Liquid Insight

BoC on hold: core inflation is far from a sustained easing

23 January 2024

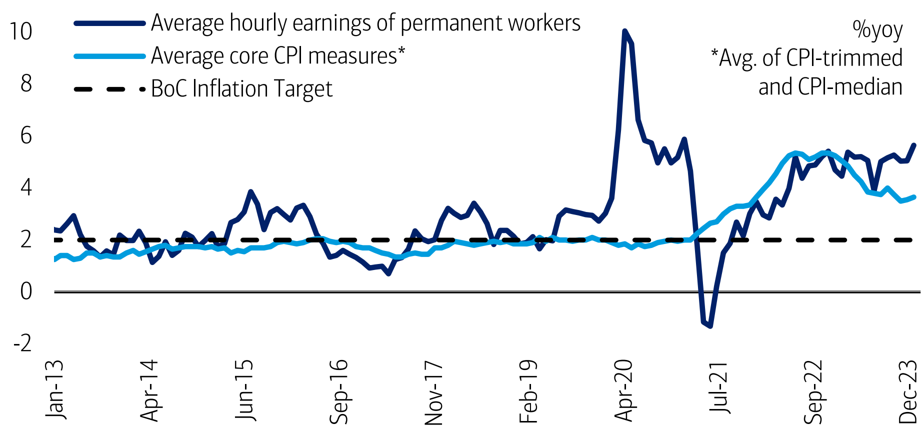
Rates and Currencies Research
Global

Key takeaways

- We expect BoC to keep the policy rate at 5.0% on Jan 24 with a hawkish statement, delaying the start of the cutting cycle.
- Core inflation remains too sticky and is far from showing a downward trend. We expect the BoC to start cutting in June.
- Rates: Scope for some outperformance of CAD govt bonds vs US. FX: We continue to estimate 1.34-1.35 as short-term fair value.

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

Chart of the day: Average hourly wage growth and average core inflation (% yoy)
Core inflation is not showing a clear downward trend and wage growth is increasing



Source: BofA Global Research, Stat Canada, Bloomberg, Haver

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BoC: on hold waiting for core inflation to fall again

We expect the Bank of Canada (BoC) to remain on hold with the overnight rate at 5.0% on January 24, with no changes to its forward guidance. Economic activity remains weak which is slowly loosening the labor market. However, wage growth remains elevated (5.7% yoy in December) and the BoC stated on its most recent summary of deliberations that wage growth above 4.0-5.0% "would not be consistent with achieving price stability." Inflation-wise, the BoC is looking for a "further and sustained decline" in core inflation, which has yet to happen (Chart of the day). We believe the BoC will wait a few months before cutting. On rates strategy, there may be scope for some outperformance of CAD gov't bonds vs US given the divergence in inflation trends between the US and Canada, with CAD pricing in less cuts than we expect and the US pricing in more. For FX strategy, we continue to estimate 1.34-1.35 as short-term fair value range for the pair and expect any CAD appreciation vs the USD in 2024 to be more backloaded.

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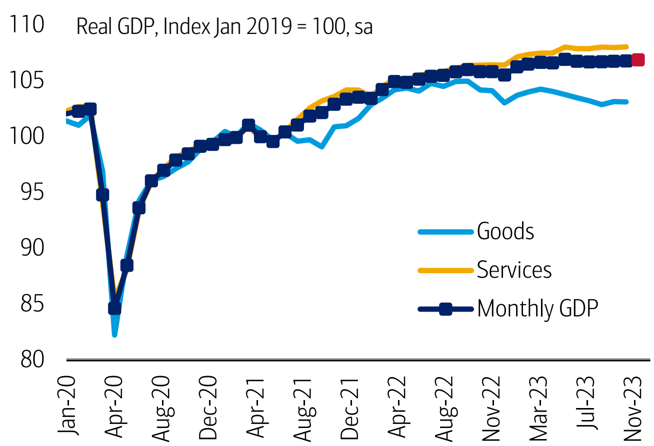
BoC: On hold waiting for core inflation to fall again

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

Economic activity has stalled

Activity remains weak. The economy contracted in 3Q 2023, and the monthly GDP in October was below expectations at 0.0% mom sa (E. 0.2%), with GDP linking three consecutive months with no growth (Exhibit 1). In the same spirit, our estimate of the output gap shows a negative output gap in 2H 2024 (Exhibit 2). At the margin, data remains mixed: the advance estimate for monthly GDP indicates a 0.1% mom sa expansion for November, and businesses' future sales expectations showed some signs of recovery in the 4Q BoC survey, but retail sales disappointed in November (-0.1% mom). We continue to expect the economy to remain weak in coming quarters.

