Liquid Insight

Bank of Canada preview – on hold but another close call

Key takeaways

- We expect the BoC to keep the policy rate at 4.75% on July 12, as inflation, core inflation and wage growth are falling.
- Importantly, the unemployment rate rose 40bp since the last decision. But it is a close call and the BoC could hike 25bp.
- CA rates continue to underperform US longer-term rates. We see balanced risk for USD/CAD at current spot level.

11 July 2023

Rates and Currencies Research
Global

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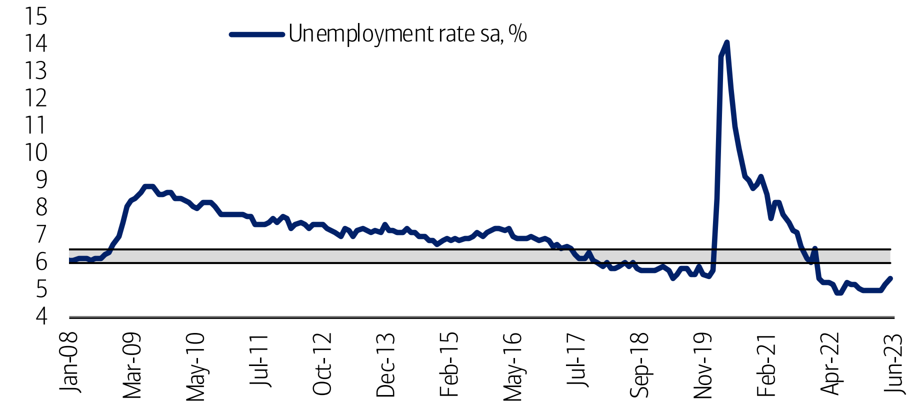
Chart of the day: The unemployment rate seems to have bottomed out
The unemployment rate rose for a second month in a row to 5.4% in June



Source: BofA Global Research, Stat Canada

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BoC: On hold, but it is another close call

We expect the Bank of Canada (BoC) to remain on hold with the overnight rate at 4.75% on July 12. The unemployment rate seems to have bottomed out (Chart of the day) and inflation, core inflation, inflation expectations and wage growth all are falling. But it is a close decision as the BoC may hike 25bp again to make sure inflation converges to the target (increasing the risks for economic activity and for financial markets). The BoC may be concerned that the economy and job creation may still be too hot to control inflation. However, we believe monetary policy acts with lags, and it is not clear at this point that the BoC needs to hike more. The main problem for inflation remains on the labor market, but immigration is helping significantly on the supply side. On the back of strong data, the market is pricing in a 75% chance of a BoC hike at the July meeting, CA rates continue to underperform US longer-term rates. We were bullish USD/CAD last week but see risk reward as more balanced now after a rally had materialized. Instead of fading the USD/CAD rally, CAD bulls could consider long CAD vs low-yielding G10 currencies.

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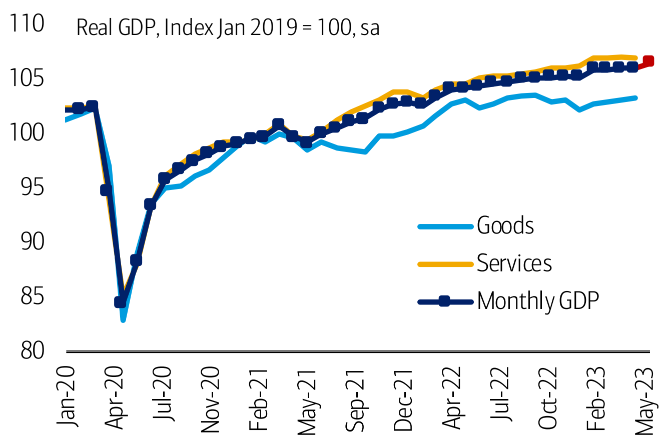
Timestamp: 11 July 2023 12:31AM EDT

BoC: On hold, but it is a close call

Economic activity decelerated but it may rebound again

Economic activity is decelerating with volatility. The Monthly GDP was below expectations in April at 0.0% mom sa down from 0.1% mom sa in March. The goods-producing industries increased 0.1% mom sa, while the services-producing industries remained flat. In annual terms, the Canadian economy increased 1.7% yoy. However, according to StatCan, the Flash GDP suggests a 0.4% mom sa increase in May (Exhibit 1). So, economic activity decelerated at the margin, but the deceleration may not last. According to the BoC's 2Q Business Outlook Survey, businesses noted that domestic demand is still going up and they have fewer concerns of a recession.

