Bank of Canada: We're Not So Hawkish Now!

- **BoC guides a first rate hike is coming between April–September...**
- **...ends incremental bond purchases…**
- **...and shifts to the reinvestment phase**
- **The Governor made all April–Sept meetings live for a first hike**
- **A shift to even earlier hike pricing has markets thinking the BoC is partially masking a bigger and more sudden rush to the exits**
- **Why markets may have a solid case for a January hike**

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Canadians should continue to prepare for higher borrowing costs but take comfort around the fact that the economy should be well positioned to take it. In fact, tighter monetary policy is an indication of confidence toward something more normal.

I'll explain what the Bank of Canada did today, how that lined up with our expectations and risks to our rate hike forecasts. Please see here for the policy statement, here for the Monetary Policy Report including forecasts, here for the Governor's opening remarks to his press conference and here for the Market Notice to explain some technical details.

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

	2020e	2021f	2022f	2023f
GDP				
Apr '21 MPR	-5.4	6.5	3.7	3.2
Jul '21 MPR	-5.3	6.0	4.6	3.3
Oct '21 MPR	-5.3	5.1	4.3	3.7
CPI Inflation				
Apr '21 MPR	0.7	2.3	1.9	2.3
Jul '21 MPR	0.7	3.0	2.4	2.2
Oct '21 MPR	0.7	3.4	3.4	2.3

Sources: Scotiabank Economics, Bank of Canada.

By the time the dust settled on the communications, the Canadian dollar appreciated by about half a penny, the 2-year Government of Canada bond yield spiked 25bps higher and yields climbed through the important 5-year part of the curve while the 30-year GoC bond yield fell in line with the rally at the US long-end. Markets are now pricing most of a first rate hike by the January 2022 meeting and about 1.5 percentage points of rate hikes by the end of 2022. The market moves will begin to translate into tighter financial conditions as they migrate through various lending products.

WHAT THE BOC DID

The BoC kicked QE to the curb, embraced the reinvestment phase of its QE program and brought forward rate hike guidance from sometime over 2022H2 to now saying sometime over Q2 or Q3 of next year.

A) SHIFTED TO THE REINVESTMENT PHASE

There was some uncertainty over whether they would shift away from the C$2B/ week rate of purchases in the Government of Canada Bond Purchase Program toward the reinvestment phase of the Government of Canada Bond Purchase Program now, or tee up such a move for later. They did shift to reinvestment today and will commence reinvestment on November 1st and accordingly met our expectations.

The BoC issued this accompanying market notice that offers further elaboration upon the decision. The notice reinforces general guidance provided in Macklem's speech last month that the reinvestment phase will target between C$4–5B/month split between the primary market ($1–2B/month) and the secondary market (C$2.5

–3.5B/mth). They say they will reinvest 'for a period of time' and 'at least until the first rate hike.' The BoC said it will adjust its percentage share of each auction over time but will aim to be "roughly uniform across maturity sectors." Real return bond purchases will be discontinued.

The aim continues to be to flat line the portfolio of bonds held on balance sheet over time rather than precisely matching flows as each bond held matures. That's because of the lumpy nature of the maturing flows on the BoC's balance sheet. Chart 1 shows the maturing amounts by year which smooths out the pattern over time.

This puts an end to the QE purchase phase but maintains the size of the portfolio of GoC bonds held constant. That means that from a flow perspective, the BoC will stop adding incremental stimulus through bond purchases but that from a stock perspective it will maintain the enormous amount of stimulus reflected in the nearly C$430B of bonds it now owns.

B) RATE HIKE GUIDANCE

Governor Macklem's press conference remark offered the clearest guidance on when the BoC might lift-off:

> "We reaffirmed we'll hold at the lower bound until slack is absorbed so that the 2% inflation target is sustainably achieved. We think that happens sometime between April and September. We would expect to be considering raising interest rates in that time period."

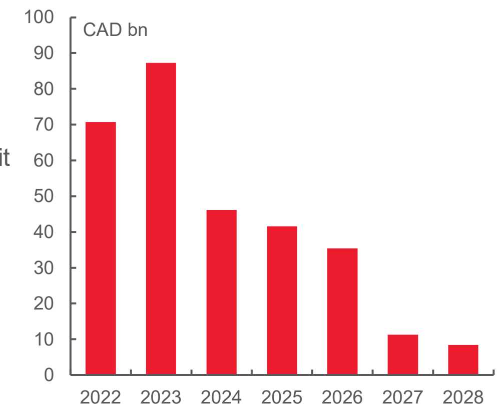
The Bank of Canada therefore formally put in play all four meetings over the second and third quarters of 2022 for the first rate hike of the cycle. I had thought they would have stuck to 2022H2 guidance for the gap to shut, but our pre-existing forecast for a first hike in July nevertheless walked down the middle of the Governor's guidance. They basically brought forward closure of spare capacity by three months from 2022H2 to 2022Q2–Q3. I'll come back to how our July hike may be too late now and as a result why we could be looking at more than our forecast four rate hikes in 2022.

