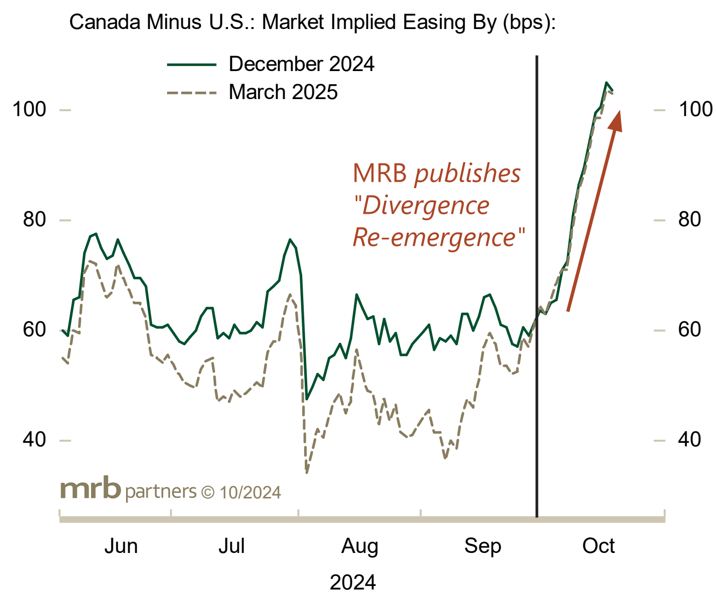
October 22, 2024

Bank of Canada: A Case For Frontloaded Easing

- The Bank of Canada has a much stronger case than the Federal Reserve to deliver sustained and/or deep rate cuts. Canada is the poster child of MRB's weak-link economies theme[1], and cracks have already been evident. We expect that the central bank will bring forward its easing, rather than risk a housing fallout and painful deleveraging adjustment.
- The BoC can justify cutting 50 bps this week and another 50 bps by yearend or early-2025, given strains from the ongoing mortgage refinancing wave and ample economic slack which will contain inflationary pressures.
- We remain overweight Canadian government bonds relative to U.S. Treasurys (hedged for currency exposure) and expect somewhat wider spreads in shorter-term interest rates (i.e. CORRA/SOFR spreads) over time. We also have an underweight allocation to the Canadian dollar.

We noted that the Federal Reserve's 50 bp cut last month would encourage select other developed market central banks with weaker economies to ramp up their dovishness and pull forward or frontload rate cuts[2]. Our key candidates were the ECB and the BoC, which we have thus far monetized in the **MRB *Absolute Return Strategy*** via a bet on wider U.S. and German 5-year bonds spreads[3] and a recommendation to position for wider Canadian versus U.S. interest rates (CORRA/SOFR) spreads (**chart 1**). Both recommendations have further to run, even though the "easy money" has been made. Note that we are also overweight Canadian government bonds (currency hedged) and underweight the Canadian dollar within a FX portfolio[4].

Chart 1 **Market Implied Policy Expectations Have Moved Considerably In Our Favor**



