Liquid Insight

Bank of Canada preview: On hold with a hawkish message

11 April 2023

Rates and Currencies Research
Global

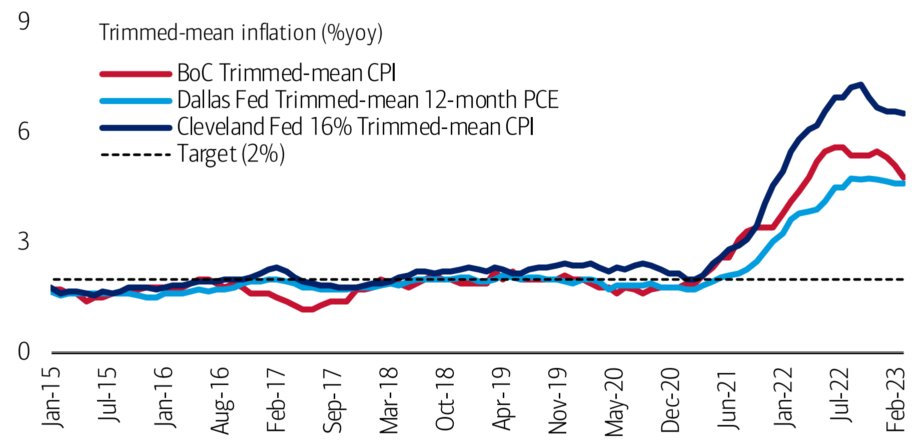
Key takeaways

- We expect the BoC to remain on pause with the policy rate at 4.50% on 12 April. Risks are skewed to the upside.
- Inflation is falling but upside pressures abound, hence the message will be hawkish. The BoC is nowhere near cutting rates.
- CA rates to outperform as BoC on pause and Fed continues to hike. FX: Expect medium-term CAD strengthening.

By Carlos Capistran, Ralph Axel, Katie Craig & Howard Du

Chart of the day: Trimmed mean CPI measures in Canada and the US

Trimmed-mean inflation remains sticky, but it is starting to trend down in Canada



Source: BofA Global Research, BoC, Dallas Fed, Cleveland Fed

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BoC: On hold with a hawkish message

We expect the Bank of Canada (BoC) to remain on pause with the overnight rate at 4.50% on 12 April. Inflation remains high, but both headline and core are falling (Chart of the day). The labor market remains tight, but it is slowly softening. We have the BoC on hold for the rest of the year. Upside risks in the short term remain as inflation is still high and the Fed is still hiking. Risks for the BoC to switch to the downside towards the end of the year remain as the economy decelerates. We expect to see CA rates outperform, but a US bank stress event re-invigorated by weaker-than-expected bank earnings could lead to CA rates underperformance due to risk-off flows and rates markets pricing in more Fed cuts. Myriad reasons for a hawkish forward guidance at this meeting should be bullish for CAD, but price action may be mixed given US CPI release on the same day. We continue to expect CAD to strengthen against USD over the medium-term.

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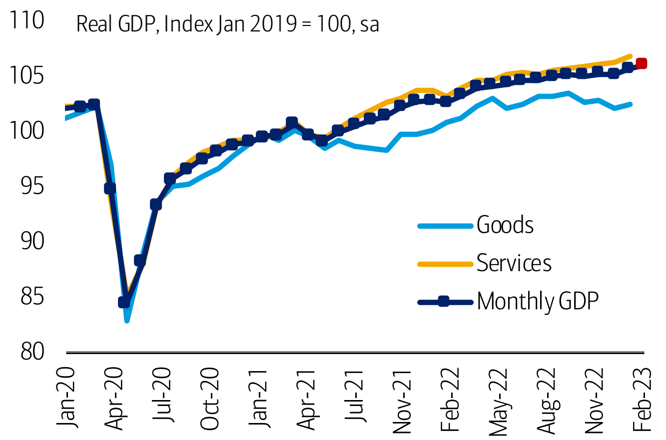
BoC: On hold with a hawkish message

The economy is decelerating, but very slowly

The economy remained strong overall at the beginning of the year with the monthly GDP at 0.5% mom sa in January. But Stats Canada expects some deceleration with flash GDP at 0.3% mom in February (Exhibit 1). Exports in February contracted -2.4% mom. We expect the economy to continue to decelerate as the US decelerates and as higher domestic interest rates impact the economy. Businesses also expect a deceleration, and business sentiment fell in the BoC survey for 1Q. The consumers' survey for 1Q showed that most respondents expect a recession in the next 12 months (Exhibit 2).

