ALPINEMACRO
A Unique Mind On The Markets

GLOBAL FIXED INCOME & CURRENCY STRATEGY

September 6, 2024

The Bank Of Canada Takes The Lead

- With inflation nearing the 2% target and the jobless rate rising, the BoC is becoming more concerned about downside risks to growth and inflation.
- Canadian core inflation is likely to fall close to the bottom of the 1-3% target band.
- While the market is priced for interest rates to return to neutral, the BoC may need to cut more and get policy to a stimulative level.
- Investors should maintain overweight positions in Canadian bonds for now. Looming rate cuts by the Fed should cap USD/CAD's upside.
- This week's JOLTS report indicates that the U.S. labor market is continuing to soften and the risks are skewed for inflation to fall below the Fed's 2% target.
- We are reluctant to chase yields lower as a significant amount of Fed easing is discounted. Use a back-up in yields to 4% to increase duration.

EDITORIAL TEAM

Harvinder Kalirai
Chief Fixed Income & FX Strategist

Chen Zhao
Chief Global Strategist

Mark McClellan
Chief U.S. Bond Strategist

Henry Wu
Senior Strategist & Head of Quantitative Research

Tony Boeckh
Editor-in-Chief

David Abramson
Chief U.S. Strategist & Director of Research

Bassam Nawfal
Chief Asset Allocation Strategist

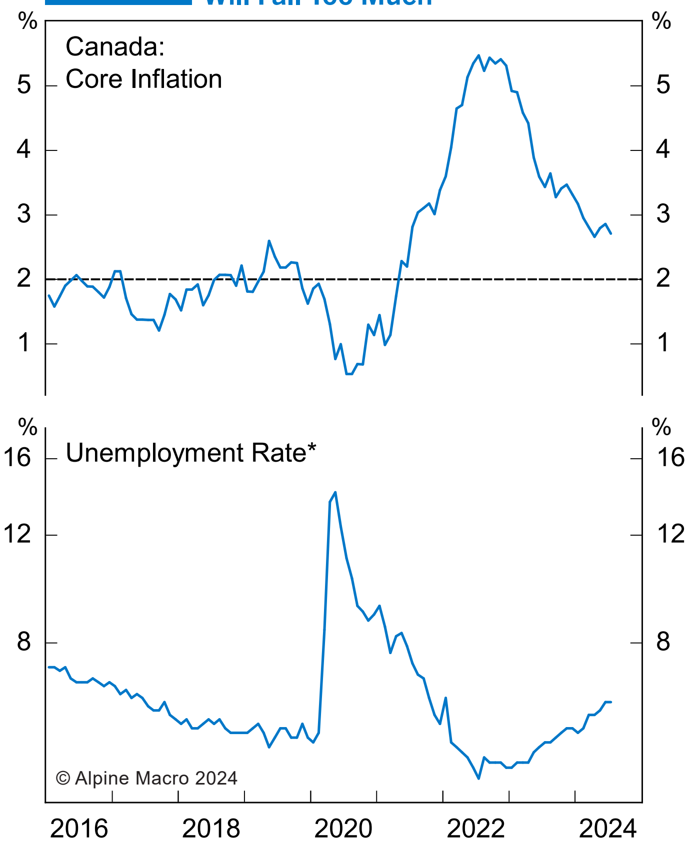
Tenzin Chozin
Research Analyst

"If inflation continues to ease broadly in line with our July forecast, it is reasonable to expect further cuts in our policy rate."

- BoC Governor Tiff Macklem

The BoC cut its policy rate by another 25bps this week. This marks the third rate cut in the cycle for a cumulative 75bps, the most delivered by a G10 central bank thus far this year. Moreover, the BoC is clearly signaling that it has further to go in lowering interest rates.

Chart 1 **The BoC Is Worried That Inflation Will Fall Too Much**



*Shown as log scale

ALPINEMACRO 2024 INVESTMENT CONFERENCE

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Tipping Point In Financial Markets: A Melt-up or Meltdown?