The statement also did so by now saying slack is expected to be absorbed "sometime in the middle quarters of 2022." That plays to both the Q2 and Q3 hike camps among economists and our present print forecast for a first hike in July roughly walks down the middle.

I personally don't think that was a very wise approach for the BoC to have taken. To an extent, embracing a shift to reinvestment now was advised to be something markets could have taken as a signal the BoC is in a rush toward the exits. On its own that might have motivated front-end cheapening. To on top of that tell markets that you are open to an April hike—even if it's part of a *range*—motivated market instincts. Markets would of course have a natural tendency to think that well, if April is a possibility, then hiking at earlier meetings may not be impossible which motivates a market pile-on effect. The BoC lost control of that part of the narrative today and handed the keys to markets to take over. I think it's partially that logic that brought markets to price a hike by January and now the BoC is put in the awkward position of having to fight markets, but we'll see how market participants test that view if contract pricing overshot.

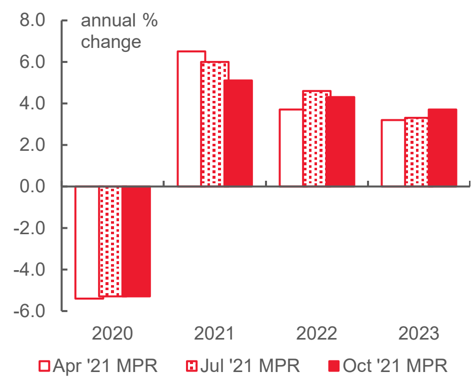
So why didn't Macklem immediately lean against the initial market reaction to price a hike by January after the opening communications were released? I can't believe that he would have been unaware going into the press conference or that nobody informed him. Rather, we're left to speculate that the Governor didn't have enough confidence to push back on the market reaction in his press conference and/or blew an opportunity to do so.

Chart 1
Bank of Canada Bond Maturities



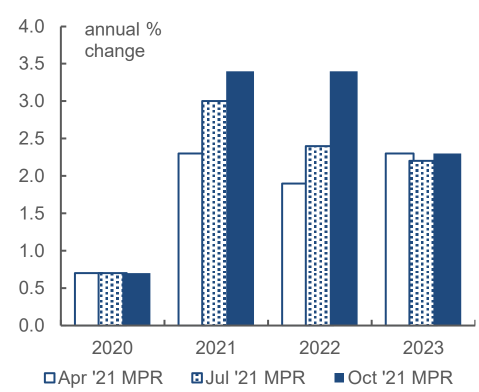
Sources: Scotiabank Economics, Bank of Canada

Chart 2
Bank of Canada GDP Forecast Revisions



Sources: Scotiabank Economics, Bank of Canada *Monetary Policy Report.*

Chart 3
Bank of Canada Inflation Forecast Revisions



Sources: Scotiabank Economics, Bank of Canada *Monetary Policy Report.*

If he didn't have the confidence to do so, then that's added evidence that earlier than April isn't impossible. I would watch for further communications around this issue.

C) BANK OF CANADA FORECASTS

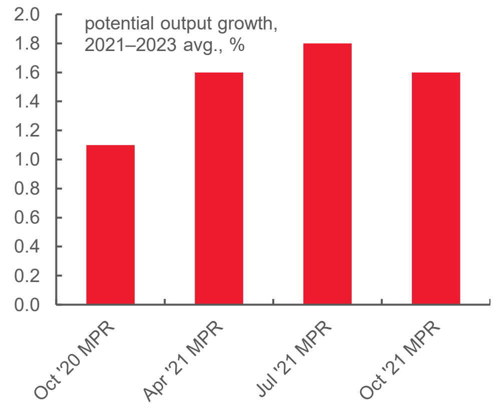
Table 1 on the front page summarizes the Bank of Canada's forecast revisions for GDP growth and CPI inflation and how they have evolved recently. Charts 2 and 3 graphically depict the BoC's GDP growth and inflation forecast revisions.

On actual GDP they bumped down 2021 to 5.1% from 6% and 2022 to 4.3% from 4.6% but bumped up 2023 to 3.7% from 3.3%.

