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The art (and science) of policy rate divergence

By Ethan Currie, Warren Lovely & Taylor Schleich

The Bank of Canada is notionally on pause. Meanwhile, the Fed is still some time from getting to that point. With markets now braced for at least 75 basis points of marginal FOMC rate increases, many investors assume the BoC will (partially) follow suit. We'd disagree. Economic and inflation developments are diverging, not to mention the stance of policymakers. It's becoming clearer to us that Canada's monetary policy transmission mechanism is more efficient, delivering closer to real-time feedback that rate hikes are having their desired effects.

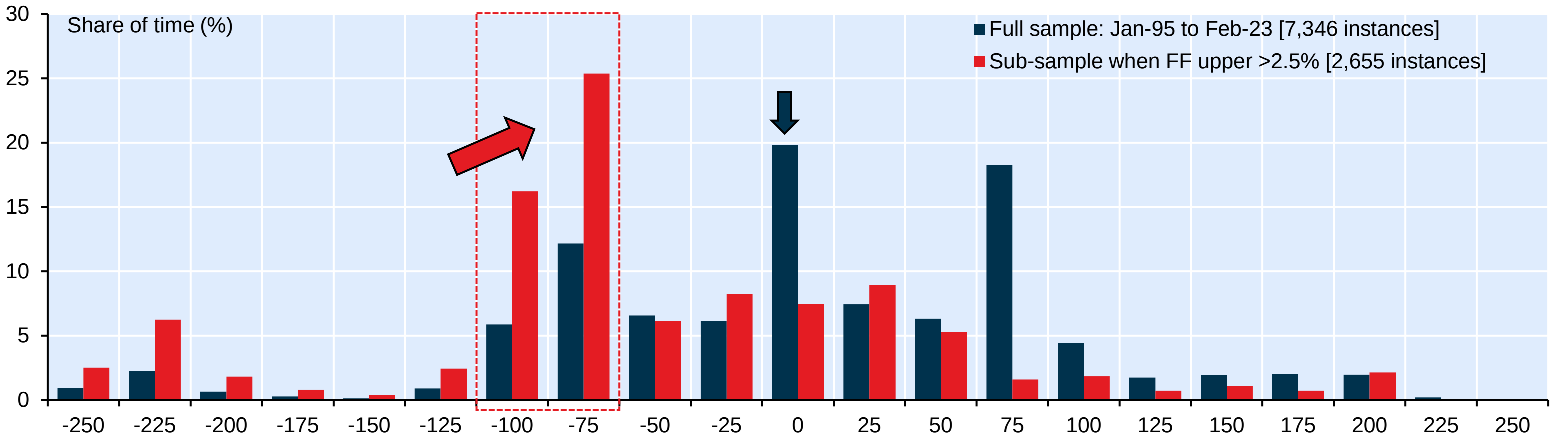
Still, the argument is advanced that discomfort with a weaker C$ will force the BoC off of the sidelines. We concede that a growing policy rate differential, which should grow to at least 100 bps this year, won't be supportive for the loonie. And we've seen BoC policymakers raise concerns about that earlier in the tightening cycle. In May, DepGov Toni Gravelle said a stronger loonie would "help tamp down the high inflation". But context is important. Price pressures were at their peak last spring, while inflation is clearly receding today. The BoC recently waded back into the debate, their stance more laissez-faire than a year ago: "we shouldn't be too concerned if Canada follows a slightly different path to normalization than our counterparts". Neither a stronger nor weaker C$ is bad, according to DepGov Paul Beaudry.

A wide interest rate gap hasn't been uncommon historically either. Since 1995, the Bank has spent about 25% of the time bearing a policy rate 75 bps or more below the Fed (even more when rates are above "neutral"). And you only need to go back to 2019 to find an example of this. Back then, 2-year differentials briefly flirted with -85 bps. At roughly -60 bps today, we'd flag Canadas as cheap (not just in 2s) and expect a more inverted rate gap over the coming months. Again, that might not be good news for the C$ but, as long as inflation moderation continues, we think the Bank will (rightly) prioritize not crushing the Canadian economy under the weight of even higher rates.

