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Liquid Insight

Bank of Canada preview – On hold, unlikely to open door for cuts yet

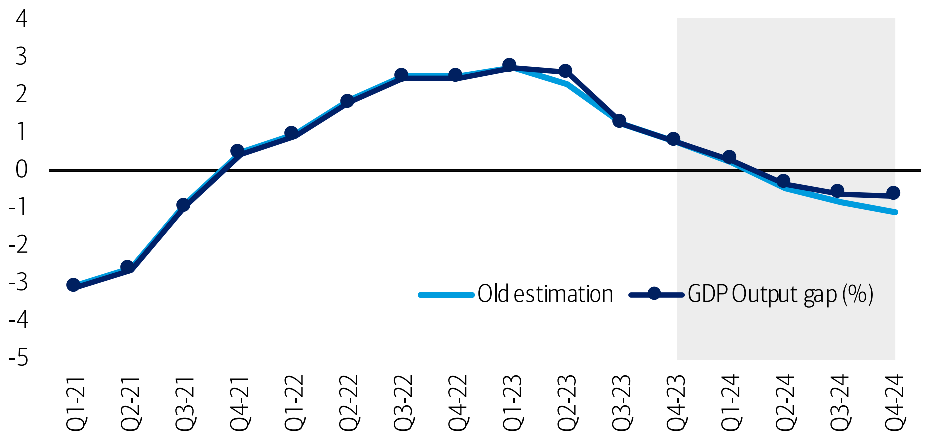
Key takeaways

- We expect the BoC to keep the policy rate at 5.0% on December 6, as the economy is weak and inflation is falling.
- The BoC is unlikely to open the door to cuts yet, but the risk is for the BoC to close the door to further hikes..
- Rates: Slower Canadian growth should eventually allow faster cuts vs the US. FX: bearish Dec. seasonality for CAD-crosses.

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

Chart of the day: Output gap revision

The output gap is still positive in 3Q 2023, and is likely to close between 1Q and 2Q 2024



Source: BofA Global Research estimates, Stat Canada, Haver

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BoC: On hold, not opening the door to cuts yet

We expect the Bank of Canada (BoC) to remain on hold with the overnight rate at 5.0% on December 6. The economy remains weak as shown by the GDP contraction in 3Q (-1.2% qoq saar) and the output gap is closing . Inflation keeps falling and core inflation is now showing an incipient downward trend. But we expect the BoC to remain concerned about inflation as the level of core is still high (3.6% yoy) and wage growth is still quite high (5.0% yoy). The risk is that instead of a "hawkish hold" the BoC changes its language, and we get a "dovish hold", although we think it is too early for that. We expect the BoC to start its cutting cycle in June 2024, with risks for an earlier start. On strategy, assuming inflation moves lower, which is the key to initiation of cutting cycles in 2024, slower Canadian growth should allow faster cuts vs the US. Amid the broad USD selloff, CAD is likely to lag other G10 "high betas" until the Fed cutting cycle begins. December seasonal is most bearish CAD vs NZD and the Scandies.

Refer to important disclosures on page 7 to 9.

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BoC: on hold, not opening the door to cuts yet

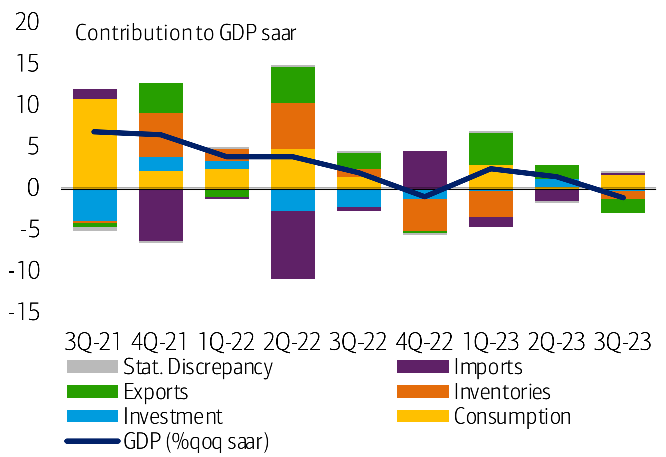
Tight monetary policy is working its way through the Canadian economy

The economy contracted surprisingly in 3Q (-1.1 % qoq saar vs. E. 0.1%) from a revised expansion in 2Q (1.4% qoq saar vs -0.1% before). By component, exports were the main contributor to the downside at -5.1% qoq saar, while investment in inventories fell -CA$5.8bn qoq saar. Gross fixed capital formation decreased -1.3% qoq saar, which shows that high interest rates are one of the reasons the economy is decelerating. Consumption grew 2.1% qoq saar, with government spending increasing 7.3% qoq saar, while household consumption showed moderated growth at 0.1% qoq saar (Exhibit 1). With information up to 3Q we estimate the output gap remains in positive territory and that it will likely close between 1Q and 2Q 2024 (Chart of the day).

