The BoC Rejected a Micro-Cut and Issued a Taper Whisper

- **BoC communications drive bond yields higher, CAD appreciation**
- **BoC upgraded growth forecasts, lowered its assessment of uncertainty**
- **A "micro-cut" was rejected**
- **Markets are put on watch for timing the next taper**
- **The BoC may be underestimating consumer strength**
- **BoC monitoring CAD strength, but not sounding too concerned**
- **2022 is still a decent bet for rate hikes**

The first step toward eventually reducing stimulus is to know when you've probably done enough. The BoC signalled this awareness today.

Guidance to fade talk of a micro rate cut worked out well and so did guidance that the BoC would take a small step in the direction of taper talk as the Bank of Canada struck a generally more upbeat tone. The statement is here, the Monetary Policy Report is here and Governor Macklem's opening remarks to the press conference are here while his comments during the Q&A will be represented below. Macklem deserved high marks for staying on script with a polished and consistent narrative throughout the full suite of communications during a difficult potential transition point for the central bank.

In response to the Bank of Canada's overall suite of communications, Canada's government bond yields increased by about 2bps across the curve today as US Treasury yields fell slightly. FX markets signalled the same interpretation as the Canadian dollar became the day's star pupil through a half cent appreciation versus the USD after reining in a somewhat stronger initial response.

SAYONARA, MICRO CUT

I thought the main takeaway was delivered in the press conference when **Governor Macklem basically ruled out a so-called micro rate cut (<0.25% while keeping the policy rate above zero) for non-fundamental reasons.** Recall that the issue here is how market-based measures of the Bank of Canada's policy rate have been below the policy rate itself which motivated some to argue they may as well take the policy rate down to validate what markets are signalling (chart 1). That's often a slippery slope.

Macklem was rather clear in saying that only fundamentals-related reasons would motivate policy easing and not technical considerations that are driving short-rates lower. Among the technical considerations is that the collapse in Treasury bills outstanding (chart 2 shows the BoC's holdings) has occurred alongside ongoing liquidity provisions by the central bank that have driven short-term paper prices higher and yields lower. This has occurred for reasons not related to the outlook for the economy and inflation. Macklem's full quote to this effect is as follows:

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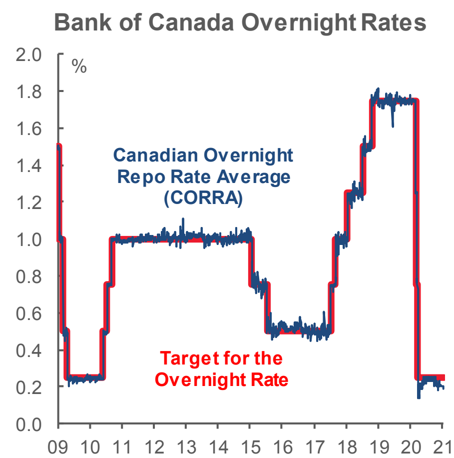
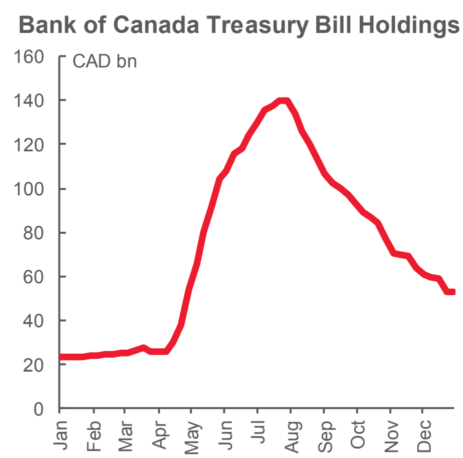
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bank of Canada.

> "Markets are working very well. We're not focused on issues around market functioning. We're very focused on the amount of stimulus needed to get us back to target. In that vein, reducing the effective lower bound to a lower but still positive value perhaps in combination with other tools would be used to provide more stimulus if needed. That's the way we see it as a monetary policy tool. Market turbulence is a different kind of discussion."

He also explained that they feel the stance of monetary policy is appropriate at this juncture.

TAPER WHISPER

I wouldn't quite call it taper talk yet, as opposed to more of a whisper in the market's ear, but the intent was nevertheless rather clear.

