Liquid Insight

Bank of Canada preview – on hold; 5.0% is likely the terminal rate

05 September 2023

Rates and Currencies Research
Global

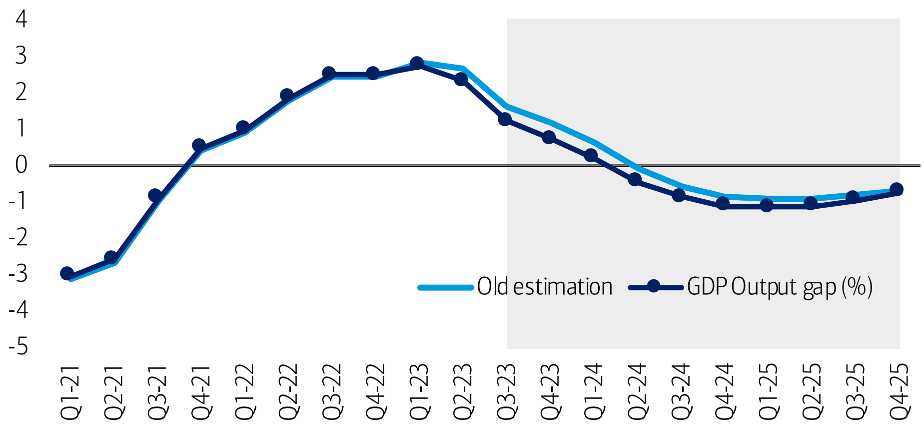
Key takeaways

- We expect the BoC to keep the policy rate at 5.0% on September 6, as the economy is clearly decelerating.
- The statement will likely continue to stress concerns on inflation, and risks remain to the upside for the policy rate.
- We hold a neutral view on USDCAD into the BoC meeting and prefer to express bearish CAD views vs AUD and NOK in G10.

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

Chart of the day: Output gap revision

The economy is decelerating, the output gap closes faster using the 2Q GDP print



Source: BofA Global Research estimates, Stat Canada, Haver

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BoC: On hold; 5.0% is likely the terminal rate

We expect the Bank of Canada (BoC) to remain on hold with the overnight rate at 5.0% on September 6. GDP contracted unexpectedly in 2Q which means the output gap is narrower and will likely close sooner than previously expected (Chart of the day). The unemployment rate seems to have bottomed out. So, pressures on core inflation are likely to subside without the need of a higher policy rate. Inflation increased recently and is likely to remain above 3% for the rest of the year, but we still expect inflation to move towards the target in 2024. We believe 5.0% is the terminal rate, although risks remain to the upside. CA rates outperformed US, driven by US economic resilience, supply / demand concerns, and positioning. As we are likely at the end of the BoC tightening cycle, we think investors should lean long duration and be in steepeners. The negative GDP print put the 3-day CAD rally into a stall. Heading into the BoC meeting, we hold a neutral view on USDCAD and prefer to express bearish CAD views vs AUD and NOK in G10.

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
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

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BoC: On hold despite higher inflation

The economy contracted unexpectedly in 2Q

The economy contracted unexpectedly in 2Q 2023 with GDP at -0.2% qoq saar, down from a downward revised 2.6% in 1Q (3.1% originally). The main drivers to the downsde were housing investment, inventory accumulation, imports, and household spending (Exhibit 1). Business investment and government spending partially offset the fall in GDP. The monthly GDP for June also contracted at -0.2% mom sa. The latter was negatively impacted by the fires in Quebec, but wholesale trade was also weak (-3.0%), which shows that the weakness was not all due to the fires. The flash estimate for July is at 0.0% mom sa. Given the downward surprise in 2Q GDP growth, we revised our 2023 GDP growth forecast to the downside to 1.1% (1.6% before). We see downside risks to our GDP growth forecasts and a recession in Canada cannot be discounted, with a contraction in 3Q a possibility.

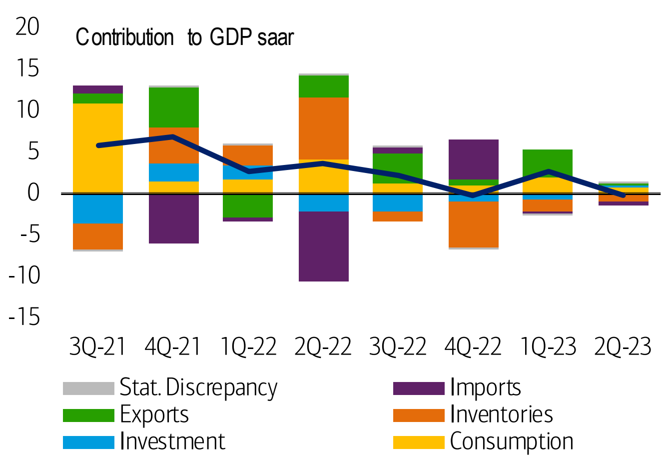
The unemployment rate seems to have bottomed out

The labor report for July was below expectations with a net job creation at -6.4k. The goods-producing sector drove the losses with -27.5k jobs. The main component was employment in construction (-45k), probably driven by a softer housing market and even the recent wildfires. The service-producing sector posted 21.2k new jobs, mainly driven by healthcare and social assistance (25.1k) and educational services (18.8k). But the highlight in our view is that the unemployment rate increased for the third consecutive month to 5.5%. This is the highest U-rate observed since the pandemic started (Exhibit 2). The labor market is softening at the margin. However, the hourly wage growth increased again in June to 5.0% yoy from 3.9% in May. We believe that wage growth will decelerate in the following months given the increase in unemployment.

