Global Economic Research

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CAPITAL MARKETS RESEARCH

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Special Update

Reinforcing Our BoC Call

Four Recent Factors That Support Our Call for a BoC Pause Until October

Perhaps the biggest market implication to yesterday's Federal Budget amazingly didn't receive any air time whatsoever. That lies in what it means for the Bank of Canada. As all three opposition parties rejected the Budget, and Finance Minister Jim Flaherty rejected any notion of further compromise, the government could well fall by the weekend and an election will follow. This G&M piece is a useful summary of the varied scenarios that could spark an election: http://www.theglobeandmail.com/news/politics/how-the-tory-government-could-fall/article1952470/. A risk relates to the fact that one 11th-hour development—though the likelihood is less than 50%—could be a formal agreement between the Federal and Quebec governments for sufficient adjustments to Quebec's value-added tax (the Quebec Sales Tax) that would result in Ottawa providing roughly $2.2 billion in transition assistance to the Province. The size of this federal transfer would make it difficult for the Bloc not to vote for the Budget, in which case it could still be possible to avert an election.

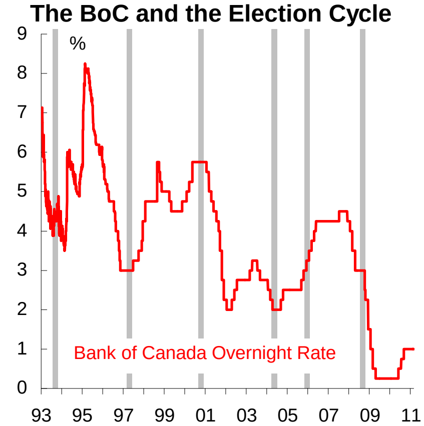
We take this opportunity to reinforce our longstanding view that the BoC is on hold until October of this year (or possibly later) by pointing to recent fiscal, political, and indicator developments. Since we're off consensus and off market pricing in our call, this would suggest the risk of near-term CAD softness if the BoC is pushed out by markets.

The BoC and The Electoral Cycle

If it arises, an election call matters to the BoC for two reasons. First, as we've previously stressed, over roughly the past twenty years, the BoC has generally avoided starting a tightening campaign during an election period (chart 1). It only did so in 1997, and that was because the economy was rapidly healing after the disaster of the first two-thirds of the 1990s when nearly three quarters of a million jobs were created in the back-to-back years of 1997-98. For our international audience, recall that this would be equivalent to a massive gain of about 7-8 million in US nonfarm payrolls. A strong macro backdrop provided the policy flexibility for the BoC to hike.

Chart 1

The BoC and the Election Cycle



Grey bars represent 3 months before Federal Election. Source: Scotia Capital Economics

Now, let's be clear that we respect the fact that the BoC is an independent institution operating at arm's length from the government, and that it has earned great favour with the markets while earning its objective inflation-fighting credentials over the past two decades. But one reason why the BoC has been historically reticent to commence a tightening campaign during an election period relates to the uncertainty over the fiscal regime that will unfold during and after an election. Historically, that has been a very legitimate reason for monetary policy to shift to the sidelines in order to digest what transpires on the political scene and in terms of fiscal policy. That's not a central bank that is politically influenced — it's just good policy.

In the current context, if a May or June vote is in the cards, then add to that the lag between the election results and when a government takes office with a fresh mandate. A further lag relates to when a new government is able to introduce a new budget and see it through to its passage and implementation. To us, the various lags push us well into the summer before further policy clarity is provided, and hence further clarity is achieved with respect to its implications for the economy and financial markets. At a minimum, that removes talk of a Spring rate hike in our view, as the April Monetary Policy Report is likely to continue setting a very cautious tone especially in the context of geopolitical, commodity market, and currency developments.