The labor market keeps easing, but wages still pose risks to inflation

The economic slowdown is softening the labor market, although it remains volatile. Even though 59.6k jobs were created in November, the unemployment rate increased in October and November, and is now at 5.8%, breaking with the resistance observed at 5.5% in previous months (Exhibit 2). The employment rate also fell, although slightly (61.8% from 61.9%), as population growth (+0.2%) outpaced employment growth (+0.1%) (Exhibit 3). The employment rate shows that the increase in labor supply has been a big help in Canada to bring inflation down. Nevertheless, wages remain sticky at 5.0% -growth observed in both October and November- and this resistance represents an upside risk for inflation (Exhibit 4). We believe that wage growth will decelerate in the following months given the increase in unemployment and economic weakness.

Exhibit 1: Contributions to GDP growth
Exports and inventories were the main drivers of 3Q's downward surprise



Source: BofA Global Research, Stat Canada Haver

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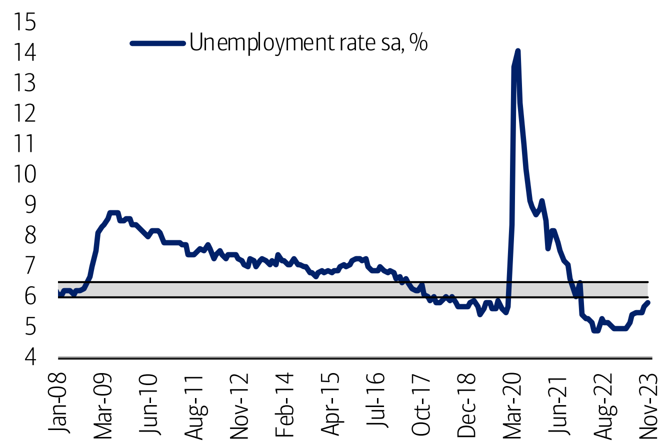
Exhibit 2: Unemployment rate
Unemployment at 5.8% in November: it has clearly bottomed out



Source: BofA Global Research, Stat Canada, Haver

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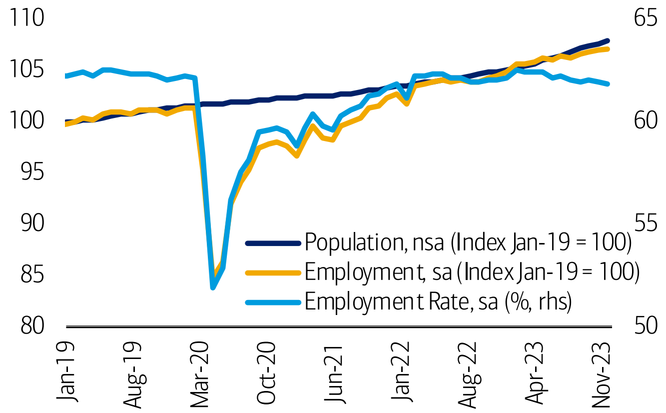
Exhibit 3: Population and employment growth, and employment rate
Population growth (+0.2%) keeps pushing employment rate down (61.8%)



Source: BofA Global Research, Stat Canada, Haver

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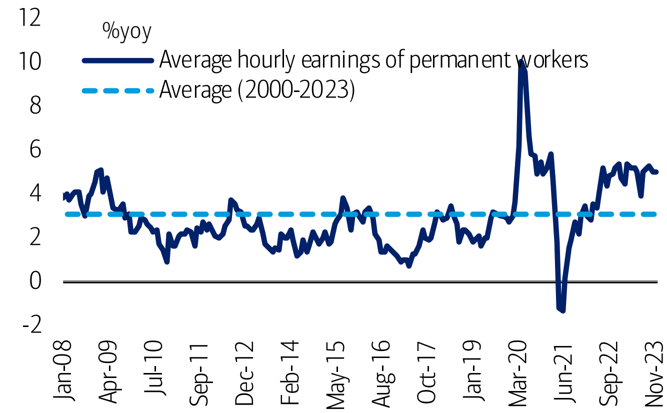
Exhibit 4: Average hourly earnings of permanent workers
Sticky wages: growth at 5.0% in November, from 5.0% in October