Global financial markets are facing increasing challenges: the risk of recession is rising as tight monetary policy has entered its 28th month, while the bull market in big tech has turned parabolic and is due for a shakeout. However, inflation has fallen sharply, and the Fed is poised to ease at a time when political and geopolitical risks have greatly escalated.

At this critical juncture, Alpine Macro's strategists are joined by a group of highly respected outside experts to discuss the pressing issues facing investors, including:

- Are we at the tail-end of the bull market in equities, or does the bull have further to run? Which sectors should investors allocate their capital to, and what will be the new leaders in the marketplace?
- How should investors hedge against the rising risk of wars and conflicts?
- Harris vs. Trump: How will the election result change U.S. economic policies and affect financial markets?
- What's next for commodities and energy? Are we heading for a new super-cycle bull market, and is ESG dead?

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Canadian inflation has come down sharply from the cyclical peak and the unemployment rate has been heading higher (**Chart 1**). These trends call for a less restrictive monetary policy stance. In fact, Governor Macklem's press conference indicates that the BoC is becoming increasingly concerned that *"the economy is too weak and inflation falls too much."*

We have long flagged that the Canadian economy is much weaker than the headline GDP numbers would suggest. GDP growth has been unable to keep pace with Canada's population boom. Even 2% real GDP growth in the first half of this year fell short of the growing population. It is no wonder that the unemployment rate is rising.

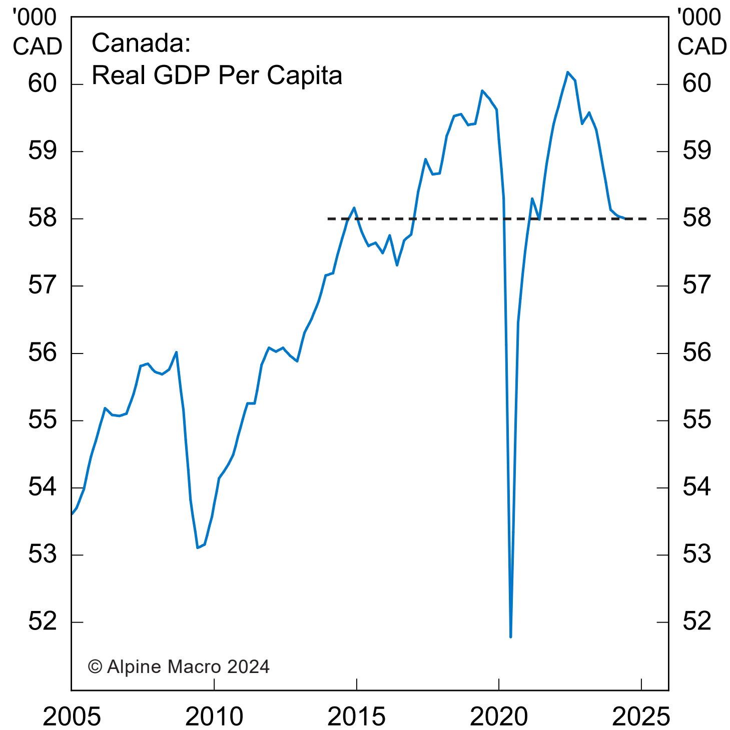
Canada's real GDP on a per capita basis has been declining since mid-2022 (**Chart 2**). Outside of the pandemic, per capita GDP is back to the levels of 2015. To put it another way, the average Canadian has been experiencing a recession for the last two years that has pushed living standards down to where they were nearly a decade ago.

Due to growth running behind the supply-side potential, the BoC believes that the Canadian economy is now operating with a degree of slack. Excess supply is pushing inflation lower and the Governor Macklem stated that *"there is little evidence of broad-based price pressures."*

The BoC singled out shelter as the main factor holding up inflation. **Chart 3** shows the three major subcomponents of shelter CPI:

- Homeowners' replacement cost is deflating with the annual rate of change at -0.8%. This subcomponent is closely correlated with home prices.