But our hunch is that fiscal drag will still lie significantly on the horizon in a manner that tightens policy conditions and does some of the BoC's work for it, along with the effects of a strong CAD and the crowding-out influences of higher commodity prices on domestic incomes and non-resource profit margins. The only question is with respect to how much of this belt tightening is distributed over this year and next. Should it be delayed somewhat because of election dynamics, then more of the fiscal drag may be postponed until later this year and into next in a fashion that continues to counsel caution at the BoC into the Fall and perhaps beyond.

A Spent-Out Canadian Consumer

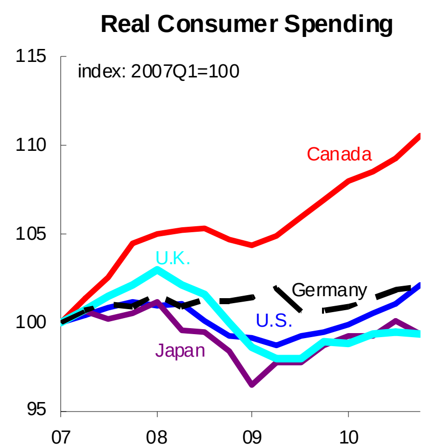
Yesterday's retail sales figures also reinforced our view on the BoC. The Canadian consumer is tapped-out. Exhausted one might say, as inflation adjusted retail sales have dropped a cumulative 1% through two successive monthly declines. Forget the chatter about how a hike in the Quebec sales tax distorted the picture. That's nonsense. For one thing, sales fell by about a half percentage point m/m in each of Ontario, BC and Alberta where there were no tax changes. For another, the impact of a hike in the QST isn't that theoretically obvious. A higher sales tax puts upward pressure on prices which should lift nominal retail sales. Front loading purchases prior to the tax hike would put downward pressure on retail sales. Thus, faced with competing effects, a 1% rise in the QST that sparked a 1% drop in nominal sales is somewhat harsh to fully pin on the QST hike. It says to me that there was indeed a sales tax influence, but that Quebec's sales apart from this effect would have been weak anyway. Add to this the evidence that sales fell in so many categories on nationwide terms, thus reflecting broad based weakness.

Why such weakness? One reason could well be to return to one of our themes that, unlike elsewhere, there is no pent-up demand in Canada. Real consumer spending indexed to the start of 2007 for Canada compared to other major economies shows Canada as being unique in having moved to record highs through the crisis and following, while every other major economy was flat to down (chart 2). The same holds true for record-high home ownership rates (chart 3) as mortgage innovation starting in 2007 at an already strong point in the housing cycle pulled forward future housing demand into the environment of the past few years. The country cannot have its cake and eat it too by way of sustained expectations that the household sector can outperform other countries through the crisis period, and expect to continue doing so in the years ahead.

The BoC's Trade Competitiveness Concerns Are Justified

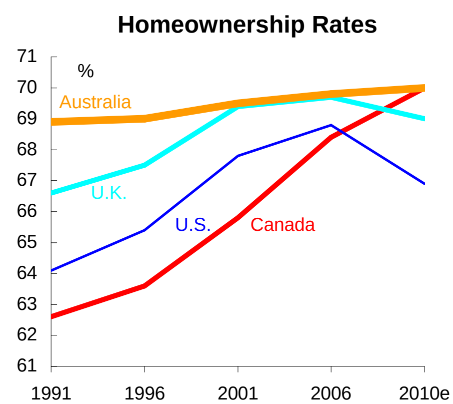
The recent trade figures also reinforce the BoC's legitimate concerns about the extent to which Canada is able to leverage up the US recovery. The real trade deficit took an abrupt turn for the worse in the latest figures for January via a massive monthly trade deficit that grew by 25% m/m, and December was not as strong as initially understood so December GDP could be revised a touch lower. This vindicates BoC concerns — and ours — over the uncertainty facing the direction of Canadian trade through a loss of export competitiveness via weak productivity and a strong CAD alongside sizeable import leakage effects.

Chart 2



Source: Global insight, Scotia Capital Economics.

Chart 3



Source: Scotia Capital Economics, Statistics Canada, U.S. Census Bureau, U.K. Office for National Statistics, Australian Bureau of Statistics.