Exhibit 1: Monthly GDP by industry
The economy is strong, but goods-producing industries are decelerating



Source: BofA Global Research, Stat Canada

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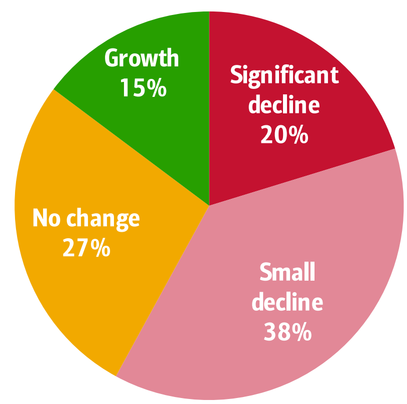
Exhibit 2: Consumers expect a recession in the near future
More than half of 1Q respondents expect a recession in the next 12 months



Source: BofA Global Research, BoC's Canadian Survey of Consumer Expectations
Note: The survey question is: "What do you think is the most likely outlook for the Canadian economy over the next 12 months?"

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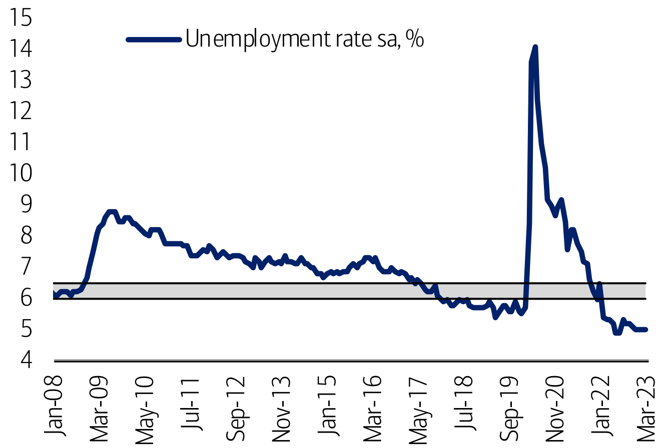
The labor market is softening, but at a snail's pace

The unemployment rate remains at 5.0%, near the lowest on record, and the economy keeps creating jobs (34.7k in March – see [Canada Watch: Tight labor = BoC cuts are far away] report) (Exhibit 3). But the goods-producing sector is showing some weakness with a net employment loss of -40.9k in March, decelerating from 17.5k in February and 25.4k in January (Exhibit 4). The services-producing sector remains hot with 75.5k new jobs in March. Wages are still growing at a high rate and Canada now has a positive real wage growth rate, however, the margin wage growth decelerated to 5.2% yoy in March from 5.4% in February. We expect the labor market to soften more markedly in the following months as the economy decelerates.

Headline inflation is falling faster than expected, but pressures remain

Headline inflation decelerated to 5.2% yoy in February from 5.9% in January and, so far, this year inflation has performed better than what the BoC expected at the beginning of the year. However, most of the deceleration in headline was due to lower gasoline prices, as CPI inflation excluding gasoline only decelerated to 5.7% (from 5.9%). Core also decelerated and the average of the trimmed and the median measures fell to 4.9% from 5.1% (Exhibit 5). However, services inflation remained unchanged at 5.3% in February (Exhibit 6). The persistence in the latter is likely due to the tightness of the labor market and is something that will keep the BoC under pressure. Inflation expectations overall seem well-anchored. We expect inflation to be 3.0% by end-2023 and 2.0% by end-2024 (see [Canada Watch: Inflation moving down helps the BoC to remain on pause] report). But we still see the balance of risks skewed to the upside in the short term from the tight labor market, higher oil prices and the potential CAD depreciation if the Fed keeps hiking and the BoC stays put. In the medium-term, the balance of risks switches to the downside as the economy decelerates.

Exhibit 3: Unemployment rate
The unemployment rate in March remained unchanged at 5.0%



Source: BofA Global Research, Stat Canada

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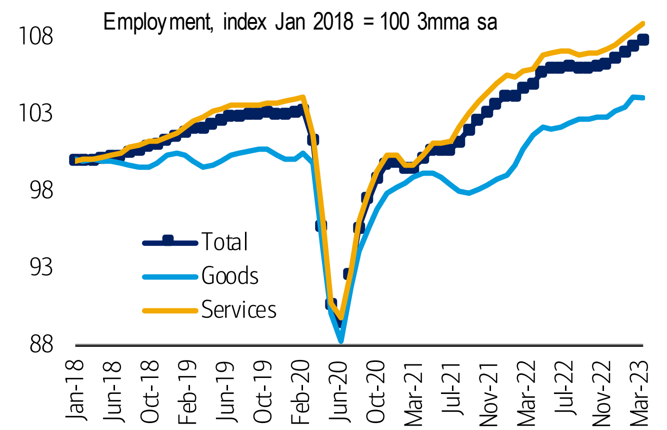
Exhibit 4: Employment in goods and services sectors
Jobs in the goods-producing sector are showing some weakness



