BofA SECURITIES

Liquid Insight

BoC on hold, waiting for confirmation of trend in core

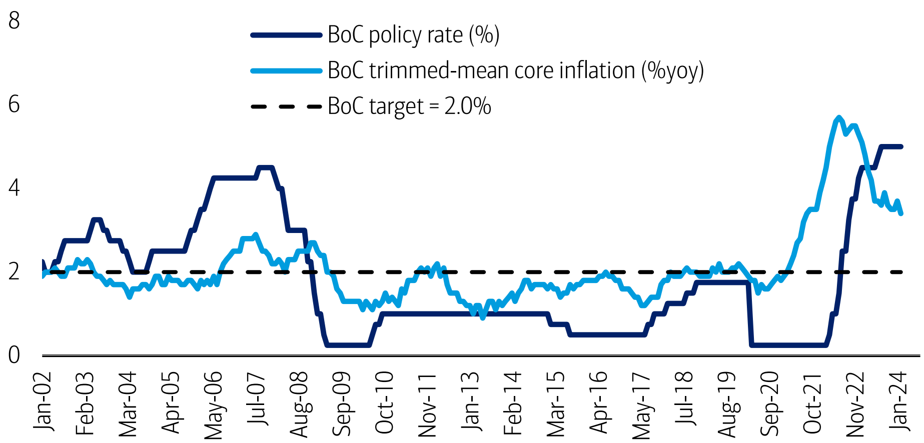
Key takeaways

- We expect the BoC to keep the policy rate at 5.0% on March 6, with unchanged guidance. We expect the BoC to cut in June.
- Core is trending down again, but more time is needed for the trend to be confirmed. The risk is for a dovish statement.
- Rates: we like long CA rates vs US as the market is underpricing BoC cuts. FX: we expect USDCAD over 1.35 in the near term.

By Carlos Capistran, Ralph Axel, Katie Craig & Vadim Iaralov

Chart of the day: BoC policy rate and trimmed-mean core inflation

Core inflation likely needs to fall more before the BoC can cut



Source: BofA Global Research, Bank of Canada

BofA GLOBAL RESEARCH

BoC: on hold still waiting for a continued fall in core

We expect the Bank of Canada (BoC) to remain on hold with the overnight rate at 5.0% on March 6, with almost no changes to the statement. Economic activity remains weak which is slowly loosening the labor market. Core inflation regained its downward trend and is below 3.5%. So, the time for the BoC to cut is likely approaching. But we think the BoC will wait a bit more for confirmation that the trend in core is sustained. We expect the BoC to cut in June. The risk for the March meeting is that the BoC emphasizes February's inflation print, in anticipation of a potential April cut. On rates strategy, we continue to believe the market is underpricing BoC cuts and therefore front-end CA rate outperformance. We continue to prefer staying long CA rates vs US, recently supported by a deceleration of inflation in CA vs upside surprises to inflation in the US. For FX strategy, we continue to expect USDCAD above 1.35 in the short-term based on disinflation risk, and a more material CAD appreciation vs the USD in 2H 2024.

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05 March 2024

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BofA GLOBAL RESEARCH

BoC: On hold still waiting for a continued fall in core

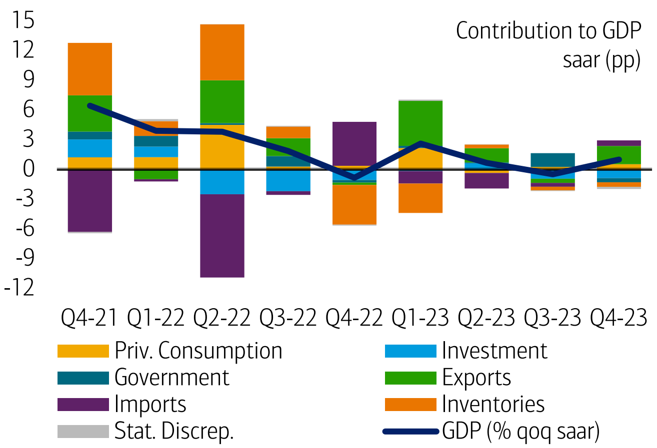
We expect the BoC to remain on hold at its March 6 meeting and to maintain the same forward guidance, which will rule out a cut in April, in our view.