Note: CORRA/SOFR spreads

[1] **MRB:** "Are The Global Weak Links About To Snap?", October 4, 2023

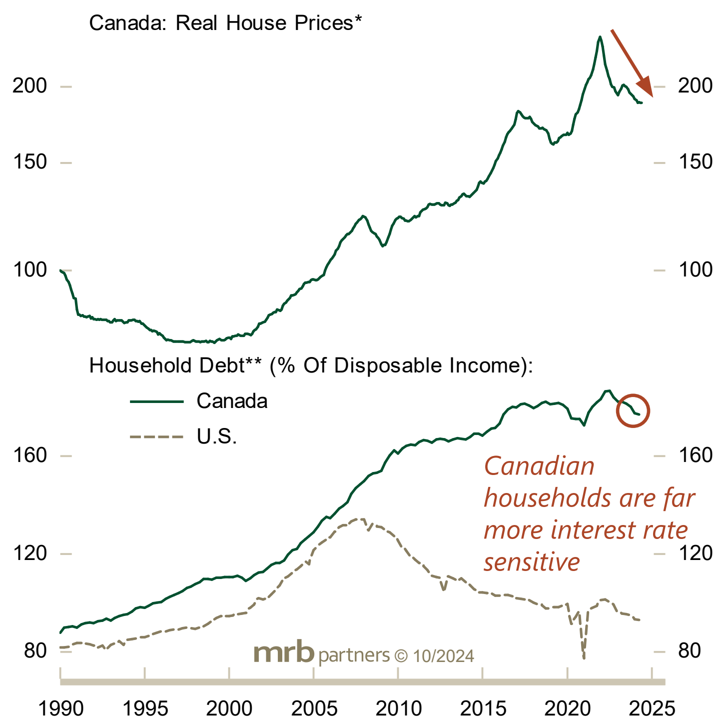
[2] **MRB:** "Fixed Income – Divergence Re-Emergence: Opportunities In Regional Bond Markets", October 1, 2024

[3] **MRB:** "Absolute Return Strategy – Extending Goldilocks", September 26, 2024

[4] **MRB:** "Global Foreign Exchange: Fed-Induced U.S. Dollar Weakness For Now", September 5, 2024

MRB has consistently warned that the Canadian economy is structurally vulnerable due to a housing bubble and excessive household leverage[5] (**chart 2**). This contrasts sharply with the U.S. where household balance sheets are (on balance) very healthy, having delevered last decade. Why this is important is that there is now a dramatic difference in interest-rate sensitivity among these two economies which sets the foundation for MRB's ongoing theme of a divergence in interest rates and bond yields[6]:

Chart 2 **Structurally Vulnerable Due To A Housing Bubble and Debt Imbalances**



* Composite MLS Home Price Index joined with Teranet index and the new house price index; deflated by headline CPI; rebased; sources: The Canadian Real Estate Association, Teranet/National Bank of Canada, and Statistics Canada
** Sources: Statistics Canada, Federal Reserve
Note: Panel 1 shown in log scale

- Our research has shown that there was little evidence that monetary policy became truly restrictive for the U.S. economy in recent years. Thus, Fed rate cuts are a dovish misstep that the central bank and bond investors will progressively realize, and continue to unwind expectations for further easing in 2025[7].

- Conversely, the Canadian economy needs lower interest rates to avoid triggering a material deleveraging wave like what the U.S. and parts of the euro area experienced in the decade after 2008. There are already a record number of Canadian homeowners struggling to make mortgage payments. To prevent crippling the consumer sector and causing a crisis due to forced selling of homes, Canadian banks and policymakers have allowed the maturity of these mortgages to be extended and/or classified the loans as negative amortization[8] (rather than treating them as nonperforming loans). With the sizable mortgage refinancing wave continuing through the end of 2026, at a point when home prices have stagnated over the last two years, further strains will build in the real estate market, financial system, and overall Canadian economy (**chart 3**).

- This strategy of postponing pain from mortgage resets is only a temporary stopgap and lower mortgage rates will ultimately be required. The substantial drop in 5-year

Interest rate sensitivity is very high in the Canadian economy and low in the U.S...

