



## PERSPECTIVE

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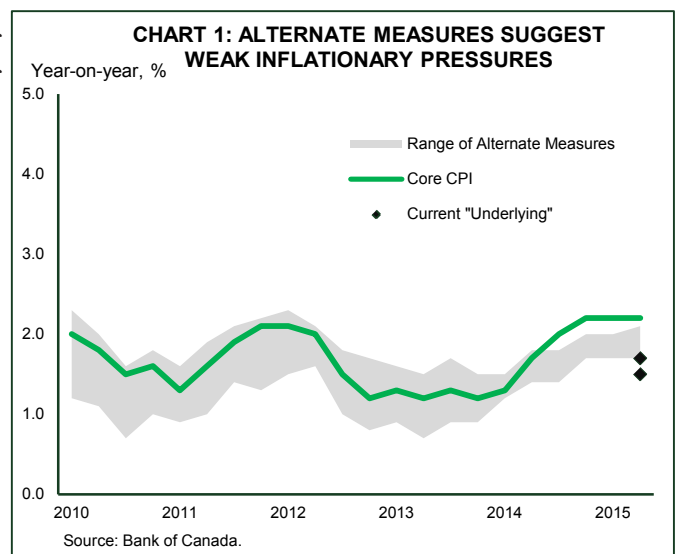


### THE TIES THAT BIND *THE BANK OF CANADA WILL NOT BE COMPELLED TO FOLLOW THE FED IN RAISING RATES*

Federal Reserve Chair, Janet Yellen, indicated in a speech last week that the majority of FOMC members supported raising the federal funds rate by the end of this year. Due to the strong economic and financial links shared between the U.S. and Canada, there is a historical parallel between rate cycles. In fact, history does not favour the Bank of Canada standing pat for too long when the Federal Reserve is raising rates, leading to some speculation that once the Fed launches a rate hike cycle, Canada will not be far behind in doing the same. Part of this story is embedded in the view that the Bank's closely monitored operational guide for inflation, the core consumer price index (CPIX<sup>1</sup>), has already nudged above its 2% threshold. Pass-through price effects from a weak loonie risk pushing it even higher. The Bank cannot risk unhinging market expectations. After two decades of fighting the good fight, if market participants believe the Bank's commitment to upholding the inflation target is wavering, it will limit the flexibility and effectiveness of monetary policy as a stabilization tool.

We don't subscribe to this follow-the-leader view. In fact, we believe the Bank of Canada will trail the Federal Reserve by at least a year in raising rates. There are two ways to interpret this. One is to say that a lag of this degree is without recent historical precedent. The other is to say that a deviation in monetary policy is not without historical precedent. Case in point, there have been two recent instances (mid-2002 and 2010) when the Bank initiated a rate hike cycle not in parallel with the Federal Reserve. In both, Canadian economic activity was persistently exceeding the Bank's expectations and was outstripping U.S. demand growth by a wide margin. In 2010, the deviation in economic conditions occurred in stark fashion. Because Canada had not inherited the same banking and lending legacy effects as the U.S. from the Great Recession, Canadian domestic demand bounced back with a vengeance under the ultra-low interest rate environment. During the first four quarters of the recovery, Canadian domestic demand grew just shy of 6%, nearly triple that of the U.S.

The dynamic is the opposite today. Canada lacks the pent-up demand conditions that exist in the U.S. for housing and consumer spending. We have the added challenge to resource sector investment and incomes from low commodity prices. We predict that Canadian domestic demand will average a measly 0.7% this year and just 1.5% over the 2016-2017 period. This will be roughly half the equivalent U.S. metric. In other words, even with stronger growth coming from the export sector, Canada will have slow uptake in excess capacity. This will be occurring alongside a greater degree of economic uncertainty, with our growth prospects tied to the vagaries of the global economy via the export,



