It’s time to act more forcefully  
By Taylor Schleich  

It hasn’t even been six weeks since the Bank of Canada last met but the speed with which markets are evolving, it might as well have been six months ago. As we contend with increasing recessionary rhetoric, policy rate expectations have whipsawed. Although markets have moved well off of peak hawkishness for 2023 (i.e., 4%–plus policy rates), there’s been nothing to upend the ultra-aggressive near-term trajectory. Quite the contrary. Another blistering inflation surprise in Canada last month means the fire under the BoC’s feet has only grown hotter. A fresh jobs report that technically showed net job losses, was much stronger than it appeared and is symptomatic of an exceedingly-tight labour market. Signs of a rapidly decelerating economy have emerged in the U.S., but Canadian economic resilience (in addition to lagging data) mean near-term prospects north of the border are still in okay shape. As a result, we expect the Bank of Canada to increase its overnight target by 75 basis points on Wednesday, noting that they will continue to ‘act forcefully’ to bring down inflation. That should mean an above-25 bp hike in September but expect the BoC to keep the ‘50 vs. 75’ debate up in the air and data dependent. Meanwhile, an updated MPR will show a much higher near-term inflation projection, though the growth outlook could be marked down. Next week’s decision will be followed by a Tiff Macklem and Carolyn Rogers press conference where the focus will surely be on how high the BoC believes it will have to hike. 

Inflation woes continue: Inflation is too high. Full stop. The BoC was already extremely uneasy with burgeoning price pressures in June, and it showed in their last rate statement. Unfortunately, the situation has only worsened since then. Another upside inflation surprise in May’s CPI report has us tracking to overshoot the BoC’s Q2 inflation projection (which was laid down just three months ago) by 1.7%-pts. While inflation forecast misses have been a staple of the past year, this one is set to be the biggest miss yet. So, once again, expect near-term inflation projections to be revised higher in the MPR. Longer-term estimates may be relatively less affected, as a possible growth downgrade might provide an offset. On the expectations front, falling breakevens are helpful to the BoC’s cause but business and consumer expectations have shown no signs of abating. Expect the statement to reiterate concerns about “elevated inflation becoming entrenched”. 

Just how forceful are we talking? We’re confident that the BoC will deliver 75 bps next week but the more important question is: what comes next? In June, the BoC’s policy rate guidance stated that “interest rates will need to rise further” and that the Governing Council is “prepared to act more forcefully if needed”. We expect the former to remain in the statement, but the latter will have to be altered, as we assume the BoC is not keen to open the door to 100 bp hikes. Instead, we’re looking for something along the lines of “the Governing Council is prepared to continue to act forcefully”. Such language would leave an appropriately hawkish bias intact (i.e., keeping the market prepped for a larger-than-25 bp move), while retaining flexibility on the size of September’s hike (i.e., 50 or 75 bps). To date, the BoC hasn’t spoken to their perceived neutral range in policy statements but, given that Wednesday’s hike will bring us into that 2%-3% window, we could see this language added. Macklem has said publicly in recent months that they may need to “take rates modestly above neutral for a period” so we’ll be on the lookout for an addition of this nature. Even if this isn’t explicitly noted, expect that to be implied and later discussed in the press conference. While the BoC isn’t required to publish a Fed-style dot plot, we anticipate them to signal a similar bias (without explicitly providing a point estimate). 

Canadian resilience or Canadian lag? Ultimately, how long and how far the BoC will have to raise rates is a function of how long it will take for economic/inflation data to roll over. While weakness is starting to sprout in the U.S. (ugly Q1 GDP revisions, a below-trend/potentially negative Q2 print coming, confidence cratering, PMIs dropping), we haven’t seen too much of that yet in Canada. Solid growth in Q1 should give way to strong growth in Q2, even with housing market activity cratering (read: normalizing). The labour market, which is already incredibly tight, might tighten further if you put any stock into the latest Business Outlook Survey. And on the jobs front, we’d stress that the headline LFS print was a head fake—this wasn’t a weak report. We fully concede that a Canadian economic slowdown is coming. However, it might not be as severe as in the U.S. given Canada’s stronger fiscal impulse and commodity exposure. And, as we’re now seeing, the onset of said slowdown won’t come until later, thanks to the aforementioned factors as well as more pent-up demand from COVID-related restrictions earlier in the year. The combination of resilience and lagging data means the BoC might not have sufficient ammunition to put an end to its cycle as soon as the Fed might. As a result, we remain confident in our call for the BoC to hike for longer and to a higher level than the Fed (3.25% vs. 3.00%). 