...this is the foundation of a divergence theme

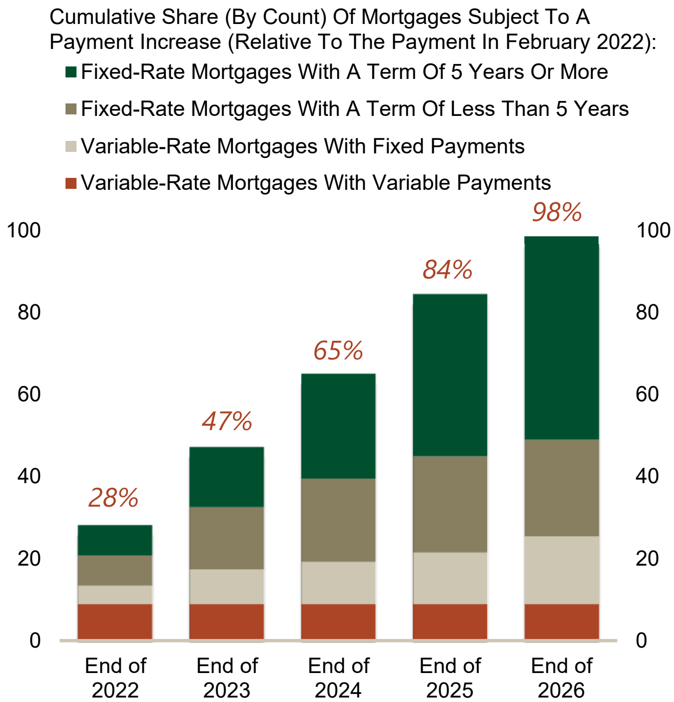
[5] **MRB**: "*Webinar: Canada's Housing Crisis & Impact For Investors*", January 17, 2023 and **MRB**: "*Canada – Housing: Sliding Down The Slippery Slope Of Hope*", September 8, 2023

[6] **MRB**: "*2024 Fixed Income Outlook: Diverging Trends*", November 22, 2023

[7] **MRB**: "*Monetary Policy – What Do U.S. Financial Conditions Imply?*", October 18, 2024 and **MRB**: "*U.S. Fed: The Makings Of Another Dovish Error*", September 19, 2024

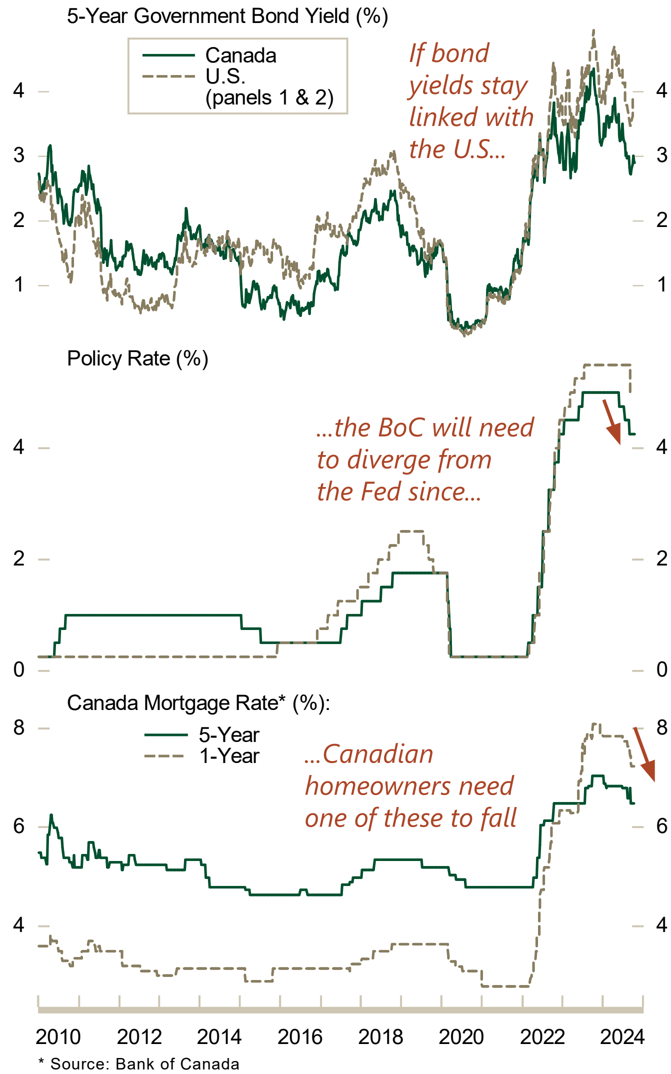
[8] Negative amortization occurs when the interest on a loan is greater than the loan payment, causing the loan balance to increase.

