Optimistic Bank of Canada bucks the dovish dollar-bloc trend

A more upbeat Bank of Canada has edged back from the more dovish line it struck in April, as policymakers grow more confident that the earlier slowdown was temporary. Unlike in other dollar-bloc economies, we think Canadian interest rates will remain on hold through 2019

Source: Bank of Canada

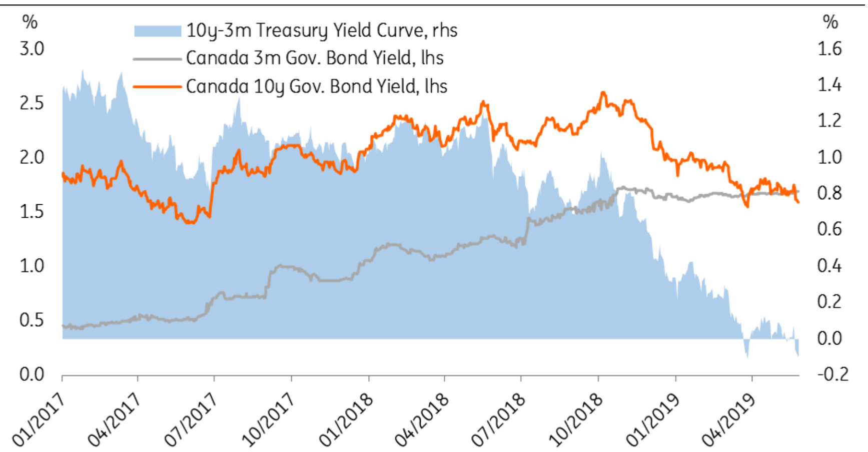
The market vs policymakers – who's right?

The Bank of Canada (BoC) kept interest rates on hold at 1.75% at Wednesday's meeting, but more importantly, the central bank is showing no inclination to begin loosening policy, despite the recent flare-up in global trade tensions.

Having taken a more dovish line back in April, the Governing Council struck a more upbeat tone on growth, which it expects to regain momentum over the next few quarters. This follows a recent interview, where BoC governor Stephen Poloz mentioned how – once growth headwinds dissipate – interest rates could feasibly start rising again. This suggests that the medium-term policy bias is still, if anything, tilted slightly towards further tightening.

In contrast, markets are now not far off pricing in a full rate cut over the next 12 months, while a 3-month bill is now yielding more than a 10-year bond.

The 3-month vs. 10-year yield curve has reached inversion (again)



Source: Macrobond

First-quarter growth: Already bottomed out for the year?

Friday's first-quarter GDP report is due on Friday, and while growth may be slightly higher than seen in the final quarter of last year, the underlying details could be more lacklustre:

1. The trade deficit was reported to be the largest since the second quarter of 2016.
2. The manufacturing PMI broke below the 50-threshold in April, thereby entering contraction territory.
3. Construction starts were down 9.9% in 1Q19, indicating that a material housing market recovery could be some way off.

1.1% ING 1Q19 GDP forecast

QoQ, annualised

Nevertheless, as we enter the second half of the year the picture looks a little more promising. Here are 3 reasons why:

1 Green light for USMCA ratification

There has finally been some brighter news on the United-States-Mexico-Canada-Agreement (USMCA). US metal tariffs and both Canada and Mexico's retaliatory tariffs were removed on Friday, 17 May. While there are still some key Democratic objections left to be resolved with certain areas of the agreement, we think that the elimination of tariffs – coupled with recent reports that US Vice President Mike Pence is putting pressure on Congress to pass the deal by summer end – suggests that ratification is ultimately possible (read here for a more detailed analysis).

2 US-China trade war: Things will get worse before they get better, but a deal is still probable

Trade tensions between the US and China have flared up once again and the risk that President Trump imposes tariffs on the remaining basket of Chinese goods, or on global car imports, is rising. This could be coupled with further retaliation from China, which could take the form of measures designed to make it harder for US businesses to operate in the country. In other words, things could get worse before they get better, but our base case remains that a deal is still ultimately probable. If this is the case, it would remove a big cloud from the global outlook – including in Canada.

3 Better economic data could be on its way

The strength of the labour market has recently been one of the only bright spots in the economy. But when you incorporate the effects of the ongoing recovery from the late-2018 oil price decline, as well as some indications that the housing market will emerge out of its current slump, we anticipate economic growth will slowly begin to regain some momentum as we enter the second half of the year.

> In our view, the Bank of Canada is likely to remain firmly on hold throughout the course of this year – although a lot depends on how the global trade war evolves, how the Fed subsequently responds, as well as what happens domestically following the federal election campaigning process.

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