Source: BofA Global Research, Stat Canada, Haver

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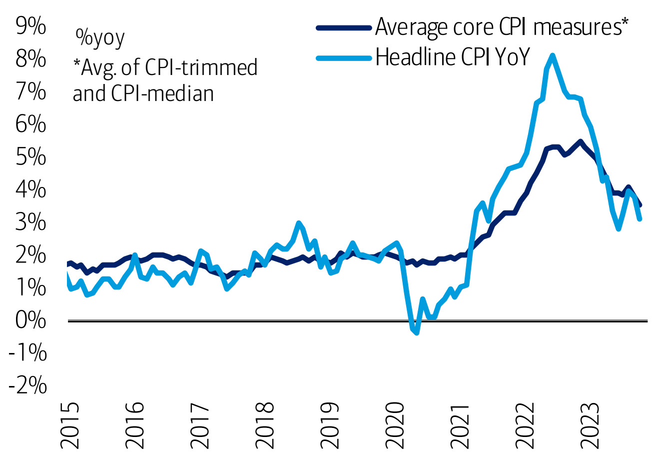
Headline inflation slows down, but services inflation refuses to tag along

Headline inflation showed a substantial decrease in October, falling to 3.1% yoy from 3.8% in September. Core inflation, which was taking the spotlight due to its stubbornness on previous months, fell in October as well. The average of the core measures (trimmed and median) reached 3.55% yoy, down from 3.80% in September (Exhibit 5), likely helped by tight monetary policy. However, we believe that some upside risks remain for core inflation. Canada has lower inflation levels than the US, but core inflation is not falling as fast despite a weaker economy (Exhibit 6). Part of the reason is that services inflation remains quite high, reaching 4.60% yoy in October, levels not seen since April 2023 (Exhibit 7). This is an upside risk for inflation as the wage mass still points to support for consumption going forward (Exhibit 8). Still, in our baseline headline inflation is likely to keep falling towards the 2% target in 2024.

Exhibit 5: Headline and core inflation
Both headline and core inflation seem to be trending down



Source: BofA Global Research, Stat Canada, Haver

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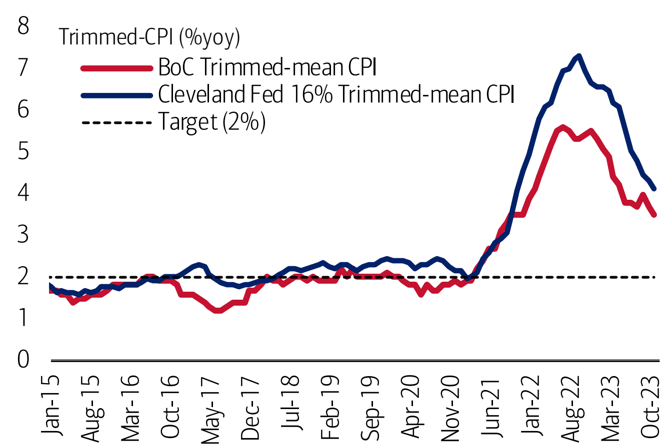
Exhibit 6: Trimmed-CPI inflation comparison
Inflation is lower in Canada, but the US shows more downward momentum



Source: BofA Global Research, Stat Canada, Bloomberg

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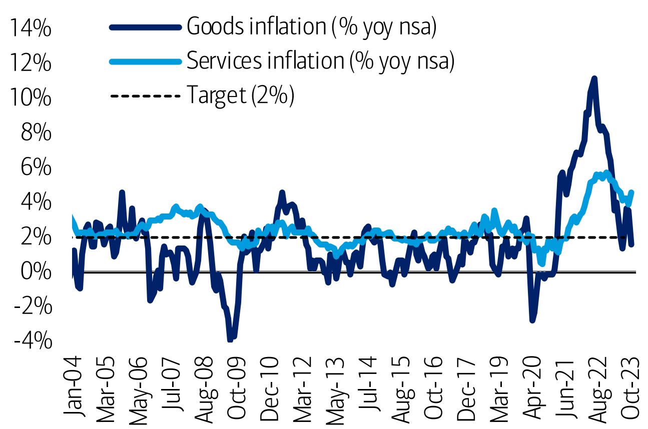
Exhibit 7: Goods and services inflation
Services inflation remains sticky at 4.60% yoy nsa



