Liquid Insight

Bank of Canada preview – A hawkish hold

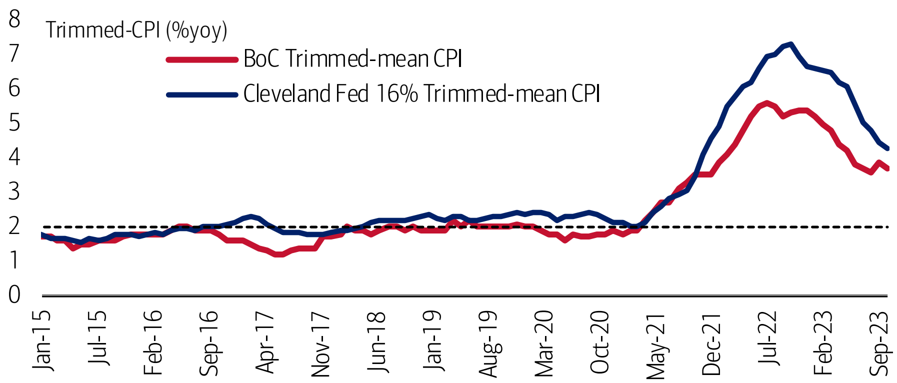
Key takeaways

- We expect the BoC to keep the policy rate at 5.0% on October 25, as the economy is clearly decelerating.
- The statement will likely continue to stress concerns on inflation and will likely leave the door open to further hikes.
- Geopolitical risk is in the driver's seat, but the spread 10y US - 10y CA could decline if US rates are near their peak.

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

Chart of the day: Trimmed-CPI inflation comparison

Inflation is lower in Canada, but the downward trend is more marked in the US



Source: BofA Global Research, Bloomberg

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BoC: A hawkish hold

We expect the Bank of Canada (BoC) to remain on hold with the overnight rate at 5.0% on October 25. The economy remains weak and the BoC will likely lower its GDP growth estimates, making the output gap close faster than in July. A weak economy, falling core inflation, and housing risks will likely keep the BoC on hold. However, the BoC is likely to sound concerned over inflation and continue to keep the door open to further hikes, which we do not discard. Core inflation and wage growth remain persistently high, which will keep the BoC on alert (Chart of the day: Trimmed-CPI inflation comparison

). We expect the BoC to start its cutting cycle in June 2024 (April 2024 before). On strategy, 10y US is now historically high relative to 10y CA rates, and we think this differential could decline if US rates are near their peak, which we think is around 5% while the Fed is on hold. For FX, geopolitical risk and valuation could drive USD/CAD more than monetary policy in the coming weeks.

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Rates and Currencies Research
Global

Global Rates & Currencies Research
MLI (UK)

Carlos Capistran
Canada and Mexico Economist
BofAS
+1 646 743 2921
carlos.capistran@bofa.com

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Katie Craig
Rates Strategist
BofAS
+1 646 855 6625
katie.craig@bofa.com

Howard Du, CFA
G10 FX Strategist
BofAS
+1 646 855 6586
yuhao.du@bofa.com

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

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BoC: A hawkish hold

The economy remains weak…

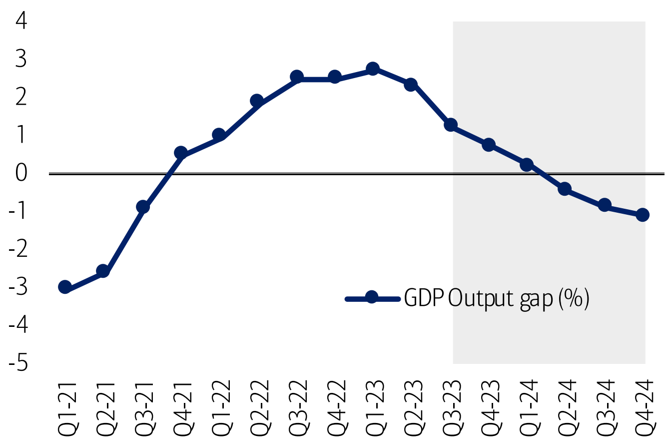
The economy contracted in 2Q (-0.2% qoq saar) and has remained weak in 3Q, which make us think that the BoC will revise its GDP growth forecasts to the downside which will impact its output gap estimate. GDP was flat in July and the flash estimate for August points to a weak 0.1% mom increase. Retail sales fell in August. The Business Outlook Survey for 3Q showed that "firms expect their sales growth to be subdued over the next 12 months". We estimate that the output gap has already peaked and that it will likely be zero in 1Q 2024 (Exhibit 1)

… but the labor market remains tight

Despite the overall economic weakness, the labor market remains tight. The unemployment rate seems to have bottomed out, but it is not yet trending up (Exhibit 2). Net job creation remains strong with almost 40k jobs created in August and almost 64k jobs created in September. And wage growth remains high, at a level that is likely inconsistent with the 2% inflation target (Exhibit 3). We believe that wage growth will decelerate in the following months given the increase in unemployment and economic weakness.