As chart 4 depicts, the real net trade deficit deteriorated sharply against the temporary December aberration against the trend. This will weigh significantly against January GDP. So will the 0.6% m/m drop in real retail sales in January. Flat hours worked will also weigh against January GDP, since GDP equals hours worked in the overall economy times labour productivity (real output per hour worked). Lastly, housing starts were flat at 170.6k in January compared to 169.3k in December such that housing is unlikely to have played a material role in driving growth. Starts bounced back in February, but almost entirely due to volatile multiples projects that offer lower economic value-added than single home construction activity. On a distorted high base effect stemming from starting key lumpy multiples projects, starts are likely to soften again. The only material bright spots in January GDP were in manufacturing and wholesale trade, and we expect those sectors to be unable to do enough of the heavy lifting on a decent GDP print against the other downsides we've listed.

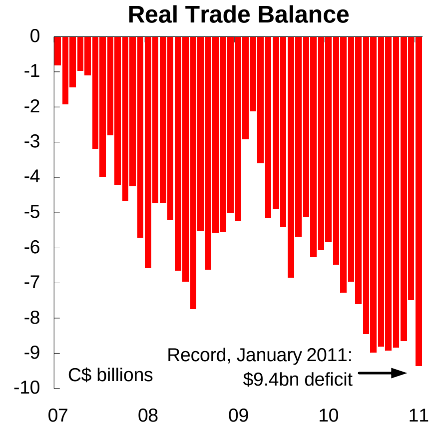
Should the net trade deterioration in January stick for the quarter with February and March posting similar real net trade balances, and based upon what we know happened to trade revisions in Q4, the very early read on real net trade sees it as a drag into Q1 with the real trade deficit rising 12% q/q non-annualized.

Thus, the implications for the output gap are such that the Q3 downward surprise on growth compared to BoC expectations, the Q4 upward surprise, and the weak start to Q1 don't leave us expecting much by way of any shift in thinking about when the country closes off its output gap. In the January MPR, the BoC expected this to occur only in late 2012. Of further significance is that the supply side of the economy continued to grow through business investment and jobs particularly via the out-sized gain in January. An expanding supply side points to still elevated levels of excess capacity in the Canadian economy. Should one work backward from when the output gap is expected to close off using standard monetary policy cycle lags, then this too might support a BoC hold until the Fall. We caution, however, that output gaps and inflation have been poorly correlated after the 1980s, such that inflation expectations, arguments for why we have relatively sticky wages and prices, and policy credibility play bigger roles in shaping the inflation outlook.

Inflation Remains Dead in Canada

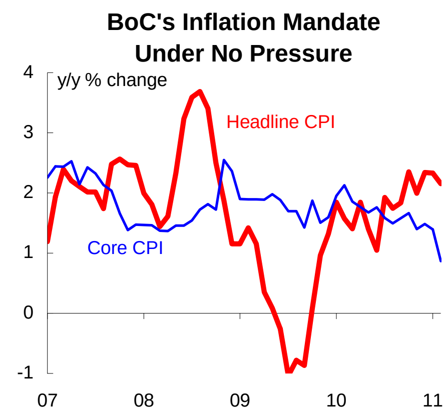
On that last note, the BoC can take its time in evaluating inflation risk. It is in no danger of breaching its inflation target any time soon. In fact, at 2.2% y/y on headline, and 0.9% y/y on core, the latest inflation prints are largely going nowhere in Canada (chart 5). The BoC targets headline but uses core as its operational guide on the view that the two measures ultimately converge upon one another. Thus, unless one anticipates sustained large percentage future changes in food and energy prices, headline inflation is likely to peak and soften in future while a weak base effect might put mild upward pressure on core inflation as the two converge upon a net picture marked by little inflation concern into 2012.

Chart 4



Source: Scotia Capital Economics, Statistics Canada.

Chart 5



Source: Scotia Capital Economics, Statistics Canada.