Source: BofA Global Research, Stat Canada

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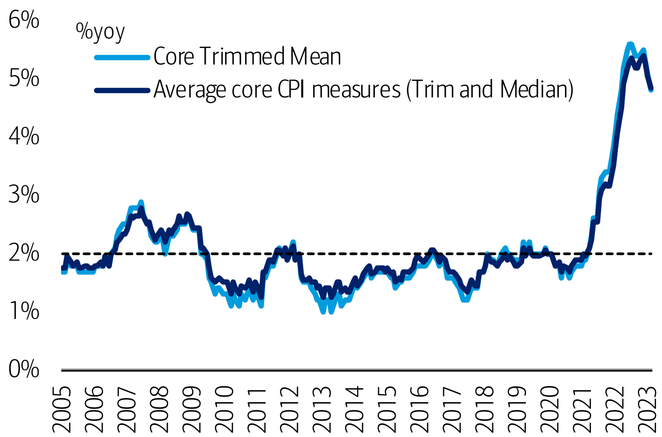
Exhibit 5: Core inflation and Trimmed-mean inflation
Core measures decelerated at the margin in February…



Source: BofA Global Research, Stat Canada

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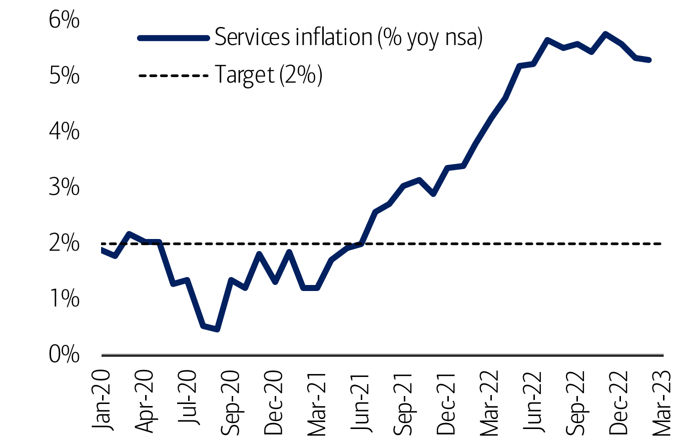
Exhibit 6: Services inflation
… but services inflation remains sticky as the labor market remains tight



Source: BofA Global Research, Stat Canada

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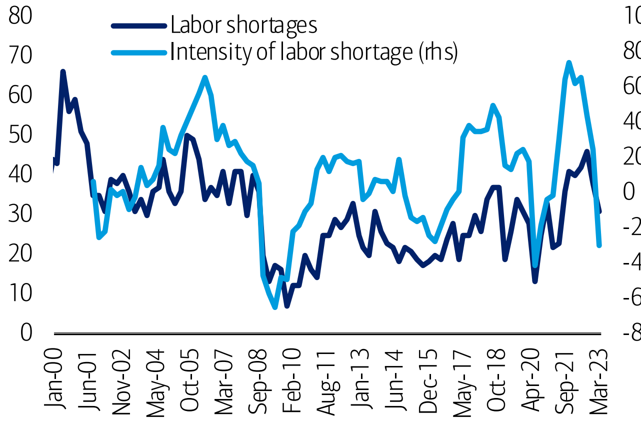
BoC on pause probably for the rest of the year

We maintain our baseline call that the BoC will remain on pause at 4.50% for the rest of the year. Falling inflation, contraction in jobs in the goods-producing sector and survey indicators point to a softer job market ahead, which will keep the BoC on hold this week, in our view (Exhibit 7). But a tight labor market, higher oil prices and a change in the fiscal outlook for the worse will likely keep the BoC hawkish and will maintain risks for the policy rate to switch to the upside (see Canada Watch: 2023 Budget: fiscal deterioration on a Made in Canada bet). We think it is too early to think about cuts in Canada. Cuts will likely materialize after the US Fed cuts or the economy decelerates enough, which in our baseline happens next year (Exhibit 8).