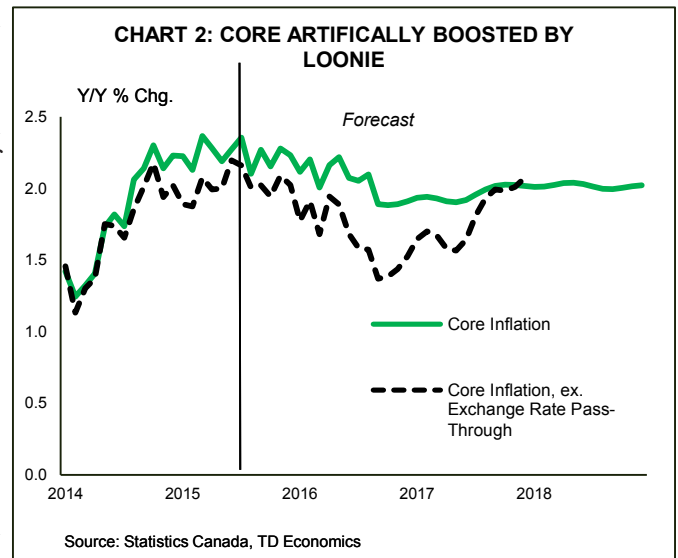
investment and commodity channels. Details are within our latest [Quarterly Economic Forecast](#). Ultimately, the decision to raise rates rests on the Bank's view of underlying inflationary pressures. This, in turn, is often a function of the output gap – the difference between actual output of the economy and its potential. If the output gap is seen as disappearing faster than expected (as was the perception in 2010), the threat of inflationary pressures looms larger. We don't think this will be the case. If all goes according to plan, the output gap is unlikely to close until mid-2017 by both our estimates and the Bank of Canada's most recent communication.

This certainly doesn't negate the concern that if underlying inflation has already squeaked above 2% despite existing economic slack, aren't the inflationary risks skewed to even higher as the economy continues to eat up slack?

First, it's worth pointing out that inflation expectations have not moved materially away from 2% in either the most recent period, or past periods of stronger core inflation. This speaks to the success of the Bank of Canada in anchoring inflation expectations. Second, it's important to understand that there is not a one-size-fit-all inflation measure. Although the Bank has identified core CPI (CPIX) as their main operational guide (since 2001), it is precisely that: a guide. The Bank actually monitors and publishes multiple measures of underlying inflation – six different versions of CPI and a handful of other measures related to broader GDP and consumer spending. Each measure has its unique advantages, but the CPIX was largely picked as the preferred operational guide because it ticked all the boxes when it came to four criteria:

1. being less volatile than total inflation
2. tracking long-run movements in the total CPI very closely (being “unbiased”)
3. reliably predicting future trend movements in the total CPI
4. being easy to understand and explain to the public

Although the CPIX succeeds on many fronts, it's not a perfect measure. At times, other measures are better at capturing underlying trends or cutting through the noise in the data. This appears to be one such time. In the July Monetary Policy Report and in various speeches, the Bank has cited an underlying inflation rate in the range of 1.5% to 1.7%, roughly half a percentage point lower than the CPIX tracking. Why? The Bank recognizes the rapid 15% depreciation in the trade-weighted loonie as a one-off influence that is lifting core inflation, just as low commodity prices are temporarily doing the opposite in pushing down the total CPI measure. To quote Governor Poloz in a recent speech, “...we expect these to be one-off effects, and, as such, we would look through them.” The Bank *should* refrain from adjusting monetary policy to transitory influences, because these are not indicative of underlying demand conditions in an economy. In fact, raising rates in response to currency pass-through to inflation can become completely counterproductive to promoting the economic and financial welfare of Canadians – which is the Bank's ultimate objective. A weakening Canadian dollar is either a signal of weaker domestic fundamentals relative to other countries, or it is a reflection of a broader global flight-to-safety movement towards deeper and more liquid markets, i.e. the U.S. dollar. The current experience appears to be a little from column A and a little from column B. Neither reflects an economy operating near or above capacity, whereby healthy demand is bidding up prices broadly in the economy. Responding by tightening monetary policy would serve to further



weaken an already lukewarm economy.

