Markets eye Bank of Canada rate cut for first time as oil rout damage deepens
By John Shmuel
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Collapsing oil prices and a weakening economy are pushing markets to start pricing in a potential interest rate cut by the Bank of Canada this year.

Those expectations grew Tuesday after Bank of Canada deputy governor Timothy Lane gave a speech in Madison, Wisc., that economists saw as tilting more dovish than usual. Mr. Lane’s speech focused on the economic effects of dropping oil prices, which has become a central concern for policymakers in Canada.

“Lane’s final phrase that ‘however things play out, we have the tools to respond’ highlights that lower rates are an option if conditions weaken sufficiently,” said Benjamin Reitzes, senior economist at BMO Capital Markets.

Markets this week have begun pricing in the possibility that the Bank of Canada might cut interest rates in the next 12 months, something not seen since oil prices began their downward trek in July of last year.

The overnight indexed swap market is now pricing in a 4% risk of an interest rate cut sometime in the next year, say Bank of Nova Scotia strategists.

“The shift has been relatively dramatic with the market having been pricing in an 8% probability of a hike just two sessions ago,” said Camilla Sutton, chief FX strategist at Scotiabank. “Weaker than expected employment combined with falling oil prices is taking its toll on BoC expectations and CAD.”

Oil prices have retreated more than 50% in the past six months, which has further hurt what had already been tepid economic growth in Canada during the past year.

Canada’s labour market continued to cool off in December, with data from Statistics Canada showing 4,300 jobs were lost in December after a loss of 10,700 jobs in November. Economists had called for a gain of 15,000 jobs in the final month of the year.

There are also signs that lower oil prices are already hitting Calgary’s housing market, which up until last year was one of Canada’s hottest.

Calgary Real Estate Board data show sales in January are down 34% from a year ago, while listings rose 22%. That follows a Canada Mortgage and Housing Corp. report last week that showed new housing construction starts fell 10% this month in the Prairie provinces.

A weakening economy and the possibility of a rate cut this year continue to hurt the loonie, which is flirting with six-year lows. The currency was trading at 84.64 cents U.S. Tuesday, its lowest level since May 2009.

Peter Buchanan, senior economist at CIBC World Markets, said Tuesday’s speech by Mr.
Lane and changing market expectations mean that the Bank of Canada is likely to tread a dovish line at its policy meeting scheduled for next week.

“While the Bank has previously stressed oil as a near term negative, the statement should reinforce expectations for a dovish message next week, supporting the short end and hurting the loonie,” he said.