Fool us once, shame on you. Fool us twice, shame on us.
By Taylor Schleich

The Bank of Canada surprised us in July with a full percentage-point hike as they adopted a poorly phrased ‘front-loading’ strategy. Now, we’re certainly more cognizant of the risk of a second straight 100 basis point interest rate hike and we think it’s a greater risk than is broadly appreciated. Nonetheless, we still expect the Bank to deliver a relatively smaller (but still massive) 75 basis point rate increase on September 7th. To us, that would be most consistent with Macklem’s speech in July when he noted: “[Front-loading] argues for getting our policy rate quickly to the top end or slightly above the neutral range”. While we could realistically see the BoC raise its policy rate anywhere from 0.5% to 1.0%, uncertainty is just compounded thereafter. As we’ve argued before, there’s a case to be made for pausing the tightening once definitively into restrictive territory. But given the increasingly hawkish central bank rhetoric globally, our conviction here has waned and we view the odds of additional hike(s) in Q4 as meaningfully higher. In any event, with September’s move bringing the policy rate north of 3%, we do expect the Bank to strike a more data dependent tone, putting the days of 75-100 bp hikes behind us. If the statement is mum on additional forward guidance, this will surely be the focus of the Economic Progress Report on Thursday, delivered by Senior Deputy Governor Carolyn Rogers.

Wide range of potential outcomes: Wednesday’s headline decision could go any number of ways. Guidance from July’s decision stated: “[Front-loading] argues for getting our policy rate quickly to the top end or slightly above the neutral range”. Currently, at 2.50%, a 50 bp hike would get us to the top end of the 2-3% neutral range, while 75 or 100 bps would bring us ‘slightly’ above, depending on how liberal their definition of ‘slightly’ is. Since that July 13th meeting, we’ve had just one BoC sighting. That came via a National Post Op-Ed from Gov. Macklem in which his only guidance was “our job is not done yet—it won’t be done until inflation gets back to the 2% target.” In other words, there’s not much to go by. (An aside: Macklem also appeared to shift focus from CPI-common to CPI-median after the former’s massive revisions.)

To us, 75 bps would be most consistent with what we’ve been told and the economic data we’ve taken receipt of. But it would be an understatement to say that the BoC (and other central banks) are deeply concerned with inflation. The ultra-hawkish rhetoric heard from the FOMC (e.g., bringing ‘pain’ to households/businesses) reflects sentiment that is likely shared by the BoC. While guidance from July might imply the debate is between 50 and 75, we’d argue that risks of a second 100 basis point move are greater than 50. And while one might be tempted to think the sub-consensus GDP report swings the odds towards a 50 bp hike next week, we think the impact of that report is marginal. Why? (a) the economy remains in excess demand, something the BoC will reiterate; and (b) growth is playing third fiddle in the BoC’s calculus. Inflation (still too high, despite momentum easing) and labour market data (still very tight, despite job losses) are the key variables that will influence the BoC.

We’re not sure they’ll be patting themselves on the back over the GDP report, especially when you consider the sub-consensus GDP report is marginal. Why? (a) the economy remains in excess demand, something the BoC will reiterate; and (b) growth is playing third fiddle in the BoC’s calculus. Inflation (still too high, despite momentum easing) and labour market data (still very tight, despite job losses) are the key variables that will influence the BoC. If the statement is mum on additional forward guidance, we would not be surprised to see them take a page out of the Fed’s book and guide us towards a slower pace of hikes. We’ll also be hoping for some more medium-term guidance. We’ve increasingly heard FOMC participants talk about the need to hold rates in restrictive territory for ‘some time’. While markets are already pricing a longer hold period for the BoC (rate cuts aren’t meaningfully priced until the first half of 2024), explicitly committing to a restrictive policy setting ‘for some time’ would help reinforce this. A restrictive-for-longer approach would help keep conditions tight and might, at the margin, substitute for additional rate increases.

Keep cuts away: We’ll also be hoping for some more medium-term guidance. We’ve increasingly heard FOMC participants talk about the need to hold rates in restrictive territory for ‘some time’. While markets are already pricing a longer hold period for the BoC (rate cuts aren’t meaningfully priced until the first half of 2024), explicitly committing to a restrictive policy setting ‘for some time’ would help reinforce this. A restrictive-for-longer approach would help keep conditions tight and might, at the margin, substitute for additional rate increases.