Chart 2 Canada's Lost Decade



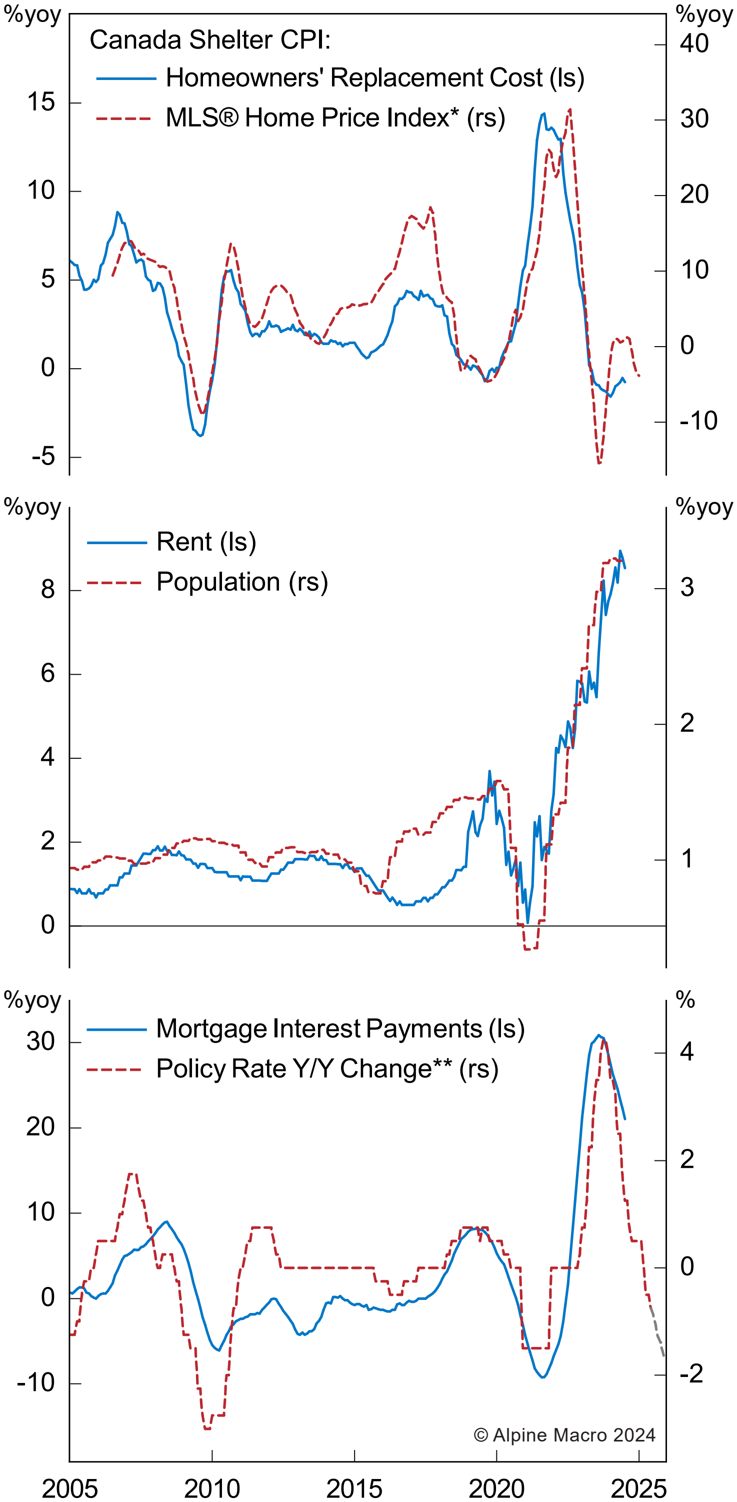
While the housing market is stabilizing, it is still pointing to subdued homeowners' replacement costs.