Economic activity keeps cooling down

The Canadian economy remains weak. GDP for 4Q posed a modest 1.0% qoq saar growth, with final domestic demand contracting by -0.7% qoq saar. The demand contraction was driven by a fall in gross fixed investment (-3.8% qoq saar) and weak final consumption (0.2% qoq saar). Nonetheless, the external sector helped growth, in line with the resilience seen in US growth (Exhibit 1). The monthly GDP was flat in December, as the contraction of the goods sector cancelled out the gains in services (Exhibit 2). However, flash GDP growth for January shows a return to some growth (0.4% mom sa). Overall, after the 4Q print we still expect growth for 2024 at 1.3% yoy and for 2025 at 2.4% yoy (Exhibit 3). Our expectations are slightly better than what the BoC expected back in January, as the economy, although weak, has performed better than expected. This is one factor that supports our call for the BoC waiting until June to cut. Although we estimate the output gap is around zero, so on the activity side the BoC has the green light to cut (Exhibit 4).

Exhibit 1: Contribution to GDP growth (pp unless stated)

External sector helped the GDP in 4Q while domestic demand contracted



Source: BofA Global Research, Stat Canada, Haver

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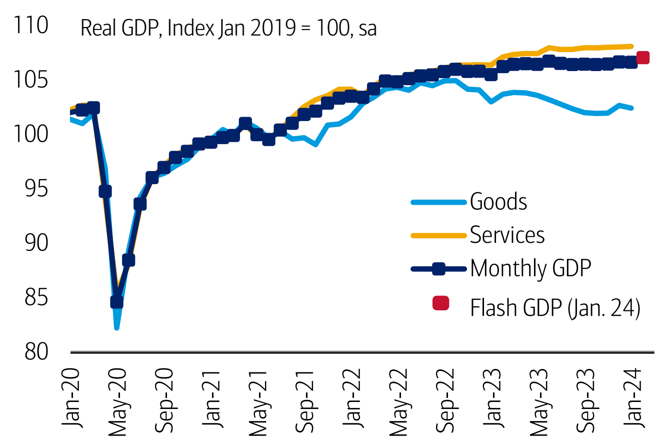
Exhibit 2: Monthly GDP by industry

Goods sector returned to its downward trend while services moved sideways



Source: BofA Global Research, Stat Canada, Haver

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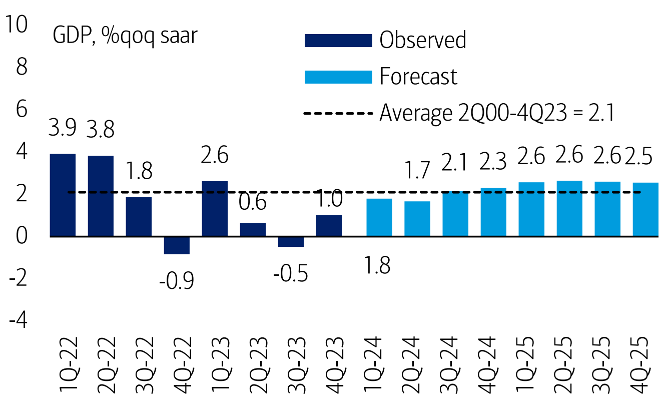
Exhibit 3: Canada's GDP growth forecast

