"Roaring" Canadian economy to spur earlier rate move by the Bank of Canada

TORONTO – Continued near-term strength in the Canadian economy is expected to bring an interest rate hike forward, say TD Economists in the June 2017 edition of their *Quarterly Economic Forecast*. TD Economics' revised interest rate outlook comes alongside a hefty boost to its growth outlook for this year to 2.8% from 2.3% in its March projection.

"A key precondition for the central bank to raise rates is for inflation to move higher. We expect this box will be ticked, especially as economic growth in Canada continues to run well above its trend rate in the coming months," according to Beata Caranci, Chief Economist. Accordingly, TD Economics has brought forward expectations of Bank of Canada lift-off by six months, to October 2017.

Near-term economic momentum = a three-peat on growth

Canada's economy has not only shown surprising strength since mid-2016, but is leading the G-7 pack with real GDP growth averaging more than 3% (annualized) through the first quarter of 2017. Moreover, early readings of the economy's performance in the second quarter point to another 3% expansion.

While the impressive pace is not expected to be sustained in the year's second half, economic growth will likely hold in a 2% to 2.5% range, above the economy's longer-term trend rate.

"Canada's momentum this year has been largely a story of consumer spending, as hiring remains solid and the benefits of past gains in housing wealth drive purchases of big-ticket items. But that's not the whole story, as we're now seeing signs of life in other sectors. Non-residential investment in particular appears to be slowly finding its legs after two very difficult years and exports are poised to make a modest comeback beginning in the second quarter," remarked Caranci.

Despite the good news, risks have not abated. For instance, the U.S. administration has pulled the trigger on NAFTA renegotiations, and domestic housing risks have become accentuated. Forecast uncertainty is running higher following a slew of policy measures by the Ontario government to rein in unsustainably strong sales and price activity. Noted Caranci: "Vancouver and other international experiences tell us that this form of policy intervention tends to cool the market, and not force a significant correction. However, Ontario imposed a broader set of measures amidst a market that may have been prone to more domestic speculative behavior, making impact-assessment more difficult. Our view is that the adjustment will continue through to the third quarter, at which point signs of stabilization in the Toronto region's resale market should become visible."

Nascent inflationary pressures to give BoC green light to raise rates

Despite several blockbuster quarters of economic growth, underlying measures of inflation are running significantly below the Bank of Canada's target of 2%, due to the economic slack that appeared in 2015 and 2016. "Given that economic slack should be largely absorbed by mid-year, inflation is nearing an inflection point," says Caranci.

January hike to be the first in 85 months

With price pressures beginning to mount, October should mark the first time in more than six years that the Bank of Canada will raise rates. With uncertainty still elevated, slow and steady will be the catch phrase thereafter. Interest rate increases at roughly six month intervals will leave the key policy rate at just 1.25% by the end of 2018. Caranci notes, "The Bank of Canada has already taken a more hawkish turn in its communications, but much will depend on the evolution of the data in the coming months. As inflationary pressures begin to re-appear, there will be nothing standing in the way of the first rate-hike in 85 months."

Outside of the U.S., Canada will be one of the only other major peer country with economic fundamentals that warrant a rate-hike cycle. As such, the Canadian dollar should strengthen towards 77 US cents by year end. Likewise, bond yields will be pressured higher by the dual impact of monetary tightening both at home and in the U.S.

Moderation in growth in store next year

TD Economics expects higher rates to help contribute to a moderation in economic growth to roughly 2%. "We don't expect a significant household deleveraging cycle to kick in, but moderate increases in borrowing costs will dampen the sugar-rush in consumer spending," noted Caranci. The gradual increase in interest rates is also expected to help ensure that a soft landing takes place in the Canadian housing market activity over the next few years.

Despite the forecast upgrade and early signs of improvement in investment, Canada's most significant longer-term vulnerability has not changed: an over-reliance on debt-fuelled consumer and housing growth. "We continue to count on increased business activity, government spending and exports to take up a good part of the slack from reduced growth in household-related spending," said Caranci.

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