Historical perspective on the BoC-FOMC policy rate differential, with a view to what's possible

Chart 1: As fed funds heads higher, not unusual for Canada-US policy rate differential to deepen

Histogram of BoC-FOMC policy rate differential: Full sample of daily observations from 1995 onwards & sub-sample where fed funds (upper) exceeds 2.5%

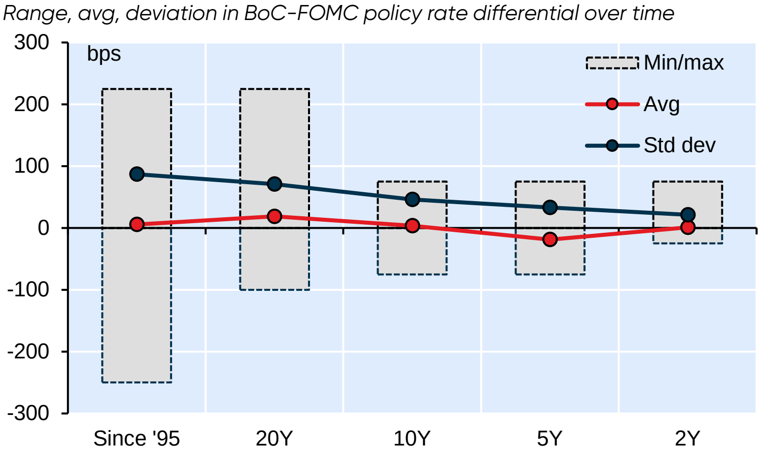


Source: NBF, Bloomberg, BoC, FRB | Note: Full sample (blue) based on >7,300 weekdays since Jan-95; sub-sample (red) includes only those periods where FF upper exceeds 2.5%

Exact overlaps in BoC-Fed policy rate differentials aren't uncommon, prevailing around 20% of the time. But this often occurs when rates are at zero. It's more interesting to examine divergences. The vast majority of time has been spent +/- 100 bps as one might expect. But we'd highlight that the more restrictive rates are, the more likely the BoC is to don a lower rate. Expect a repeat of this ahead.

Chart 2: Don't be fooled by apparent policy convergence…

Range, avg, deviation in BoC-FOMC policy rate differential over time

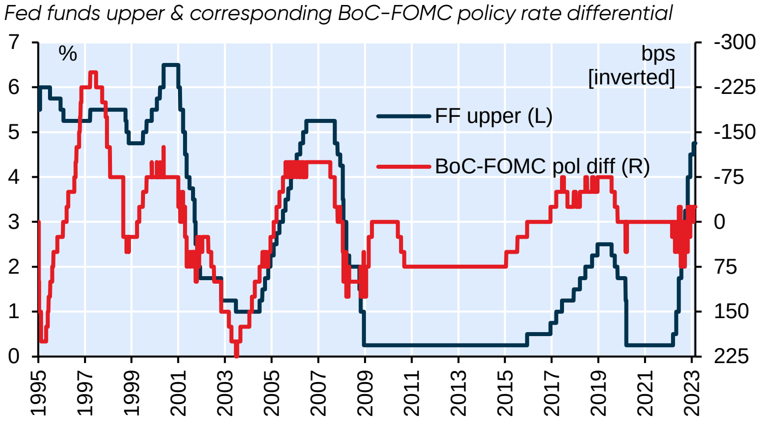


Source: NBF, Bloomberg, BoC, FRB | Note: Based on daily (weekday) obs from 1995-23

While more recent samples indicate tighter policy gaps, the notional reduction in volatility can be largely explained by the low and stable interest rate settings in 2020-21 and since the GFC…

Chart 3: … as we spent a *long* time at relatively low rates

Fed funds upper & corresponding BoC-FOMC policy rate differential

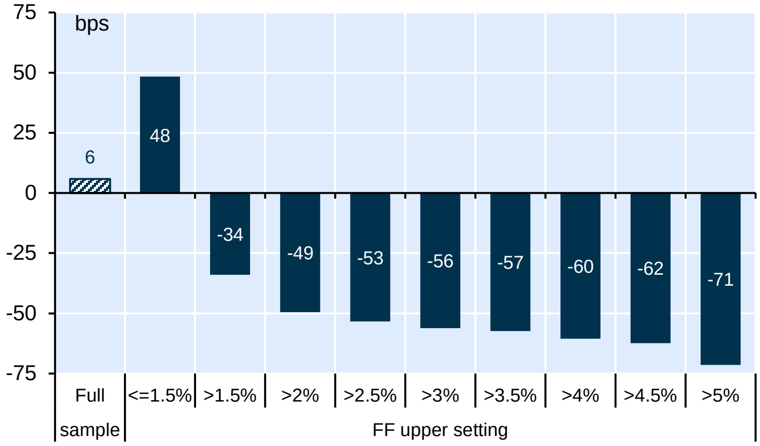


Source: NBF, Bloomberg, BoC, FRB | Note: Policy rate differential is inverted at right

