TUFF RISK management

The Governor of the Bank of Canada Plans to Retire

This Economic Outlook Newsletter focuses on the economic pressures behind the Bank of Canada's recent decision to raise the Bank rate and provides a look at the imminent yield curve in our future.

Canadians fully understand that the Bank of Canada's primary role is to ensure inflation does not rise to the point to where our future earnings become worthless. If it ever comes to needing a wheelbarrow full of Canadian dollars to buy a loaf of bread, we are all in trouble.

With dangers of inflation now well ingrained in our innermost thoughts due to the continual reminder at all levels of government of the pending doom should Canadians reach beyond their grasp, the Bank of Canada has been provided card blanche authority when it comes to tinkering with our economy. We are told, "Canadians carry too much debt" and that as a consumer nation, inflation is staring back at us from around the corner. There is not a day that goes by without some official reminds us that bubble is soon to burst, in real estate, the stock market and now, even the bit coin.

Therefore with a string of recent increases in the Bank rate, Stephen Poloz, Governor of the Bank of Canada, plans to valiantly save Canadians from themselves.

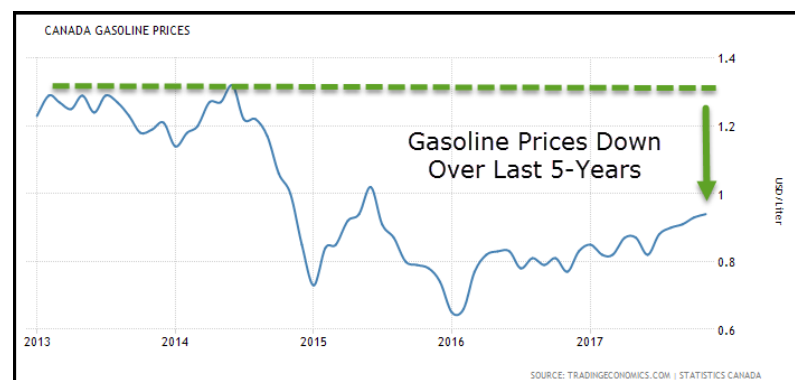
Poloz is correct in many aspects when he states prices are rising. Just step into an automobile showroom to discover the unaffordability of a new car. Check out the cost of homes in Canada's major urban centres, where a majority of Canadian jobs are found.

The only thing is… people such as myself contribute very little to inflationary pressure, with typically 10-years between new car purchases and a lengthy 21-year stint in our last house until a recent commitment to a new home. The items most purchased in this household over the years have been typical expenditures: food, fuel, furnishings and fun.

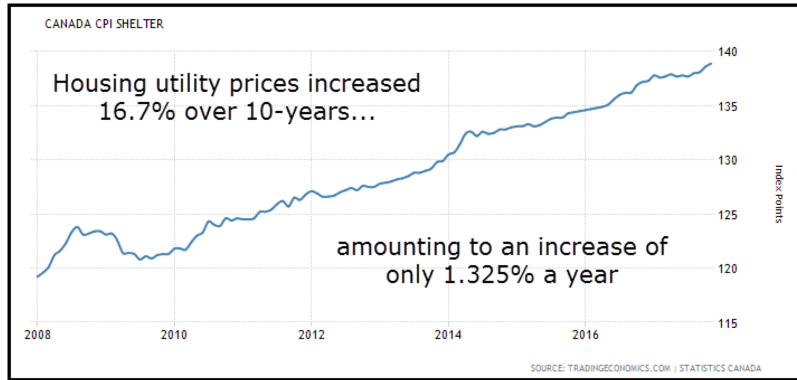
Although Statistics Canada does not track spending on fun, it does monitor increases in the price of pretty much everything else.

Canada Food Inflation, as highlighted in the adjacent chart has actually been deflationary over the last two years and currently sits well below 2.0%.