Exhibit 1: Output gap

According to our estimates, the output gap should close in Q1 2024



Source: BofA Global Research estimates, Haver

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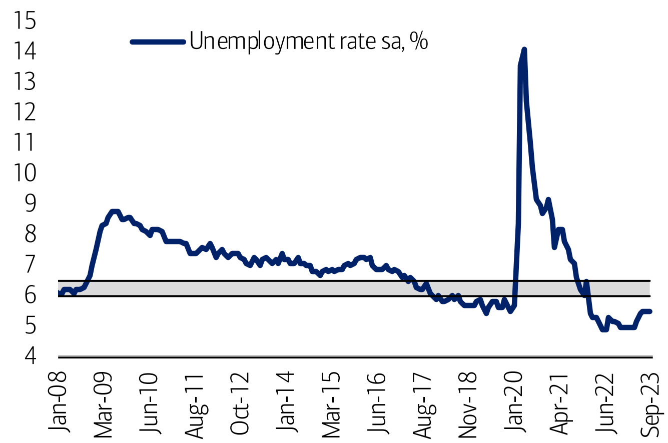
Exhibit 2: Unemployment rate

Unemployment has remained unchanged for the past three months



Source: BofA Global Research, Haver

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Inflation is falling, but not fast enough

Headline inflation in September fell to 3.8% yoy from 4.0% driven by core inflation. This is welcome news for the BoC after two consecutive months with inflation increasing. Even core inflation had moved up in August (Exhibit 4). But in September the average of the two core measures (trimmed and median) fell to 3.8% yoy from 4.0% a month ago, with both measures below 4.0%. Services inflation fell to 3.9% yoy in September from 4.3% yoy in August (Exhibit 5). Mortgage interest costs decelerated slightly to 30.6% yoy from 30.9% a month ago, though they remain an important upward pressure. We continue to expect the economic deceleration to bring core inflation down, which will drive headline inflation down, in our view. We expect inflation at 3.7% by end-2023 and at 1.9% by end-2024. We see upside risks to our inflation forecasts in the following months, but we continue to expect inflation to converge to the target by 2H 2024.

Exhibit 3: Wage growth

Wage growth is one of the most important remaining inflationary pressures

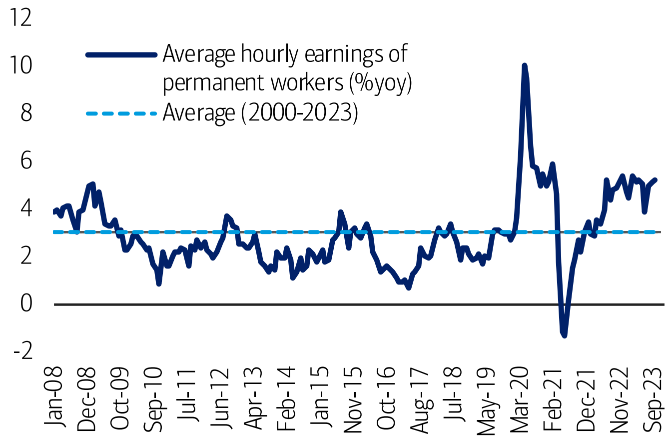

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Exhibit 4: Headline and core inflation

Headline and core inflations are back on their downward trends

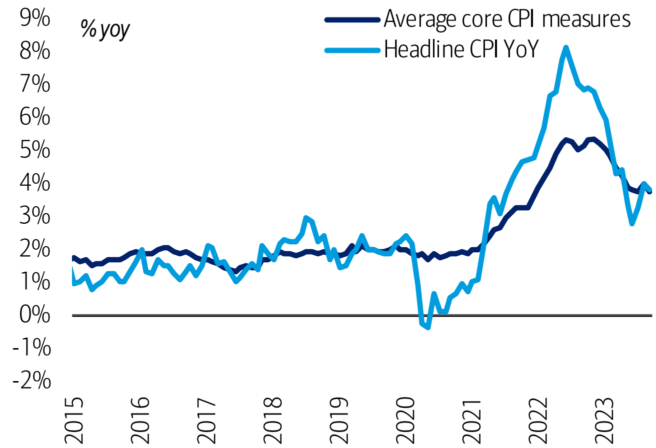

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Exhibit 5: Goods and services inflation