- Rents have been rising sharply due to the influx of immigrants and the booming population. Rental inflation could remain historically high, but some relief should be coming as the government plans to lower the number of new immigrants coming into the country.

- Rising at over 20% y/y, mortgage interest is by far making the largest contribution to shelter inflation. This is a direct outcome of the BoC's tightening cycle and should not be considered inflationary. Importantly, this component is about to decelerate sharply with the BoC now cutting interest rates.

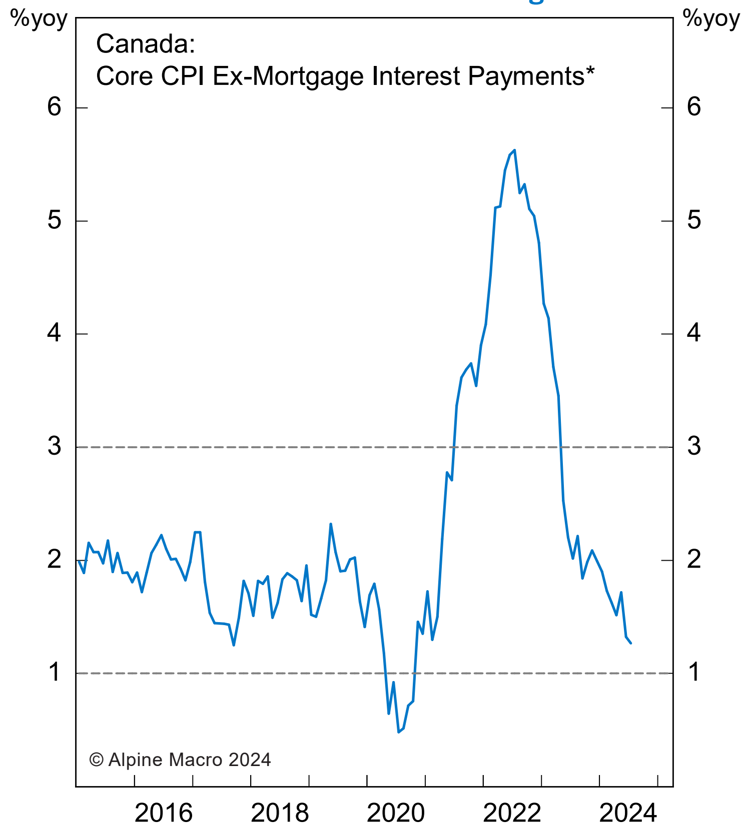
After stripping out mortgage interest costs, Canadian core inflation has fallen to just 1.3%, which is close

Chart 3 What's Driving Shelter Inflation?



*Series advanced by 6 months; source: Canadian Real Estate Association (CREA)
**Series advanced by 9 months; dotted gray line denotes market expectations from OIS curve

Chart 4 Ex-Mortgage Interest Costs, Core Inflation Is Nearing 1%



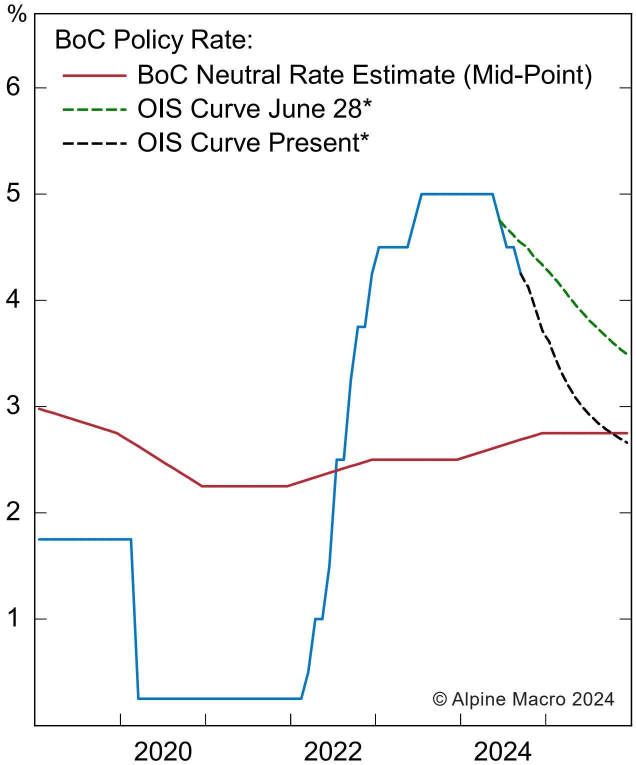
*Alpine Macro calculation
Note: The dotted horizontal lines show the BoC target range

