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Chart 1

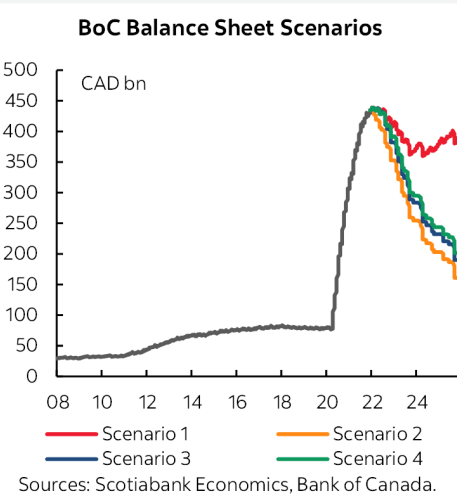
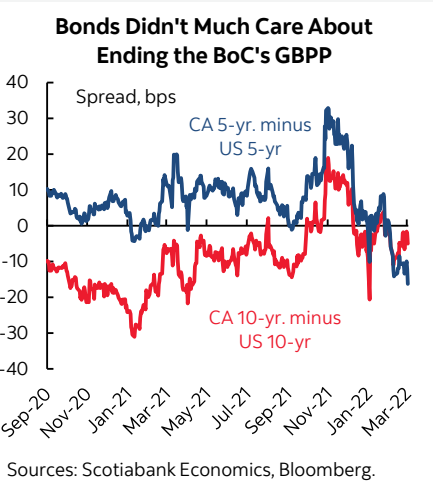


Chart 2



## BoC Commences Aggressive Tightening Path, QT Next

- The BoC has started the hike cycle. Expect steady tightening.
- Statement language was incrementally hawkish
- QT was not expected and not delivered...
- ...but tomorrow's Macklem speech could lay out the parameters

The hawks laid a beating on the doves at the Bank of Canada as the Governing Council did what they should have done in January and arguably earlier than that.

The statement-only affair met our expectations for a 25bps hike while offering no concrete steps yet on changing reinvestment plans. The statement language escalated concern toward inflationary pressures and builds on our confidence toward expecting a series of rate hikes going forward ending 2022 with a policy rate of 2% from 0.5% now.

### MARKET VOLATILITY ENSUED

Markets were at first rather volatile in response but eventually got the message. In fact, the moves in rates and CAD looked like the most compressed set of oscillating sugar rushes and crashes that I've ever seen traders experience. The Canada two-year yield, for instance, was rallying a bit into the statement, then sold off by spiking 3bps, then rallied by 4bps and is now back to the high point on the day which is about 11bps higher than yesterday. USDCAD went for a somewhat similar ride by rallying a touch into the statement, then cheapening, and now it's back to being about ¾ of a cent firmer to the USD on the day.

Why such a mixed market reaction? I think it was because markets may have initially perceived the BoC to be more hawkish but then covered as they awaited the full messaging from Chair Powell. The hawkish reaction was reasserted upon hearing Powell guide that he too is leaning toward a series of rate hikes going forward. Monetary policy is clearly pivoting toward a more hawkish stance on both sides of the border.

### NO QT GUIDANCE—YET

The alternative explanation for the initial market oscillations that some may prefer is that the BoC disappointed by not embracing quantitative tightening through laying out its parameters to reduce the pace at which it allows maturing holdings of Government of Canada bonds to drop off the balance sheet. I think that interpretation is misguided.

I had not expected the BoC to embrace a pivot toward curtailing reinvestment today as a base case scenario and I doubt that many did. The BoC's emphasis upon methodically managing the message to death before acting would have been violated had they sprung reinvestment plans today without having previously guided their specific intentions in advance.

The focus therefore shifts toward tomorrow's speech by Governor Macklem and his press conference. I think that's where we might see the BoC lay out its reinvestment guidelines on key points such as how much of a reduction in reinvested maturing flows it intends as a first step and the potential pace thereafter including the factors that may govern this pace.

My expectation remains that a plausible scenario is for the BoC to pursue a path of measured reductions in gross purchases from the present C\$4-5B/month with reductions of \$1-2B per MPR meeting on the path toward fully ending reinvestment and thus dropping roll-off caps within 9-12 months. That path is the green line in chart 1. A more aggressive path is feasible and in my personal opinion would be justified, but the BoC is very unlikely to have the appetite to do what the RBNZ did in abruptly ending reinvestment and embracing managed asset sales.

March 2, 2022

The rate equivalence to such a reduction of reinvestment toward full roll-off would probably be very low which is one reason why you hear the BoC reinforcing that the policy rate will be the primary tool they rely upon as they tighten monetary policy.

How so? Well, for two reasons. For one, the BoC's staff research itself says the Government of Canada Bond Purchase Program had little effect upon yields ([here](#)). They deemed that the initial announcement effect of the GBPP was a miniscule -10bps and that the ensuing flow effect was modest, transitory and typically lasting only a handful of trading days after each action. If it had little effect going in, it should have little effect going out in relation to other more important global drivers such as the actions of bigger central banks and global developments.