Indeed, weak growth in the early 2010s kept fed funds anchored at zero as policymakers aimed to stimulate growth… There was a bit more volatility at the BoC but rates never passed 2%.

Chart 4: The higher fed goes, the more BoC tends to lag

BoC-FOMC policy rate differential relative to underlying fed funds upper level

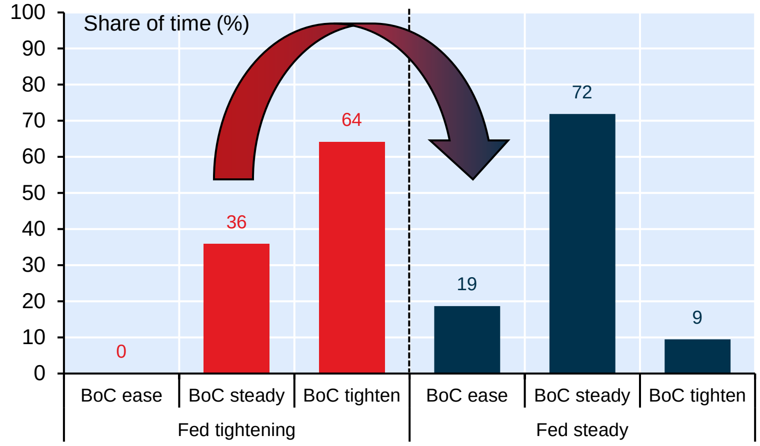


Source: NBF, Bloomberg, BoC, FRB | Note: Based on daily (weekday) obs from 1995-23

As the FOMC raises their target rate, the BoC has a harder time keeping pace. The result is a more negative differential the more the Fed tightens policy. This hiking cycle should fit the mould.

Chart 5: How divergent can policy postures really be?

BoC policy rate stance relative to FOMC tightening & neutral policy periods

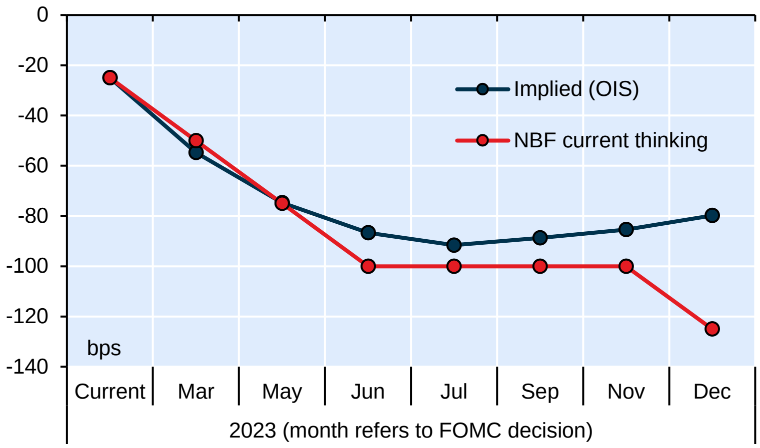


Source: NBF, Bloomberg, BoC, FRB | Note: Based on daily (weekday) obs from 1995-23

There's been no case where the Bank is easing while the FOMC remains tightening. It's unlikely that will change this cycle. Eventual BoC cuts will have to wait at least until the Fed pauses.

Chart 6: 100bp policy rate differential by end of spring?

