ECONOMIC AND FINANCIAL MARKET UPDATE

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Range bound

Bond markets struggled to find direction in March, following the ebb and flow of economic data and central bank speak and ultimately ended the month little changed. Fiscal and monetary policy continued to share the spotlight in the US where Treasuries sold off early in the month as a more hawkish tone from Fed officials cemented expectations for another rate hike. That trend reversed, however, when the Committee's statement and projections failed to double down on the hawkish shift. Indication that the Trump Administration might have difficulty passing fiscal stimulus measures was also a factor pushing UST yields back to the lower end of their recent range. Canadian yields followed a similar pattern, driven in large part by US moves but with the domestic narrative also playing along. With Canada's economy continuing to outperform expectations (and the labour market going along for the ride), markets were pricing in rising odds that the Bank of Canada would follow the Fed in scaling back accommodation later this year. However, a less-than-optimistic tone from members of the Governing Council served to undercut those expectations ahead of the Bank's Monetary Policy Report on April 12.

The European Central Bank has also had to talk down expectations for tighter monetary policy after subtle changes to their March statement led to markets pricing in higher rates next year. While the euro area's recovery is clearly gaining momentum, the ECB has been keen to emphasize that stimulus will remain in place at least until a sustained pickup in underlying inflation is evident. The argument is more finely balanced in the UK, where a clash between rising inflation and expectations of softer growth have left the Bank of England ready to respond in either direction. Markets continue to lean in the direction of a rate hike this year, but with some evidence that Brexit effects are starting to weigh on the economy, we think those expectations will ultimately be disappointed.

Canada's economy jumped out of the starting gate in 2017…

Canada's run of solid economic growth showed no sign of letting up with January GDP rising 0.6%—twice the pace expected heading into the report—to build on solid gains in late-2016. January's increase was widespread across industries; goods production recorded another solid gain on strength in manufacturing and mining while growth in the more stable services sector was the strongest in a year. On a year-over-year basis, non-commodities output continues to increase at a 2% pace while a shift to positive growth in the energy sector—in contrast with the sharp declines seen for much of the last two years—has helped overall GDP growth accelerate to an above-trend rate. This pickup in economic activity gives less reason to discount strong labour market data, although the pace of job gains since mid-2016 still looks unsustainable.

Given the solid start to the year, we have revised up our Q1/17 GDP growth forecast to 3.8% from 1.9% previously. That would mark a third consecutive quarter of Canada's economy outperforming the US. It would also represent another sizeable upside surprise relative to the Bank's January growth projections—implying slack in the economy is being absorbed more quickly than policymakers anticipated. That said, it isn't a foregone conclusion that the Bank will bring forward their estimate of when the economy is likely to reach full capacity. The Governing Council seems keen to avoid any hawkish shift that might lead markets to price in higher Canadian policy rates as the Fed continues to tighten in the US. If the Bank continues to project slack persisting until mid-2018, attention will be paid to the factors offsetting stronger growth.

…and business sentiment is improving…

The Bank of Canada's quarterly Business Outlook Survey (BOS) joined the growing list of indicators showing improvement in the economic backdrop. The most positive development was a further increase in firms' investment intentions, with the balance of opinion on machinery and equipment spending now the second-best since the recession. That improvement is at odds with Statistics Canada's CAPEX survey from a month ago—one of the few disappointing data releases so far this year—that pointed to declining private sector investment intentions in 2017. The Bank's survey does imply that nonresidential investment won't act as a drag on growth again this year. Also in the BOS, hiring intentions and expectations for future sales growth remained positive with both domestically-oriented firms (including those in energy-producing regions) and exporters seeing improving prospects. The latter group, however, is facing heightened uncertainty amid potential US policy changes including corporate tax cuts and protectionist trade measures—two issues that the Bank highlighted recently.

…so time for a change of tune?

The Bank of Canada's March policy statement fell on the cautious side of neutral and recent comments from the Governing Council have maintained that tone despite accumulating upside surprises in the data. Governor Poloz, while careful not to prejudge the upcoming forecast, sounded somewhat skeptical of recent indicators, noting we've seen improving trends in years past that haven't been sustained. So while the Bank will have to acknowledge evidence of a strengthening economic backdrop in the April MPR, we expect some of that optimism will be tempered by continued emphasis on risks to the outlook and persistent slack in the economy.

As noted above, the Bank might tweak growth forecasts (or key assumptions) rather than bring forward their estimate of when the economy will reach full capacity. Indeed, despite recent strength in GDP, employment, and headline inflation, the Bank can point to little change in their preferred measures of underlying inflation (all below 2%) and weak wage growth as evidence of slack. Results of the latest BOS were also consistent with limited capacity pressures or labour shortages and little change in inflation expectations. As for risks to the outlook, the threat of protectionism will likely remain a significant concern as the new US administration seeks to renegotiate NAFTA and global support for trade liberalization appears to be faltering (the latest G20 meeting saw finance ministers drop a pledge to oppose protectionism). Overall, while it is becoming increasingly difficult to justify a dovish stance—and a rate cut now seems like a remote possibility compared with six months ago—there are enough risks and caveats in recent data for the Bank to continue to push back against market odds (~36%) of a rate hike this year.