Table 1: The evolution of the economic outlook

<table>
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<tr>
<th>Projection source</th>
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<th>Q4</th>
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<td></td>
<td></td>
<td></td>
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<tr>
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<td>April MPR</td>
<td>5.8</td>
<td>-</td>
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<td>-</td>
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<td>7.1</td>
<td>6.3</td>
<td>6.7</td>
<td>2.7</td>
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</table>

Source: NBF, Bank of Canada. All figures are Y/Y except for quarterly GDP which is Q/Q. GDP figures are SAAR. NBF Forecasts subject to change in our Sep. Economic Monitor.
Chart 2: There are signs that inflation momentum is easing…
Month-over-month change in CPI-Trim (in-house replication)

Source: NBF, StatCan

Chart 3: …which is encouraging but core is still far from target
3M, 6M and Y/Y CPI-Trim inflation since 2021

Source: NBF, CPI-trim based on in-house replication of index

Chart 4: Despite LFS job losses, vacancies are elevated
Canada job vacancies through Q2:2022


Chart 5: Rising input costs and labour shortages look sticky
Select obstacles cited by Canadian businesses/organizations over time

Source: NBF, StatCan | Note: Labour shortages & input costs two of many obstacles

Chart 6: Rising inflation’ chief obstacle to doing business, according to firms surveyed by Statistics Canada
Noted obstacles to doing business over coming three months: Ranked from most to least commonly cited by Canadian businesses/organizations (2022:Q3)

Source: NBF, StatCan | Note: Refer to survey for detailed descriptions of individual obstacles
Bank of Canada increases policy interest rate by 100 basis points, continues quantitative tightening

The Bank of Canada today increased its target for the overnight rate to 2½%, with the Bank Rate at 2¾% and the deposit rate at 2½%. The Bank is also continuing its policy of quantitative tightening (QT).

Inflation in Canada is higher and more persistent than the Bank expected in its April Monetary Policy Report (MPR), and will likely remain around 8% in the next few months. While global factors such as the war in Ukraine and ongoing supply disruptions have been the biggest drivers, domestic price pressures from excess demand are becoming more prominent. More than half of the components that make up the CPI are now rising by more than 5%. With this broadening of price pressures, the Bank’s core measures of inflation have moved up to between 3.9% and 5.4%. Also, surveys indicate more consumers and businesses are expecting inflation to be higher for longer, raising the risk that elevated inflation becomes entrenched in price- and wage-setting. If that occurs, the economic cost of restoring price stability will be higher.

Global inflation is higher, reflecting the impact of the Russian invasion of Ukraine, ongoing supply constraints, and strong demand. Many central banks are tightening monetary policy to combat inflation, and the resulting tighter financial conditions are moderating economic growth. In the United States, high inflation and rising interest rates are contributing to a slowdown in domestic demand. China’s economy is being held back by waves of restrictive measures to contain COVID-19 outbreaks. Oil prices remain high and volatile. The Bank now expects global economic growth to slow to about 3¼% this year and 2% in 2023 before strengthening to 3% in 2024.

Further excess demand has built up in the Canadian economy. Labour markets are tight with a record low unemployment rate, widespread labour shortages, and increasing wage pressures. With strong demand, businesses are passing on higher input and labour costs by raising prices. Consumption is robust, led by a rebound in spending on hard-to-distance services. Business investment is solid and exports are being boosted by elevated commodity prices. The Bank estimates that GDP grew by about 4% in the second quarter. Growth is expected to slow to about 2% in the third quarter as consumption growth moderates and housing market activity pulls back following unsustainable strength during the pandemic.

The Bank expects Canada’s economy to grow by 3½% in 2022, 1¼% in 2023, and 2½% in 2024. Economic activity will slow as global growth moderates and tighter monetary policy works its way through the economy. This, combined with the resolution of supply disruptions, will bring demand and supply back into balance and alleviate inflationary pressures. Global energy prices are also projected to decline. The July outlook has inflation starting to come back down later this year, easing to about 3% by the end of next year and returning to the 2% target by the end of 2024.

With the economy clearly in excess demand, inflation high and broadening, and more businesses and consumers expecting high inflation to persist for longer, the Governing Council decided to front-load the path to higher interest rates by raising the policy rate by 100 basis points today. The Governing Council continues to judge that interest rates will need to rise further, and the pace of increases will be guided by the Bank’s ongoing assessment of the economy and inflation. Quantitative tightening continues and is complementing increases in the policy interest rate. The Governing Council is resolute in its commitment to price stability and will continue to take action as required to achieve the 2% inflation target.

Information note

The next scheduled date for announcing the overnight rate target is September 7, 2022. The Bank will publish its next full outlook for the economy and inflation, including risks to the projection, in the MPR on October 26, 2022.

Source: Bank of Canada
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