BoC-FOMC policy rate differential: Current & implied/forecasted path for '23

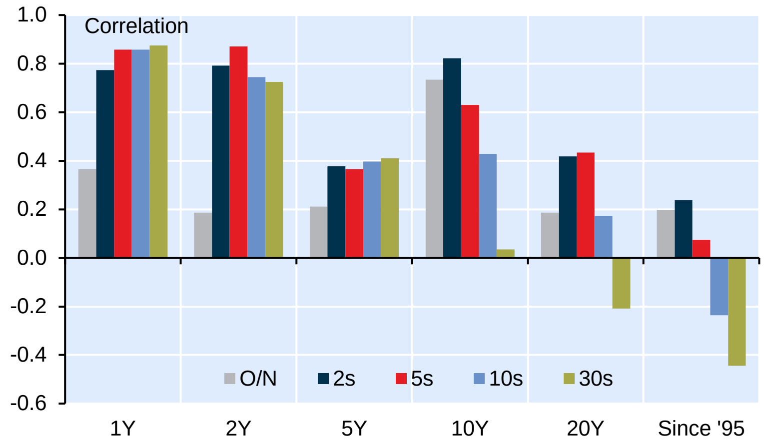


Source: NBF, Bloomberg | Note: OIS pricing as at 1-Mar (9am ET)

OIS markets see the 25 bp policy gap widening 50+ bps. That's close to our view for a -100 bp gap by June. BoC cuts could briefly widen the gap in Q4 but only if Fed cuts were also imminent.

Chart 7: Caution: There's a non-trivial tie-in to the currency

Historical correlation btw Canadian dollar & Cda-US interest rate differentials

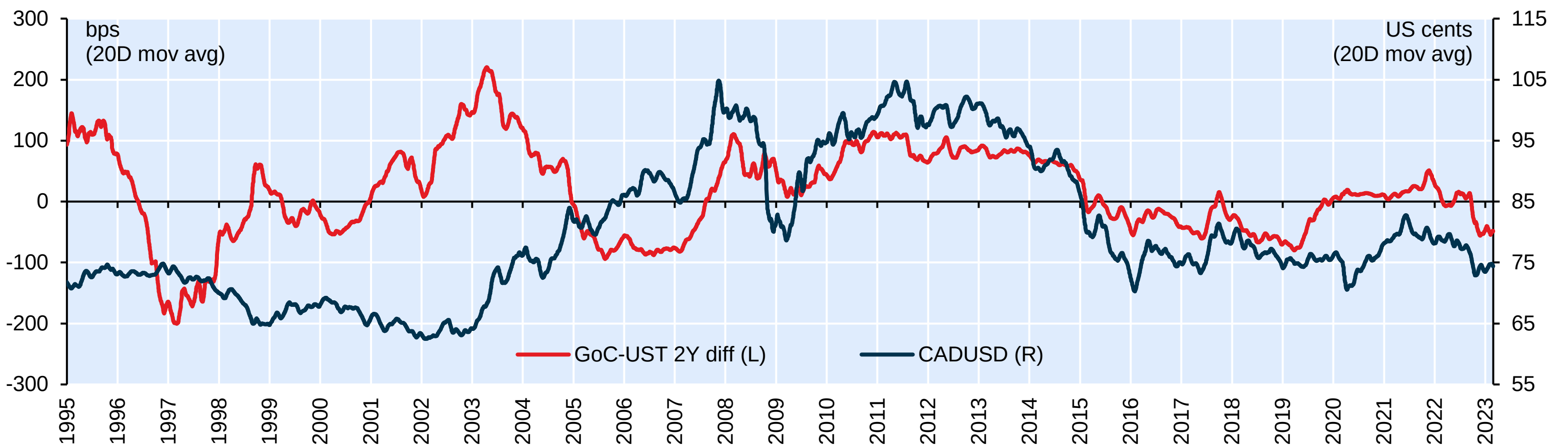


Source: NBF, Bloomberg | Note: Based on daily (weekday) obs from 1995-23

One wildcard to consider in policy differentials is the linkage to currency performance. We'll keep a closer eye on the CA-US 2s and 5s spreads, which are typically better indicators than others.

Chart 8: Wider for longer policy rate gap won't do loonie any favours in the near term (but this isn't the 1990s)

Canada-US 2Y interest rate differential & Canadian dollar



Source: NBF, Bloomberg | Note: Based on daily (weekday) obs from 1995-23

It's no secret that interest rate differentials are an important (but not the only) variable in any type of currency valuation. To us, a wider-for-longer policy rate differential will keep CA-US 2Y spreads at wide(r) levels, perhaps delaying and complicating arguments for near-term CAD appreciation. For more detailed thoughts, you can refer to our most recent foreign exchange monitor here.

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