Exhibit 7: Business perception of labor market tightness
The perception of labor shortages fell drastically in the recent quarters



Source: BofA Global Research, Haver, BoC Business Outlook

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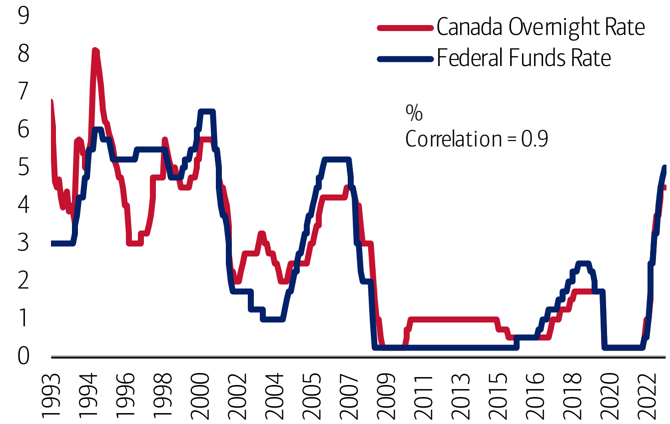
Exhibit 8: Nominal rates in Canada and US
The policy rates in the US and in Canada are highly correlated



Source: BofA Global Research, Bloomberg, BoC, Fed

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What to expect from the Monetary Policy Report?

We expect the BoC to maintain its GDP growth expectations for 2023 (currently at 1.0%, BofAe 1.0%), but revise to the downside its estimate for 2024 (currently at 1.8%, BofAe 0.4%). Regarding inflation, we think the BoC will likely revise its inflation forecasts to the downside for 2023 (currently at an average of 3.6% for the year, BofAe 3.6%) and for 2024 (currently at 2.3%, BofAe 2.2%). The BoC is likely to estimate inflation convergence to the 2% target in 4Q-2024. The BoC will update its projection for a neutral policy rate, but we expect the 2% to 3% range to remain unchanged.

Rates: Recent US bank stress drove CA rate underperformance

Economic data in Canada remains strong, but is softening on the margin. Recent bank stress in the US has led to some recalibration in rates markets with respect to the future BoC rate path. Prior to the recent bank stress, rates markets were pricing in risks that strong economic data in the US and Canada would force the BoC to continue its rate hikes. However, a full 25bp cut is now priced in by YE 2023.

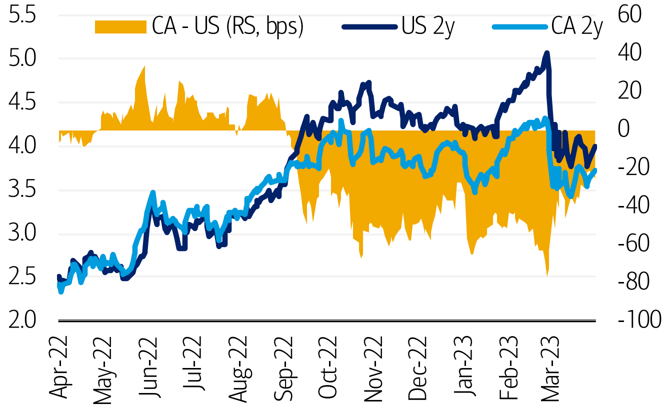
While we expect no change to the BoC's policy rate at this week's meeting, the forward guidance is likely to be more hawkish than the market currently expects, given the continued strength in inflation and labor market data and recent stabilization of bank stress. This could lead to a CA rates sell-off driven by front-end rates. However, upcoming bank earnings pose some risk to lower rates if banks guide towards a near-term contraction in lending or tightening of lending standards due to the recent bank episode.

While the BoC is projected to be on hold, our US economists forecast one more Fed hike at their next policy meeting in May. The spreads between US and CA rates are strongly correlated with the expectations for terminal. As the BoC remains on pause and Fed continues to hike, we expect to see CA rates outperform.

However, with strong data continuing to be a theme in both economies, both central banks will likely need to decide between inflation and financial stability. A US bank stress event re-invigorated by weaker-than-expected bank earnings could lead to CA rates underperformance due to risk-off flows and rates markets pricing in more Fed cuts.

The spreads between US and CA rates peaked just ahead of the bank stress episode as expectations for further Fed hikes were being priced in but have since narrowed significantly for both 2y and 10y rates (Exhibit 9, Exhibit 10). Canadian 10y rates have sold off 39 bps since the Mar BoC meeting vs. 65bps for the US. The CA 2y underperformed US 2y over the same period with the spread narrowing from -77bps to -25bps.