Chart 3 The Mortgage Refinancing Wave Will Continue Over The Next Two Years



mrb partners © 10/2024

Chart 4 The BoC Will Need To Provide An Offset By Lowering Mortgage Rates



* Source: Bank of Canada

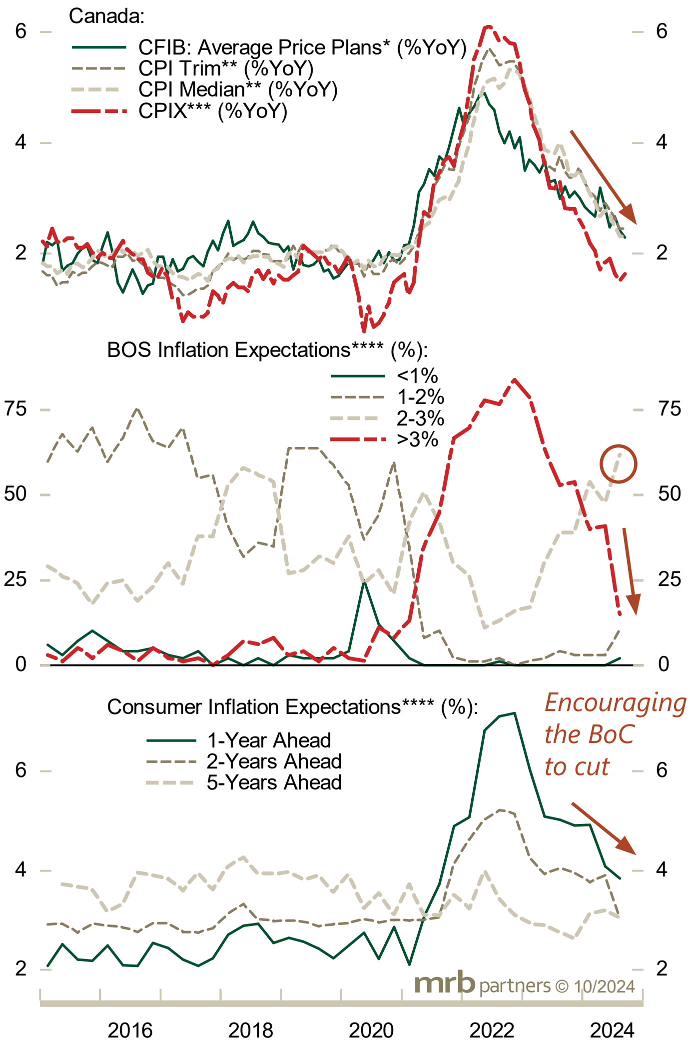
mrb partners © 10/2024

Canadian government bond yields and (to a lesser extent) mortgage rates since peaking in October 2023, has provided much needed support. However, as bond investors realize that the U.S. economy is more durable than they previously thought, U.S. Treasury yields are likely to rise further and could drag up Canadian bond yields. If so, the BoC will need to provide the offset by lowering short-term mortgage rates (**chart 4**). Ironically, strength in the U.S. economy will not have the traditional benefit for Canada ***if*** it were to lift domestic borrowing rates.

There has been increased speculation among investors that the BoC will deliver a 50 bp cut at this week's meeting. We expect that there is a good chance of this outcome. While the BoC has often surprised markets in recent years, we think it is less inclined to disappoint on the hawkish side now that its easing cycle is underway and Canada's excesses and now widening cracks are fully appreciated. BoC Governor Tiff Macklem's rhetoric in recent months has been dovish, signaling a preference for more accommodative policy on a go forward basis. Indeed, Macklem has acknowledged that data has broadly underwhelmed the central bank's July projections and has explicitly noted that growth ***"must pick-up to prevent an undershoot of the inflation target"***.