Renewed inflation pressures in July

Consumer Price Index (CPI) inflation surprised above expectations at 3.3% yoy in July, up from 2.8% in June. In monthly terms, inflation was also above expectations at 0.5% mom sa. The main upside drivers were higher-than-expected transportation inflation at 1.3% (gasoline), shelter at 0.7% (mortgage interest costs), and recreation at 2.1% (travel tours at 15.5% mom and airfare at 13.6%). Upside price pressures in headline inflation were widespread, which made us increase our inflation forecast for year end to 3.7% yoy from 3.2% before. However, the average of the two core inflation measures (trimmed and median) fell slightly to 3.65% yoy in July from 3.70% in June (Exhibit 3). We expect core inflation to continue falling given the weak economy and a softer labor market.

Exhibit 1: Contributions to GDP growth
Imports and inventories were the main drivers of the 2Q downside surprise



Source: BofA Global Research, Stat Canada, Haver

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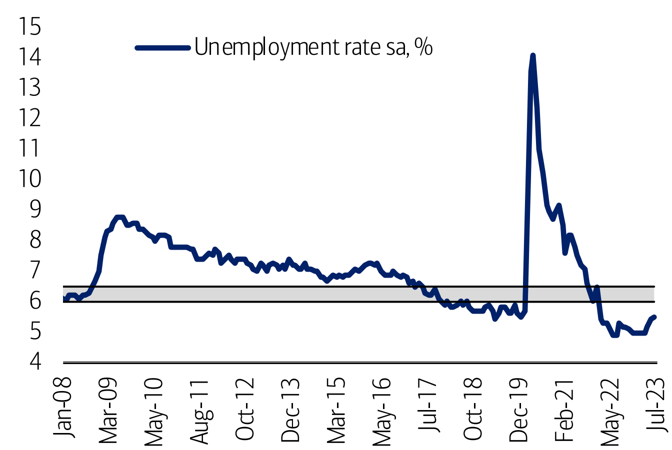
Exhibit 2: Unemployment rate
Unemployment rate seems to have bottomed out



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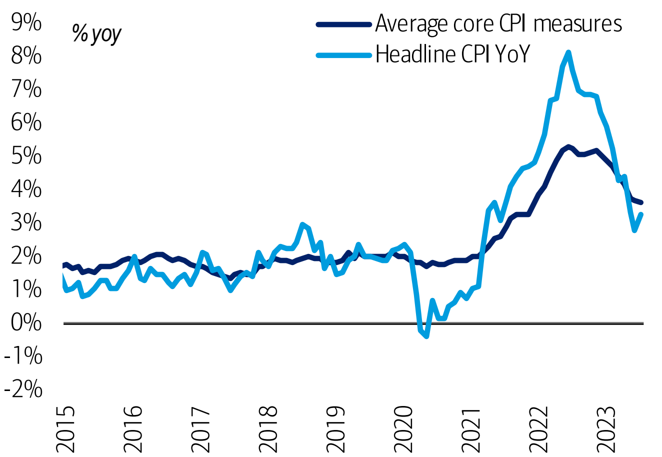
We expect the BoC on hold in September; 5% may be terminal

The BoC remains in a data dependent mode and has not closed the door to further hikes yet. But we estimate that the output gap likely peaked in 1Q 2023, and that it will slowly close in the following quarters, which would allow the BoC to remain on hold for now, even if the Fed hikes once more, and cut ahead of other DM central banks in 2024 (Exhibit 4). Rising unemployment also supports our call. Hence, we believe that 5.0% is likely the terminal rate, although risks remain to the upside given that inflation is still above the target. We expect the BoC to start its cutting cycle in 2Q 2024, followed by five 25bp additional cuts to reach a rate of 3.50% by end-2024.

Exhibit 3: Headline and core inflation
Headline rebounded while core continues its downward trend



Source: BofA Global Research, Stat Canada, Haver

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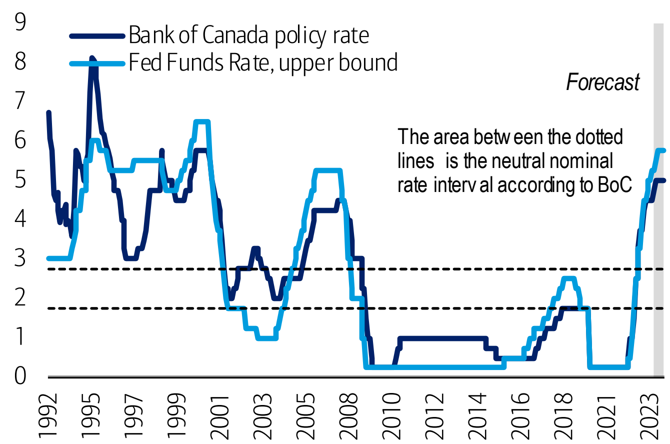
Exhibit 4: Bank of Canada and Fed rates
Rates are highly correlated, but usually end with a higher terminal rate



