FINANCIAL MARKETS

BANK OF CANADA: THE NEXT RATE HIKE?

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We believe that sound investment and trading decisions begin with a strong grounding in financial education. Our goal is to make this available to everyone - and this free eBook is part of that commitment.

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THE BANK OF CANADA

FOREWORD

In this eBook, we will take a look at what the coming months hold for the Bank Of Canada's monetary policy.

There's currently a debate as to whether the next interest rate hike is more likely to happen in September or October. We will explore when the next move is likely to come.

We will also take a look at how the timing of an interest rate hike could affect the Canadian dollar.

Patrick Latchford
CEO, Blackwell Global Investments (UK) Limited

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ANOTHER HIKING CYCLE

MONETARY POLICY STATUS

The Bank Of Canada is currently in a hiking cycle. The most recent hike was in July 2018 - and that was the fourth hike in just a year.

Steady economic growth and low unemployment have led to the gradual tightening of monetary policy.

Back in May, Statistics Canada announced that the Canadian economy grew by 0.5%. This was mostly thanks to an improved performance by the domestic and export-oriented sectors.

This result was above the market expectations of 0.3%, according to Josh Nye, the senior economist at RBC Economists Research. With activity rising each month in 19 out of 20 industries, this was Canada's broadest gain in over a decade.

It's why most economists were expecting another rate hike in October 2018.

GDP GROWTH

So why did the Canadian economy grow by 0.5% m/m in May? Let's take a closer look.

Canadian GDP only grew by 0.1% in April 2018. This has been attributed to poor weather as an ice storm wreaked havoc on Central and Eastern Canada.

There was also a brief shutdown of some oilsands projects in Alberta taking place for maintenance. As a large contributor to the Canadian economy, this also dragged on GDP in April.

With those oilsands facilities returning to production in May, Canada's gas and oil sector expanded by 2.5%. Retail also saw its largest monthly increase since October 2017. There were also gains in construction, export-oriented sectors and manufacturing.

AN INFLATION CURVEBALL

However, recent inflation has led to speculation that the Bank Of Canada might need to speed up its rate hikes.

First, let's get some context. Remember - inflation is simply the rate at which the cost of goods and services is increasing. Most economies track inflation on a monthly and annual basis.

Initially, the Canadian Consumer Price Index (CPI) inflation data forecasts for July were at 0.1% m/m. However, expectations were once again surpassed and the month ended with a CPI reading of 0.5% for the month. This gain saw the annual inflation rate jump from 2.5% to 3% - the highest rate since 2011.

This puts inflation at the edge of the Bank Of Canada's control target (which is 1% - 3%). Such a reading has ignited suspicions that the Bank Of Canada may hike interest rates as soon as September.

Now, why would the Bank Of Canada want to increase its interest rates to address inflation?

It's actually quite simple. By increasing interest rates, the Bank Of Canada is essentially making it more expensive for commercial banks to borrow capital. Commercial banks tend to pass these increased borrowing costs onto their customers too.

Usually, this acts to reduce the flow of money within an economy, reducing inflationary pressure in the process. Practically, this causes prices to fall.

WHAT SHOULD WE EXPECT?

WHEN WILL THE HIKE HAPPEN?

With CPI inflation as high as 3%, you would expect the interest rate hike to happen sooner rather than later.

Some market commentators have expressed that there is a good reason to believe this could happen in September - but this is not necessarily the case.

When we analyse average core inflation measures (a measure of inflation that excludes volatile energy prices) it only increased from 1.97% to 2% from June to July. This shows that inflation is at a sustainable for the Bank Of Canada.

Now, as a trader, you need to know that the Bank Of Canada attributes more weight to core inflation measures that CPI inflation data. They are both extremely important - but CPI inflation can fluctuate.

This is why the market overwhelmingly expects a 25 basis point rate hike in October rather than September.

WHAT TO EXPECT FROM THE CAD

The idea of faster rate hikes caused the Canadian dollar to climb to C$1.3070 against the US dollar. But as we've already explained, core inflation measures indicate that a rate hike will likely happen in October.

As it stands, the only serious threat for a monetary policy shift would be the North American Free Trade Agreement (NAFTA). President Trump is currently renegotiating NAFTA in an attempt to balance the US trade deficit.

Plus, earlier this year, President Trump imposed 25% import tariffs on Canadian steel and 10% import tariffs on aluminium. Canada went on to retaliate with 25% import tariffs on US assorted metal products.

As this situation develops, CAD could easily enter periods of volatility. If NAFTA negotiations hit difficulty, CAD could also experience serious downward pressure. This could change the whole monetary policy picture for the Bank Of Canada.

Put simply, free trade is critical for a strong Canadian dollar. If the US leaves NAFTA, the Canadian dollar is likely to face extreme downward pressure.

However, at the time of writing, traders should anticipate another interest rate hike to 1.75% in October.

Remember - interest rate hikes tend to strengthen currencies over the long-term. This happens because the money supply is tightened, while demand for the currency is still high. Higher interest rates also attract foreign direct investment, which again increases demand for the currency.


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