Source: BofA Global Research, Stat Canada, Haver

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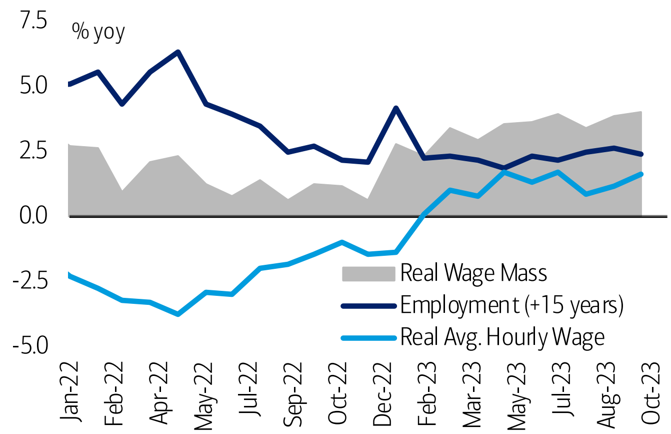
Exhibit 8: Real wage mass
Real wage mass increased 4% yoy in October, still pressuring prices up



Source: BofA Global Research, Stat Canada, Haver

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The BoC is done hiking, it is likely to start cutting in 1H 2024

With the economy already contracting and the unemployment rate steadily increasing it is unlikely the Bank of Canada (BoC) needs to hike again. But we expect the BoC to remain on hold for some time, as inflation remains above the target and as wage growth remains quite sticky. We believe that BoC could start a cutting cycle in 2Q 2024 if inflation keeps falling. Our baseline is the first cut in June 2024 (Exhibit 9). But since core inflation is already trending down the risk is that the BoC decides to start cutting in 1Q, in which case it could change its language as soon as this meeting (December).

Exhibit 9: Expected monetary policy paths
Throughout 2024, the BoC is expected to cut 125bps vs. 75bps of the Fed

Date	BoC	Change (bp)	Fed (upper bound)	Change (bp)
Dec-23	5.00		5.50	
Jan-24	5.00		5.50	
Feb-24	5.00		5.50	
Mar-24	5.00		5.50	
Apr-24	5.00		5.50	
May-24	5.00		5.50	
Jun-24	4.75	-25	5.25	-25
Jul-24	4.50	-25	5.25	
Aug-24	4.50		5.25	
Sep-24	4.25	-25	5.00	-25
Oct-24	4.00	-25	5.00	
Nov-24	4.00		5.00	
Dec-24	3.75	-25	4.75	-25

Source: BofA Global Research estimates
Shaded areas indicate interest rate announcements

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CA rates: more aggressive cutting cycle for BoC than Fed

Asymmetry in market pricing of BoC vs Fed path in 2024

Assuming inflation moves lower, which is the key to initiation of cutting cycles in 2024, slower Canadian growth should allow faster cuts vs the US. While BoC and Fed are expected to start cutting around the same time in June '24, BoC may adopt a once per meeting stance rather than once per quarter which is our Fed outlook. In 2H '24, we expect BoC cuts of 125bps vs 75bp of Fed cuts. Market pricing, however, does not expect a rapid pace of BoC cuts vs the Fed. At the moment, CAD is pricing about 106bp of cuts by end 2024 and USD is pricing about 113bp.

The divergence in our BoC and Fed rates forecasts drives our forecasts for CA rates. Due to the more aggressive path of cuts, we expect 2y CA rates to outperform US 2y and for the CA 2s10s curve to steepen. Due to our economists' expectations for BoC cuts, our rates forecasts are also more aggressive than the forwards. By year-end '24, we forecast the 2y yield will be flat to the BoC's terminal rate at 3%.

BoC QT likely to end with first rate cut in June '24

BoC settlement balances are currently around $140b and are projected to fall through most of 2024. Earlier this year, Deputy Governor Gravelle announced the BoC would likely end QT in late '24 or the first half of '25 when settlement balances are between CAD20b to 60b. However, we expect the BoC could end QT early with the first BoC cut in June '24, especially if prompted by a recession. Based on our forecasts, settlement balances would be roughly CAD100b, well above projected levels of settlement balance scarcity. We will continue to monitor CORRA for sustained upward pressure as indication of settlement balances becoming scarce.

FX: bearish December seasonality for CAD-crosses

Consensus and market pricing broadly expect a rate hold decision as the baseline for the final BoC meeting of the year. With no new monetary policy report and government Macklem not participating in the post-meeting press conference, we believe this meeting would likely have a low impact on the exchange rate.

As discussed in G10 FX Year Ahead: The year of the landing (20 November 2023), our baseline view is broadly bearish USD vs rest of G10 FX into next year. For USD/CAD, we are moderately bullish CAD on growth recoupling in first half of 2024. But until the Fed cutting cycle begins, CAD would likely lag behind other G10 "high-beta" peers. December seasonals for CAD-crosses would support this view, with CAD NEER lower 46% of the time for a median return of -0.2%. Over the past two decades, December has been the most bearish for CAD vs NZD and the Scandies, but neutral to moderately bullish CAD vs the USD and JPY (Exhibit 10). So looking ahead, we expect USD/CAD to continue trading around the 1.35-handle until signals for Fed or BoC rate cut timing occur in 2024, and prefer to express any bearish CAD views on the crosses for the time being.

