

Memo to BoC: Don't take your cue from the market on oil shock

By Warren Lovely, Stefane Marion, Matthieu Arseneau

With the current geopolitical imbroglio in the Middle East having driven crude oil prices violently higher (among other commodities), more inflation is on the way. Qualitatively, of this we can be certain. Granted, the full magnitude and duration of the unfolding oil-related inflation shock remain to be seen, hinging on when (and in what fashion) the Strait of Hormuz is ultimately re-opened.

Notwithstanding ongoing geopolitical uncertainty — including conflicting signals from the main protagonists — global bond markets have rushed to judgement. In pursuit/defense of price stability mandates, central banks will either need to tighten monetary policy or won't be able to bring forth marginal accommodation. Or so the thinking goes.

A series of near-term interest rate hikes are now expected from both the Bank of England and the European Central Bank. That prospective tightening may be warranted. In the U.S., bets on FOMC rate cuts have been roundly abandoned, the latest 'dot plot' ostensibly dead on arrival.

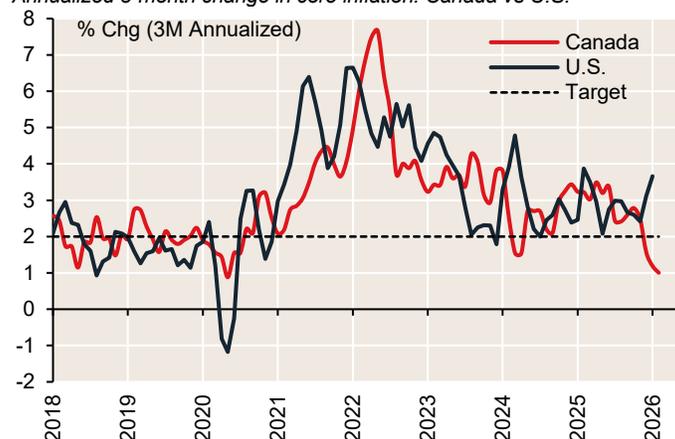
Here in Canada, the monetary policy re-think has likewise been striking. Relative to the current policy rate of 2.25%, markets now price a near-3% overnight target by late 2026/early 2027. Shifting sentiment on the BoC has driven 2-year GoC bond yields almost 60 basis points higher in March, one of the largest monthly selloffs since the last oil-price shock set central banks (and fixed income investors) on edge.

But this is not 2022 and we believe the market is getting ahead of itself. In this *de facto* memo to the Bank of Canada, we argue that Governing Council shouldn't be too hasty in reacting to a headline inflation spike — unless fresh fiscal stimulus fuels inflation, as it did during the 2022 oil shock. In no particular order, here are ten considerations that argue for a more patient policy stance:

- In Canada at least, inflation had been well-contained prior to the recent oil price shock** ➤ The latest available reading (for February) put Canadian headline inflation at 1.8%. In contrast, CPI inflation was already red hot when an oil price shock hit in 2022, as all items CPI was north of 5%. One could congratulate the BoC for restoring/securing price stability ahead of many of peers. While we don't advocate complacency, today's more becalmed starting point should permit a more deliberate reaction in Canada vs. jurisdictions where inflation never was brought to heel.
- Inflation expectations, while moving higher, have not fundamentally de-anchored** ➤ The federal government's lamentable decision to axe Real Return Bonds robs Canada of a well-functioning linker market, valuable when gauging inflation expectations. Saying that, softer data/surveys have consistently pointed to well anchored longer term inflation expectations. That could partly explain the smaller relative adjustment to the Canadian inflation outlook in the OECD's fresh forecast update ([link](#)).
- The pass through from higher energy prices to 'core' inflation is less-than-certain, perhaps unlikely** ➤ Simply put, core inflation momentum has been better behaved in Canada than elsewhere, including in the U.S. (Chart). Given underlying vulnerabilities (which we are coming to), we see much less risk a major energy price pass-through to the broader CPI basket.

More favourable inflation momentum in Canada

Annualized 3-month change in core inflation: Canada vs U.S.