Exhibit 1: Monthly GDP by industry
Stats Canada advance estimate suggest a 0.4% increase in May



Source: BofA Global Research, Stat Canada

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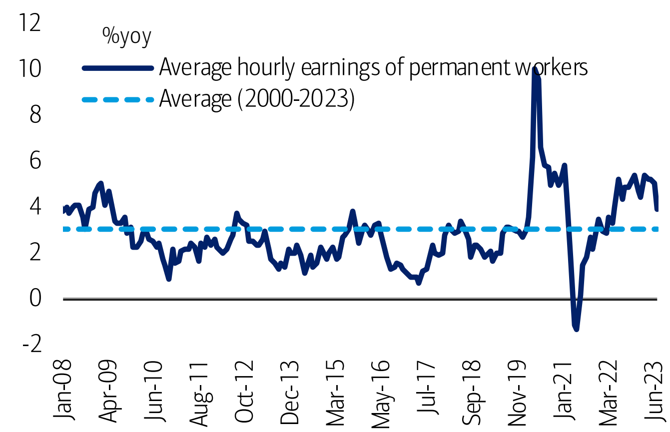
Exhibit 2: Average hourly earnings of permanent workers
Wage growth decelerated sharply to 4.2%, but remains above its average



Source: BofA Global Research, Stat Canada

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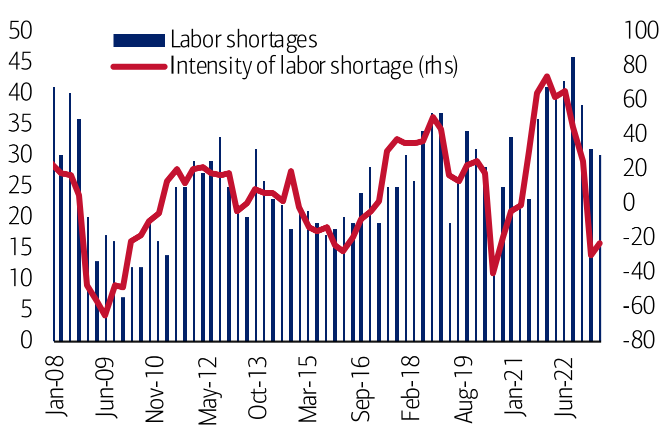
Higher unemployment favors a cautious BoC

The labor market remains tight, but there are some signs of deceleration. The labor report for June had mixed results. On one side, the net change in employment surprised to the upside at 60.0k, with a large increase in full time employment (109.6k). On the other side, the unemployment rate increased for a second consecutive month to 5.4%, the highest rate since February 2022 (Chart of the day) The rise in the unemployment rate is explained by the increase in the labor force as more people is looking for a job, in part due to strong immigration. The latter is important as it is helping on the supply side

Exhibit 3: Businesses perception of labor shortages
Labor shortages have softened, but remain at high levels



Source: BofA Global Research, BoC Business Outlook Survey

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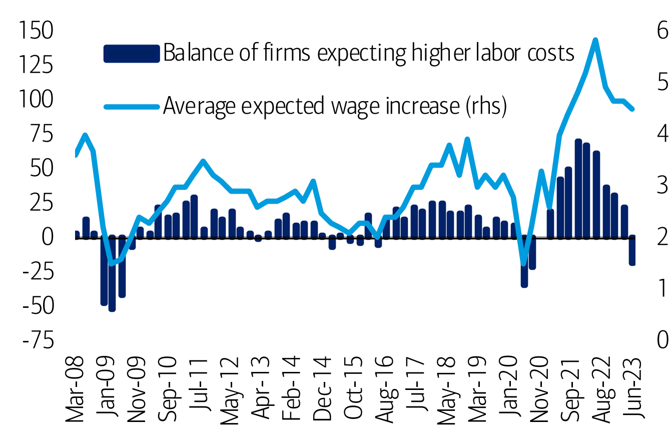
Exhibit 4: Businesses expect lesser labor costs in following months
However, the expected wage growth rate remains high