Exhibit 1: Monthly GDP by industry
Monthly GDP has not increased recently



Source: BofA Global Research, Stat Canada, Haver

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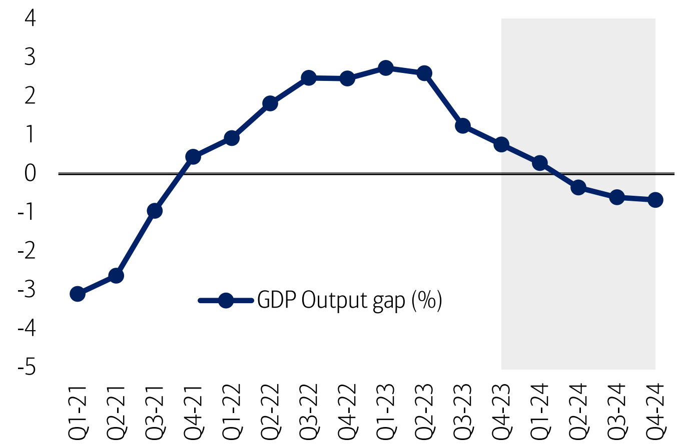
Exhibit 2: Canadian output gap (%)
We expect the Canadian economy to be below potential in 2H24



Source: BofA Global Research estimates, Stat Canada

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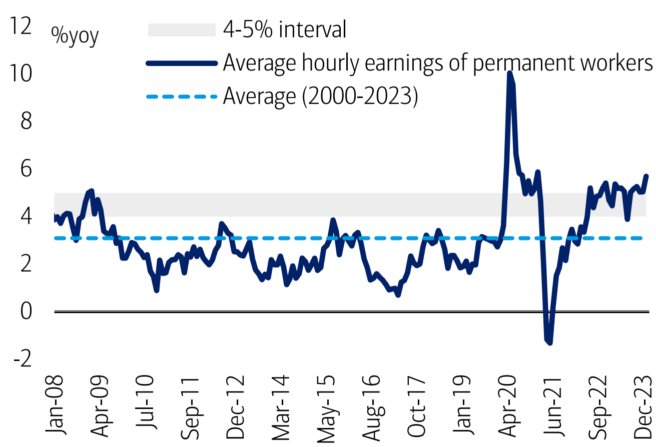
Wage growth is still above range. The BoC might not be comfortable just yet

The labor market seems to be softening as net job creation was weak in December. However, wage growth remains high at 5.7% (Exhibit 3). This is above the 4.0-5.0% range the BoC has stated could put rate cut discussions on the table. We expect wage

Exhibit 3: Average hourly earnings of permanent workers (% yoy)
A wage growth of 5.7% will likely keep the BoC on hold for some time



Source: BofA Global Research, Stat Canada, Haver

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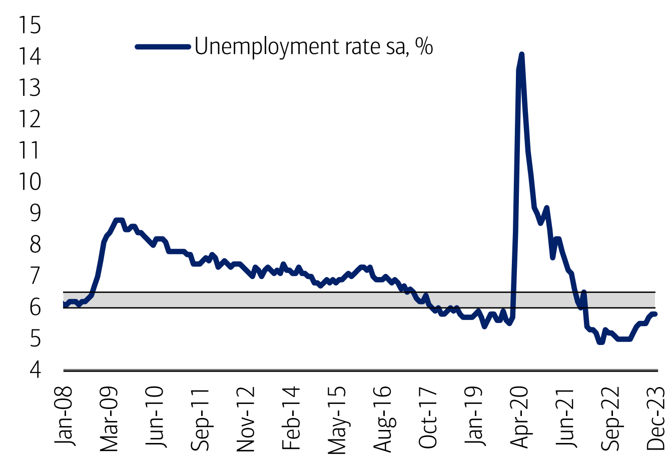
Exhibit 4: Unemployment rate (%)
The unemployment rate will likely increase in the following months