The signal that the BoC is open to tapering the C$4 billion or more per week of Government of Canada bond purchases conditional upon the evolution of its forecasts was delivered in the second last sentence of the statement and the Governor's opening remarks to kick off the press conference. The quotes below indicate that if they see signs of their forecast recovery unfolding, then they are likely to take steps toward reducing the flow of purchases. What to monitor may include their assumption that restrictions will begin to be lifted next month, vaccine roll-outs and Q2 rebound evidence that could well drive the next taper decision as soon as this Spring.

> "And as we gain confidence in the strength of the recovery, the pace of net purchases of Government of Canada bonds will be adjusted as required." [ed. "gain confidence" obviously would imply not expanding purchases, but rather in the opposite direction.]

> "We agreed that if the economy turns out to be substantially weaker than we are projecting—leading to more disinflationary pressures—then we have options to add even more stimulus. And we are prepared to use these options as needed."

> "We also agreed that it is too early to consider slowing the pace of our purchases of Government of Canada bonds. However, if the economy and inflation play out broadly in line or stronger than we projected, then the amount of quantitative easing (QE) stimulus needed will diminish over time."

FORECAST UPGRADES

The BoC upgraded its forecasts (table 1 for Canada) and guided that "the arrival of effective vaccines combined with further fiscal and monetary policy support have boosted the medium-term outlook for growth." Macklem emphasized the heavy conditionality of their forecasts upon vaccine progress. It was a positive coincidence to see Pfizer announce earlier that trials on virus mutations have proven to be successful while the WHO announced that they may authorize the Astrazeneca COVID-19 vaccine either this month or next and is planning vaccine approvals for global roll-out.

The Bank of Canada's Monetary Policy Report (MPR) Canadian Macroeconomic Projections, annual % change

	2020e	2021f	2022f	2023f
GDP				
July '20 MPR	-7.8	5.1	3.7	
Oct '20 MPR	-5.7	4.2	3.7	
Jan '21 MPR	-5.5	4.0	4.8	2.5
CPI Inflation				
July '20 MPR	0.6	1.2	1.7	
Oct '20 MPR	0.6	1.0	1.7	
Jan '21 MPR	0.7	1.6	1.7	2.1

Sources: Scotiabank Economics, Bank of Canada

- Canada's economy is projected to grow by 4.0% this year (4.2% previously) but next year was revised up to 4.8% (3.7% prior) and 2023 is forecast to growth by 2.5%. All of these numbers are above the economy's longer term non-inflationary speed limit.
- On the quarterly breakdown, the BoC projects that Canada's economy will shrink by -2.5% q/q SAAR in Q1 after upgrading Q4 from +1% to 4.8%. This meets the expectation they would upgrade Q4 because we already know the data is tracking stronger for the quarter, but that some of the effects are offset by downgrading Q1 with the net level of GDP tracking not far off expectations. The central bank thinks COVID-19 restrictions will be lifted in February as a nearer term tracking risk (See Box 1, page 12 of the MPR).
- World growth was upgraded to 5.6% this year (4.8% previously), 4.6% in 2022 (4.3% previously) and the first attempt at forecasting 2023 pegs 3.9%.

- US GDP growth was upgraded to 5.0% in 2021 (3.1% prior), 3.9% next year (3.4% prior) and 2.0% in 2023.

Note that alongside its forecasts, the BoC also lowered the risks surrounding them. The direct quote was:

> "The earlier-than-anticipated arrival of effective vaccines will save lives and livelihoods, and has reduced uncertainty from extreme levels. Nevertheless, uncertainty is still elevated, and the outlook remains highly conditional on the path of the virus and the timeline for the effective rollout of vaccines. "

Overall the suite of communications sets a very high bar against expectations for any further policy easing as we slip into tracking mode on their forecasts. They are saying they're on auto pilot for a time. Barring a shock out of left field, the next move is likely to tighten policy but even I think that's a 2022 story. As 2021 evolves, market rates through the front-end will more convincingly price such expectations alongside vaccine take-up and data.

IS THERE FURTHER UPSIDE TO THE BOC'S FORECASTS FOR CONSUMERS?

Notwithstanding the forecast upgrades, I think the BoC continues to underestimated how consumer spending will behave. They have not had a good track record at judging how retail sales and housing markets would respond to powerful stimulus to date. More fundamentally, however, I think the arguments offered today are debatable.