Source: BofA Global Research estimates, Bank of Canada, Bloomberg

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CA rates: lean long duration and be in steepeners

Market pricing heading into this week's meeting has been on a downward trend since mid-Aug but dropped to just under 4bps priced in after the weaker than expected 2Q GDP print, in line with our expectations for the BoC to be on hold. The market is now pricing in cuts starting in April 2024 with nearly 50bps of cuts priced in by the December 2024 BoC meeting.

CA rates have outperformed US, driven by US economic resilience, UST supply/demand concerns & positioning. Our economists believe that the Fed is likely to hike one more time in November but for the BoC to be on pause. 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. As we are likely at the end of the BoC tightening cycle, investors should lean long duration and be in steepeners.

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

Additionally, 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. In addition, the earlier timing of Fed cuts (Nov-Dec OIS is inverted) could normalize closer to that priced for the BoC, which would also support cheapening vs CAD rates.

FX: Bearish CAD vs G10 high-betas into September BoC

We had argued for a short-term reversal of the CAD rout after the August selloff (FX Viewpoint: 29 August 2023), but the weaker than expected Q2 GDP data print put the 3-day CAD rally since August 29 into a stall. Details of the Q2 GDP read better than the headline miss, in our view. The bulk of the growth decline came from inventory and residential investment, like another recent negative print from Q4 2022. Upon release of the Q4 2022 Canada GDP at the end of February 2023, CAD initially weakened in March (for the most part due to the US regional bank risk-off shock) but ultimately recovered before end of the month.

So, looking into the rest of September, we hold a more neutral USDCAD view and favor short CAD expressions vs other G10 high-beta currencies like AUD and NOK. The moderating August US payrolls data poses headwinds for short-term USD rallies as investors further pare back Fed rate hike pricing. Improvement in broad risk sentiment on the back of a September Fed rate hold decision after the August turmoil (FX Viewpoint: 16 August 2023) could support the CAD vs USD. We prefer to retain any bearish CAD view against AUD and NOK, given AUDCAD and CADNOK are both looking to break through the 50d SMA (Exhibit 5-Exhibit 6). Incremental stimulus announcements from China and a Norges Bank that is still looking to hike rates are also bullish factors for AUD and NOK.

Exhibit 5: AUDCAD looking to break above 50d SMA
AUD/CAD vs 50d SMA

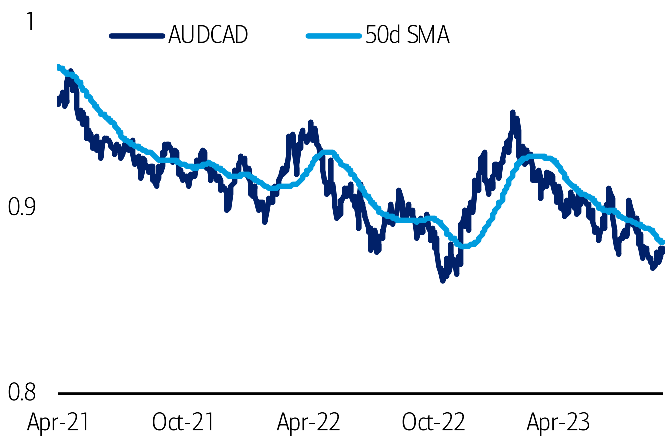

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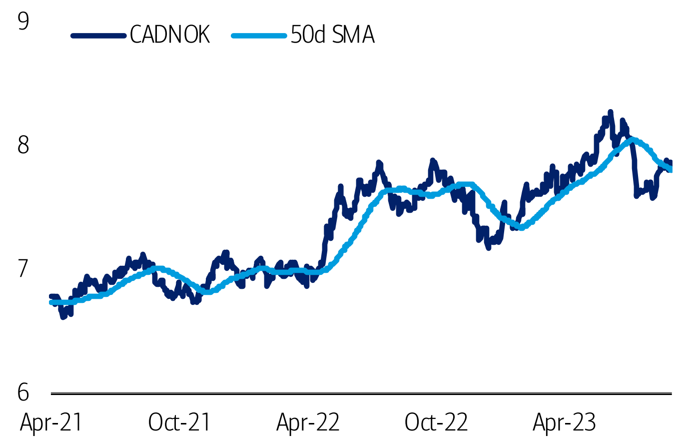
Exhibit 6: CADNOK is also looking to break through 50d SMA
CAD/NOK vs 50d SMA



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- Little else matters **Global FX Weekly**, 1 Sep 2023
- Belabored day **Global Rates Weekly**, 1 Sep 2023
- Support for USD vs. GBP, CHF, CAD; EM interventions, **Liquid Cross Border Flows**, 21 Aug 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: Little else matters 01 September 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
Rates 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