing in around a two-thirds probability of a rate cut in October, whereas the latest survey of analysts by Bloomberg continues to peg stable rates through this year and next.

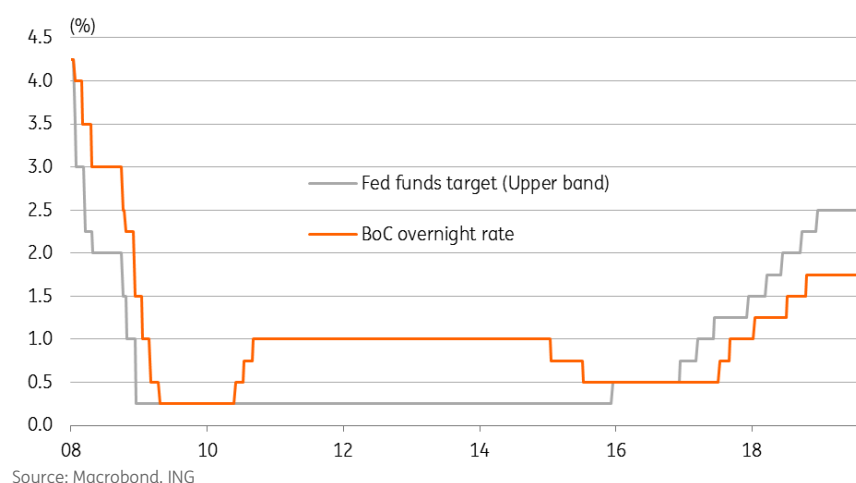
Given the BoC's tendency in the past to move swiftly after signalling a change, we are now

forecasting a 25bp rate cut at the October 30 meeting. In this regard think back to 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. We also remember 2017, when it surprised with a September hike after already hiking rates in July. Swift, but modest action seems to be the BoC's mantra.

One and done

For now, we have just this one rate cut in total pencilled into our forecasts, characterised as an insurance move. But given the uncertain global and trade situation there could be more in early 2020. How the US-China dialogue plays out will be critical. For now though we would point out that the BoC was far less aggressive in hiking rates than the Federal Reserve over the past couple of years. As such, there is arguably less need for a significant corrective move lower in rates.

Canada didn't hike rates as aggressively as the Fed, so less need to cut...

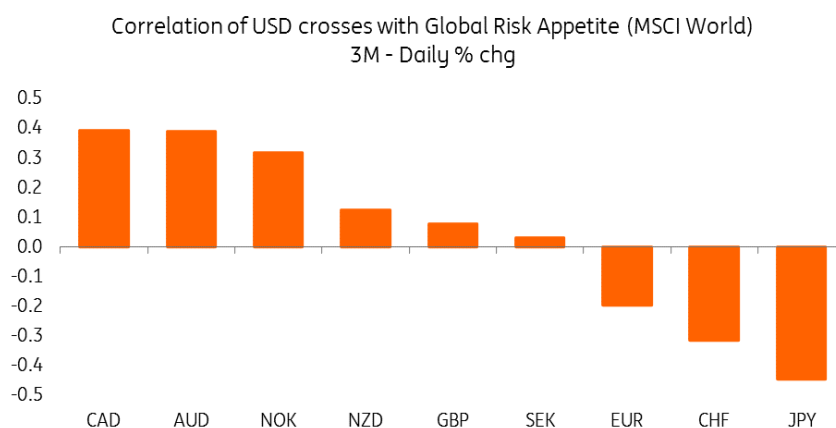


CAD: Still weak in the short-term, but close to the bottom

Trade tensions seems to be the root of all evil for the Canadian dollar given its negative impact on the three main drivers of the currency:

1. Global risk appetite: in the past three months, only the USD/JPY has been more sensitive than USD/CAD to swings in global risk sentiment (as measured by the correlation with the MSCI World stock index). A high-yielding activity currency such as CAD is naturally hit by rising risk aversion, and the extraordinary rally seen in June and July is now presenting the bill.
2. Oil prices: despite OPEC+ efforts to revive the battered oil market, trade tensions are fuelling fears of a global slowdown on the demand side, keeping crude prices on the back foot. On the internal side, the state of Alberta has extended its output gap, but this has done little to help CAD.
3. Rate outlook: BoC rate expectations have been under pressure as trade wars escalated and

markets are currently pricing in one rate cut by the end of the year.

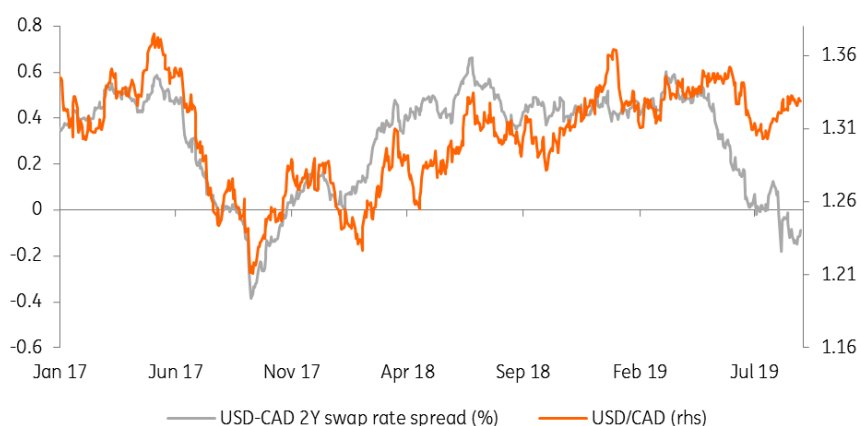


Source: Bloomberg, ING

In light of this, trade tensions continue to be a big question mark on the CAD outlook and will inevitably be the key driver for the currency moving on. Nonetheless, it can be noted how most of the negatives for CAD appear to be mostly in the price and that a number of developments may allow the loonie to hold its ground better than its risk-sensitive peers. First, our commodities team tends to exclude more extended downside in crude oil prices, instead forecasting a recovery in the coming months, with the WTI benchmark possibly back to the 60\$/bbl levels in 4Q.

Second, a rate cut in October by the BoC (as we expect) is mostly in the price and may have limited downside impact on front-end rates. By contrast, we also expect the October cut to be a one-off move and this would prompt markets to pare back the expectations for 25bp of additional easing by June 2020 currently embedded in the OIS curve. In addition, the much-awaited ratification of the USMCA (which should materialize in the coming weeks) should offer some support to the Canadian trade outlook and probably give some respite to CAD.

USD-CAD 2Y swap rate spread v USD/CAD



Source: Bloomberg, ING

Trade tensions have been the main factor preventing USD/CAD to recouple with the short-term rate spread that would still suggest a weakening of the pair ahead. We expect the rate

differential to prevail as a driver in the longer term and remain in the view that USD/CAD can explore the below-1.30 area by 1Q20 and maintain a downward-sloping trajectory for the remainder of 2020.

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