to the floor of the BoC's 1-3% target band (**Chart 4**). As mortgage payments decelerate, Canada's overall core inflation could also fall to around 1%.

It should be no surprise that the BoC is becoming increasingly worried about downside risks to inflation. Once again, Macklem said that *"as inflation gets closer to target, we want to see economic growth pick up to absorb the slack in the economy so inflation returns sustainably to the 2% target."*

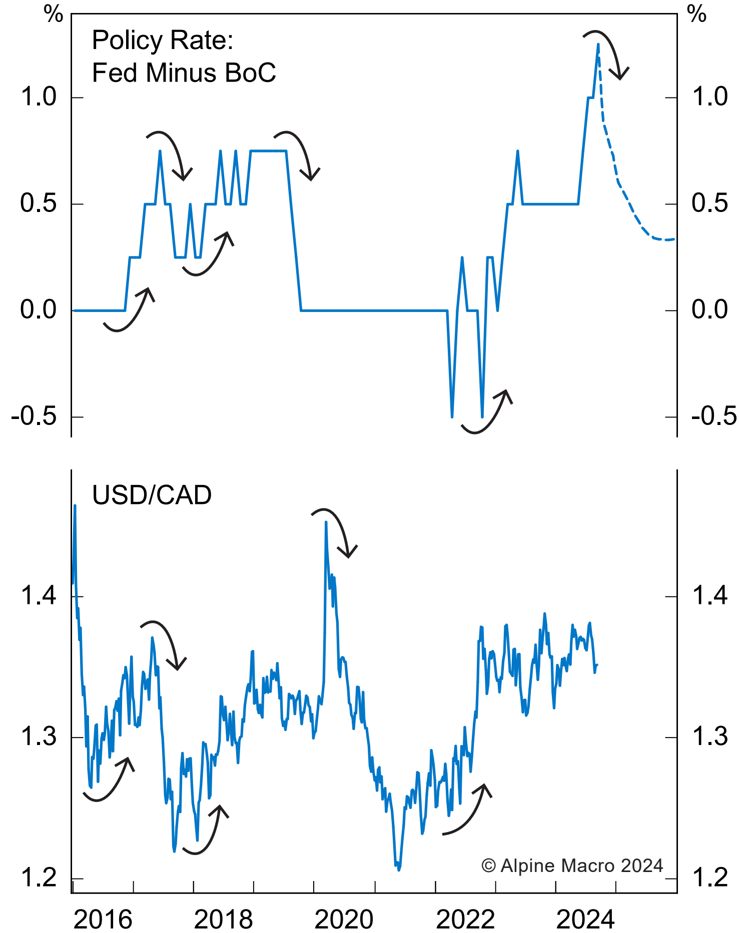
To prevent the negative output gap from widening further, Canadian growth needs to improve. At minimum, real GDP growth must get back to trend. To close the output gap, GDP growth would have to accelerate to an above-trend pace.

Chart 5 The Market Expects The BoC To Cut Rates To Neutral



*Source: Bloomberg Finance L.P.

