Bank of Canada Preview

Economics and Strategy

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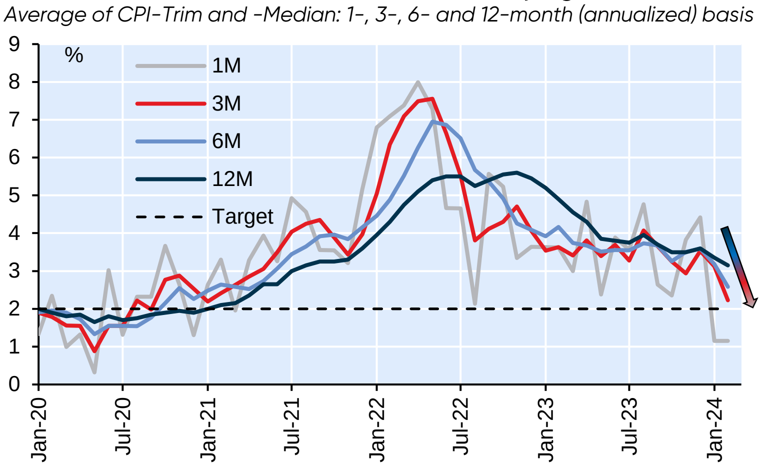
Cutting conditions *slow*ly falling into place

By Taylor Schleich & Warren Lovely

We expect the Bank of Canada to leave its overnight target unchanged for a sixth straight meeting and adopt a more permissive stance on the possibility of rate cuts at coming decisions. The last two CPI reports in Canada have been encouraging, which should be acknowledged in a fresh rate statement. This will also be reflected in an updated MPR which will see the inflation outlook downwardly revised. Still, policymakers are likely to be cautious, noting that further progress is needed and reiterating that upside inflation risks remain. On the flip side, the Bank's growth forecasts are due to be upgraded and significantly so in the near-term based on monthly GDP data. Despite this expected pick-up, they should reiterate that the economy remains in "modest excess supply". That assessment would be consistent with recent labour market data which showed a further rise in the jobless rate. The rate statement should also note that some of the Bank's closely-watched indicators (wage growth, inflation expectations, corporate pricing behaviour) have continued improving. Governing Council could therefore update their 'forward guidance' paragraph to reflect recent developments and open the door to easing at future meetings. Signfiicant statement-to-statement variability makes predicting exact phrasing impossible, but we could see something to the effect of "*if Governing Council sees further and sustained easing in core inflation, it may soon become appropriate to start dialling back the degree of monetary policy restraint*." Such language may intensify June rate cut bets but Macklem, in the post-decision press conference, will surely stress that future decisions will be guided by incoming data. Beyond the headline decision, the MPR will offer us a view of the BoC's updated neutral rate projection. This is almost assured to be revised up (likely to a range of 2.25% to 3.25%) after many comments suggesting as much over the past year. Finally, expect no change to balance sheet policy after DepGov Toni Gravelle signalled full speed ahead on QT in March.

Do two good inflation months make a trend?: Simply put, recent inflation data has been encouraging. The BoC has long said they need to see clear downward momentum in core inflation, and one could argue that has arrived. CPI-Trim and -Median are running at 2.2% (on average) over the last three months after hovering between 3% and 5% for a year and a half. 6- and 12-month measures have likewise stepped down. Moreover, as we argued recently, the BoC's preferred core measures are biased higher anyway. Will the BoC see these last two (very) good months as enough to definitively declare a trend change and imminent inflation victory? Perhaps not. And in their defence, an ongoing oil price rally might limit scope for further headline declines in the near-term. However, if recent core relief persists, they can't justifiably maintain the same stance they have.