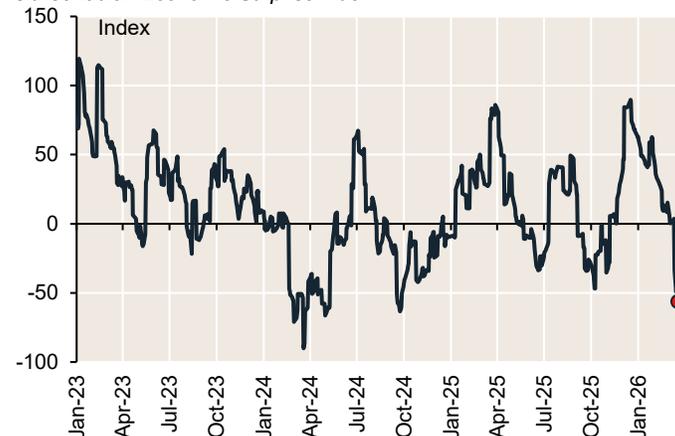


Source: NBC, StatCan, BEA | Note: Average of CPI-Trim and CPI-Median in Canada, Core PCE (ex. Food and energy) in the U.S.

- There remains excess slack in the Canadian economy and recent momentum is concerning** ➤ While large-scale revisions to GDP data cloud the picture, there's some degree of slack in the Canadian economy. In January, the BoC pegged the output gap at 0.5% to 1.5% and the economy has not performed well since. Recent economic data have been 'surprising' to the downside, highlighting an economy under some duress even with the policy interest rate at borderline stimulative levels.

Economic data have been surprising to the downside

Citi Canadian Economic Surprise Index



Source: NBC, BBG | Note: Reading below zero suggests downside surprises

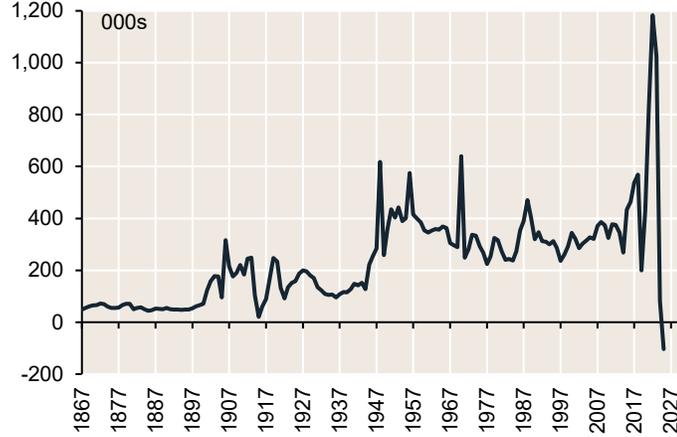
- Notwithstanding some mixed signals, the labour market appears weak/vulnerable and is likely to remain so** ➤ Having slammed the brakes on international immigration, Canada's population is going through an unprecedented contraction, with still-uncertain economic implications beyond weaker demand-side inflation. Declining population lowers the hurdle rate for monthly job creation and muddies the water when assessing labour market health. Still, recent job losses and employment rates near cyclical lows betray labour market fragility. Job vacancies have evaporated and hiring plans are lukewarm at best. A soft employment market



blunts expected wage growth and threatens consumer spending more generally — a major caution.