Chart 6 The Fed Will Follow The BoC



Note: Dotted line denotes market expectations from OIS curves

This means that monetary policy needs to move from restrictive to stimulative. The BoC believes that the neutral nominal interest rate is between 2.25-3.25%. **Chart 5** shows the market's pricing for short-term Canadian interest rates versus the mid-point of the BoC's estimate of the neutral rate.

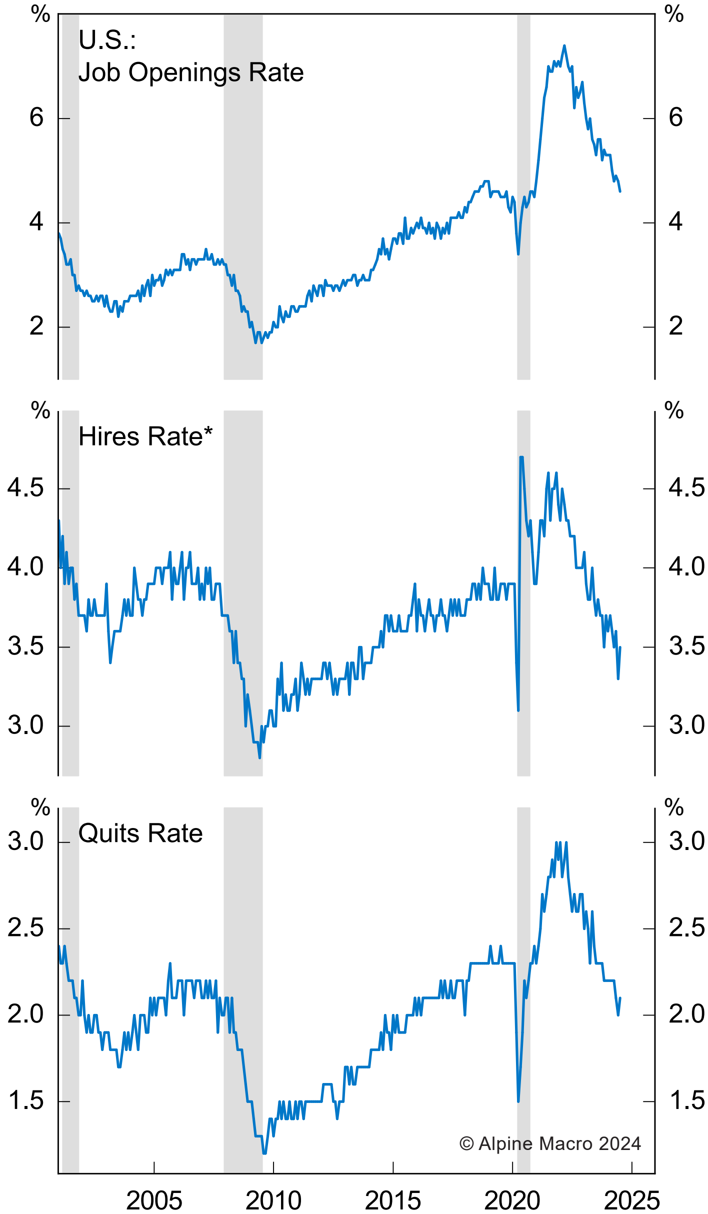
Market expectations have come down significantly over the summer. The OIS curve now sees the BoC cutting rates to neutral by the end of 2025. However, if Canadian inflation falls to the floor of the target band and growth is not strong enough to close the output gap, then the BoC will have to cut rates to below neutral.

Admittedly, there is a lot of uncertainty about the neutral policy rate. At this stage, it is unclear that the Canada's neutral rate has increased significantly following the pandemic. Stronger population growth could push the neutral rate higher, but this is being offset by Canada's poor productivity growth.

Bottom Line: Canadian bonds have rallied nicely since May, but it is too early to cut overweight positions. While the market is priced for interest rates to return to neutral, the BoC may need to cut more. The upside for USD/CAD should be limited as the Fed will soon follow the BoC in cutting rates (**Chart 6**). Ongoing weakness in China and energy prices pose the greatest risk to the Canadian dollar.