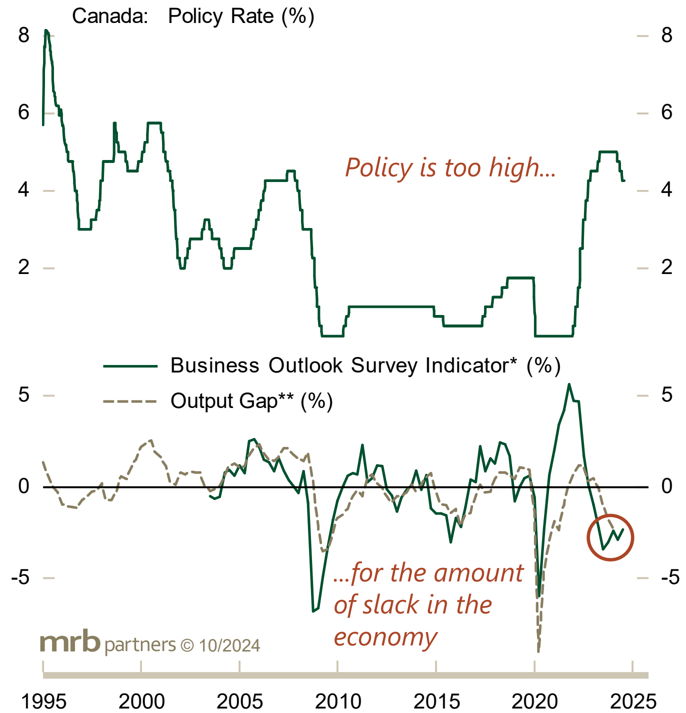
Ironically U.S. economic strength may not be good for Canada

Chart 5 **The BoC Can Act Aggressively As Price Pressures Have Eased Drastically...**



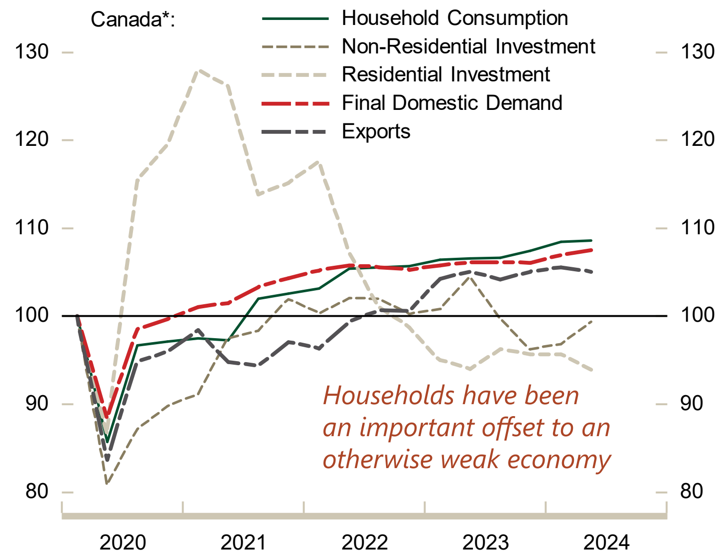
* Source: Canadian Federation of Independent Business
** Source: Statistics Canada
*** CPIX excludes 8 most volatile items; source: Statistics Canada
**** Source: Bank of Canada

Chart 6 **...As Significant Economic Slack Has Accumulated**



* Source: Bank of Canada (BoC)
** Average of BoC output gap measures; truncated below -9; source: BoC