Gasoline, a highly taxed item and another weekly pocket book item

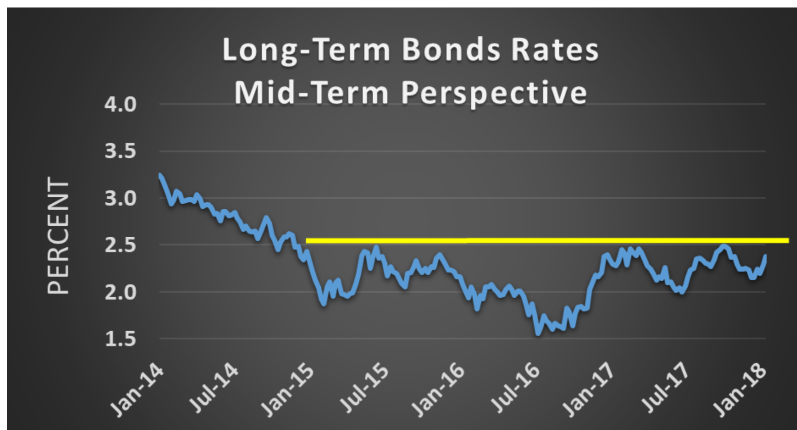


for most Canadians, has remarkably fallen in price over the last 5-years.



Another household expenditure well known to all Canadians given our frigid winters is the home utility bill. Like food, these costs cannot be avoided yet they demand a healthy portion of the average Canadian's disposable income. Although housing utility costs have steadily risen over the last 10-years, the overall increase has been quite modest, at 1.325% per year.

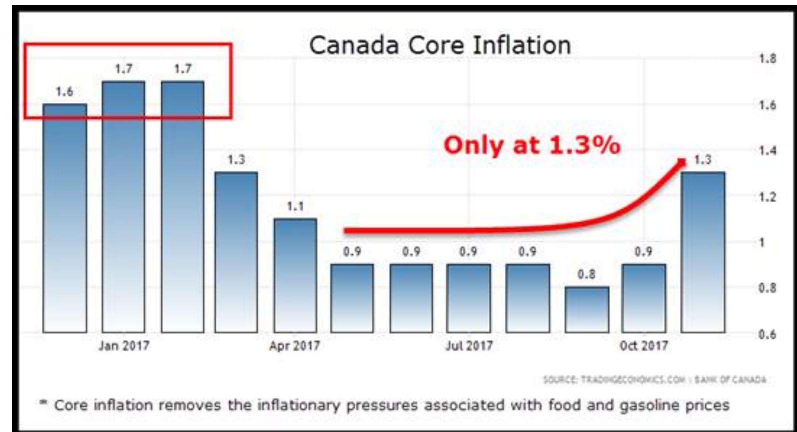
These are the very reasons why the marketplace has not priced in risk of inflation.



The adjacent chart shows Canadian long-bond interest rates over the last four years. Clearly, any investor investing in 25-year bonds would demand much higher yields if future inflation was expected. Yet, long-bond yields have not risen above 2.5% over this four-year period.

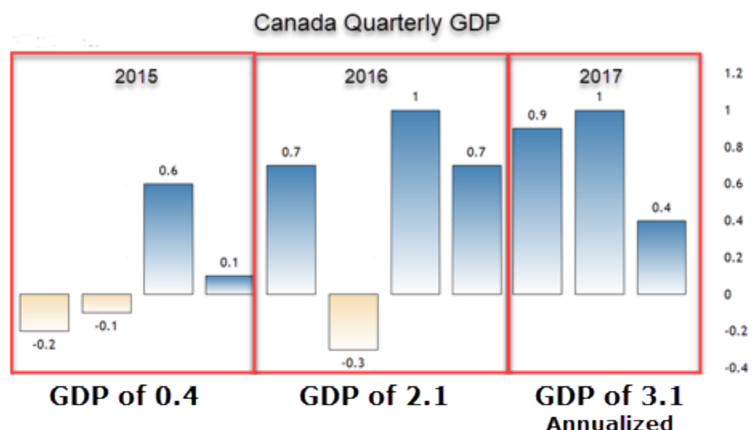
CPI-trim	1.8%
CPI-median	1.9%
CPI-common	1.5%

The most recent read on core inflation in Canada was at 1.3%, indicating little inflation is to be found.



