# ECONOMIC AND FINANCIAL MARKET UPDATE

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## Pushing ahead

The gradual shift away from ultra-accommodative global monetary policy continued in earnest in September. The charge is being led by the Fed who announced they would begin tapering reinvestment of QE holdings in October. They are the first of the 'big four' central banks to start shrinking their sizeable balance sheet after years of buying assets to stimulate the economy. The Fed also indicated they expect to continue on a path of gradually normalizing interest rates later this year and throughout 2018. Confirmation that rate hikes are likely to continue despite low inflation contributed to a selloff in US Treasuries, with the 2-year yield in particular rising to a post-recession high of around 1.5%. And the US dollar rallied further from the year-to-date lows seen in early-September. The prospect of US lawmakers turning their attention to tax cuts also contributed to fixed income and currency moves.

Not to be left behind, the Bank of Canada raised rates again in September following indications that the Canadian economy continued to grow faster than expected over the first half of the year. A subsequent speech by BoC Governor Poloz toned down the hawkishness, emphasizing data dependency and uncertainty about slack in the economy. On balance, however, his comments were consistent with a further, gradual withdrawal of stimulus. Meanwhile, the Bank of England indicated in September that a rate hike might not be far off if high inflation and low unemployment persist. We still see downside risks to the UK's economic outlook, so while the Bank Rate is likely to be raised in November, we don't think the move will be followed by further tightening near-term. Finally, while the ECB continues to provide stimulus through QE and low interest rates, we expect they will announce the pace of asset purchases will be trimmed next year.

## Canada's economy took a breather in July

Canadian GDP was flat in July following eight consecutive monthly increases with growth averaging an impressive 0.4% over that period. July's pause reflected a pullback in the goods sector led by further runoff of an earlier, unexpected increase in oil and gas production. That offset a trend-like increase in services output driven by another solid gain in wholesale trade. With the economy having carried good momentum into mid-year, the slow start to Q3 didn't dent our forecast for another above-trend GDP gain. We continue to forecast a 2.5% annualized increase—slightly ahead of the Bank of Canada's 2% projection—though we'll need to see a return to at least modest monthly gains in August and September to hit that mark. We think Q3 will mark the start of a more moderate but still above-trend period of growth after the economy posted its best-year-over-year increase in more than a decade in Q2. Consumer spending and business investment will remain the primary contributors to growth, though not at the heady pace recorded over the first half of the year.

## Businesses grappling with policy uncertainty

Canadian businesses are facing policy uncertainty on several fronts. Internationally, concerns about US protectionism continue to loom large. Trump's threats to tear up NAFTA may have lost their shock value, but the US's tough stance on trade was evident when the Commerce Department slapped a sizeable countervailing duty on some of Canada's aircraft exports—in the middle of the third round of NAFTA renegotiation no less. Also south of the border, potential changes to US tax policy could impact Canadian businesses. The Trump administration's proposal to lower the corporate tax rate to 20% would erode Canada's competitive advantage in that area, potentially offsetting any strengthening in US GDP growth—and thus increased demand for Canadian exports—that comes along with the cut.

Policy changes at home are also generating uncertainty. The federal government's proposed tweaks to the taxation of small businesses have been a source of controversy, while a planned increase in Ontario's minimum wage has businesses across a range of sectors concerned about rising labour costs. Those issues may have been behind a drop in small business confidence in September, with Ontario's reading in particular falling to a post-recession low. We'll be keeping a close eye on the Bank of Canada's Q3 Business Outlook Survey, due October 16th, to see if the decline in small business sentiment shows up in the form of reduced investment or hiring intentions. The latter survey remains an important input in the BoC's decision-making process, with strong readings in Q2 playing a role in their decision to start raising rates in July.

## Bank of Canada breaks the silence

We hadn't heard a peep from the Bank of Canada since their July hike but that didn't stop policymakers from raising rates again in September, arguing that their emphasis on data dependence combined with steady upside surprises provided all the information necessary. Either way, the Governing Council broke their silence with two speeches in September. The first, by Deputy Governor Lane, centred more on trade than current monetary policy although his concern about recent Canadian dollar strength was notable. But it was the second speech by Governor Poloz that really drew attention. He emphasized that monetary policy remains particularly data dependent, with uncertainty around potential GDP growth, the impact of technology on inflation, puzzlingly slow wage growth and highly indebted households' reaction to higher rates all making it difficult to pin down the appropriate path for interest rates.

The speech was less hawkish than prior comments, and Governor Poloz's views on economic slack were of particular significance. He acknowledged that a mechanical reading of their earlier estimate of slack alongside recent growth numbers would indicate the output gap is now closed. However, he also noted that stronger productivity growth and resulting supply-side expansion meant the economy may still have some room to run. So don't be surprised if the BoC's October forecast shows stronger potential growth and some remaining slack. Nonetheless, we think the economy's proximity to full capacity and decent growth momentum will leave the bank confident that we're not far from 'home' and a gradual withdrawal of monetary policy stimulus should continue. We still expect another rate hike this year but acknowledge the odds of a third consecutive move at the upcoming meeting have slipped in the wake of Poloz's speech.