BoC: Extrapolative expectations

By Warren Lovely

No one will blame the Bank of Canada for being boring or predictable. Notwithstanding some overtly hawkish rhetoric in the lead up to Wednesday’s rate decision, the Bank opted against an all-but-fully priced 75 bp hike, favouring a smaller (though not particularly small) 50 bp move. This isn’t the first time the Bank has bucked consensus thinking and/or market pricing, such is their prerogative.

The Bank’s recent decision profile has gone like this then: +100 bps in July ➔ +75 bps in September ➔ +50 bps in October. What comes next? Simple pattern recognition and/or extrapolative expectations might imply an even smaller or more “normal” hike next time out (i.e., +25 bps on December 7th). Beyond that, the next logical step could be a pause early in 2023, followed by (you guessed it) less-restrictive policy in the latter half of next year. Seems a not-unreasonable scenario to us and one we outlined in our latest Monthly Fixed Income Monitor.

The Bank may still be telegraphing additional tightening, but markets have been forced to embrace a flatter trajectory and lower terminal rate given the adoption of a more balanced (or less-skewed) risk assessment Wednesday. Put another way, the Bank looks to be fine-tuning from here, the policy rate trajectory tied to the evolution of key data series (including GDP, jobs and of course inflation). On that score, rate hikes are working, of this we were already certain. Canadian growth is falling out of bed. The Bank now openly talks about a “stall” in quarterly growth. If anything, there might still be downside risk to their 2023 growth call. Inflation clearly remains too high, but here too the Bank just downgraded its forecast. The Fed, it should be noted, went the other way, revising up its thinking on headline and core PCE inflation in September’s Summary of Economic Projections. As with real GDP growth, the Bank could be surprised by how quickly inflation recedes.

It might not be fair to say the Bank ‘blinked’ on Wednesday, but pragmatism now looks to trump dogma. That may leave the Bank out of alignment with the Fed in the near-term… at least until the FOMC recalibrates its own thinking in response to accumulating economic damage. That the Bank is prepared to lag the Fed at this late stage of the tightening cycle is perhaps appropriate given Canada’s outsized reliance on housing and commodity prices that are now declining. It’s a BoC policy stance that also hinges on fiscal restraint in Canada, since the more the feds and provinces spend the more Macklem and GC need to hike (all else equal). Finally, it should be noted that this isn’t the only policy race being run these days. When it comes to Quantitative Tightening, the Bank is clearly out in front of the Fed and aiming to stay there.

Note: This Market View supplements our BoC Policy Monitor, which is available here.
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