The Bank of Canada's new inflationary measures shown above also indicate inflation in Canada is quite tame.

Therefore, the question has to ask is, "Why did the Governor of the Bank of Canada raise the Bank rate on January 17th?"



The foremost reason given is the current strength in the Canadian economy. With reads on GDP for the first three quarters of 2017 all in positive territory, Canada shows very strong growth economic growth for 2017. Annualized, GDP for last year reads at 3.1%

		Inflation	GDP Annualized	GDP USD Billion	Global Proportion
1	United States of America	2.10%	2.30%	$18,624	23.9%
2	Euro Zone	1.40%	2.60%	$11,886	15.2%
3	China	1.80%	6.80%	$11,199	14.4%
4	Japan	0.60%	2.10%	$4,940	6.3%
5	India	5.10%	6.30%	$2,264	2.9%
6	Canada	2.10%	3.00%	$1,530	2.0%
7	South Korea	1.50%	1.50%	$1,411	1.8%
8	Russia	1.08%	2.50%	$1,283	1.6%
9	Australia	1.80%	0.60%	$1,205	1.5%
10	Mexico	6.77%	-0.30%	$1,047	1.3%
	Weighted Average	**1.92%**	**3.34%**	**$ 55,389**	**71.0%**

Compared to countries making up 71% of global activity, Canada's economy appears quite strong with a GDP recorded at 3.00%. Only China and India outpace the Canadian economy with GDP levels of 6.80% and 6.30%, respectively. Although this is impressive growth for Canada, economists predict GDP will decline to around 2.20% in 2018, back to the middle of the pack at best. Not too hot, yet not too cold, which is hardly a recipe for rising rates today.

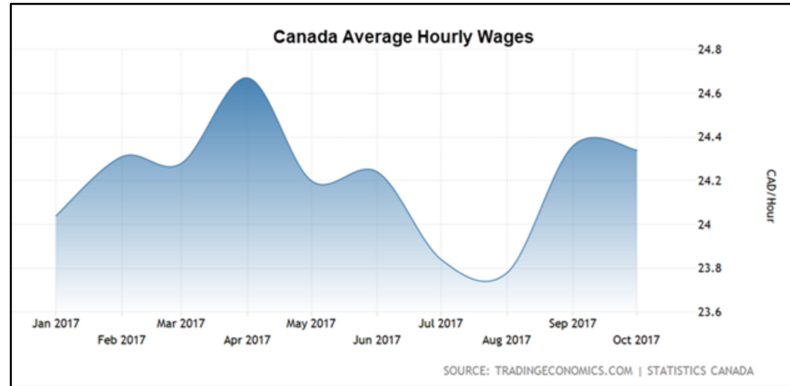
Another reason the bank of Canada raised the bank rate is the recent growth in Canadian employment. The Canadian economy added 422,500 jobs last year, of which 93% were full-time. According to Statistics Canada, the unemployment rate has not been this low in 40-years.

Changing the perspective from unemployment to *employment*, a different picture appears, even though one would expect the unemployment/employment rates to mirror one another.

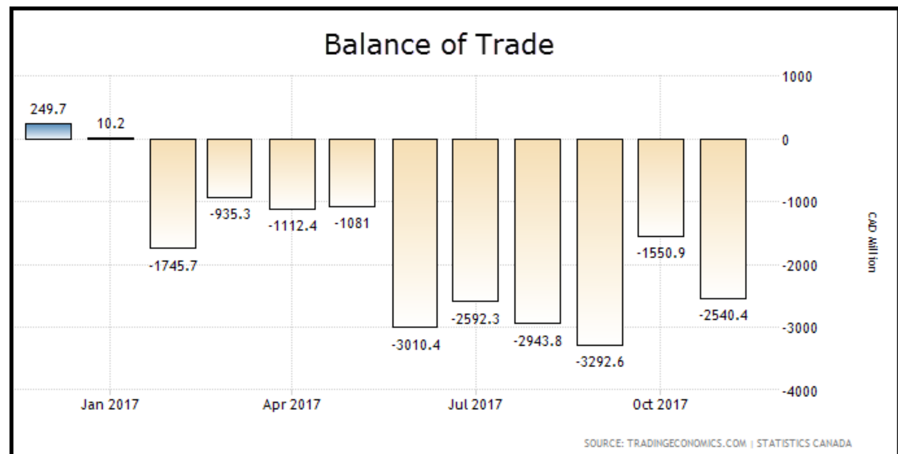
The above chart, provided by the ever reliable database at *tradingeconomics.com*, shows Canada's employment rate at only 62% today (Line "B") compared to a high of 63.7% in 2008 (Line "A"). Relative to 2016, things may look rosy today, but current employment levels are nowhere near 2008 levels.