We continue to expect GDP growth at 1.3% in 2024 and 2.4% in 2025



Source: BofA Global Research estimates

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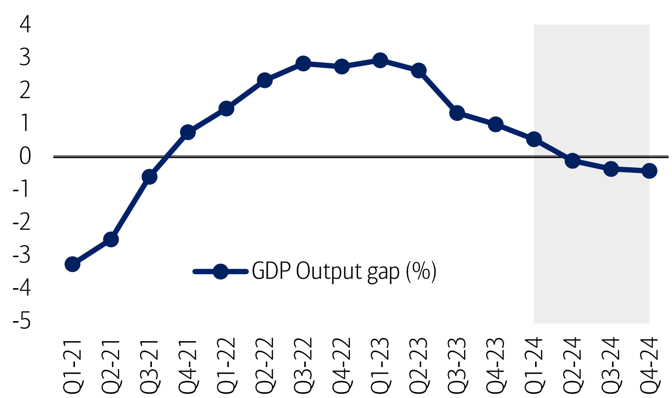
Exhibit 4: Canada's output gap (%)

A restrictive monetary policy is about to turn negative Canada's output gap



Source: BofA Global Research estimates

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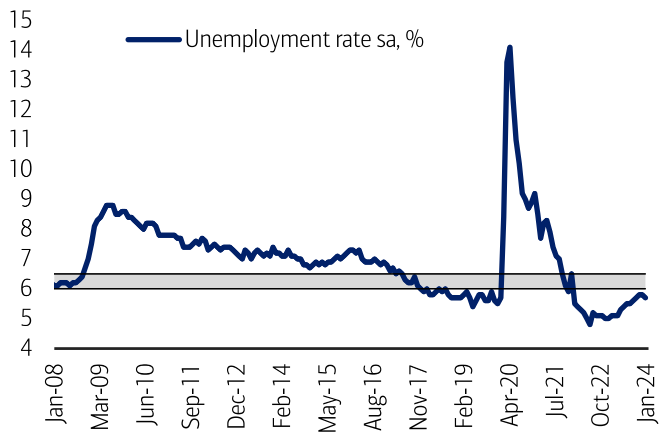
Labor market is likely easing, but wage growth remains high

The labor market posed a positive surprise in January as the unemployment rate fell for the first time since December 2022 to 5.7% from 5.8% (Exhibit 5) and the job market added 37.3k jobs. However, the gain in jobs was driven by part-time employment at +48.9k new jobs, while full-time jobs contracted by -11.6k (Exhibit 6), and the employment rate fell again to 61.6% since population growth outpaced employment growth (Exhibit 7). However, wages kept growing at levels above the 4.0-5.0% interval, which the BoC sees as not consistent with inflation converging to the 2% target (Exhibit 8).

Exhibit 5: Unemployment rate (%)
The unemployment rate fell but, overall, the labor market seems to be easing



Source: BofA Global Research, Stat Canada, Haver

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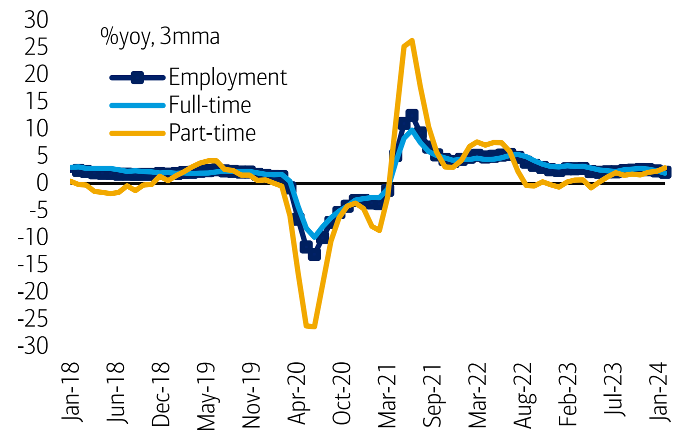
Exhibit 6: Employment growth (%yoy)
The increase of part-time employment drove the stronger print in January