Chart 7 **The Consumer Has Shouldered The Growth Burden**



* Rebased; source: Statistics Canada
mrb partners © 10/2024

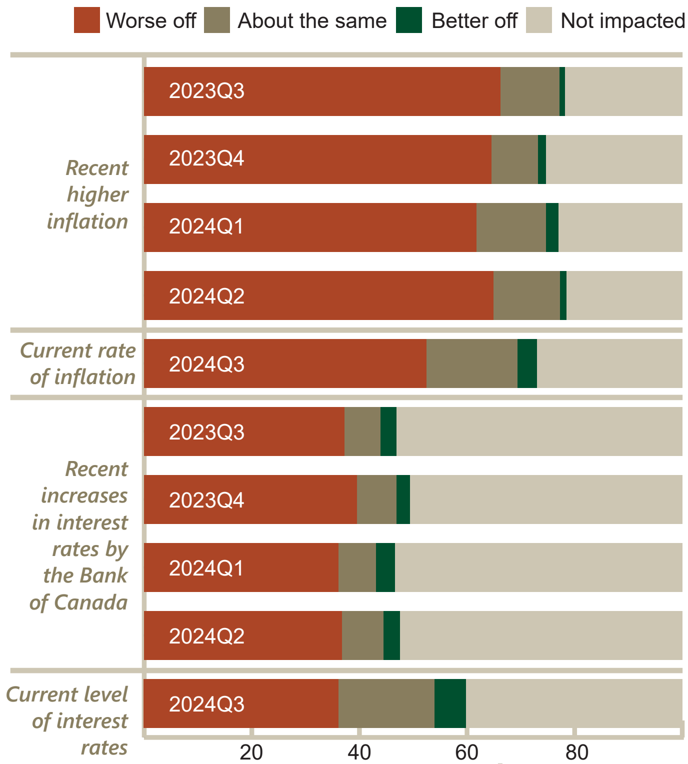
Recent inflation data showed a continued moderation in the BoC's core CPI measures (trimmed mean, median and traditional core that excludes 8 of the most volatile items). This has also been accompanied by an easing in inflation expectations in both the business and consumer sectors (**chart 5**). Looking ahead, the economy has built up significant slack over the past year, with output gap measures decisively negative (**chart 6**). In turn, inflation should remain well anchored in Canada and provide the central bank with ample scope to deliver significant rate cuts.

The outlook for economic growth is also softening. Canadian consumers have had to do much of the heavy lifting since interest rates began rising in 2022 to offset significant drags in residential and non-residential investment (**chart 7**, previous page). However, consumers are now showing signs of fatigue. Retail sales are sluggish and the BoC's Canadian Survey of Consumer Expectations – a key input to policy deliberations – has also revealed reduced spending intentions due to ongoing strains from elevated borrowing rates (**chart 8**). With a substantial percentage of mortgages yet to be reset, the risk is that households go into hibernation, or worse retrench. The increase in principal due to negative amortizing mortgages also likely is weighing on consumers' willingness to spend.

The major support for households has been solid employment and income trends. Job growth has slowed, albeit to a still healthy rate. However, there has been a deterioration in business sector employment intentions which provide a warning that investors need to monitor closely (**chart 9**). If this support were to fray, there is little savings cushion to support consumption and deleveraging forces could rapidly develop. In turn, ***the BoC is likely to be aggressive going forward to avoid the need for dramatic support later***.