Goods inflation recently reversed its upward trend, while services is still falling

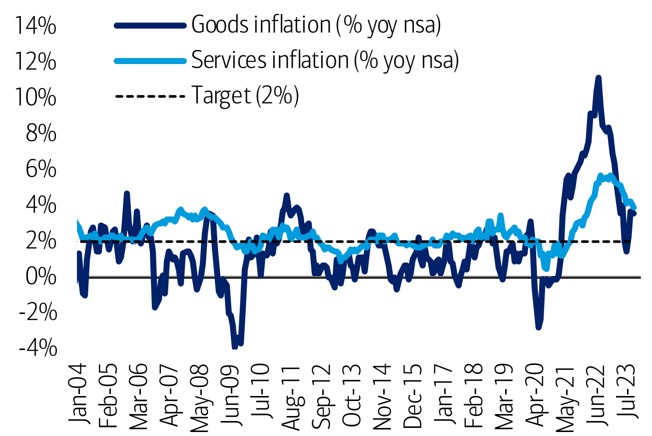

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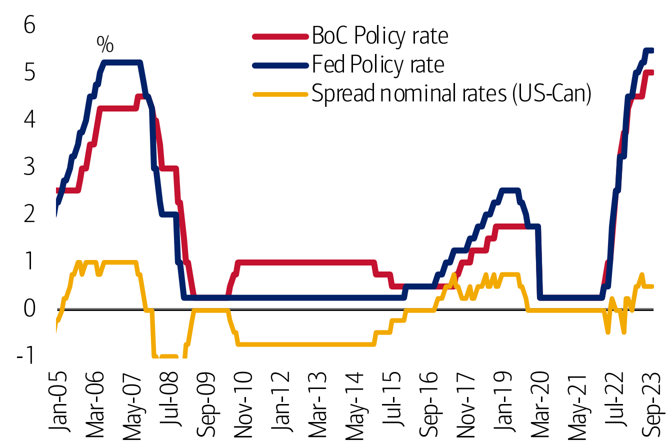
Exhibit 6: Policy rate spread

The US-Can spread has been positive throughout 2023



Source: BofA Global Research, Bloomberg

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We expect the BoC on hold in October; 5.0% may be terminal

The BoC remains in a data dependent mode and has not closed the door to further hikes. But we believe the economy has weakened enough for the BoC to refrain from hiking more. However, BoC is likely to continue to keep the door open as long as wage growth remains high (above 3% yoy) and until core inflation resumes a clear downward path. In addition, higher for longer rates in the US, a strong US dollar and higher oil prices are all upside risks for the policy rate in Canada (Exhibit 6). So, we now believe that the BoC will keep the policy rate on hold for longer and we move the date of the first cut to June 2024 from April 2024 before (Exhibit 7). We still believe that the BoC could cut ahead of the Fed, cut faster than the Fed or both.

Exhibit 7: BoC expected path

We now expect the BoC to start its cutting cycle in June 2024 instead of April 2024

K	New		Old	
	Rate	Change (bp)	Rate	Change (bp)
Jul-23	5.00		5.00	
Aug-23	5.00		5.00	
Sep-23	5.00		5.00	
Oct-23	5.00		5.00	
Nov-23	5.00		5.00	
Dec-23	5.00		5.00	
Jan-24	5.00		5.00	
Feb-24	5.00		5.00	
Mar-24	5.00		5.00	
Apr-24	5.00		4.75	-25.00
May-24	5.00		4.75	
Jun-24	4.75	-25.00	4.50	-25.00
Jul-24	4.50	-25.00	4.25	-25.00
Aug-24	4.50		4.25	
Sep-24	4.25	-25.00	4.00	-25.00
Oct-24	4.00	-25.00	3.75	-25.00
Nov-24	4.00		3.75	
Dec-24	3.75	-25.00	3.50	-25.00
Jan-25	3.50	-25.00	3.25	-25.00
Feb-25	3.50		3.25	
Mar-25	3.25	-25.00	3.00	-25.00
Apr-25	3.00	-25.00	3.00	
May-25	3.00		3.00	
Jun-25	3.00		3.00	
Jul-25	3.00		3.00	
Aug-25	3.00		3.00	
Sep-25	3.00		3.00	
Oct-25	3.00		3.00	
Nov-25	3.00		3.00	
Dec-25	3.00		3.00	

Source: BofA Global Research estimates, Bloomberg

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What to expect from the Monetary Policy Report?