Think the staffers aren't market savvy enough to reach such a conclusion on the effects of the GBPP program independent of other forces guiding bond yields? Well, alright, let's look at how you traded then. Chart 2 shows that the period of time since just before the BoC started to taper bond purchases in October 2020 to after they had fully ended quantitative easing last October was marked by indifference in Canadian bond spreads to comparable maturity US bonds. As the Fed continued to buy by the truckload, the market couldn't have cared less about the BoC shutting down its own purchase program.

I think that should assuage any concerns the BoC has about abruptly exiting the reinvestment phase. The BoC is likely to be slow and gradual in its approach because, well, that's their nature, but either way, it's likely to be very tough to discern market effects relative to other developments whether they go cold turkey on reinvestment or drag it out for a long time.

Hence, we're back to the guidance around the policy rate as the bigger issue.

### STATEMENT GUIDANCE WAS DECIDEDLY MORE HAWKISH

As for the statement language that informed the hawkish pivot here are the most salient points.

- First, I thought the line about how "Persistently elevated inflation is increasing the risk that longer-run inflation expectations could drift upwards" was the BoC's version of shouting fire in a packed room. The risk of unmoored inflation expectations is striking the fear of Milton Friedman into the Governing Council as it would almost any other central bank.
- Second, the BoC noted that "inflation is now expected to be higher in the near term than projected in January" and this is partly due to their sensible assessment that "The invasion of Ukraine is putting further upward pressure on prices for both energy and food-related commodities."
- Third, while the prior statement pivoted toward embracing rate hikes, this statement reaffirmed that the Governing Council has in mind a path marked by a series of hikes. They did so by noting that "interest rates will need to rise further."
- They also acknowledged that Q4 GDP growth of 6.7% was stronger than they anticipated in the January MPR when they had forecast growth of 5.8%. They also noted that Q1 GDP growth "is now looking more solid than previously projected" given they had forecast GDP growth of 2% in Q1.
- At the global level, on the one hand they describe global economic data as evolving in line with their expectations, but go on to say that "economies are emerging from the impact of the Omicron variant of COVID-19 more quickly than expected." That hints at possible upward forecast revisions before further assessing the role of the war in Ukraine.

### THE REACTION FUNCTION HAS FUNDAMENTALLY CHANGED

Most important of all is that the BoC is completing the full pivot away from its pollyannaish views toward inflation risk that marked developments until late last year. The Governor and Governing Council had clung to a view that inflation was just driven by year-ago base effects with very low breadth and that it would prove to be transitory in nature once temporary reopening effects subsided and in the context of no wage growth. In arguing against that view since the end of 2020 I'm now pleased to see them getting serious by acknowledging that "price increases have become more pervasive, and measures of core inflation have all risen" while reinforcing their recent pivot toward finally acknowledging wage pressures. The BoC lost precious time in the fight against inflation by pivoting too late and now faces a more arduous effort toward getting the genie back in the bottle without derailing the economy.

The point here is that markets should have little doubt that the BoC is embarking upon a *path* of rising rates toward something more neutral and in keeping with our 2% year-end policy rate forecast. I would personally tilt the risks toward perhaps moving faster than slower than that. They have fundamentally abandoned their prior inflation narrative and realize they have a lot of work to do to restore credibility going forward.

**KEY RISKS**

On the mixed side of their communications is the fair acknowledgement that the war in Ukraine is “a major new source of uncertainty.” They walked the line between noting “this will add to inflation around the world” while it could “weigh on global growth.” Their bottom line is sensibly conveyed as “following events closely.” To an inflation-targeting central bank that is far behind in the fight against inflation, it would take a severely damaging outcome for global and domestic growth to pivot away from focusing upon escalating inflation risk. That’s not impossible by any means and so monitoring systemic risk and spillover effects has taken on heightened importance as the war and the response of the allies have unfolded.

The path for oil prices from here is an added uncertainty partly due to Ukraine and partly due to OPEC+ sticking it to global consumers. With the usual caveat that futures prices may not accurately forecast future spot prices, the oil futures curve is signalling that oil prices may be temporarily overshooting (chart 3). Still, even the outer period of the curve is indicating high enough oil prices to support most projects’ break-evens.

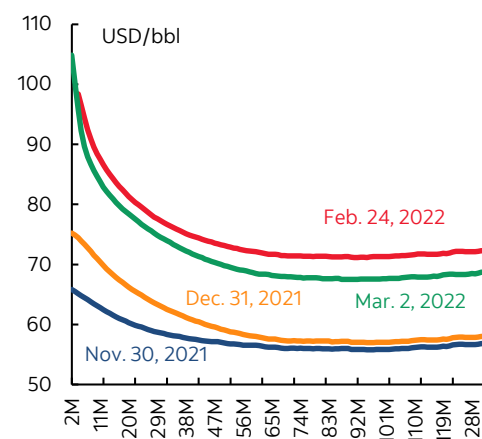
Please see the accompanying statement comparison.

Governor Macklem will deliver his Economic Progress Report tomorrow at 11:30amET and will host a press conference at about 12:45pmET.

