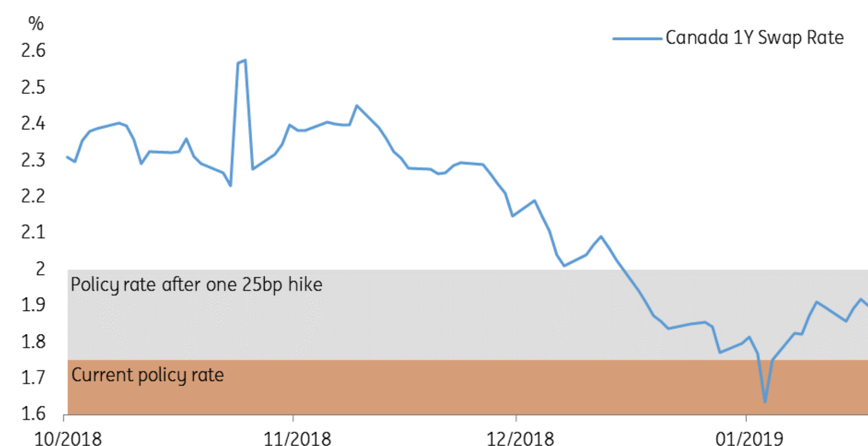
Canada: Economic slowdown will be mild, not major

Current market expectations imply that a Bank of Canada rate hike this year is unlikely. But in our view, the outlook is good enough to keep the central bank in policy normalisation mode

Following the Bank of Canada's (BoC's) more dovish tone in December and our view that the Federal Reserve will take a pause on tightening policy in the first quarter, Canada's 1Y swap rate has been experiencing downward pressure. It currently (below) indicates there's around a 60% chance of one full rate hike in the coming year, whereas back in October, markets had two full rate hikes priced in.

Canada's 1Y swap rate experiencing downward pressure



Source: Bloomberg

Two reasons for the key shift in markets

Following the Fed

We have projected a modest slowdown in the US this year for some time, but the unexpected arrival of the government shutdown suggests growth risks are moving to the downside (read our in-depth analysis of the shutdown here). This reinforces our view that the Federal Reserve will take a pause in the first quarter.

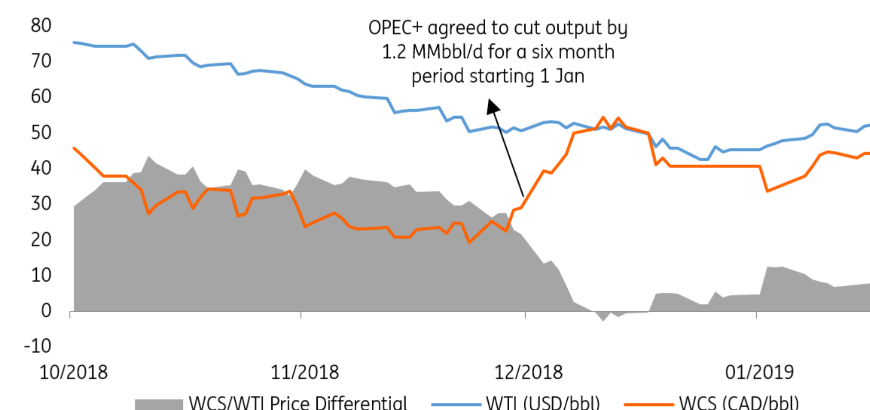
Canada tends to track its neighbour relatively closely when it comes to economic trends, hence why market expectations on the Federal Reserve's policy decisions influence that of the BoC, and forms part of the explanation why Canada's 1Y swap rate has shifted quite dramatically.

The commodity story

In the last few months of 2018 there was a sharp decline in world oil prices, particularly in Western Canada; the price differential to Western Texas Intermediate (WTI) reached US$50/bbl in mid-October. The latter can be largely attributed to delays in oil pipeline projects - namely TransCanada's Keystone XL, where construction has been paused due to ongoing legal battles.

To alleviate the pressure on crude producers, OPEC+ agreed to curb its output – starting 1 January. Along with this came action in Alberta, where compulsory production cuts were also activated in January. As a result, oil prices have been lifted - Western Canada Select (WCS)/WTI price differential narrowed to below US$10/bb, and our commodities team sees this trend carrying on throughout 2019 (here's 5 reasons why).

WCS/WTI price differential has narrowed significantly



Source: Macrobond

When you take a step back, Canada's oil story is very mixed...

- **The good:** The support the Alberta production cuts have given to WCS led WCS/WTI to recently reach the narrowest price differential since 2009 (less than US$7/bbl).
- **The bad:** Reducing output isn't all good news though. The cuts should leave Canada's energy sector substantially weaker this year, which will likely result in a lower contribution to growth.
- **And the ugly:** Canada is a large net-exporter of oil, so this was a significant factor in our downward growth revision in 2019.

The economy is set to undergo a mild - not major - slowdown

A slowdown is on the horizon, but it won't come as a surprise – nor will it be extensive. That said, this year won't go without turbulence, and in light of the risk environment, we've recently revised our annual 2019 growth forecast down from 2.1% to 1.8%. Here are a few more reasons why...

Recent business activity data was far from buoyant

Based on current data, business momentum is fragile with specific focus on two key factors: Business spending in the third quarter of 2018 disappointed considerably, and the long-awaited pick-up in wage growth is yet to arrive; it stayed at 1.5% YoY in December for full-time workers.

Still, we are optimistic about 2019. In the BoC's most recent Business Outlook Survey, the investment indicator remained positive (despite receding slightly) due to expectations that sufficient demand will be sustained. Firms also reported that they will be pushing wages higher as a strategy to attract workers, as labour-related production constraints were frequently cited as an issue.

A housing market correction?

Higher rates and tighter mortgage rules are likely to see further declines in housing resales. This is also likely to feed back into more muted residential investment given excess supply issues, which will weigh on growth. Signs of stabilisation already in the housing market will be a mild concern for policymakers.

Household activity could be under pressure as home owners start to see one of their largest financial assets lose value

The BoC has indicated it wants to take the policy rate to its neutral range (2.5%-3%, based on-at target inflation), to achieve the inflation target. However, the lagged effect of rate hikes - the central bank's workhorse model states it takes around six quarters until the full impact of an increase is felt- suggests the housing market correction is far from over. As a result, household activity could be under pressure, as homeowners start to see one of their largest financial assets lose value.

Nevertheless, the unemployment rate is at a four-decade low, core inflation has remained around the bank's 2% target and our expectation that there will be a constructive U-turn for business activity (outside of the energy sector) suggests that the above downside factors shouldn't push the central bank into hitting the brakes just yet. We see a rate hike in both the third and fourth quarter, but believe the risks are skewed to the downside, especially given our view that the Fed is likely to moderate policy tightening in the US.

Author

James Knightley
Chief International Economist, US
james.knightley@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("**ING**") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit http://www.ing.com.