We expect the BoC to revise to the downside its GDP growth expectation for 2023 (currently at 1.8%, BofA 1.1%) and for 2024 (currently at 1.2%, BofA 0.8%), as we are already seeing the effects of high interest rates on economic activity. Regarding inflation, the BoC could increase its forecast a bit for 2023 (currently at an average for the year of 3.7%, BofA 3.9%) due to higher energy prices. We believe it will keep 2024 unchanged (currently at 2.5%, BofA 2.5%). The BoC will likely reiterate that inflation will converge to the 2% target in 2Q-2025. The BoC will likely maintain its projection for the neutral (nominal) policy rate at 2.00% to 3.00%.

CA rates: Markets pricing in BoC to remain on hold

Market pricing ahead of the October BoC meeting dropped significantly following the Sept CPI data. Markets are currently pricing in a 10% chance of a hike, down from a peak of 44% just ahead of the CPI print. The reduction in market expectations aligns with our economist's forecast for a pause. The market is currently only pricing in 38bps of cuts next year starting in June vs our economist's forecast for 125bps in cuts.

Since August, CA rates underperformed US on the short-end but outperformed on the long-end, driven by the disinversion of the Treasury curve as Fed cuts were priced out of the market and supply pressures built. 10y US is now historically high relative to 10y CA rates, and we think this differential could decline if US rates are near their peak, which we think is around 5% while the Fed is on hold.

Our economists currently expect both the Fed and the BoC to remain on hold at their respective meetings but leave the door open for further hikes if the data reaccelerates. A divergence in the terminal rate could drive the relative performance in the sovereign rates. 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.

Additionally, expectations of Treasury supply in the US 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. In addition, the path of Fed cuts could continue to normalize closer to that priced for the BoC, which would also support cheapening vs CAD rates.

CAD: Torn between elevated macro risk and valuation

The market expects both the BoC and Fed to stay on hold for the next meeting, in-line with our economists' view (US Economic Weekly: 20 October 2023). Recent Fed and BoC communications also suggest both central banks are in data-dependent mode. Until a material data surprise occurs, we believe other factors such as increased geopolitical risk and valuation could drive USD/CAD more than monetary policy in the coming weeks.

At a 1.36-handle, USD/CAD spot is currently trading 2-3 big figures above fair value, in our view. Should risky assets stage a risk-on rally into year-end (Chart Blast: 06 October 2023) on the back of solid Q3 corporate earnings beats (Chart Blast: 06 October 2023) and extreme bear positioning (The Flow Show: 19 October 2023), it would be bullish for CAD vs the USD and the pair should drift lower towards our estimated fair value. However, there is plenty of uncertainty due to increased geopolitical risk. An oil supply shock has not been bullish for CAD vs the USD in the past (Liquid Insight: 03 October 2023). Should a macro risk-off shock occur, further deterioration in risk sentiment would be bearish for CAD, and USD/CAD could spike higher on positive spot-to-vol correlation.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Positioning matters until it doesn't**, Global FX Weekly**, 20 Oct 2023
- Hi 5s 20**, Global Rates Weekly**, 20 Oct 2023
- Waiting for the next catalyst, **Liquid Cross Border Flows**, 16 Oct 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: Positioning matters until it doesn't 20 October 2023

Global Rates Weekly: Hi 5s 20 October 2023

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Research Analysts

US

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Paul Ciana, CMT
Technical Strategist
BofAS
+1 646 855 6007
paul.ciana@bofa.com

John Shin
FX Strategist
BofAS
+1 646 855 9342
joong.s.shin@bofa.com

Vadim Iaralov
FX Strategist
BofAS
+1 646 855 8732
vadim.iaralov@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Europe

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
+44 20 7995 7331
ralf.preusser@bofa.com

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 20 7995 0279
athanasios.vamvakidis@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Pac Rim

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Shusuke Yamada, CFA
FX/Rates Strategist
BofAS Japan
+81 3 6225 8515
shusuke.yamada@bofa.com