Source: BofA Global Research, Stat Canada

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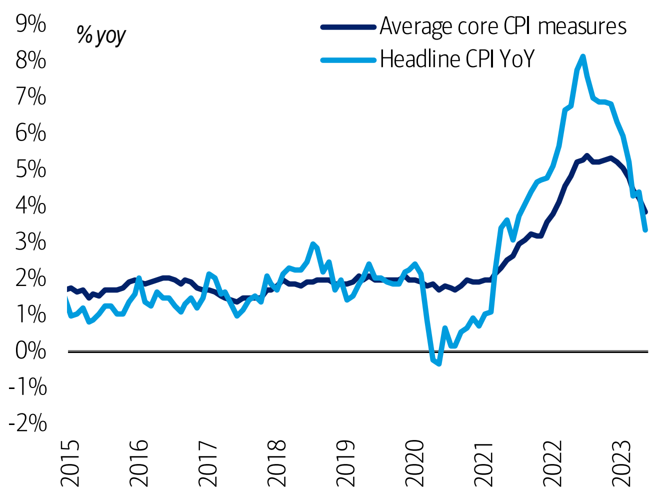
of the labor market, which is great news for the BoC. Moreover, wage growth decelerated sharply to 4.2% down, from 5.1% yoy nsa, although it remains above its historical average (Exhibit 2). The BoC Business Outlook Survey for 2Q showed that businesses are less concerned regarding labor shortages and labor costs (Exhibit 3). Businesses also expect a lower wage growth rate going forward (Exhibit 4).

Falling inflation suggests no more hikes

Consumer Price Index (CPI) inflation decelerated for the eleventh consecutive month to 3.4% yoy in May, down from 4.4% yoy in April (Exhibit 5). This is the lowest rate since June 2021. The year-over-year print benefited from a base-year effect, but the monthly rate also showed a meaningful improvement as it softened to 0.1% mom sa, down from 0.5% mom sa in April. The average of the two core inflation measures (trimmed and median) also fell, printing 3.9% yoy in May, the lowest rate since January 2022. Services inflation fell as well to 4.6% yoy. We continue to expect inflation to fall towards the 2% target in the following months. According to the BoC Business Leader Pulse (BLP) Survey, businesses' inflation expectations at all horizons fell at the margin, although they remain at high levels, especially the 1-year and 2-year ahead horizons (Exhibit 6). The Survey of Consumer expectations for 2Q shows that inflation expectations have come down again, although they remain above their levels from before the pandemic.

Exhibit 5: Headline and avg of core measures are falling quickly

Lower inflation suggests no more hikes



Source: BofA Global Research, Stat Canada

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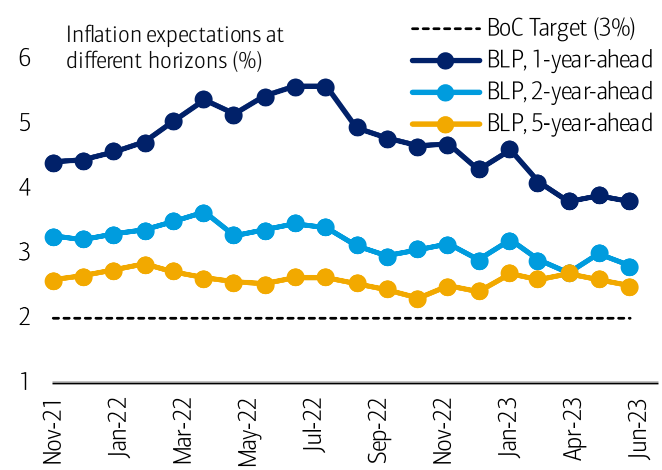
Exhibit 6: Businesses' inflation expectations

Inflation expectations at all horizons fell at the margin



Source: BofA Global Research, BoC Business Leader Pulse Survey

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Lower inflation and a higher unemployment rate favors BoC on hold