Source: BofA Global Research, Stat Canada, Haver

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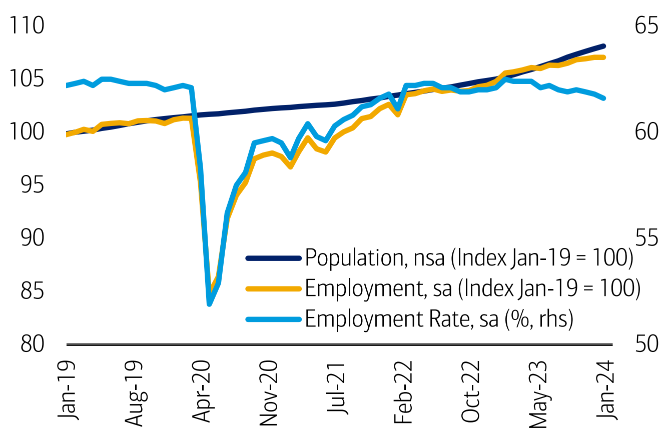
Exhibit 7: Population & employment growth, and employment rate
Population growth has been a key factor behind labor market's cool down



Source: BofA Global Research, Stat Canada, Haver

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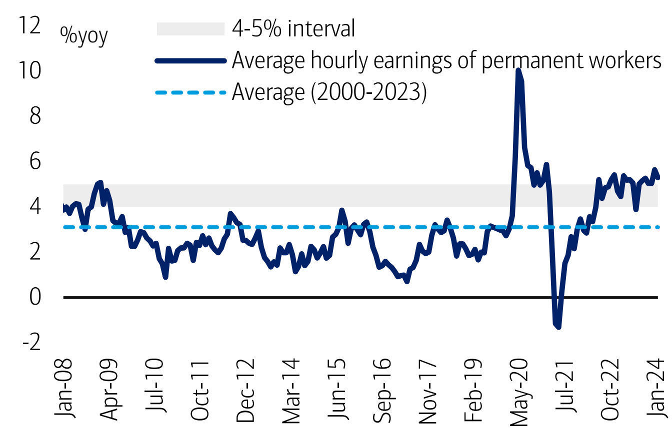
Exhibit 8: Average hourly earnings of permanent workers (%)
Wage growth fell slightly although it remains at high levels



Source: BofA Global Research, Stat Canada, Haver

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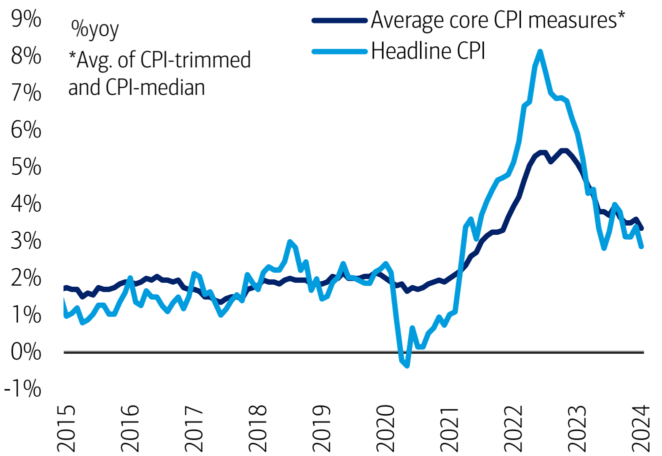
Core inflation eased further but more data is needed to confirm a trend

Headline inflation surprised to the downside in January at 2.9% yoy from 3.4% in December given the deflation in gasoline prices, while the average of core measures fell to 3.35% (vs. 3.60% in December), the first time below 3.5% since December 2021 (Exhibit 9, Exhibit 10). The lower core is explained by goods inflation, which is now below the BoC's target, but services inflation remains sticky as shelter inflation has shown resistance and has increased for three months in a row (Exhibit 11, Exhibit 12). Notice that inflation excluding the eight more volatile components is now at 1.6% when looking at the annualized monthly rate, so that measure is already below the BoC's target (Exhibit 13). Looking forward, we expect headline inflation to converge to the target by the end of 2024 (Exhibit 14). Core inflation is likely to continue to trend down.