First year of falling population since Confederation

Annual change in the Canadian population

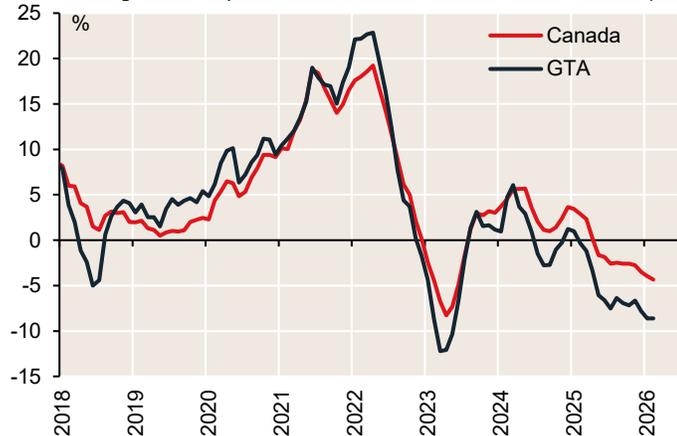


Source: NBC, StatCan

- **Key housing markets have remained sluggish, with buyers understandably reluctant to enter the fray** > Canada's is an interest-rate sensitive economy, one where housing plays an outsized role (in generating economic activity and supporting financial system health). It makes the recent malaise in housing markets worrisome, with earlier BoC rate cuts having failed to power up this vital sector. The BoC might argue that a moribund housing market, where prices are wilting, helps to bolster affordability. But careful what you wish for...
- **Wealth destruction (observed and threatened) will dull consumer enthusiasm** > All else equal, falling housing prices might aid affordability but the associated wealth destruction is no tonic for consumer confidence, which in March remained 50% below its 2022 peak. Rate hikes could push housing prices into a deeper dive, which might prove counterproductive from our perspective. (Overkill might be another way to put it.) Elsewhere, investment portfolios enjoyed a stellar 2025. But the picture has soured here too, where the threat of an equity bear market—a feature of every oil shock since 1956 (see our [Equity Monitor](#))—could add another unfortunate dimension to household wealth destruction.

Falling home prices spur wealth destruction

Annual change in home prices: Canada and the Greater Toronto Area (GTA)

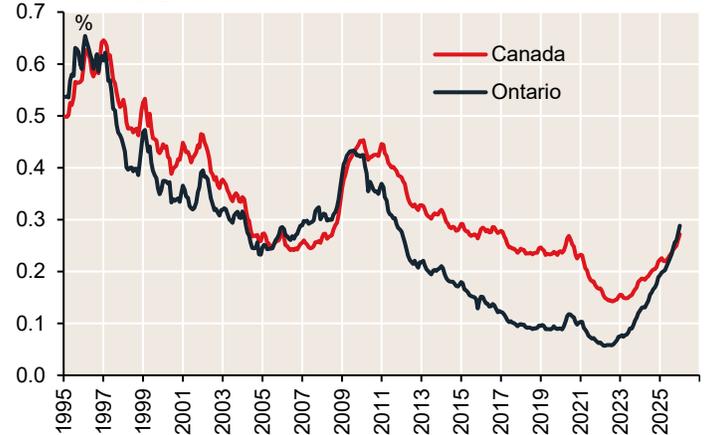


Source: NBC, Teranet-National Bank Home Price Index

- **Homeowners are having more difficulty servicing their mortgages** > As it is, more Canadians are falling behind on their mortgage, with delinquencies above pre-pandemic levels (Chart). True, the majority of Canadian mortgage credit has been reset, but it seems the new, higher rates borrowers are carrying/facing are a strain, siphoning disposable income away from other areas. When mortgage delinquencies flash 'red', a central bank should take heed.

Mortgage delinquencies are on the rise in Canada

Share of mortgages in arrears 90 days or more



Source: NBC, CBA

- **Business confidence and investment intentions are generally handicapped by ongoing trade uncertainty** > Yes, we're talking about USMCA and the still-noisy Canada-U.S. trade relationship. This is unquestionably a major source of uncertainty and until Canada's preferential access to the U.S. is affirmed businesses will have little reason to invest. Even in the oil patch, higher prices might not spur much near-term development, Canada's earlier failure to seriously augment egress capping our potential. That's partly why we see little to no real economic uplift coming from the oil price shock, despite Canada's status as an oil exporting nation. There will be more nominal income sure, but likely little in the way of jobs and investment (at least this year).
- **Fiscal policies, while notionally stimulative, are increasingly geared to productivity-enhancing initiatives (and are less problematic from an inflation perspective)** > Federally and provincially, economic transformation is the name of the game. The more fiscal initiatives hew to capital investment (as opposed to operational spending and/or household initiatives), the less short-term inflation we need to fear. Indeed, this investment focus requires patience, the real dividends likely to be clipped far down the road (i.e., in perhaps years from now). We'd note that certain governments stand to collect more revenue than they have planned for in 2026-27. Assuming those bonus proceeds go to deficit reduction/debt containment, the stronger the case would be for the BoC holding back on hikes. Conversely, any move to flow marginal revenue into short-term stimulus might complicate the picture for the BoC. In this way, our argument for monetary policy patience is conditioned on the budgetary choices Canadian governments opt for. That may be what the market is pricing in at this writing — namely, a repeat of the 2022-style fiscal response — but that seems at odds with the Carney government's budget pledge to "spend less to invest more" and, by extension, to favour investment over consumption.



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