Hahahahahah Canada thinks it's as strong as the US hahahahaha

Chart 7 **The U.S. Labor Market Continues To Ease**



*Truncated at 4.7%
Note: Shading denotes U.S. recessions

Chart 8 **There Could Soon Be Fewer Job Openings Than Unemployed Workers**

*Truncated at -12.9

Is The Fed JOLTed?

The Fed has raised the importance of the labor market for the direction of monetary policy. At last month's Jackson Hole symposium, Chairman Powell clearly stated that FOMC members *"do not seek or welcome further cooling in labor market conditions."*

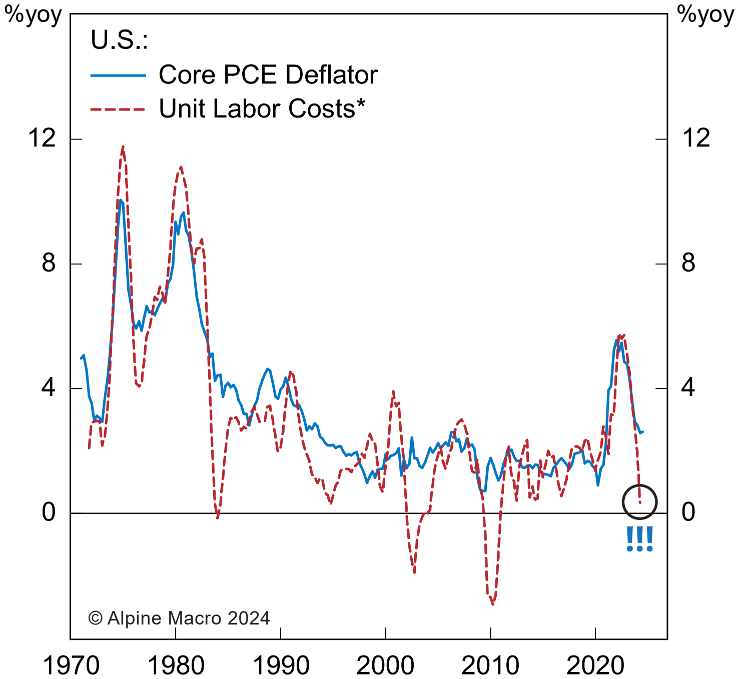
We are publishing today's report ahead of the U.S. jobs data for August, which could be pivotal to whether the Fed kicks off the easing cycle later this month with a 25bps or 50bps rate cut. There is a lot of noise to the monthly data and accurate forecasts are impossible to make.

Looking beyond the short-term volatility in the data, this week's JOLTS report paints a picture of a continued softening in the labor market. The rates for job openings, hirings, and quits are all trending lower (Chart 7).

Perhaps the most important takeaway from the JOLTS data is that job openings are on the verge of falling short of unemployed workers (Chart 8). This is what prevailed for most of the pre-pandemic period. The result was persistently weak gains in wages and an inflation rate that mostly ran below the Fed's target.

