July 15, 2015

Another unnecessary rate cut by the Bank of Canada

In what was one of the more hotly debated decisions in recent memory, the Bank of Canada (BoC) this morning announced a 0.25% decrease in the target for the overnight rate, which now stands at 0.50%. This cut is the second this year and comes almost six months after the BoC's 0.25% surprise reduction in January.

Impact on our bond portfolios

We expect today's rate decision will have little impact on our bond portfolios. Given the recent decline in market interest rates – especially for short term bonds – we believe that this BoC move was mostly anticipated. Our portfolios' durations remain shorter than their respective benchmarks as we continue to believe that bond prices imply much more economic pessimism than is warranted.

Why the BoC made the cut

The interest rate decision ultimately rested on the fact that economic conditions in 2015 have been weaker than the BoC expected. Negative growth in the first quarter combined with what looks to be near 0% growth in the second quarter has put the BoC's last quarterly GDP projection more than 2% behind estimates. For a central bank that emphasizes the "output gap", the difference between an economy's actual output and its potential output, this significant gap provided the BoC with a powerful reason to cut the overnight rate.

Given the weak Canadian dollar and an improving U.S. economy, exports – which the BoC expected to help growth – have been surprisingly weak. Non-energy exports, key indicators for BoC Governor Stephen Poloz, have fallen in seven of the last 10 months and are now down 3.5% from last year. Add in the instability in the Middle East, Greece, and China, plus a slump in commodity prices, and hopes for a near-term rebound in domestic activity appear less certain.

The view from Foyston, Gordon & Payne

We believe that the rate cut was unnecessary.

While Canada's economic performance in the first half of the year has been undoubtedly weak, a broad-based or lengthy recession is not imminent. The economy has added almost 100,000 jobs this year and the unemployment rate is down to 6.8% from 7.0% a year ago. At the same time, this rate cut will encourage more borrowing that will further inflate the overheated housing market. We continue to believe that better U.S. growth and the weaker dollar will jumpstart the economy. However a little more patience is required since these effects often work with a bit of a lag.

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The BoC's overnight rate is already at an exceptionally low level. It's now just 0.25% above the rate seen during the global financial crisis. We don't believe that current economic conditions are even remotely as poor as those experienced during the early days of the "Great Recession".

Given base effects and the weaker dollar, it is entirely possible that both headline and core inflation, which has already been above target for the past 10 months, will both be above the BoC's 2% target by the end of 2015. The rate cut is hardly conducive to keeping inflation low.

The BoC's credibility would certainly be damaged if it were to express four bias shifts in one year – the rate cut in January, a neutral bias, today's cut, then a potential move to a neutral bias later this year if economic growth is better than expected and/or if inflation starts to creep higher.

Given our opinion that the Canadian economy will eventually rebound, we expect no further cuts in the near future. And since the BoC has its credibility to worry about, we don't anticipate any medium-term BoC rate increases either.

Effect on the yield curve

The Canadian yield curve (2-year to 30-year bonds) has steepened by over 50 basis points in 2015. Given that yields on 30-year bonds have changed little this year, short term bonds have been responsible for the entire steepening. Since the BoC can influence short term bonds the most, it is not too surprising that the market has already fully priced in this rate cut. In the long end of the yield curve where the BoC has little influence, we believe that there will be a move to higher rates, and a steeper yield curve, as inflation expectations rise.