



Bank of Canada Hikes Benchmark Rate by 25 Basis Points

Markets Expect Further Tightening This Year



Key points:



The Bank of Canada (BOC) raised its overnight policy rate by a quarter point to 0.75%

This was the BOC's first rate hike in almost 7 years and garnered global attention as Canada became the first G-7 country to begin raising rates along with the US in this market cycle.

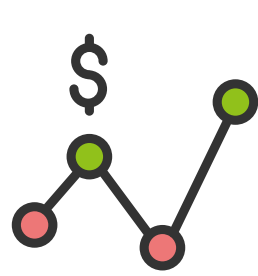


Following the BOC decision, markets priced-in higher odds of another rate hike to over 70% by December 2017. In afternoon trading, the loonie rallied at one stage by over 1.75% (or 1.4 cents) to reach 78.75 against the US dollar.



Early gains in the TSX faded following the BOC decision and the Canadian government 10-year bond yield rose slightly, contrasting with the broad decline in global government yields today.

Why did the Bank decide to hike rates?



The rate hike was widely expected by markets following a string of hawkish BOC speeches and communications beginning around June 12, including at the Sintra meeting of global central bankers.

In its decision, the BOC focused on stronger-than expected macroeconomic performance that increased its "confidence" the economy will absorb remaining excess capacity by the end of this year rather than by mid-2018 as it previously forecast.



Recent strong macro data also encouraged the BOC to hike. Real GDP growth of 3.7% in the first quarter expanded well above trend, and the BOC upgraded its full year forecast to 2.8%.

The rebound in economic growth was also broad-based across many sectors, suggesting the uptick in growth is robust. Net employment increased by about 45,000 jobs in June, reinforcing the optimistic outlook.



The decision to hike rates sooner reflected other factors as well, including gradually rising inflation that is expected to reach the 2% target by mid-2018; concerns about financial stability, especially after rapid increases in housing prices; and tighter US monetary policy that provides room for the BOC to hike rates without widening the interest rate differential.

The BOC views currently low underlying inflation as mostly temporary, but highlighted that future rate hikes will be influenced by the evolving inflation outlook.



Why did the Canadian dollar jump so sharply?



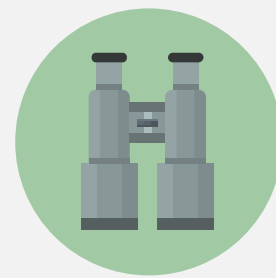
Based on swap prices, investors were expecting an **over 90%** chance of this rate hike. However, the decision was still followed by a strong rally in the loonie.



A key factor in the rally was the BOC's optimistic economic forecast for 2017-18. Inflationary pressures typically build after an economy absorbs remaining excess capacity, raising the odds of another rate hike this year to avoid falling behind the inflation curve.

Why are global markets focusing even more than usual on the BOC rate hike?

The BOC is only the second major central bank to begin hiking rates in this cycle, and markets are looking for 1 signals that other major central banks will follow suit.



At the Sintra conference about two weeks ago, other major central banks also expressed more optimistic economic outlooks and sent hawkish signals to markets about tightening monetary policy, including the Bank of England and the ECB.



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