# Bank of Canada hikes rates for first time in 7 years

Strong growth has led the Bank to hike rates but is this as good as it gets for the Canadian dollar?

## Banking on inflation

After a surprise turn-around in communication from Governor Stephen Poloz and his deputy, Carolyn Wilkins (above), over the past few weeks, the Bank of Canada (BoC) has hiked rates for the first time in seven years. That comes after a run of encouraging growth since the start of the year which “bolstered the Bank’s confidence in its outlook for above-potential growth”.

The big question for markets now is 'what next?'

In hiking rates, the BoC is banking on the stronger growth and employment backdrop pushing up inflation over the next 12-18 months, in effect hoping that the Philips Curve effect will come through.

With all three of the Bank’s core inflation measures having fallen back considerably over recent months, markets may ultimately view this as a fairly bold move. The BoC is citing a range of temporary factors, electricity rebates in Ontario and heightened food price competition, amongst others, as reasons for the recent weakness in inflation. This argument sounds very familiar to Fed watchers.

## Consideration of household debt, house prices and Trump

Household debt and house prices will also be another big consideration. This issue is always a bit of a double-edged sword; on the one hand, there is a need to curtail the boom in both prices and debt, but an overly aggressive rate hike path could risk causing economic damage.

Add in the degree of uncertainty in the US related to President Trump's economic policies, and all this leads us to think the path of rate hikes will be fairly cautious and gradual. The four rate hikes being priced in by markets over the next 12-18 months may prove to be a little bit too steep at this stage.

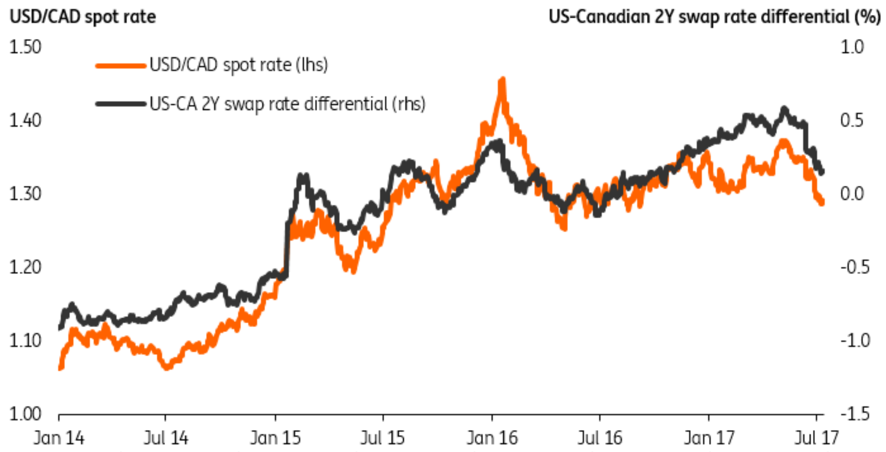
## FX implications

Optimistic BoC projections mean this could be as good as it gets for CAD.The Bank's expectations for the output gap to close fully by year-end lies on the optimistic side - given that it stood at 1.4% in 1Q17. While the lack of forward guidance and explicit concern over currency strength will confirm the current hawkish market bias in the near-term, we think the risks to short-term domestic rates – and CAD – lie to the downside once markets settle.

2Y US-Canadian swap rates have narrowed quite substantially over the past month and making the case for any further narrowing is difficult. To see the BoC hiking faster than the Fed over a 2-year horizon would require a significant divergence in the outlooks for the two economies and that's not something central to our scenario.

In reality, the 'one (or two) and done' nature of any policy normalisation means that chasing CAD upside from here could prove unrewarding. Key data releases over the coming months will either justify or disprove the BoC's hawkish tone. With officials setting the bar fairly high, the risks are that data disappoints. We would look for USD/CAD to consolidate in the 1.2750-1.2950 range over the near-term, with risks the pair trades closer towards the top of this range. Any disappointing Canadian inflation data later in July risks a sharp correction towards 1.30.

## Narrowing swap rates have strengthened CAD




Source: Bloomberg

Photo credit: Bank of Canada