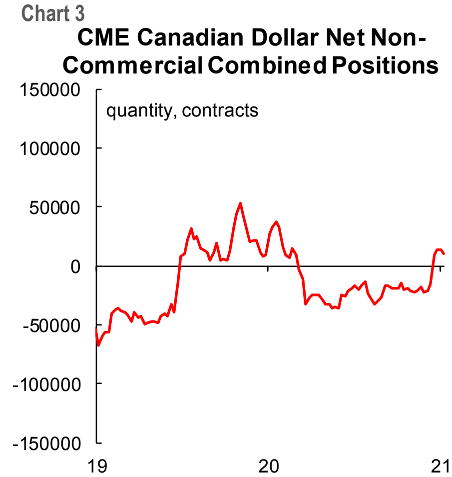
Macklem noted that the BoC is assuming most of the horded cash and high saving rates at households will not return as an even more powerful consumer spending surge than they forecast. I think that's an area where they could be positively surprised. When asked during the press conference why he is assuming that households will not redeploy horded cash in the recovery, Macklem responded with a few points. One was that he thinks that most of the savings are in upper income households that are more likely to spend more of their money on high contact forms of spending with that past spending gone forever. He explained that they are more likely to travel or go to restaurants and that while they've substituted some of this away from high contact spending toward other things, you can't unleash pent-up demand for services by, say, getting twice as many hair cuts to use his metaphor.

This is where I see it differently. First, it's not just higher income households that have saved more. The BoC's October edition of their consumer survey (chart 1–A here) showed that 20% of households earnings less than C$40k per year increased savings, 38% of households earnings $40–99k saved more and 47% of upper income households saved more. A first point is that there are many fewer households in upper-income categories than middle and lower income categories and so multiply these response rates by sheer numbers of people in those cohorts and you'd perhaps get a different picture of where the savings sit. Second, $99k as an upper income definition is a pretty modest one; does the BoC think that level of household income is 'rich' in cities like, say, Toronto or Vancouver and that folks in those markets if not elsewhere will just sit on their cash stockpiles? I think that assumption is, well, rather rich, to be cheeky about it. If so, then the BoC is overestimating the amount of savings across these "upper income" households that will continue to be horded.

Further, they don't have to release it such savings on services per se. They can spend it on buying more bigger ticket goods instead. Spending less on gas and transit, restaurants and travel or movie tickets may well mean more spent on a wide variety of other things, like, well, homes, autos, computers and gadgets, boats, atvs etc as we've seen. The operating assumption here is never to underestimate the capacity of consumers to spend.

Finally, the BoC is relying perhaps too strongly on survey-based evidence that portrays households as darling little angels who will diligently put all horded savings toward paying down debt. Such surveys are a waste of ink. They said the same thing about American consumers in the lead-up to the GFC and we know how that ended. Actions speak far louder than words when assessing the behaviour of consumers and the BoC is indicating that perhaps it hasn't spent enough time on assessing the actions to date as retail sales soared to a record during the pandemic and took home sales with them. Hang onto low rates too low with vaccines arriving and I have a hunch we'll see spending rip over time.

Chart 3



Source: Scotiabank Economics, Bloomberg.

CAD BEING MONITORED, BUT NOT A WORRY YET

When asked about C$ strength and net positioning that continues to indicate net longs in CAD (chart 3), Macklem noted that their convention is to use the current spot exchange rate and that at about 78 CADUSD cents (1.28 USDCAD to market participants) the currency "dampens exports on the margin." The BoC does this because of the perils associated with a central bank forecasting the currency and probably because of the difficulty in doing so to begin with. He went on to note that "the risk is that we see a further appreciation that will become more of a headwind as a downward risk to our projection. I would underline it's important to assess why the C$ is moving. We don't target CAD. Most of the appreciation of the C$ is because of depreciation in USD and so the C$ is becoming a factor in its own right in our projections."

Notwithstanding these points, the BoC's forecasts include a weighted contribution to GDP growth from gross exports of 1.7 percentage points in 2021, 1.9 points in 2022 and another 1.0 point in 2023. The implied assumption is that stronger global—and particularly US—GDP growth will pull in enough export growth to offset the deterioration in export competitiveness. Net of imports, they expect a drag of 1.1 points in 2021, no contribution in 2022 and a small drag in 2023 (-0.3%). Even with this net drag factored into the projections, the BoC's is still pointing toward strong 4-handled GDP growth in 2021–22 and above potential at 2.5% in 2023. I would think that any drag from net exports through currency strength would have to be materially stronger than they are forecasting to knock their GDP numbers off track, especially if the above argument on consumer spending upsides proves to be on the mark although part of that would leak out through imports.