The BoC ended its monetary pause by hiking 25bp on June 7 to put the overnight rate target at 4.75%. At the time, the BoC dropped any forward guidance and moved to a data dependent mode. The data since the June decision points to lower inflation (lower headline, lower core, lower wage growth) and higher unemployment, so we believe the BoC will remain on hold at its July 12 meeting. However, the BoC may decide to hike another 25bp (which is what consensus expects). The case for another hike is based on the still high levels of inflation, resilient activity and, in particular, a large increase in net job creation in full-time jobs in June. So, it is a close call. Two more factors to consider are, first, that the BoC believes that the neutral rate has increased, but we do not know if by 25 or by 50bp, which is instrumental for this decision. The BoC will provide its new estimate with the July Monetary Policy Report. We believe the neutral rate is 25bp higher than before. The second factor to consider is the US Fed. We expect the Fed to hike twice more (July and September) to decelerate the US economy. We believe, in contrast to many analysts, that more Fed hikes mean that less hikes are needed in Canada. In any case, hold or hike, the BoC is likely to keep the door open to further hikes, if needed, and maintain a data dependent approach. We expect the BoC to remain on hold for the rest of the year as the economy and inflation decelerate.

What to expect from the Monetary Policy Report?

We expect the BoC to maintain its GDP growth expectation for 2023 (currently at 1.4%, BofA 1.4%), but revise to the downside its estimate for 2024 (currently at 1.3%, BofA 0.2%). Regarding inflation, the BoC will likely keep unchanged its forecast for 2023 (currently at an average for the year of 3.5%, BofA 3.7%), but it may revise upwards the forecast for 2024 (currently at 2.3%, BofA 2.6%). The BoC is likely to keep the message that inflation will converge to the 2% target in 4Q-2024. The BoC will likely update its projection for the neutral policy rate upwards to 2.25% to 3.25%, from 2.0% to 3.0% before. Importantly, if the BoC increases its new estimate of neutral by 50bp instead of by 25bp as we expect, then this could be used to justify a hike in July.

Rates: Further BoC hikes continue to get priced in

As noted, our economist expects the BoC to remain on hold at the upcoming meeting but acknowledge the upside risk, especially as the market is pricing in a 75% chance of a hike according to BoC OIS. On the back of strong data, the market has pushed out risk of a BoC cut until 2024 with over 1.5 25bp hikes now being priced in by year-end. The CA forward OIS curve is upward sloping through the 1y point, in line with our economist's view that upside risks remain.

Since the start of June, CA 2y & 10y rates have underperformed US, likely driven by slightly more BoC hikes being priced in by year-end. Both the BoC and the Fed appear to be considering another 25bp hike in July. Our analysis of US-CA spreads indicates that the relative setting of monetary policy and expectations for the path of policy have a strong and direct effect on spreads further out on the curve.

Our economists currently expect the Fed to hike but for the BoC to remain on hold at their respective July meetings but market expectations for further BoC hikes could continue the underperformance of CA rates at longer-dated spreads.

Conversely, expectations of Treasury supply in the US between now and year-end, could support a cheapening of US Treasuries vs CA gov't bonds. We continue to expect the BoC to passively roll-off maturing bonds from their balance sheet via QT.

FX: Balanced risk for USD/CAD at current spot level

At the start of last week, we discussed our tactically bullish USD/CAD view (Tactically bullish USD/CAD, 03 July 2023). But with the pair having rallied to a mid-1.33 handle, we see the risk reward as more balanced now. The pair would likely be driven more by US CPI in the coming week. Should the US core inflation decelerate to 0.3% m/m as our economists expect (CPI Inflation Watch: 06 July 2023), USD/CAD could grind lower to our Q3 forecast of 1.32 (CAD mid-year review, 15 June 2023).

Whether BoC hikes rate by 25 bp at this meeting or not, it would likely still stick with a hawkish "high for longer" guidance. Instead of fading last week's USD/CAD rally, CAD bulls could consider long CAD expressions vs low yielding currencies in G10, in our view. We believe CHF is broadly overvalued vs G10 peers (Global FX Weekly: 07 July 2023) and remain fundamentally bearish JPY for this year on carry divergences (Japan Rates and FX Watch: 22 June 2023).

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Data points to more divergence ahead **Global FX Weekly**, 7 July 2023
- Break out the shorts **Global Rates Weekly**, 7 July 2023
- Ahead of H2, **Liquid Cross Border Flows**, 3 July 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: Data points to more divergence ahead 07 July 2023

Global Rates Weekly: Break out the shorts 07 July 2023

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