Simply returning to employment levels of 2012 should not be a reason to increase the Bank rate. However… and on the other hand…an increase in employment coupled with rising wages is a reason for raising interest rates. Unfortunately this does not seem to be the case, as can be seen in the following chart.

Wages, as reported by Statistics Canada, are today lower than in 2017. Although the increase in minimum wage in Ontario may slightly increase the overall average wage hourly wage, only a small proportion of hourly workers in Canada make only the minimum wage. At this time, as in the USA, there is no inflationary pressure today from higher wages.



One other economic factor that may be an influence in the Governor of the Bank of Canada's decision to raise interest rates is if Canada was demonstrating impressive trade. To this regard, Canadian exports did increase 3.7% month-over-month in November, due to higher sales of motor vehicles and parts and consumer goods. Imports to Canada however advanced 5.8% in November, the strongest increase since July of 2009.



Overall, the Balance of Trade in Canada has been negative throughout most of 2017, where imports are greater than imports. Not good at all, particularly with the state of negotiation with respect to the North American Free Trade Agreement currently underway with our largest trade partner.

It is not as if the average Canadian is on a wild spending spree buying imports rather than domestic, needing reined in. Consumer spending over the last three years has increased only 2.06% a year. Further dampening the ability of Canadians to spend has been the 13.8% increase in personal taxes in 2016.

It appears the Governor of the Bank of Canada is ignoring many of the economic indicators and is using Canada's fleeting economic strength as justification to reload his almost empty war chest. By

"normalizing" interest rates, the Governor will be able to, at some point in the future, lower the Bank rate should the Canadian economy begin to falter. Normalizing the Bank rate with a middle-of-the-road economy will only result in a flat yield curve, where short-term interest rates will rise and longer interest rates remain at low levels. This in turn will most affect those borrowing at floating rates.

If indeed, the stronger economy of the USA drags Canadian interest rates higher, as they too rush to normalize their interest rates, higher long-term interest rates in Canada would limit new investment in this country, as a higher ROI's would be demanded and may not be available, as higher interest rates are generally a drag on any economy. This, in turn, would affect Canada's balance of trade… and then the spiral begins.

Earlier this week Tuff Risk attended a dinner at which Mohamad El-Erian spoke of the economic danger related to Central Banks around the world all wanting to normalize interest the first sign of global economic strength, in particular the European Central Bank, the Bank of Japan, the People's Bank of China and US Federal Reserve Bank. Mr. El-Erian, a Bloomberg View columnist, the chief economic adviser at Allianz SE (the parent company of Pimco, where he was CEO), the former chairman of President Obama's Global Development Council, the CEO and president of Harvard Management Company, the managing director at Salomon Smith Barney and the deputy director of the IMF, believes that if the Central Banks of the four major economic regions all begin to raise their respective bank rates, the global economy will suffer greatly.

Regardless of the economic dangers associated with removing monetary stimulus, which the global economy has grown accustomed to, Central banks around the world are seemingly obsessed with normalizing interest rates.

Normalizing interest rates in Canada translates into a Bank rate of 3.0%, which means the Governor of the Bank of Canada will attempt to increase Bank rate seven more times. Tuff Risk predicts that when Stephen Poloz achieves his goal of normalized interest rates, he will retire to the former Central Bank Governors' consulting firm, located on the floor just above the International Monetary Fund.