As growth falters, dovish Bank of Canada firmly in wait-and-see mode

The mixed domestic and global economic backdrop has pushed Canada's central bank into a more dovish territory, but it might be too early to completely rule out a rate hike this year

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At its latest policy meeting, the Bank of Canada opted to keep rates at 1.75% but went up a notch on the dovish scale, but this isn't too surprising in the aftermath of the steep downside miss on fourth-quarter GDP (0.4% QoQ, annualised). Growth has slowed sharply since its second-quarter peak, with energy-related factors driving investment significantly lower in the final three months of the year (-2.7% QoQ).

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For this reason, the BoC has made it clear that it will be prolonging its pause for a little while longer, with the press release indicating there is 'increased uncertainty about the timing of future rate increases'.

Nonetheless, we still believe the central bank would like to resume its tightening cycle this year if economic fundamentals don't deteriorate further and downside risks stay at bay. The earliest this is likely to be is in the third quarter, allowing time to see how the Federal Reserve acts over the next few months.

Next rate hike will depend on three key factors

1 Household spending

Unemployment has been hovering around a 40-year low for some time now, but the relatively strong labour market hasn't always translated into better household activity. Both the housing market and overall spending suffered in the final quarter of last year - a mixture of higher interest rates, tighter mortgage rules and trade-related confidence knockback being the likely causes.

However, there are increasing signs of strength. January finally brought a long-awaited pick-up in wages, and we don't expect this to be a one-off. Recent Business surveys have suggested firms are wanting to invest in their workforce to lift labour-related production constraints, suggesting further upside in wage growth may be on the horizon. This bodes well for domestic demand if this upward trend continues.

Read Canada: What wage growth concerns?

2 Oil markets

Last year's fall in oil prices and the weakening in Canadian oil differentials were at the heart of Canada's disappointing growth story. Pipeline constraints restricted export flows, leading to large inventory builds in the domestic market, which weighed on Western Canada Select significantly more than global benchmarks.

New Year, a new story – kind of. Global oil prices have regained some poise in 2019, but the problems for Canada's energy sector haven't yet ended. To alleviate the pressures faced by crude producers in Western Canada, the Alberta government-enforced mandatory production cuts - started on 1 January, has seen Canadian price differentials recover, but the impact of reduced output will continue to dampen economic growth throughout the year.

3 US and China trade developments

Global trade policy was mentioned a few times, during today's press release, and it is apparent the BoC are putting a lot of weight on the situation. The press release said that "trade tensions and uncertainty are weighing heavy on confidence and economic activity". This suggests any more worsening of the situation may pretty much wipe out the chance of any rate hikes this year.

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Nevertheless, recent development have taken a slight turn for the better, as the 1 March US tariff increase deadline on Chinese goods was pushed back. There is still some way to go, but if a permanent resolution can be found, market sentiment would improve, and we may see commodity prices firm – reinforcing our commodities teams' view that Brent crude and WTI should edge higher throughout this year and next.

> The central bank clearly seems to be happy to sit back and see how these three risks play out over the coming months. If these downside risks don't materialise, then we still think the central bank will look to make a move later in the year.
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> With that in mind, we are still pencilling in a third-quarter rate rise, although a lot depends on how the Fed responses over the next few months.

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