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Don't be driving 25 in a 50 zone

By Taylor Schleich

After six weeks, the Bank of Canada is set to meet again and is all but guaranteed to deliver the second leg of its first back-to-back hike since 2017. With economic data still coming in hot and with hawks in full flight south of the border, it's likely the imminent rate hike will be of the 50 basis point variety—a move not seen since 2000. In addition to the increase in the overnight target, we also expect the Bank to usher in the start of quantitative tightening after Macklem laid the groundwork in his post-meeting presser last month. There are still details here that need to be clarified (i.e., auction participation) but the final QT plan should involve little (if any) bond purchases. Released alongside the interest rate statement will be a fresh MPR which is set to show *another* increase to inflation forecasts and a stronger near-term growth profile. While us BoC watchers don't have the benefit of receiving a dot plot to guide us on the rate trajectory, the Bank is set to update its annual projection of the estimated neutral range—an indication of where overnight might settle in the medium/longer term. *Some* recent BoC comments might suggest that range could be moved lower on Wednesday but with BoC having already cut its neutral estimate by 50 bps since 2019 and given the Bank's optimism for investment/productivity, we think the status-quo is more likely. We'll also be looking for near-term guidance on policy, namely the potential for further 50 bp hikes ahead, though we're unlikely to get much in writing or in the presser. Rather, we expect the Bank to keep it vague, reiterating that interest rates 'need to rise further' and they're prepared to act forcefully if needed.

50 or bust: Economically, it's hard to argue *against* a 50 bp hike on Wednesday. While the Russian invasion of Ukraine complicated the March meeting, you could've said the same 6 weeks ago. What have we learned since then? Well, the Canadian economy has added over 400 thousand jobs, bringing the unemployment rate to the lowest on record. While the BoC doesn't make labour market projections you can bet if they did, they wouldn't have forecast this kind of strength. The inflation outlook, meanwhile, continues to move higher. In March, Macklem argued that current inflation is "not the result of too much demand in the economy", pointing to the less-hot "services, ex-shelter" inflation and the Bank's preferred core measure, CPI-common. We disagreed at the time and the BoC argument looks even more out of line after February's CPI report. Inflation expectations of markets, businesses and households have all increased too. Meanwhile, GDP data were more resilient to Omicron than expected so a boost to near-term growth is in the cards in the MPR. Then, throw in the mix the latest Business Outlook Survey. While the main indictor technically moderated from the prior report, it continues to signal an overheating economy. To be sure, Macklem and the BoC have proven themselves to be ultra-cautious to date. They famously passed on a nearly-fully priced January hike in order to give Canadians clear guidance of incoming hikes. That approach might argue for a 25 bp move this week given that Macklem hasn't exactly 'teed up' a 50 bp hike. However, unlike in January, Canadians are already on notice that rates are to be on 'a rising path'. Additionally, the market *and* the overwhelming majority of the forecasting community has given them the green light for 50 (including all of the 'Big 6'). Finally, over the last 6 weeks, we've seen an increasingly hawkish stance adopted by the Fed. Recall, the last time the Bank met, the dot plot still showed just 3 Fed rate hikes this year. With many (most?) FOMC participants on board for 50 in May, it should make Macklem's "50 decision" much easier.

Queuing up QT: For all the reasons listed above, we see no point in delaying the onset of QT any further. After Macklem's speech in early March, ample notice has been given and the basic groundwork for balance sheet normalization has been laid out. Thus, we expect the BoC to signal in the rate statement that it plans to cease reinvestment of its maturing bonds. From this stems two questions. Firstly, when will this officially begin? Technically, the Bank has planned reinvestment purchases for this current week and next. However, that needn't mean it needs to follow through on this schedule. When the reinvestment phase was announced in October, the Bank scrapped the purchase schedule it had planned for the following week, replacing it with a trimmed down version. Thus, after this week, we think secondary purchases are likely to be discontinued. Secondly, there's lingering uncertainty whether "we will stop purchasing GoC bonds" actually means what it says. While this statement from Macklem's March speech is unambiguous, he subsequently noted in his press conference that they might still buy in primary for 'operational' purposes. A full withdrawal was made from the T-bill market, but we wouldn't be surprised if they opted for a token participation rate in bond auctions (at least to have some bonds to lend via its SROs). To be clear, this might represent $10 billion in purchases over the balance of year, so it's unlikely to move the needle much. While planned issuance came in lower than expected in last week's budget, the Bank's QT process will still mean a record supply of GoC bonds will have to be absorbed by end investors this year.