Table 1: The evolution of the economic outlook 
NBF and BoC forecasts for real GDP and CPI inflation 

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<th>Projection source</th>
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<td><strong>CPI inflation</strong></td>
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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 July Economic Monitor.

Chart 1: Markets have moved off of peak hawkishness 
OIS-implied overnight rate: pre–June Fed meeting vs. current 

Source: NBF, Bloomberg
Chart 2: BoC has missed the mark on inflation forecasting…
CPI inflation trajectory projected in last five BoC MPRs vs. actual inflation
Source: NBF, Bank of Canada, StatCan | Note: Some quarters not explicitly provided by BoC. These are estimated based on the quarterly, Q4/Q4 and full-year inflation projections given.

Chart 3: …private sector economists haven’t been any better
Consensus forecasts for 2022 CPI inflation by month (w/ current NBF forecast)
Source: NBF, Consensus Economics

Chart 4: Momentum in inflation is even more concerning…
CPI inflation and BoC’s preferred core measures
Source: NBF, StatCan

Chart 5: …while firms’ inflation expectations keep rising
Share of firms* expecting inflation above 3% over the next two years
Source: NBF, BoC Business Outlook Survey | * Due to a large number of firms not providing an estimate in Q2 survey, this chart reflects the share of firms who provided an estimate.

Chart 6: Firms still plan to hire & have to raise wages to do so
Balance of opinion on hiring intentions vs. average expected wage increase
Source: NBF, BoC Business Outlook Survey | Note: Dotted line represent post-2008 avg.

Chart 7: Growth outlook has held up much better in Canada
Consensus forecasts for 2022 GDP growth: Canada vs. U.S.
Source: NBF, Consensus Economics
Bank of Canada Preview

Latest Policy Statement – June 1, 2022

**Bank of Canada increases policy interest rate by 50 basis points, continues quantitative tightening**

The Bank of Canada today increased its target for the overnight rate to 1½%, with the Bank Rate at 1¾% and the deposit rate at 1½%. The Bank is also continuing its policy of quantitative tightening (QT).

Inflation globally and in Canada continues to rise, largely driven by higher prices for energy and food. In Canada, CPI inflation reached 6.8% for the month of April – well above the Bank’s forecast – and will likely move even higher in the near term before beginning to ease. As pervasive input price pressures feed through into consumer prices, inflation continues to broaden, with core measures of inflation ranging between 3.2% and 5.1%. Almost 70% of CPI categories now show inflation above 3%. The risk of elevated inflation becoming entrenched has risen. The Bank will use its monetary policy tools to return inflation to target and keep inflation expectations well anchored.

The increase in global inflation is occurring as the global economy slows. The Russian invasion of Ukraine, China’s COVID-related lockdowns, and ongoing supply disruptions are all weighing on activity and boosting inflation. The war has increased uncertainty and is putting further upward pressure on prices for energy and agricultural commodities. This is dampening the outlook, particularly in Europe. In the United States, private domestic demand remains robust, despite the economy contracting in the first quarter of 2022. US labour market strength continues, with wage pressures intensifying. Global financial conditions have tightened and markets have been volatile.

Canadian economic activity is strong and the economy is clearly operating in excess demand. National accounts data for the first quarter of 2022 showed GDP growth of 3.1 percent, in line with the Bank’s April Monetary Policy Report (MPR) projection. Job vacancies are elevated, companies are reporting widespread labour shortages, and wage growth has been rising and broadening across sectors. Housing market activity is moderating from exceptionally high levels. With consumer spending in Canada remaining robust and exports anticipated to strengthen, growth in the second quarter is expected to be solid.

With the economy in excess demand, and inflation persisting well above target and expected to move higher in the near term, the Governing Council continues to judge that interest rates will need to rise further. The policy interest rate remains the Bank’s primary monetary policy instrument, with quantitative tightening acting as a complementary tool. The pace of further increases in the policy rate will be guided by the Bank’s ongoing assessment of the economy and inflation, and the Governing Council is prepared to act more forcefully if needed to meet its commitment to achieve the 2% inflation target.

**Information note**

The next scheduled date for announcing the overnight rate target is July 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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