Exhibit 9: Headline and core inflation (%yoy)
Both headline and core recovered its downward trend



Source: BofA Global Research, Stat Canada, Haver

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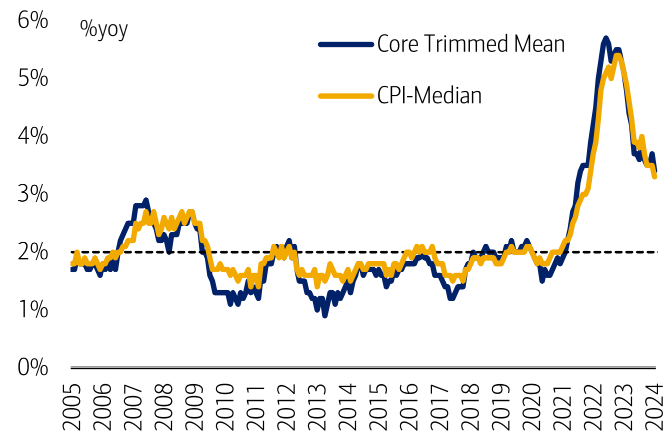
Exhibit 10: Core inflation measures (%yoy)
Core inflation has eased further but is yet to be seen if it is sustained



Source: BofA Global Research, Stat Canada, Haver

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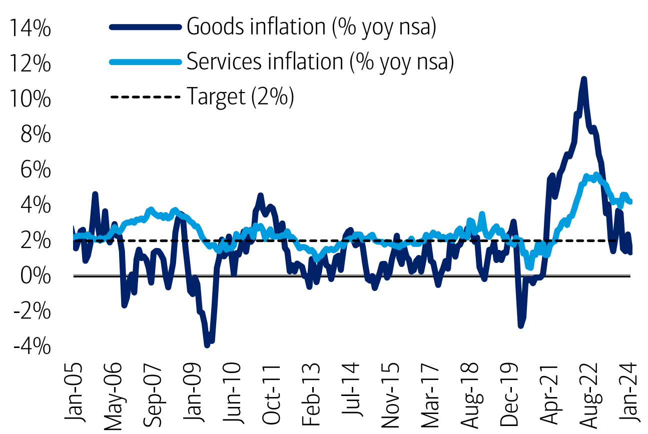
Exhibit 11: Goods and services inflation (%yoy)
Services' still shows resistance and is at high levels while goods' keeps falling



Source: BofA Global Research, Stat Canada, Haver

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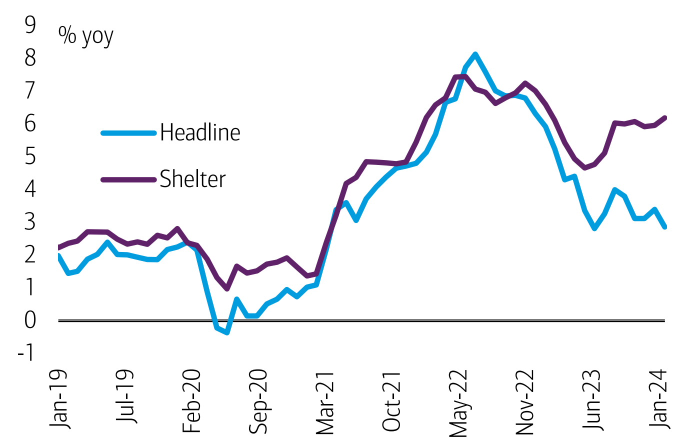
Exhibit 12: Headline and shelter inflation (%yoy)
Shelter costs keep rising due to the restrictive monetary policy