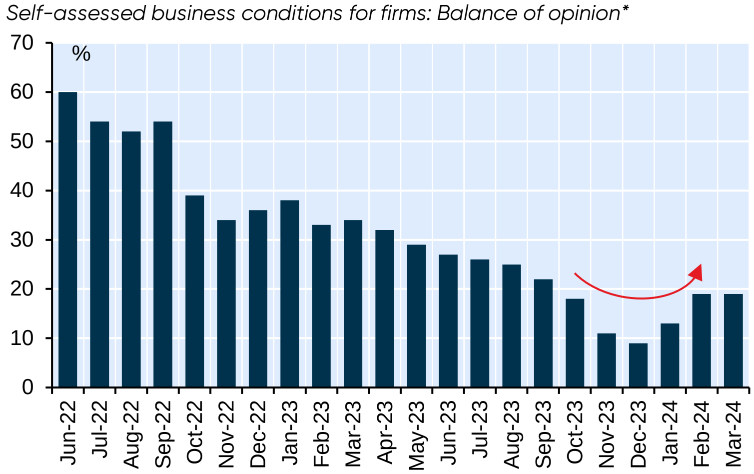
Chart 1: Is this a downward trend in underlying inflation?
Average of CPI-Trim and -Median: 1-, 3-, 6- and 12-month (annualized) basis



Source: NBF, StatCan

Upside risks to growth have emerged: Long before inflation started co-operating, it was growth data that most clearly reflected the impacts of tight monetary policy. While the GDP outlook remains sluggish by most estimates/indicators, upside risks are emerging. Monthly data from Q1 has been solid and the quarterly advance is likely to come around 3%. That's well above the BoC's January estimate, which will be revised up in the MPR. When it comes to 'soft data', the Q1 Business Outlook Survey indicated firms were growing more optimistic (or at least less pessimistic). Importantly, a less dire outlook is predicated on the delivery of rate cuts which creates something of a chicken-and-egg conundrum. Still, the improving soft data taken alongside an apparent rebound in hard data, all else equal, might lead the BoC to determine that there's no rush to begin easing.

Chart 2: Business sentiment is turning 'less bad'
*Self-assessed business conditions for firms: Balance of opinion**



*Source: NBF, BoC | Note: *% of firms reporting positive sentiment minus % of firms reporting negative sentiment. Index is double-weighted (i.e. very good/bad receives 2X weight).*

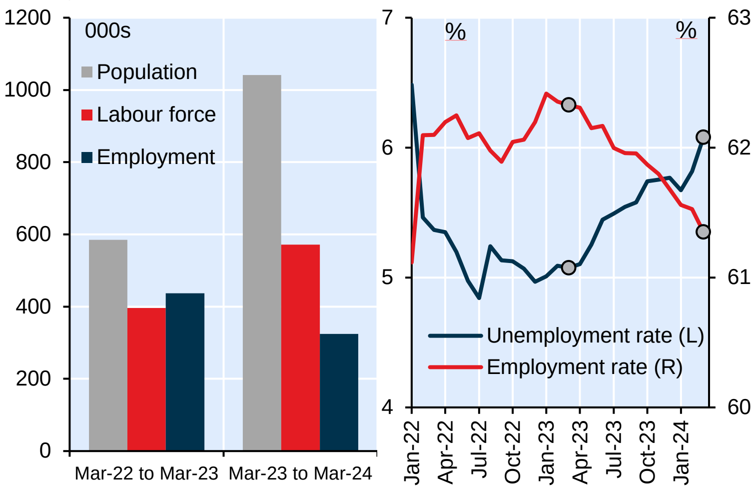
Supply-demand mismatch in the job market: The story hasn't changed in Canada's labour market and it can be succinctly summarized as: labour supply > labour demand. While material job losses continue to be avoided, hiring can't keep pace with population growth. That's led to more potential workers standing on the sideline. Interestingly, the BoC's Summary of Deliberations last month noted:

> *"Members agreed that the associated risk of a sharp rise in unemployment had also diminished. Conditions in the labour market had continued to move into better balance, and various indicators suggest a gradual, rather than sudden, slowdown".*

To be fair, that *did* appear to be the case. One must always be careful putting too much stock in a single LFS report, but the March jobless rate increase can *only* be described as sharp. Large jumps in unemployment may not become the norm but the BoC has no reason to expect recent labour market dynamics to improve anytime soon. When it comes to wages, the recent LFS offered little relief. However, other measures (SEPH, National Accounts) have started to soften which is something the BoC recently highlighted. Pressures haven't fully normalized, no matter the measure, but they are improving.