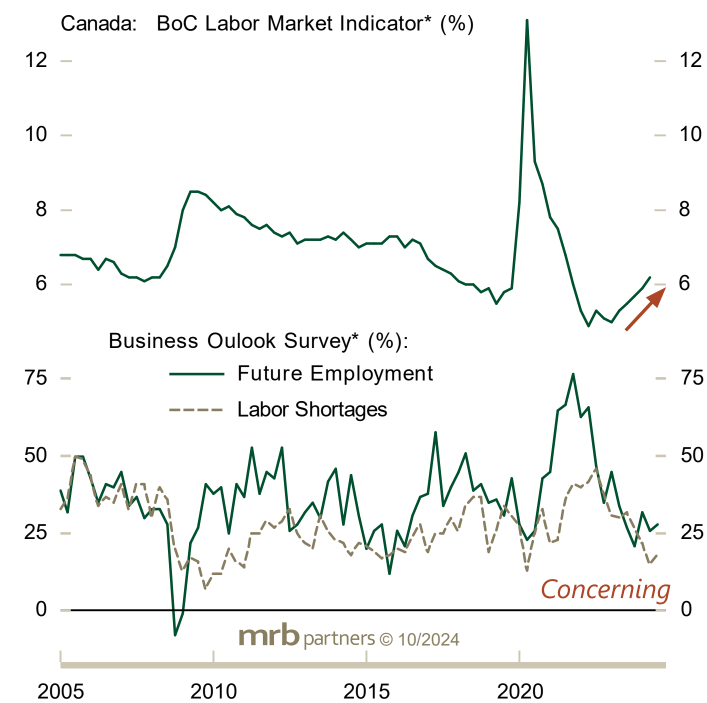
We expect a historically abnormal and sustained divergence between Canadian and U.S. policy rates and bond yields in the years ahead as the Canadian housing and debt bubbles deflate: the only question is whether an orderly deflation occurs, or something closer to the extremely painful U.S. example 15 years ago. We expect the BoC to deliver more aggressive easing and diverge from the Fed in 2025:

Chart 8 But Households Are Feeling An Ongoing Pinch



* Source: Bank of Canada
Note: Survey questions were changed in 2024Q3 to better reflect current inflationary and monetary policy environments. Survey asks whether consumers are better or worse over vs. 12m ago.

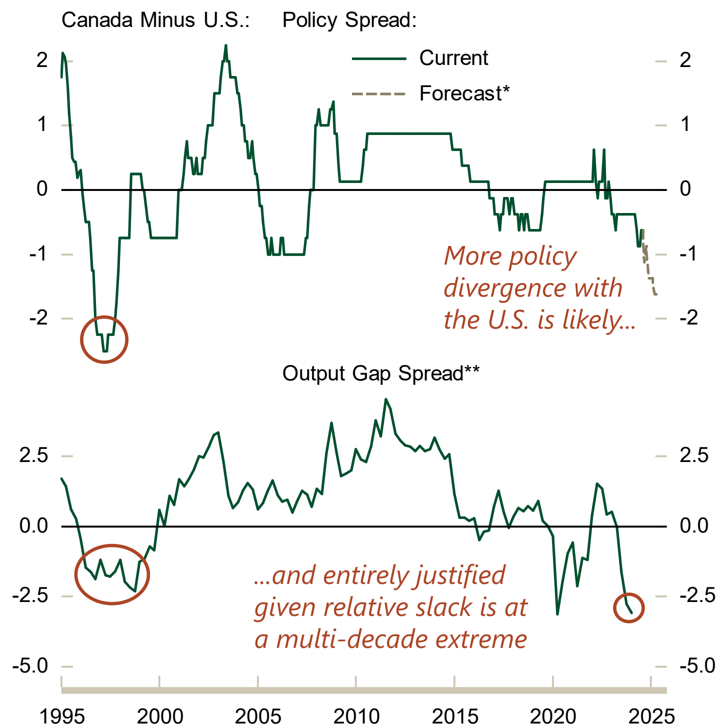
Chart 9 Labor Market Slack Is Beginning To Emerge



* Source: Bank of Canada

- Since the adoption of a 2% inflation target in the 1990s, the BoC and Fed policy rates have typically not diverged by more than roughly 100 bps from each other (**chart 10**). The BoC can effectively reach this extreme if it delivers back-to-back 50 bp cuts at its October and December meetings, and the Fed follows through on its dot plot projection for 2024 which calls for 100 bps of total easing (i.e. 2 more 25 bps cuts since it already delivered 50 bps last month). This seems to be a reasonable bet for the Fed, albeit continued rate cuts through 2025 becomes more debatable given that the U.S. economy is already showing more resilience than the consensus and the Fed were expecting (which is consistent with MRB's view).