Exhibit 10: December is seasonally most bearish for CAD against NZD, SEK and NOK

December seasonality for CAD-crosses since 1999

	CADEUR	CADGBP	CADAUD	CADNZD	CADUSD	CADCHF	CADSEK	CADNOK	CADJPY	CAD NEER
1999	2.2%	0.6%	-1.4%	-0.5%	1.9%	1.9%	3.8%	1.3%	2.3%	1.9%
2000	-5.2%	-2.2%	-3.1%	-4.7%	2.6%	-4.5%	-4.1%	-2.6%	6.8%	1.9%
2001	-0.5%	-3.3%	1.2%	-1.1%	-1.3%	-0.1%	-1.7%	-0.3%	5.2%	-0.9%
2002	-5.7%	-3.7%	-0.6%	-5.5%	-0.5%	-7.2%	-4.7%	-5.4%	-2.9%	-1.6%
2003	-4.5%	-3.4%	-3.4%	-2.2%	0.2%	-3.7%	-4.4%	-1.9%	-1.9%	-0.4%
2004	-3.2%	-1.6%	-2.1%	-1.8%	-1.2%	-1.4%	-2.2%	-2.1%	-1.6%	-1.5%
2005	-0.2%	0.7%	1.0%	3.3%	0.3%	0.2%	-1.4%	0.4%	-1.4%	0.0%
2006	-1.9%	-1.8%	-2.1%	-4.9%	-2.2%	-0.4%	-2.2%	-0.9%	0.6%	-2.0%
2007	0.3%	3.6%	1.1%	0.6%	0.0%	0.2%	1.2%	-1.9%	0.5%	1.1%
2008	-7.6%	7.1%	-5.2%	-3.6%	1.7%	-10.4%	-1.7%	0.9%	-3.5%	-0.4%
2009	5.1%	2.0%	2.4%	-0.9%	0.4%	3.3%	3.0%	2.3%	8.0%	2.0%
2010	-0.3%	2.5%	-3.7%	-2.0%	2.8%	-4.2%	-1.8%	-3.6%	-0.3%	2.2%
2011	3.4%	0.7%	0.4%	0.0%	-0.4%	2.4%	1.4%	3.2%	-1.3%	0.7%
2012	-1.3%	-1.2%	0.5%	-0.8%	0.2%	-1.1%	-2.2%	-1.7%	5.4%	-0.3%
2013	-1.2%	-1.2%	2.1%	-1.3%	-0.1%	-1.6%	-1.7%	-1.0%	2.7%	-0.5%
2014	1.1%	-1.3%	2.3%	-1.1%	-1.8%	1.2%	3.0%	4.1%	-0.8%	-0.5%
2015	-6.1%	-1.3%	-4.2%	-6.9%	-3.4%	-6.0%	-6.6%	-1.9%	-5.7%	-3.5%
2016	0.6%	1.3%	2.5%	2.2%	0.0%	0.1%	-1.3%	1.4%	2.1%	0.3%
2017	1.7%	2.7%	-0.6%	-1.3%	2.6%	1.7%	0.4%	1.2%	2.7%	2.9%
2018	-3.8%	-2.6%	1.0%	-0.2%	-2.5%	-4.0%	-5.2%	-2.0%	-5.9%	-3.1%
2019	0.5%	-0.3%	-1.4%	-2.5%	2.2%	-1.1%	0.0%	-2.6%	1.4%	1.2%
2020	-0.3%	-0.4%	-2.5%	-0.3%	2.2%	-0.6%	-2.1%	-1.5%	1.1%	0.9%
2021	0.8%	-0.6%	-0.8%	0.8%	1.1%	0.7%	1.3%	-1.3%	2.8%	0.2%
2022	-3.8%	-1.3%	-1.4%	-1.8%	-1.0%	-3.2%	-1.7%	-1.5%	-6.0%	-1.1%
hit ratio	38%	38%	42%	21%	54%	38%	29%	33%	54%	46%
median return	-0.4%	-0.9%	-0.7%	-1.2%	0.1%	-0.9%	-1.7%	-1.4%	0.5%	-0.2%

Source: BofA Global Research, Bloomberg

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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
- Investors chasing the USD lower, **Liquid Cross Border Flows**, 20 Nov 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: Before the year ends 01 December 2023

Global Rates Weekly: Tree up, yields down 01 December 2023

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