Chart 3: Population surges while hiring slows

12M chg. in labour market indicators (L), employment/unemployment rate (R)

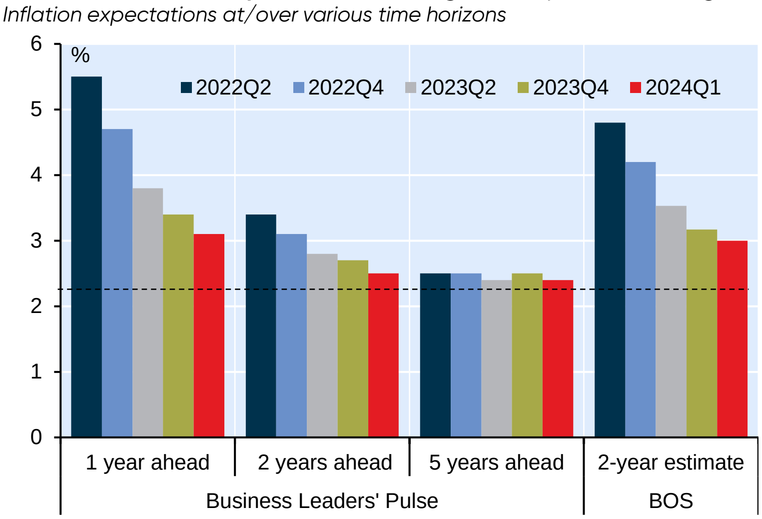


Source: NBF, StatCan

More progress on checklist items: For more than a year, the BoC has held up a list of indicators that they're most closely monitoring. In addition to underlying inflation momentum, they're being guided by the balance of supply and demand, inflation expectations, wage growth and corporate pricing behaviour. Notwithstanding a firmer Q1, growth over the past year has been soft, allowing aggregate supply and demand to come into better balance (the BoC has already acknowledged the economy is in excess supply). Wage growth is still hot, but policymakers see encouraging signs here too. The other two items are also coming back down to earth, as the latest BOS showed. Near-term inflation expectations fell further in Q1, while fewer Canadian businesses are planning aggressive pricing strategies over the next year. To be sure, these measures aren't quite back to 'normal'. But they're steadily getting closer. By the time the next update rolls around (in early July), they may well be at a level that is compatible with rate cuts.

Chart 4: Inflation expectations are (gradually) normalizing

Inflation expectations at/over various time horizons



Source: NBF, Bank of Canada

Housing under the microscope: If you don't think the BoC is worried about upside housing market risks, take a look at the March minutes:

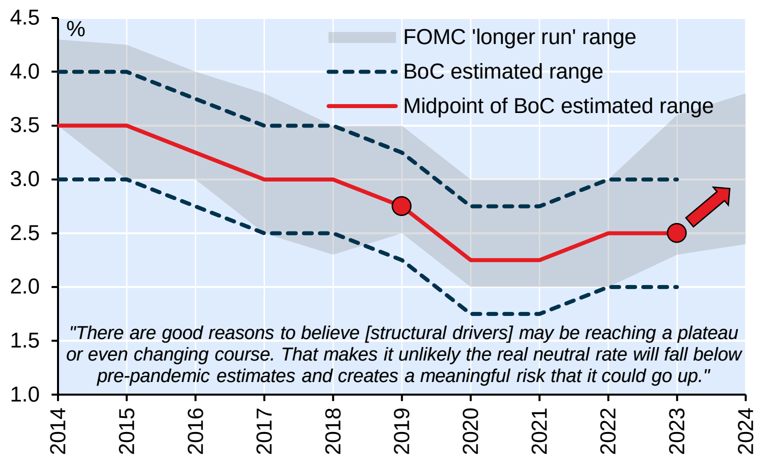
> *"Governing Council members expressed concern that the housing market continued to pose upside risks to the inflation outlook. While house prices continued to fall in January, recent strength in resales could translate into a pickup in house prices and stoke shelter price inflation."*

The jury is still out on the strength of this spring homebuying season, but policymakers may be reluctant to say/do anything to stoke demand having seen what happened last spring. The latest Survey of Consumer Expectations showed homebuying intentions are rising, this pent-up demand skewing risks to house prices higher. All else equal, the BoC would probably love to sit out the spring before re-assessing.