HOUSING: CLINGING TO A FORECAST BIAS THAT HASN'T WORKED?

On housing markets, the BoC guided that housing's contribution to GDP growth will slow from a weighted 0.7% lift to GDP this year to no contribution next year and in 2023. They said "Activity should slow toward levels consistent with the rate of new household formation." We'll see about that. The BoC has seriously underestimated the housing response to rate cuts thus far and they appear to be sweeping that under the rug.

WHY RATE HIKES MAY COME SOONER THAN THE BOC GUIDES

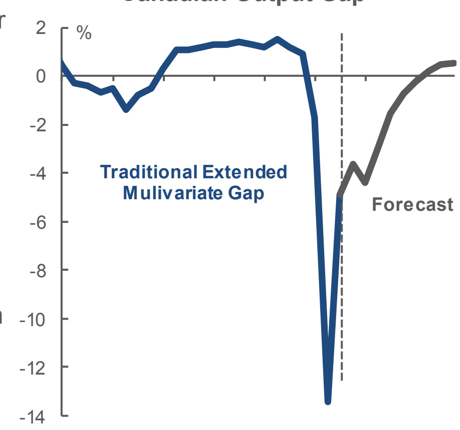
Since November when vaccine trials became a nascent game changer, I've been arguing that there is a strong case for the BoC to hike its policy rate earlier than 2023 and that promising longer guidance could perversely drive deeper imbalances in the household sector. To that effect, perhaps the best question posed to the Governor during the press conference was why he has not significantly changed guidance around what the BoC expects for inflation despite upgrading forecasts for growth while leaving the BoC's forecasts for potential growth (the noninflationary speed limit) unchanged.

Macklem's response was that the BoC is expecting a choppy recovery, that right now "we're in a big chop" in reference to the Q1 GDP drop and hence a deeper hole now. He went on to explain that forecasts for 2023 are still "a ways away" and that "we're not being overly precise now." Fair enough in that an awful lot can happen over the next 2–3 years and they have plenty of time ahead to reassess.

But to investors in the Canada rates curve across maturities throughout the belly and longer end, I find that the overall forecast guidance doesn't hang together terribly well. With very similar forecast numbers—we have 4.3% growth in each of this year and next and the BoC averages 4.4% over this period—the output gap measure of slack closes off by about mid-2022 (chart 4). Inflation is forecast back at 2% and then just above 2% starting around the middle of 2022. That, in turn, counsels guiding rate hike risk along a similar time horizon in 2022.

Governor Macklem likely knows that and no doubt has plenty of economists advising him on the issue, but he probably wants to see the proof in the pudding. At this juncture I wouldn't blame him while sitting in his seat as a policymaker focused upon risk management, versus an investor who needs to formulate dynamic expectations for such an environment well ahead of time and can't wait for the BoC to signal the all clear for tighter policy at which point it's too late. That bifurcation of duties isn't always understood terribly well outside of Ottawa. For that audience that the street serves, I would continue to emphasize hike risk in 2022 alongside exiting the QE game around the end of this year.

Chart 4 Canadian Output Gap



Sources: Scotiabank Economics, Statistics Canada.

RELEASE DATE: January 20, 2021

The Bank of Canada today held its target for the overnight rate at the ***effective lower bound of ¼ percent***, with the Bank Rate at ½ percent and the deposit rate at ¼ percent. The Bank is maintaining its extraordinary forward guidance, reinforced and supplemented by its quantitative easing (QE) program, which continues at its current pace of at least $4 billion per week.

The COVID-19 pandemic continues to take a severe human and economic toll in Canada and around the world. ***The earlier-than anticipated arrival of effective vaccines will save lives and livelihoods, and has reduced uncertainty from extreme levels. Nevertheless, uncertainty is still elevated, and the outlook remains highly conditional on the path of the virus and the timeline for the effective rollout of vaccines.***

The economic recovery has been interrupted in many countries as new waves of COVID-19 infections force governments to re-impose containment measures. However, the arrival of effective vaccines combined with further fiscal and monetary policy support have boosted the medium-term outlook for growth. In its January Monetary Policy Report (MPR), the Bank projects global growth to average just over 5 percent per year in 2021 and 2022, before slowing to just under 4 percent in 2023. Global financial markets and commodity prices have reacted positively to improving economic prospects. A broad-based decline in the US exchange rate combined with stronger commodity prices have led to a further appreciation of the Canadian dollar.