Source: BofA Global Research, Stat Can, Haver

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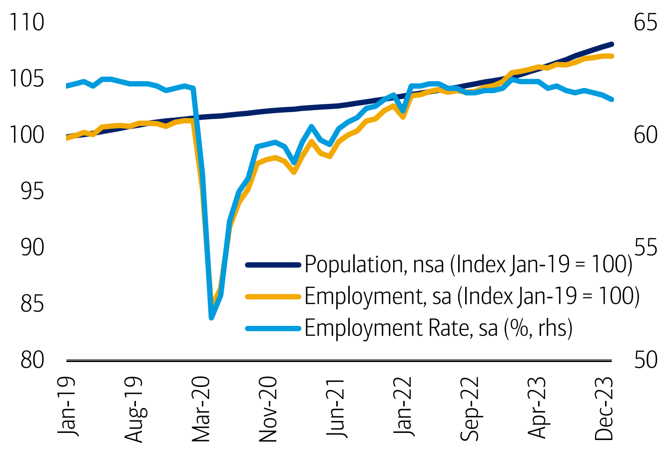
growth to fall in the following months as the unemployment rate has bottomed out (Exhibit 4) and as the employment rate continues to fall (Exhibit 5).

Exhibit 5: Population, employment growth and employment rate
Decrease of employment rate helps the market to cool down



Source: BofA Global Research, Stat Canada, Haver

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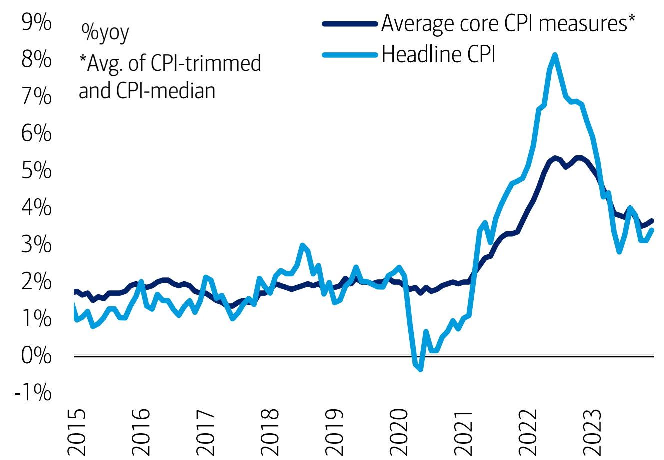
Exhibit 6: Headline and core inflation (% yoy)
We believe the uptick in headline and core will weigh on BoC's decision



Source: BofA Global Research, Stat Canada, Haver

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BoC wants "further and sustained easing" of inflation. We are not there yet.
Headline inflation edged up to 3.4% yoy in December from 3.1% in November mostly due to a base-effect in gasoline prices. But core inflation also accelerated in December, as the average of the two core measures (trimmed and median) increased to 3.65% yoy from a revised 3.55% (previously 3.45%) in November (Exhibit 6). This uptick in core inflation was driven by goods inflation, which grew 2.4% yoy in December (vs 1.4% in November), while services inflation decreased to 4.3% yoy from 4.6%. Note that goods inflation tends to be more volatile than services inflation (Exhibit 7). Still, in our baseline headline inflation is likely to keep falling towards the 2% target in 2024 given economic weakness (Exhibit 8).

Exhibit 7: Inflation breakdown: (goods and services, % yoy)
Services inflation remains very resilient