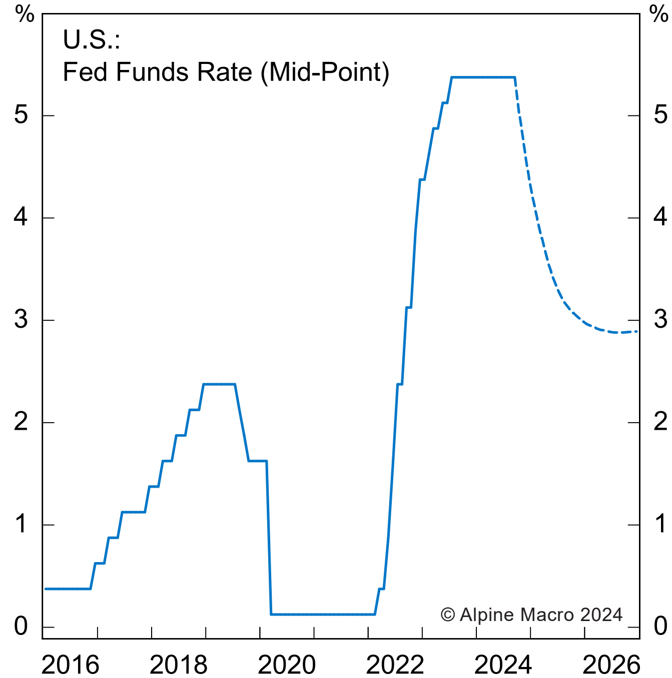
Jobs/job-searchers ratio is tending to 1

Chart 9 U.S. Wage Pressures Are Consistent With Sub 2% Inflation



*Shown as a 4-quarter moving average except latest data point

Chart 10 A Lot Is Discounted For The Fed



Note: Dotted blue line denotes market expectations from OIS curve

The U.S. labor market is once again moving to the point where the risks are skewed in the direction of inflation falling below 2%. This point was evident in this week's revised productivity and labor costs data. The combination of slowing nominal wage gains and stronger productivity growth has led to a sharp deceleration in unit labor costs.

Of all the wage metrics that are available, unit labor costs are the most important for inflation trends. Nominal wage gains that are matched with improved productivity are not inflationary. This week's revisions show that unit labor costs increased by just 0.3% y/y in Q2 (**Chart 9**). This pace is already consistent with inflation falling below 2%.

As we discussed last month, downside risks are building to the Fed's dual mandate.[1] The U.S. labor market is weakening to the point that it could soon fall short of "maximum employment". In turn, a softer labor market will increase the odds that inflation could undershoot the Fed's 2% target.

Interest rate expectations are rapidly adjusting to this growing risk. The OIS curve is priced for the Fed to slash rates down to around 3% by the end of 2025 (**Chart 10**).

Having recommended to cut duration to neutral in August, we are reluctant to chase yields lower as a significant amount of Fed easing is already discounted. Our bias is to use a back-up in yields to 4% to increase duration.

Harvinder Kalirai
Chief Fixed Income & FX Strategist

1 Alpine Macro *Global FX & Currency Strategy* "Dual Mandate At Risk" (August 23, 2024).

Currency Outlook

Vs THE DOLLAR		
	1-3 Months	9-12 Months
EUR	UP	UP
JPY	UP	UP
GBP	UP	UP
CHF	UP	UP
CAD	FLAT	UP
AUD	FLAT	UP
NZD	FLAT	UP

Vs THE EURO		
	1-3 Months	9-12 Months
JPY	UP	UP
GBP	UP	UP
CHF	UP	UP
SEK	FLAT	UP
NOK	FLAT	UP

Fixed-Income Outlook

OVERALL PORTFOLIO DURATION

AT BENCHMARK

COUNTRY ALLOCATION*	
U.S.	4
Japan	1
Eurozone	3
Core	4
Periphery	2
U.K.	3
Switzerland	2
Norway	2
Sweden	3
Canada	4
Australia	4

* Numbers denote allocation where 1 = maximum underweight and 5 = maximum overweight

Currency Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L		
					Spot	Carry	Total
Long AUD/NZD	2019-04-29	1.0574	1.2000	-	2.37%	-3.99%	-1.62%
Long Gold	2022-03-04	1,928	-	-	30.33%	-	30.33%
Short USD/JPY	2024-08-23	146.23	-	-	2.06%	-0.19%	1.86%
Long GBP/USD	2024-08-23	1.3094	-	-	0.57%	-0.01%	0.56%

Fixed Income Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L
Long 2-Year/Short 10-Year U.S. Treasuries	2022-12-02	4.24%/3.51%	-	-	70.87 bps

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