Source: BofA Global Research, Stat Canada, Haver

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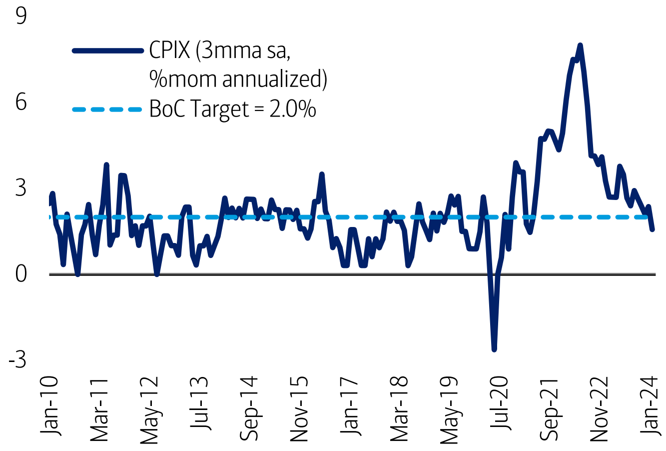
Exhibit 13: CPI excl. 8 most volatile components (CPIX, %)
CPIX has fallen below policy target which is good news for the BoC



Source: BofA Global Research, Stat Canada, Haver

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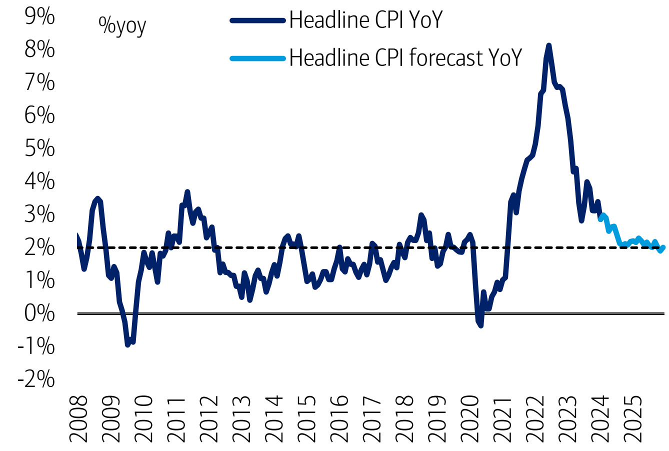
Exhibit 14: Inflation forecast 2024 – 2025 (%yoy)
Our inflation forecasts point to convergence in 2025



Source: BofA Global Research estimates, Stat Canada, Haver

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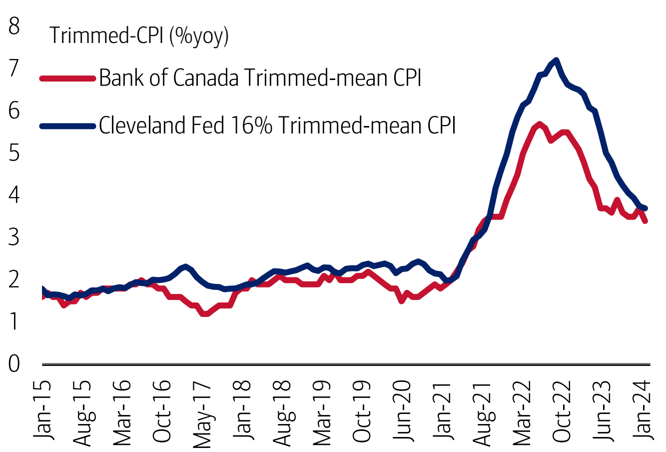
BoC likely to cut in June

Weak economic activity and core inflation regaining a downward trend mean that the start of the cutting cycle in Canada is likley not far. The BoC has said it needs to see "further and sustained easing" in core, and January's print likely checks the former. Now we need confirmation that the trend can be sustained. Since the trend has not been confirmed, we believe that the BoC will not cut in March (Exhibit 15). Since there is only one more inflation print before the April 10 meeting, we believe that the BoC will not cut in April either. So we do not expect the BoC to change the statement in March in a way that anticipates a cut in April. Our baseline remains a cut in June.