Chart 10 The BoC Can Justify Greater Policy Divergence



* MRB calculation based on Fed's own policy projection and assumed BoC policy profile of back-to-back 50bp cuts
** Sources: Bank of Canada, U.S. Congressional Budget Office
mrb partners © 10/2024

- The notable exception to this policy rate divergence "rule" was in the mid-1990s when the output gap spread between Canada and the U.S. was as wide as it is now. Coupled with excessive household leverage in the economy (and relative to the U.S.), it is likely that the BoC will err once again on the dovish side. That may be one reason Macklem has noted that while there are limitations to policy divergence, they are not even close to it being a problem at present (i.e. he has provided the BoC with an opening to diverge significantly).

Final Word: *We expect the BoC to take advantage of softer growth and lower inflation to frontload rate cuts to avoid cracks in the economy from dangerously widening. History shows that deflating of housing and debt bubbles is typically very painful and requires extreme and open-ended offsetting monetary and fiscal reflation (and often a very cheap currency), something Canadian policymakers understand. Thus, we expect the BoC will ease aggressively now, rather than lagging and risk a debt-deflation spiral which would require much deeper rate cuts later and likely a considerably worse overall economic outcome.*

Expect an abnormal and prolonged divergence between Canada and U.S. policy rate

Investment Strategy

We believe the BoC has a desire to enter its nominal neutral range of 2.25-3.25% by early next year, and would likely prefer to reach the mid-point of 2.75%[9]. The

[9] **MRB:** "*Global Fixed Income – Rate Cuts: Not Needed, But Coming In Any Case*" August 1, 2024

bond market is close to pricing in this outcome, with the 2-year/1-year forward swaps now in the BoC's neutral range (**chart 11**). That said, there is room for the market bring forward easing and extrapolate slightly if the BoC provides a 50 bp rate cut this week.

While the "easy money" has now been made, we still favor betting on wider CORRA/SOFR spreads up to the first half of next year, focusing on March (H5) and June (M5) contracts. In the short-term, we think 100-125 bps for March bets will be a durable floor/range. That said, we think there is an asymmetry to widen further over the medium-term especially if the Fed delivers less easing than it projects (and inflation begins to firm again). We also remain overweight Canadian government bonds relative to U.S. Treasurys (hedged for currency exposure), and are underweight the Canadian versus U.S. dollar.

Mazen Issa
Strategist, Fixed Income

Phillip Colmar
Partner, Global Strategy

Chart 11 Divergence In Market Proxy For Long-Run Policy Rates Will Persist

* Source: Bloomberg

MacroResearchBoard

mrb partners

Independent Investment Strategy

MRB - Macro Research Board is an independent top-down research firm that provides integrated, global, multi-asset investment strategy as well as actionable absolute and relative return ideas. Our views incorporate a long-term outlook based on in-depth thematic research, together with a rigorous set of frameworks and forecasting models/indicators that drive 6-12 month asset market performance. MRB's team of analysts and strategists leverage the firm's robust research engine and their extensive experience to form one cohesive house view and ensure that investment strategy is articulated in a client-friendly manner.

For more information, please contact:

Client Relations

clientrelations@mrbpartners.com

London

24 Old Bond Street, 3rd Floor,
London, W1S 4AP, United Kingdom
Tel (+)44 (0) 20 3523 9618

Montreal

1275 Ave. des Canadiens-de-Montréal, Suite 500
Montreal, Quebec H3B 0G4, Canada
Tel +1 514 558 1515

New York

1345 Avenue of the Americas, FL 2
New York, NY, 10105, United States
Tel +1 212 390 1148

MRB Research Coverage

- Weekly Macro Strategy
- Global Macro & Investment Themes
- Global Asset Allocation
- Absolute Return Strategy
- U.S. & Developed Market Strategy
- China & Emerging Market Strategy
- Regional Equity Strategy
- U.S. Equity Sectors Strategy
- Global Fixed Income Strategy
- Foreign Exchange Strategy
- Commodity Strategy
- Webcasts & Live Events