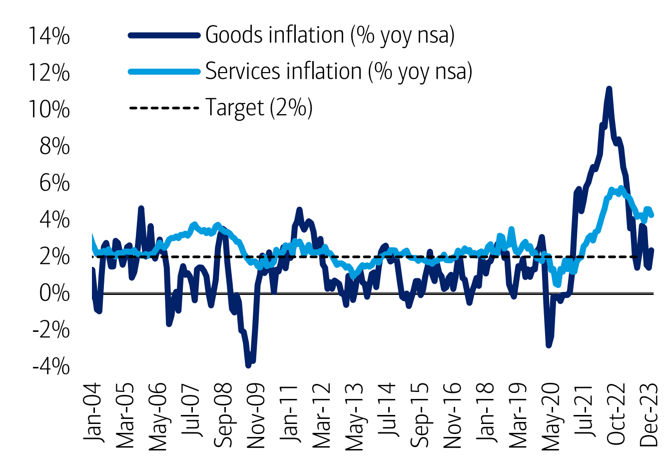

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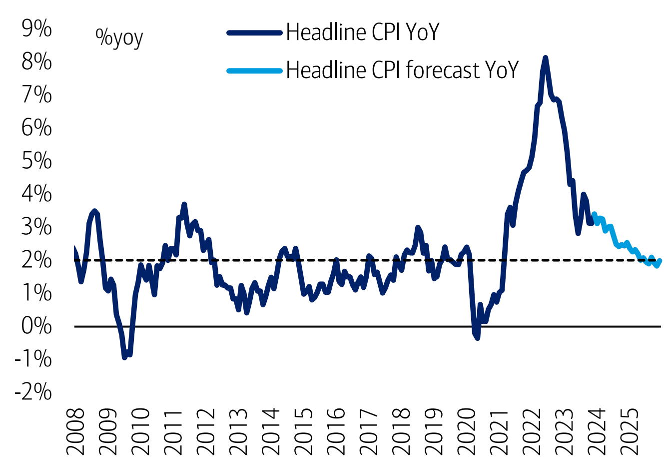
Exhibit 8: Inflation forecast 2024 – 2025 (%yoy)
Our inflation forecasts point to convergence in 2025



Source: BofA Global Research estimates, Stat Canada, Haver

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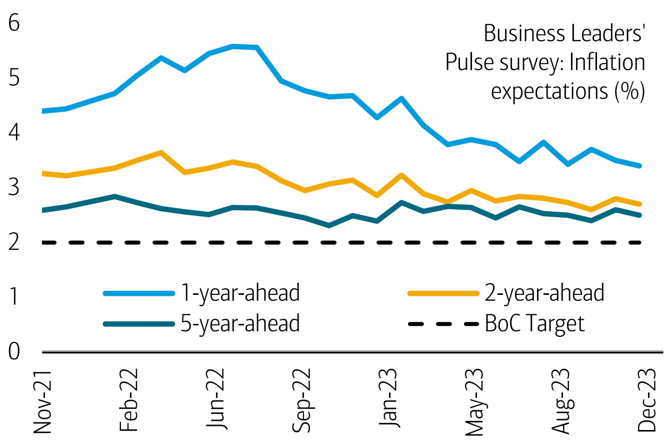
BoC will likely wait until June to cut
We expect the BoC's next movement to be a cut, as the economy and the labor market continue to weaken. However, we believe the BoC will start cutting until June, since December's core inflation print is still far from the "further and sustained decline in core inflation" the BoC is looking for. Furthermore, results from the Business Outlook and

Consumer Expectations Surveys show inflation expectations remain above target (Exhibit 9, Exhibit 10). Our call for the first cut in June does not depend on the US Fed cutting in March or delaying the start of the cycle to later in the year (Exhibit 11).

The main risk to our view for January's decision is that the BoC signals a cut in March, for instance by closing the door to further hikes, but we think the chance is small. The main risk for our view afterwards is that core regains downward momentum, and the BoC decides to change language in March and starts cutting in April.

Exhibit 9: Inflation expectations (Business Leaders' Pulse Survey, %)
Firms still expect inflation to be above BoC's target for some time



Source: BofA Global Research, Bank of Canada

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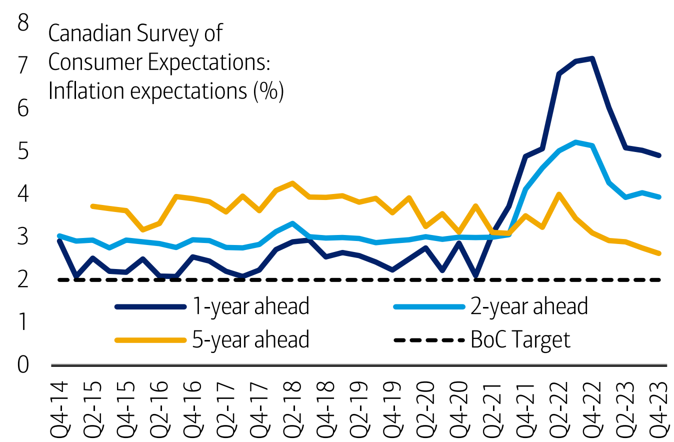
Exhibit 10: Inflation expectations (Canadian Survey of Cons. Expect, %)
Consumers expect high inflation in the short term