Neutral estimate to be our quasi-dot plot: Fortunately for the Bank/unfortunately for us, there's no BoC dot plot to give us quantifiable rate guidance for the balance of the year. Rather, we expect the Bank/Macklem to keep the statement/presser somewhat vague, simply maintaining a hawkish stance and flagging that 'interest rates will need to rise further'. Assuming the Bank does opt for 50 on Wednesday, the obvious follow-up question will be if they'll need to hike 50 bps again. We doubt Macklem will put any sort of probability to that outcome, but he will probably reiterate that they'll 'act forcefully' if needed. Another jobs report and two CPI readings before the next meeting are likely to be the deciding factors on this front. Without any relief here, a subsequent 50 would be needed in our view. The next obvious question is, will the BoC have to hike above neutral, like the Fed has signalled it will? Again, we don't think Macklem will have any interest in committing to that at this juncture, though we doubt he rules this out. The Bank will, however, be providing an updated estimate for the neutral rate, giving us some idea of where they see the policy rate settling over the medium/longer term. There's been speculation that the BoC could move down its estimated neutral range (currently 1.75%-2.75%) after the BoC/GoC statement on the mandate renewal ("Neutral interest rates are likely to be lower than in the past"). However, we'd note that since the Bank's prior mandate renewal in 2016, its estimate has already been cut by 100 bps (including a 50 bp reduction in 2020). On the flip side, the Bank's ultra optimistic outlook for business investment and productivity growth in Canada could argue for higher neutral rates, all else equal. To be clear, we don't expect any change here on Wednesday, but we don't see a huge risk of another downgrade to its assessment. Overall, we think there will be plenty of questions left on the rate outlook after the meeting. We don't see Macklem ceding any flexibility and thus, don't see ultra-aggressive market expectations being pared (or added to) meaningfully. Data dependency will continue to be the name of the game as the BoC hopes and prays for some signs of cooling on the inflation front.

Latest Policy Statement – March 2, 2022

Bank of Canada increases policy interest rate

The Bank of Canada today increased its target for the overnight rate to ½ %, with the Bank Rate at ¾ % and the deposit rate at ½ %. The Bank is continuing its reinvestment phase, keeping its overall holdings of Government of Canada bonds on its balance sheet roughly constant until such time as it becomes appropriate to allow the size of its balance sheet to decline.

The unprovoked invasion of Ukraine by Russia is a major new source of uncertainty. Prices for oil and other commodities have risen sharply. This will add to inflation around the world, and negative impacts on confidence and new supply disruptions could weigh on global growth. Financial market volatility has increased. The situation remains fluid and we are following events closely.

Global economic data has come in broadly in line with projections in the Bank's January Monetary Policy Report (MPR). Economies are emerging from the impact of the Omicron variant of COVID-19 more quickly than expected, although the virus continues to circulate and the possibility of new variants remains a concern. Demand is robust, particularly in the United States. Global supply bottlenecks remain challenging, although there are indications that some constraints have eased.

Economic growth in Canada was very strong in the fourth quarter of last year at 6.7%. This is stronger than the Bank's projection and confirms its view that economic slack has been absorbed. Both exports and imports have picked up, consistent with solid global demand. In January, the recovery in Canada's labour market suffered a setback due to the Omicron variant, with temporary layoffs in service sectors and elevated employee absenteeism. However, the rebound from Omicron now appears to be well in train: household spending is proving resilient and should strengthen further with the lifting of public health restrictions. Housing market activity is more elevated, adding further pressure to house prices. Overall, first-quarter growth is now looking more solid than previously projected.

CPI inflation is currently at 5.1%, as expected in January, and remains well above the Bank's target range. Price increases have become more pervasive, and measures of core inflation have all risen. Poor harvests and higher transportation costs have pushed up food prices. The invasion of Ukraine is putting further upward pressure on prices for both energy and food-related commodities. All told, inflation is now expected to be higher in the near term than projected in January. Persistently elevated inflation is increasing the risk that longer-run inflation expectations could drift upwards. The Bank will use its monetary policy tools to return inflation to the 2% target and keep inflation expectations well-anchored.

The policy rate is the Bank's primary monetary policy instrument. As the economy continues to expand and inflation pressures remain elevated, the Governing Council expects interest rates will need to rise further. The Governing Council will also be considering when to end the reinvestment phase and allow its holdings of Government of Canada bonds to begin to shrink. The resulting quantitative tightening (QT) would complement increases in the policy interest rate. The timing and pace of further increases in the policy rate, and the start of QT, will be guided by the Bank's ongoing assessment of the economy and its commitment to achieving the 2% inflation target.

Information note

The next scheduled date for announcing the overnight rate target is April 13, 2022. 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

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