Exhibit 9: CA and US 2y rates (%) and spread (bps)
Spreads widened to -77 ahead of bank stress, now -25



Source: Bloomberg

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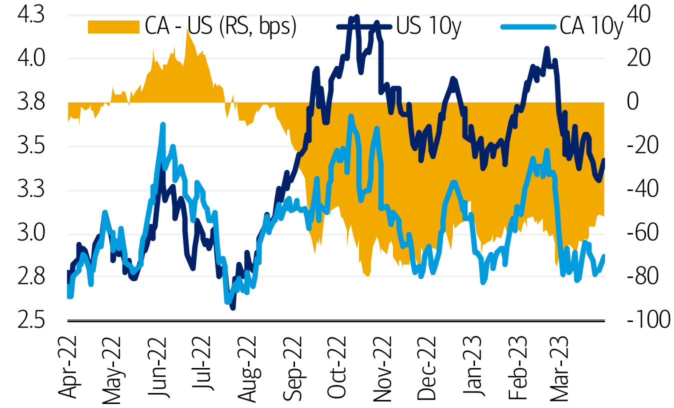
Exhibit 10: CA and US 10y rates (%) and spread (bps)
Spreads widened to -81 ahead of bank stress, now -57



Source: Bloomberg

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FX: Expect more medium-term CAD strengthening

Several developments pointing to upside inflation risk took place since the last monetary policy meeting:

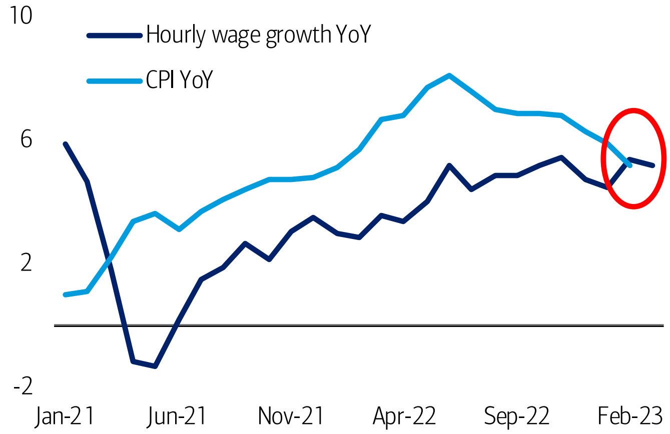
1. OPEC announced new crude oil supply cuts, causing WTI price to rally by around 8% from end of March to now.

2. The 2023 fiscal budget turned out to pencil in a higher fiscal deficit than was previously announced in the 2022 Fall Economic Statement (Canada Watch: 2023 Budget: fiscal deterioration on a Made in Canada bet, 29 March 2023).

3. Wage growth remains resilient in Canada. The latest employment data shows that the current level of wage growth is now above headline inflation (Exhibit 11).

While we believe the BoC would likely keep the policy rate on hold at this meeting, the forward guidance would likely be more hawkish than the market expects. Rates market currently sees the BoC cutting rates from 3Q 2023 with the policy rate dropping to 3% by September 2024 (Exhibit 12). This pricing is too aggressive vs. our expectation of BoC rate cuts beginning only in 1Q 2024. Any repricing of market expectation on the back of a hawkish BoC guidance should be bullish for the CAD. However, market reaction may be mixed as the US CPI release will happen on the same day. We continue to expect CAD to strengthen against USD over the medium-term (see report: Patience needed for the CAD rebound, 13 March 2023).

Exhibit 11: Latest pace of wage growth is above inflation
Headline CPI YoY vs. hourly wage growth YoY



Source: BofA Global Research, Bloomberg

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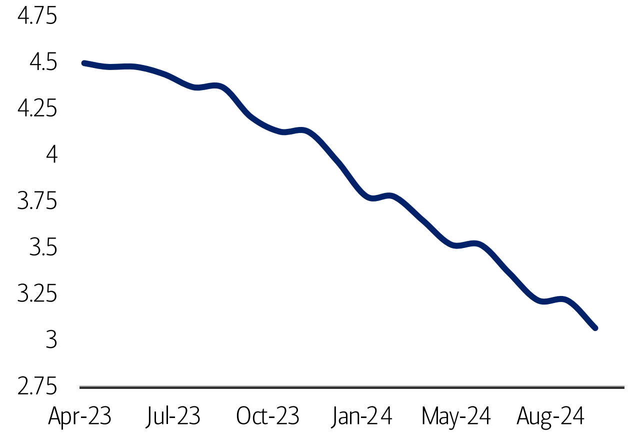
Exhibit 12: Market is pricing straight cuts for BoC from now on
Rates market pricing of future BoC policy rate



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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- After the storm, **Global FX Weekly**, 31 Mar 2023
- Budding stability **Global Rates Weekly**, 31 Mar 2023
- As the market dust settles, **Liquid Cross Border Flows**, 3 Apr 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: After the storm 31 March 2023

Global Rates Weekly: Budding stability 31 March 2023

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