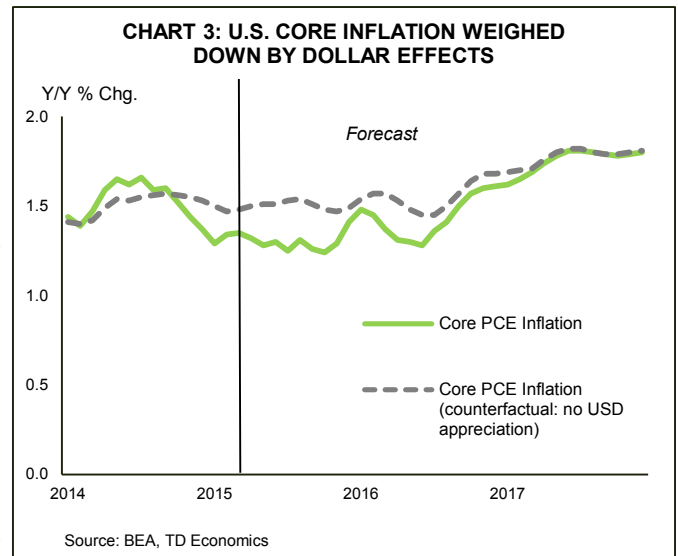
This is why it's important to consider alternative measures of core inflation, so the Bank can have a more fulsome understanding of the inflationary influences. For instance, Deputy Governor, Agatha Cote has cited the Bank's "common component" CPI measure as being well suited to seeing through one-off isolated price changes, with the added advantage of being more highly correlated with measures of economic slack. This measure is tracking 1.7%, the upper range of the Bank's current view. On the front page, Chart 1 shows that among the Bank's various underlying CPI measures, most are below the CPIX operational guide.

To get a read on the influence of the lower loonie on core inflation, we've isolated and excluded the exchange-rate pass-through (Chart 2). While not meant to be interpreted as a precise measurement, it offers a guide and may be indicative of the Bank's motivation in downplaying the current inflationary risks. The Federal Reserve

finds itself on the exact opposite side of this dynamic, with U.S. inflationary pressures feeling the downdraft of a higher greenback (Chart 3).

All this to say, we believe the Bank of Canada will be patient in tightening monetary policy, likely erring on the side of caution and waiting long after the Federal Reserve commences lift off to do the same. However, there is a twist. Even with the Bank staying pat on policy, Canada will still experience tighter financial conditions as the Fed raises rates. That's because when it comes to Canada and U.S. bond yields, the ties really do bind. Movements in Canadian longer terms yields have about an 85% correlation to movements in their U.S. counterparts. This is true even in times when the Bank of Canada's monetary policy diverges with the Fed.

We do think the Federal Reserve will take their benchmark rate up by 75 basis points by the end of 2016. This will correspond to a slight upward shift in the U.S. yield curve that will trickle into Canada's yield curve beyond the one-year horizon (for forecast details see [Dollars and Sense](#)). The difference between the two yield curves is that the Canadian curve will steepen with the Bank not adjusting the short end, while the American curve will more broadly flatten out. Even though we expect the loonie to weaken further in the near-term, the benefits to improved competitiveness within the export sector will be offset by potentially higher business and household lending rates, which are largely priced off changes in the government bond yields. Residential mortgage demand is particularly sensitive to the favoured 5-year mortgage rate. Our analysis indicates that a change of 40-60 basis points would restrain homes sales activity by roughly 10-15% over a 6-9 month period. The 5-year mortgage rate is also the benchmark that applicants are income tested against for approval. Movement here will be particularly material following Fed lift-off, even if mortgage applicants shift their preference towards the variable rate. We have already baked this analysis into our baseline view, with expectations that Canada's housing market will cool next year and particularly in 2017. But, it does point to the notion that even with the Bank of Canada standing pat next year, the economy will be experiencing an implicit tightening in financial conditions. This will help keep inflationary pressures at bay and afford the Bank more time in ensuring that the Canadian economy is on stronger footing before lift-off in the policy rate. The bottom line is that the economic growth trajectory must be the main driving factor behind the inflation and monetary policy trajectories.



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## Endnotes

- 1 The CPIX (core CPI) measure excludes the 8 volatile components of fruits, vegetables, gasoline, fuel oil, natural gas, mortgage interest, inter-city transportation and tobacco. It is further adjusted to exclude the effect of changes in indirect taxes.

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