Source: BofA Global Research, Bank of Canada

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Exhibit 11: Monetary policy paths (BoC vs. Fed)
BoC to remain on hold in March, even if Fed cuts. We see, however, a faster cutting cycle for BoC

Date	BoC	Change (bp)	Fed	Change (bp)
Jan-24	5.00		5.50	
Feb-24	5.00		5.50	
Mar-24	5.00		5.25	-25
Apr-24	5.00		5.25	
May-24	5.00		5.25	
Jun-24	4.75	-25	5.00	-25
Jul-24	4.50	-25	5.00	
Aug-24	4.50		5.00	
Sep-24	4.25	-25	4.75	-25
Oct-24	4.00	-25	4.75	
Nov-24	4.00		4.75	
Dec-24	3.75	-25	4.50	-25
Jan-25	3.50	-25	4.50	
Feb-25	3.50		4.50	
Mar-25	3.25	-25	4.25	-25
Apr-25	3.00	-25	4.25	
May-25	3.00		4.25	
Jun-25	3.00		4.00	-25
Jul-25	3.00		4.00	
Aug-25	3.00		4.00	
Sep-25	3.00		3.75	-25
Oct-25	3.00		3.75	
Nov-25	3.00		3.75	
Dec-25	3.00		3.50	-25

Source: BofA Global Research estimates

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What to expect from the Monetary Policy Report?

We expect the BoC to leave its GDP growth expectation for 2024 unchanged (currently at 0.9%, BofA 0.9%), but to cut its GDP growth expectation for 2025 (currently at 2.5%, BofA 2.0%), since we do not expect cuts until June and monetary policy will probably continue to impact the economy at the beginning of 2025. Regarding inflation, we expect the BoC to cut its forecast for 2024 (currently at 3.0%, BofA 2.5%), but only slightly given December's print (where headline inflation rose). The BoC will likely reiterate that inflation will converge to the 2% target after 2Q25 and we believe it will revise to the downside its forecast for 2025 (currently at 2.2%, BofA 2.0%). The BoC will likely maintain its projection for the neutral (nominal) policy rate at 2.00% to 3.00%.

CA rates: Market pushing back first cut after sticky CPI

Market pricing of BoC cuts have moderated following another sticky inflation print in December. The market currently has 4 BoC cuts priced in for 2024, down from over 6 cuts priced in around late last year. The series of sticky inflation prints are likely to keep the BoC on hold for longer until a consistent downturn in inflation is observed. Our economists currently expect the BoC to start cutting in June at a pace of 1 cut per meeting for a total of 5 cuts in 2024.

The sticky trend in CA inflation stands in contract to indicators pointing to lower inflation in the US. The divergence is also observed in the market pricing of cuts for the Fed now around 5.5 cuts priced in for 2024 with cuts starting in March. With CAD pricing in less cuts than we expect and the US pricing in more, there may be scope for some outperformance of CAD govt bonds vs US. The path of realized inflation will likely be the main determinant of the rate differential between the 2 regions this year.

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, at least until the first cut in June, although early signs of funding pressures may lead to an earlier end to QT.

FX: Short-term fair value range at 1.34-1.35 for USDCAD

USDCAD has seen roundtrip price action over the past month. It initially sold off on the back of the dovish December FOMC meeting. Into January, the pair rallied back on a combination of short USD position unwind and increased global geopolitical tension (Liquid Insight: 17 January 2024). Against other major global currencies, CAD has stayed resilient due to its close proximity to the USD and paring back of BoC rate cuts.

Looking ahead, we continue to estimate 1.34-1.35 as the near-term fair value range for USDCAD. But should an equity risk-off shock materialize or growth data for Canada surprise to the downside, the pair could face short-term upside risks (FX Viewpoint: 16 January 2024). For the year as a whole, we continue to hold a more constructive view on CAD vs the USD and see the pair falling to 1.30 by end of the year, mainly driven by bearish USD forces that are likely to play out later in 2024 (FX Viewpoint: 05 January 2024).

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
- Explaining USD resilience, **Liquid Cross Border Flows**, 15 Jan 2024

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: Destination unknown 19 January 2024

Global Rates Weekly: Longs on ice 19 January 2024

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