Canada's economy had strong momentum through to late 2020, but the resurgence of cases and the reintroduction of lockdown measures are a serious setback. Growth in the first quarter of 2021 is now expected to be negative. Assuming restrictions are lifted later in the first quarter, the Bank expects a strong second-quarter rebound. Consumption is forecast to gain strength as parts of the economy reopen and confidence improves, and exports and business investment will be buoyed by rising foreign demand. Beyond the near term, the outlook for Canada is now stronger and more secure than in the October projection, thanks to earlier-than-expected availability of vaccines and significant ongoing policy stimulus. After a decline in real GDP of 5 ½ percent in 2020, the Bank projects the economy will grow by 4 percent in 2021, almost 5 percent in 2022, and around 2 ½ percent in 2023.

CPI inflation has risen to the low end of the Bank's 1-3 percent target range in recent months, while measures of core inflation are still below 2 percent. CPI inflation is forecast to rise temporarily to around 2 percent in the first half of the year, as the base-year effects of price declines at the pandemic's outset — mostly gasoline — dissipate. Excess supply is expected to weigh on inflation throughout the projection period. As it is absorbed, inflation is expected to return sustainably to the 2 percent target in 2023.

In view of the weakness of near-term growth and the protracted nature of the recovery, the Canadian economy will continue to require extraordinary monetary policy support. The Governing Council will hold the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved. In our projection, this does not happen until into 2023. To reinforce this commitment and keep interest rates low across the yield curve, the Bank will continue its QE program until the recovery is well underway. ***As the Governing Council gains confidence in the strength of the recovery, the pace of net purchases of Government of Canada bonds will be adjusted as required.*** We remain committed to providing the appropriate degree of monetary policy stimulus to support the recovery and achieve the inflation objective.

RELEASE DATE: December 9, 2020

The Bank of Canada today maintained its target for the overnight rate at the effective lower bound of ¼ percent, with the Bank Rate at ½ percent and the deposit rate at ¼ percent. The Bank is maintaining its extraordinary forward guidance, reinforced and supplemented by its quantitative easing (QE) program, which continues at its current pace of at least $4 billion per week.

The rebound in the global and Canadian economies has unfolded largely as the Bank had anticipated in its October *Monetary Policy Report* (MPR). More recently, news on the development of effective vaccines is providing reassurance that the pandemic will end and more normal activities will resume, although the pace and breadth of the global rollout of vaccinations remain uncertain. Near term, new waves of infections are expected to set back recoveries in many parts of the world. Accommodative policy and financial conditions are continuing to provide support across most regions. Stronger demand is pushing up prices for most commodities, including oil. A broad-based decline in the US exchange rate has contributed to a further appreciation of the Canadian dollar.

In Canada, national accounts data for the third quarter were consistent with the Bank's expectations of a sharp economic rebound following the precipitous decline in the second quarter. The labour market continues to recoup the jobs that were lost at the start of the pandemic, albeit at a slower pace. However, activity remains highly uneven across different sectors and groups of workers. Economic momentum heading into the fourth quarter appears to be stronger than was expected in October but, in recent weeks, record high cases of COVID-19 in many parts of Canada are forcing re-imposition of restrictions. This can be expected to weigh on growth in the first quarter of 2021 and contribute to a choppy trajectory until a vaccine is widely available. The federal government's recently announced measures should help maintain business and household incomes during this second wave of the pandemic and support the recovery.

CPI inflation in October picked up to 0.7 percent, largely reflecting higher prices for fresh fruits and vegetables. While this suggests a slightly firmer track for inflation in the fourth quarter, the outlook for inflation remains in line with the October MPR projection. Measures of core inflation are all below 2 percent, and considerable economic slack is expected to continue to weigh on inflation for some time.

Canada's economic recovery will continue to require extraordinary monetary policy support. The Governing Council will hold the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved. In our October projection, this does not happen until into 2023. To reinforce this commitment and keep interest rates low across the yield curve, the Bank will continue its QE program until the recovery is well underway and will adjust it as required to help bring inflation back to target on a sustainable basis. We remain committed to providing the monetary policy stimulus needed to support the recovery and achieve the inflation objective.