They lowered the potential GDP starting point and potential growth only a little to 1.6% over 2021–23 from 1.8% in July which takes them back to their estimate in the April 2021 MPR (chart 4). In reality, I couldn't care less how this gets fudged to fit the narrative and nobody knows what the economy's sustainable non-inflationary speed limit may turn out to be in a pandemic. The output gap framework will always bend to fit reality and even BoC staff research downplays its usefulness as an inflation driver (here).

Chart 4

Did the Boc Upward Drift on Potential Overshoot?



Sources: Scotiabank Economics, Bank of Canada MPRs.

The BoC repeated that their projections rest upon a neutral rate in the middle of the 1.75–2.75% range they have previously published (ie: 2.25%). That is also our terminal rate toward the end of 2023.

D) OTHER STATEMENT CHANGES—TWO POWERFUL WORDS ARE NOW GONE

The statement struck out "considerable" in front of "considerable excess capacity" which is material. I didn't think they would do that just yet, but it's a further indication that the BoC has materially lowered its estimate of existing spare disinflationary capacity.

They also replaced a need for "extraordinary monetary policy support" with "considerable monetary policy support" which reflects where they are now going.

The statement codified what Macklem has previously said in that "the main forces pushing up prices—higher energy prices and pandemic-related supply bottlenecks—now appear to be stronger and more persistent than expected."

RISKS TO OUR RATE HIKE CALL

While Bank of Canada Governor Macklem broadly met our expectations on multiple counts today, the risks could well point toward earlier rate hikes than the Governor let on—and even more hikes in 2022 than our forecast. A hike in April would probably lead us to bring forward more of the profile of rate hikes, but it wouldn't necessarily stop at that due to a combination of expected events and where markets are pushing the central bank.

Financial market instruments are pricing a first rate hike by the January 26th meeting. The BoC may scoff at the suggestion that markets will push them into such an outcome. Bear in mind, however, that monetary policy cycles are replete with evidence of central banks being led by markets both on the way in when stimulus is being introduced and on the way out. That often starts with bond markets acting in advance of central bankers and migrates into the contract pricing around individual meetings as we've seen. If we go into the January 2022 meeting and 25bps is priced, then it's very feasible that the BoC could take it as a free option to hike, sound cautious toward future moves and without being concerned about destabilizing anything across the suite of financial market evidence.

Furthermore, there are a lot of developments that could conceivably drive the BoC to sound even more upbeat when it goes into the January MPR forecast meeting. Several of these could influence its timing of when spare capacity is eliminated and/or raise confidence in this expectation. By then:

- Canada's top ranking in the world on vaccinations will have risen further when the 5–11 aged cohort gets vaccinated in sizeable numbers.
- We should have a Fall fiscal update probably by early December that may add a modest amount to fiscal stimulus given revenue beats and a minority government's quest to keep the NDP onside and through more than just cabinet appointments.

- The Biden administration may have passed legislation totalling around US$2¼ trillion in new fiscal stimulus including just over $500B in incremental infrastructure funding within the US$1T package, plus the possibility that the Biden-Manchin agreement could yield a proxy for the families plan at around US$1¾ trillion with only a few hundred billion funded by higher revenues.

- Inflation is likely to be approaching 5% toward year-end and creating even greater sticker shock.

- This could be reflected across measures of expectations that, among other things, are poised for updates when the BoC releases its Winter editions of the business and consumer surveys.

- Also bear in mind that by then the Fed will have probably been tapering for a handful of months and the BoE will have probably hiked at least once.

- Finally, if we continue to march along the rebound path in the economy away from the fourth wave that was pretty modest in the most populous provinces and the trend in three more jobs reports is supportive then the economic backdrop should be providing some data to go along with the BoC's rebound narrative.

One last suggestion is that by hiking sooner rather than later, the BoC could increase its optionality around future policy adjustments. In other words, if they fall behind inflationary pressure a little less than they already have and less than they would if they sat around through 2021H1, then perhaps they'd have to tighten less later.

Please also see the attached statement comparison.

RELEASE DATE: October 27, 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's extraordinary forward guidance on the path for the overnight rate is being maintained. ***The Bank is ending quantitative easing (QE) and moving into the reinvestment phase, during which it will purchase Government of Canada bonds solely to replace maturing bonds.***

The global economic recovery from the COVID-19 pandemic is ***progressing. Vaccines are proving highly effective against the virus, although their availability and distribution globally remain uneven and COVID variants pose risks*** to health and economic activity. In the face of strong global demand for goods, pandemic-related disruptions to production and transportation are constraining growth. Inflation rates have increased in many countries, boosted by these supply bottlenecks and by higher energy prices. While bond yields have risen in recent weeks, financial conditions remain accommodative and continue to support economic activity.