We see risks, however, skewed to a cut in April given that the output gap is already around zero and inflation is falling. On the other hand, the BoC will likely prefer to cut as close as possible as when the Fed cuts, but the risk for the Fed is that it keeps delaying the first cut (Exhibit 16).

Exhibit 15: US-Canada trimmed CPI comparison (%)
Core in Canada still needs to show a clear downward trend



Source: BofA Global Research, Stat Canada, US Fed, Haver

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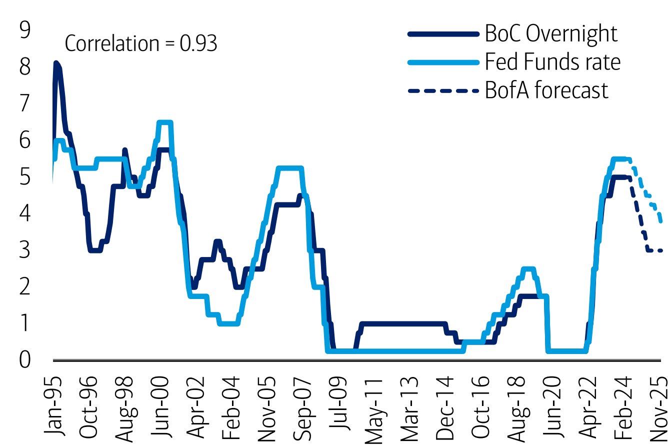
Exhibit 16: BoC rate and Fed funds rate
We believe the BoC and the Fed will start cutting in June but the BoC will likely cut faster and deeper



Source: BofA Global Research, BoC, Fed, Bloomberg

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CA rates: market underpricing BoC cuts in 2024

Market pricing of BoC cuts in 2024 is now around 78bps, a minor increase after a softer than expected inflation print. We expect strong data in the US and a pushing out of expectations for Fed cuts are contributing to the limited re-pricing for BoC cuts, despite the weaker Canadian economy and diverging inflation trends. Client feedback has reflected expectations that the BoC would not move before the Fed nor more aggressively, but we differ in this regard. Our economists currently expect the BoC to start cutting in June at a pace of one cut per meeting for a total of five cuts in 2024.

We have long held the view that the market is underpricing BoC cuts and is therefore underpricing front-end CA performance, especially vs the US. We expressed this view by going long 2y CA vs 2y US. We continue to prefer staying long CA rates vs US, recently supported by a deceleration of inflation in CA vs upside surprises to inflation in the US. Convergence of market pricing towards our view would continue to support our preference for CAD longs. The path of realized inflation will likely be the main determinant of the rate differential between the two regions this year.

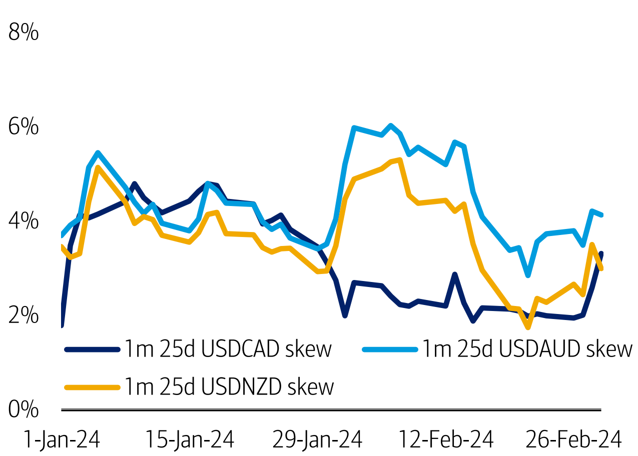
Additionally, the recent reimplementation of the Receiver General cash balance auction facility has helped to reverse some of the upward pressure in CORRA, which was leading to expectations for an early end to QT (see BoC liquidity facility risks later QT end date). The implementation of this facility will allow QT to continue for longer, potentially beyond the first BoC cut. Our base case is currently for QT to end with the first cut in June with risk skewed to later.