Neutral rate to be revised: Last year, as part of its annual update, the BoC left its estimated range for Canada's 'neutral rate' unchanged at 2-3%. Not even two months later, now-retired Deputy Governor Paul Beaudry delivered a speech which argued that "*risks around that base case are tilted to the upside*". He added it's "*unlikely the real neutral rate will fall below pre-pandemic estimates*". It is therefore surprising to see that the current working estimate *is* below the Bank's pre-pandemic estimates. Indeed, since the Bank started to regularly publish neutral rate research, estimates have ranged from 3.0-4.0% range (in 2014) to 2.25%-3.25% (in 2019). Beaudry's comments might then suggest current estimates could be ratcheted up by at least 50 bps. While possible, we'd note that central banks tend to favour gradualism so it may be more likely that a smaller 25 bp adjustment is made. That would bring the estimate back to where it was in 2019, with policymakers likely to flag that risks may be tilted higher still.

Chart 5: Neutral estimate to return to pre-pandemic level

Estimated range of Canada's neutral rate over time (w/ FOMC equivalent)



Source: NBF, Bank of Canada

Full speed ahead on QT: Deputy Governor Toni Gravelle's March speech indicated the BoC has no plans to stop the balance sheet run-off process this year. Better behaved repo markets and a recent uptick in Lynx settlement balances (driven by lower GoC cash balances) keeps the pressure off the Bank for now. Therefore, don't expect anything beyond the usual, "*the Bank is continuing its policy of quantitative tightening*". However, as the government replenishes its bank account, settlement balance drainage will resume which we still believe brings some risk of renewed repo market pressures (even if they're above the BoC's estimated $20-60 billion range).

Latest policy statement: March 6, 2024

Bank of Canada maintains policy rate, continues quantitative tightening

The Bank of Canada today held its target for the overnight rate at 5%, with the Bank Rate at 5¼% and the deposit rate at 5%. The Bank is continuing its policy of quantitative tightening.

Global economic growth slowed in the fourth quarter. US GDP growth also slowed but remained surprisingly robust and broad-based, with solid contributions from consumption and exports. Euro area economic growth was flat at the end of the year after contracting in the third quarter. Inflation in the United States and the euro area continued to ease. Bond yields have increased since January while corporate credit spreads have narrowed. Equity markets have risen sharply. Global oil prices are slightly higher than what was assumed in the January Monetary Policy Report (MPR).

In Canada, the economy grew in the fourth quarter by more than expected, although the pace remained weak and below potential. Real GDP expanded by 1% after contracting 0.5% in the third quarter. Consumption was up a modest 1%, and final domestic demand contracted with a large decline in business investment. A strong increase in exports boosted growth. Employment continues to grow more slowly than the population, and there are now some signs that wage pressures may be easing. Overall, the data point to an economy in modest excess supply.

CPI inflation eased to 2.9% in January, as goods price inflation moderated further. Shelter price inflation remains elevated and is the biggest contributor to inflation. Underlying inflationary pressures persist: year-over-year and three-month measures of core inflation are in the 3% to 3.5% range, and the share of CPI components growing above 3% declined but is still above the historical average. The Bank continues to expect inflation to remain close to 3% during the first half of this year before gradually easing.

Governing Council decided to hold the policy rate at 5% and to continue to normalize the Bank's balance sheet. The Council is still concerned about risks to the outlook for inflation, particularly the persistence in underlying inflation. Governing Council wants to see further and sustained easing in core inflation and continues to focus on the balance between demand and supply in the economy, inflation expectations, wage growth, and corporate pricing behaviour. The Bank remains resolute in its commitment to restoring price stability for Canadians.

Information note

The next scheduled date for announcing the overnight rate target is April 10, 2024. The Bank will publish its next full outlook for the economy and inflation, including risks to the projection, in the MPR at the same time.

Source: Bank of Canada

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Daren King, CFA
Economist
daren.king@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Alexandra Ducharme
Economist
alexandra.ducharme@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
Chief Rates and Public Sector Strategist
warren.lovely@nbc.ca

Taylor Schleich
Rates Strategist
taylor.schleich@nbc.ca

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