The Bank projects global GDP will grow by 6½ percent in 2021 – a strong pace but less than projected in the July *Monetary Policy Report* (MPR) – and by 4¼ percent in 2022 and about 3½ percent in 2023.

In Canada, ***robust economic growth has resumed, following a pause in the second quarter.*** Strong employment gains in recent months were concentrated in hard-to-distance sectors and among workers most affected by lockdowns. This has significantly reduced the very uneven impact of the pandemic on workers. As the economy reopens, it is taking time for workers to find the right jobs and for employers to hire people with the right skills. This is contributing to labour shortages in certain sectors, even as slack remains in the overall labour market.

The Bank now forecasts Canada's economy will grow by 5 percent this year before moderating to 4¼ percent in 2022 and 3¾ percent in 2023. Demand is expected to be supported by strong consumption and business investment, and a rebound in exports as the US economy continues to recover. Housing activity has moderated, but is expected to remain elevated. On the supply side, shortages of manufacturing inputs, transportation bottlenecks, and difficulties in matching jobs to workers are limiting the economy's productive capacity. Although the impact and persistence of these supply factors are hard to quantify, the output gap is likely to be narrower than the Bank had forecast in July.

The recent increase in CPI inflation was anticipated in July, but ***the main forces pushing up prices – higher energy prices and pandemic-related supply bottlenecks – now appear to be stronger and more persistent than expected.*** Core measures of inflation have also risen, but by less than the CPI. The Bank now expects CPI inflation to be elevated into next year, and ease back to around the 2 percent target by late 2022. The Bank is closely watching inflation expectations and labour costs to ensure that the temporary forces pushing up prices do not become embedded in ongoing inflation.

The Governing Council judges that in view of ongoing excess capacity, the economy continues to require ***considerable*** monetary policy support. We remain committed to holding 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 the Bank's projection, ***this happens sometime in the middle quarters of 2022.*** In light of the progress made in the economic recovery, the Governing Council has decided to end quantitative easing and keep its overall holdings of Government of Canada bonds roughly constant.

We will continue to provide the appropriate degree of monetary policy stimulus to support the recovery and achieve the inflation target.

RELEASE DATE: September 8, 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 on the path for the overnight rate. This is reinforced and supplemented by the Bank's quantitative easing (QE) program***, which is being maintained at a target pace of $2 billion per week.***

The global economic recovery ***continued*** through the second quarter, led by strong US growth, and had solid momentum heading into the third quarter. However, supply chain disruptions are restraining activity in some sectors and rising cases of COVID-19 in many regions pose a risk to the strength of the global recovery. Financial conditions remain highly accommodative.

In Canada, ***GDP contracted by about 1 percent in the second quarter***, weaker than anticipated in the Bank's July Monetary Policy Report (MPR). This largely reflects a contraction in exports, due in part to supply chain disruptions, especially in the auto sector. Housing market activity pulled back from recent high levels, largely as expected. Consumption, business investment and government spending all contributed positively to growth, with domestic demand growing at more than 3 percent. Employment rebounded through June and July, with hard-to-distance sectors hiring as public health restrictions eased. This is reducing unevenness in the labour market, although considerable slack remains and some groups – particularly low-wage workers – are still disproportionately affected. The Bank continues to expect the economy to strengthen in the second half of 2021, although the fourth wave of COVID-19 infections and ongoing supply bottlenecks could weigh on the recovery.

CPI inflation remains above 3 percent as expected, boosted by base-year effects, gasoline prices, and pandemic-related supply bottlenecks. These factors pushing up inflation are expected to be transitory, but ***their persistence and magnitude are uncertain and will be monitored closely***. Wage increases have been moderate to date, and medium-term inflation expectations remain well-anchored. Core measures of inflation have risen, but by less than the CPI.

The Governing Council judges that the Canadian economy still has ***considerable*** excess capacity, and that the recovery continues to require ***extraordinary*** monetary policy support. We remain committed to holding 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 the Bank's July projection, this happens in the second half of 2022.*** The Bank's QE program continues to reinforce this commitment and keep interest rates low across the yield curve. Decisions regarding future adjustments to the pace of net bond purchases will be guided by Governing Council's ongoing assessment of the strength and durability of the recovery. We will continue to provide the appropriate degree of monetary policy stimulus to support the recovery and achieve the inflation objective.