CAD: short-term weakness on disinflation risks

We see USDCAD firmly staying above the 1.35-handle after the soft January CPI (World at a Glance, 28-Feb-2024). USDCAD should be in a holding pattern until the next US catalyst triggers a broad-based USD move. After a dovish RBNZ surprise, options investors' demand for short-dated CAD puts has increased, suggesting investors are positioning for any dovish communications surprise from the BoC. But the overall level of FX vol is relatively muted near multiyear lows in G10, despite USD gains year-to-date. The lack of broad demand for USD options to chase after the USD rally suggests to us the broad macro backdrop for this year has not changed (FX Viewpoint: 21 February 2024), and we continue to expect more material CAD appreciation to take place in H2 '24.

Exhibit 17: Dovish RBNZ surprise made investors reprice richer high-beta FX skew for puts

Short-dated skew (%atm) in AUD, NZD and CAD



Source: BofA Global Research, Bloomberg

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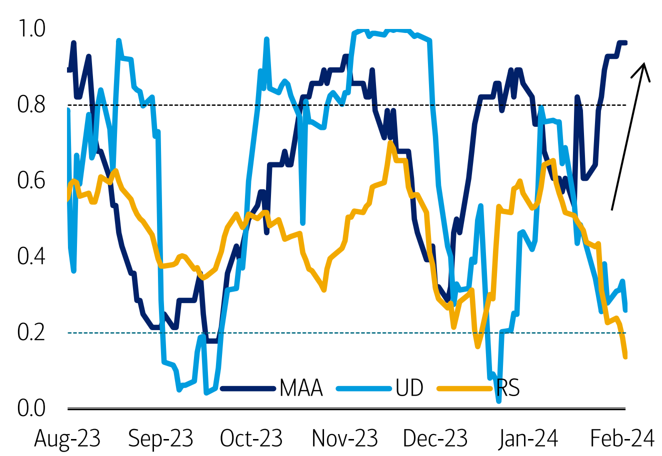
Exhibit 18: GBP/CAD is gaining momentum with skew tilting for calls

GBPCAD Moving Average Aggregator (MAA), Up-Down vol (UD) and Residual put Skew (RS)



Source: BofA Global Research, Bloomberg

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CAD put skew richened with NZD and AUD post-RBNZ

Dovish RBNZ surprise made investors broadly reprice richer high-beta FX put skew (Exhibit 17). In case of CAD, investors are positioning for any dovish communications surprise from the BoC. Bigger picture, CAD skew is relatively flat vs. history because the market expects the Fed cutting cycle to pave the way for (i) a weaker USD, (ii) a more volatile downtrend in 2024. For now, we interpret the skew moving for CAD puts as a near-term bearish signal for the currency.

Bullish GBP/CAD ahead of BoC meeting

Our MAA positioning model has a new short-term bullish signal for GBPCAD. The derived Residual Skew has tilted for GBPCAD calls and is supporting the uptrend, in our view (Exhibit 18). Higher GBPCAD is also positioned for any dovish speak from the BoC next week as they open the door for cuts at one of the subsequent meetings (Econ base case is first cut in June with a risk of April). By contrast, UK core inflation remains relatively high and the rates market has fewer cuts priced in Canada vs. UK the first half of 2024. This is consistent with our Global rates team view for rates to diverge further and they like paying UK rates vs. Canada in front end (European Rates Alpha, 6-Feb-2024). The risk to these views is an upside to Canada wage growth.

Notable Rates and FX Research

- **Global Macro Year Ahead 2024 -** Hope for the best, prepare for the worst, 19 Nov 2023
- **Global Rates Year Ahead 2024 –** Cloudy with a chance of landing, 19 Nov 2023
- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- When in doubt..., **Liquid Cross Border Flows**, 26 Feb 2024

Rates, FX & EM trades for 2024

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: June a big deal, but still far 01 March 2024

Global Rates Weekly: Leap fear 01 March 2024

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