Is Stephen Poloz shorting the Canadian dollar?

By David Rosenberg
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The Bank of Canada's press statement this past Wednesday had a "dovish" tone and my interpretation is that central bank Governor Stephen Poloz would not be at all unhappy with a softer loonie.

The bank trimmed its growth forecast for 2016 to 1.1 per cent from 1.3 per cent and to 2 per cent from 2.2 per cent for 2017, "due in large part to slower near-term housing resale activity and a lower trajectory for exports."

And for good measure, the bank's statement added this: "Recent export data are improving but are not strong enough to make up for ground lost during the first half of 2016, despite the effects of the Canadian dollar's past depreciation. Growth in exports over 2017 and 2018 are projected to be slower than previously forecast, due to lower estimates of global demand, a composition of U.S. growth that appears less favourable to Canadian exports, and ongoing competitiveness challenges for Canadian firms."

There's lots of talk about exports – three mentions above – and when a central banker discusses "competitiveness challenges," that is code for "currency depreciation required."

The bank's new growth projection implies that the economy will return to full capacity "around mid-2018," materially later than the bank had anticipated in July – as in, at least six months further out than was thought in mid-summer, when the output gap was expected to close "towards the end of 2017."

The bank added that while the risks may be "roughly balanced" and the current policy stance "appropriate," it is in the "context of heightened uncertainty."

In the old days, we would have dubbed this as a slight "bias to ease."

What was truly startling was the open admission by Mr. Poloz in the opening statement of his post-meeting press conference that a rate cut had been on the table for discussion. To wit: "Given the downgrade to our outlook, Governing Council actively discussed the possibility of adding more monetary stimulus at this time, in order to speed up the return of the economy to full capacity. … Indeed, a combination of lower interest rates and more stringent macro-prudential policy would likely work to reduce both financial stability risks and the risk of an undershoot of inflation at the same time."

Mr. Poloz clearly believes that the federal government's tightening of mortgage rules affords him the flexibility to do so at some point, and the casualty will be the listless loonie.

If, as the Bank of Canada estimates, these new tighter mortgage rules will end up trimming Canadian GDP growth by 30 basis points, then a quarter-point rate cut at some point would provide the necessary offsetting impact – and Mr. Poloz showed his hand purposefully on Wednesday when he stated that a policy easing was on the table for discussion. (A basis point is 1/100th of a percentage point.)

The bank held back from cutting rates at this last meeting, perhaps because the Canadian dollar would have undoubtedly faced a significant drubbing, seeing as the financial markets were pricing in a mere 2.5-per-cent probability of such a move and no economist was calling for a cut. Shades of Jan. 21, 2015, when the BoC's surprise rate cut that day sparked a near 2-per-cent plunge in the loonie and caused quite a stir over the central bank's communication skills.

But now that markets have moved to at least price in a 20-per-cent probability of a rate cut, and once the other 80 per cent move in that direction, it will undoubtedly place a further drag on the Canadian dollar.

It is often the case that what does not happen is just as important as what does happen. And what did not happen is that the Canadian dollar did not respond to the firm oil price of late or 15-month highs posted in the local stock market.

If the loonie had moved in lockstep with the West Texas intermediate (WTI) crude oil price or the Toronto Stock Exchange, it would be trading closer to 80 cents (U.S.) right now than 75 cents.

What is undermining the Canadian dollar is this overt dovish stance by the Bank of Canada, at a time when investors are laying down bets on a Fed rate hike by year end, and when interest rate spreads across the yield curve are in epic negative terrain as it is.

So what’s the bottom line?

Policy rates in Canada are not going up for at least two years and there is a non-trivial prospect that the next move is a cut, with the recent mortgage rule changes giving the BoC latitude to nudge rates lower without adding fuel to the housing bubble in Vancouver and Toronto. At the same time, a weaker exchange rate is needed to bolster exports as the needed antidote to the looming correction in residential real estate.

This last point is crucial because the housing sector has contributed more than 60 per cent to the overall growth in the Canadian economy in the past year, and over 20 per cent in the past three years, and so something is going to have to step in and fill that void quickly. Exports are going to have to play a critical role in that “something.”

To be sure, the various models we rely on suggest that the Canadian dollar is “undervalued” right now by about 10 per cent, but it will have to become even cheaper to spark the upturn in industrial activity that will be needed to offset the looming drag in the residential real estate industry.

And while currency depreciation is no antidote for the myriad of Canada’s competitive hurdles, it will still give the positive jolt to exporters that we desperately need to maintain even the lacklustre growth we have on our hands, as the hot housing market most assuredly cools off in the months ahead.