The next BoC meeting will be on April 13th when revised projections, the full Monetary Policy Report and a press conference will accompany the statement.

**Chart 3**

**WTI Forward Curves**



Sources: Scotiabank Economics, Bloomberg.

March 2, 2022

**RELEASE DATE: March 2, 2022**

The Bank of Canada today **increased its target for the overnight rate** to ½ %, with the Bank Rate at ¾ % and the deposit rate at ½ %. The Bank is continuing its reinvestment phase, keeping its overall holdings of Government of Canada bonds on its balance sheet roughly constant until such time as it becomes appropriate to allow the size of its balance sheet to decline.

**The unprovoked invasion of Ukraine by Russia is a major new source of uncertainty. Prices for oil and other commodities have risen sharply. This will add to inflation around the world, and negative impacts on confidence and new supply disruptions could weigh on global growth. Financial market volatility has increased. The situation remains fluid and we are following events closely.**

Global economic data has come in broadly in line with projections in the Bank's January *Monetary Policy Report* (MPR). **Economies are emerging from the impact of the Omicron variant of COVID-19 more quickly than expected**, although the virus continues to circulate and the possibility of new variants remains a concern. Demand is robust, particularly in the United States. **Global supply bottlenecks remain challenging, although there are indications that some constraints have eased.**

Economic growth in Canada was very strong in the fourth quarter of last year at 6.7%. **This is stronger than the Bank's projection and confirms its view that economic slack has been absorbed.** Both exports and imports have picked up, consistent with solid global demand. In January, the recovery in Canada's labour market suffered a setback due to the Omicron variant, with temporary layoffs in service sectors and elevated employee absenteeism. However, **the rebound from Omicron now appears to be well in train:** household spending is proving resilient and should strengthen further with the lifting of public health restrictions. Housing market activity is more elevated, adding further pressure to house prices. **Overall, first-quarter growth is now looking more solid than previously projected.**

CPI inflation is currently at 5.1%, as expected in January, and remains well above the Bank's target range. **Price increases have become more pervasive, and measures of core inflation have all risen.** Poor harvests and higher transportation costs have pushed up food prices. **The invasion of Ukraine is putting further upward pressure on prices for both energy and food-related commodities. All told, inflation is now expected to be higher in the near term than projected in January.** Persistently **elevated inflation is increasing the risk that longer-run inflation expectations could drift upwards.** The Bank will use its monetary policy tools to return inflation to the 2% target and keep inflation expectations well-anchored.

The policy rate is the Bank's primary monetary policy instrument. As the economy continues to expand and inflation pressures remain elevated, **the Governing Council expects interest rates will need to rise further. The Governing Council will also be considering when to end the reinvestment phase and allow its holdings of Government of Canada bonds to begin to shrink.** The resulting quantitative tightening (QT) would complement increases in the policy interest rate. The timing and pace of further increases in the policy rate, and the start of QT, will be guided by the Bank's ongoing assessment of the economy and its commitment to achieving the 2% inflation target.

**RELEASE DATE: January 26, 2022**

The Bank of Canada today **held its target for the overnight rate** at the effective lower bound of ¼ %, with the Bank Rate at ½ % and the deposit rate at ¼ %. With overall economic slack now absorbed, the Bank has removed its exceptional forward guidance on its policy interest rate. The Bank is continuing its reinvestment phase, keeping its overall holdings of Government of Canada bonds roughly constant.

**The global recovery from the COVID-19 pandemic is strong but uneven.**

The US economy is growing robustly while growth in some other regions appears more moderate, especially in China due to current weakness in its property sector. Strong global demand for goods combined with supply bottlenecks that hinder production and transportation are pushing up inflation in most regions. As well, oil prices have rebounded to well above pre-pandemic levels following a decline at the onset of the Omicron variant of COVID-19. Financial conditions remain broadly accommodative but have tightened with growing expectations that monetary policy will normalize sooner than was anticipated, and with rising geopolitical tensions. Overall, the Bank projects global GDP growth to moderate from 6¾ % in 2021 to about 3½ % in 2022 and 2023.

In Canada, **GDP growth in the second half of 2021 now looks to have been even stronger than expected.** The economy entered 2022 with considerable momentum, and a broad set of measures are now indicating that economic slack is absorbed. With strong employment growth, the labour market has tightened significantly. Job vacancies are elevated, hiring intentions are strong, and wage gains are picking up. Elevated housing market activity continues to put upward pressure on house prices.

**The Omicron variant is weighing on activity in the first quarter.** While its economic impact will depend on how quickly this wave passes, it is expected to be less severe than previous waves. Economic growth is then expected to bounce back and remain robust over the projection horizon, led by consumer spending on services, and supported by strength in exports and business investment. After GDP growth of 4½ % in 2021, the Bank expects Canada's economy to grow by 4% in 2022 and about 3½ % in 2023.

CPI inflation remains well above the target range and core measures of inflation have edged up since October. Persistent supply constraints are feeding through to a broader range of goods prices and, combined with higher food and energy prices, are expected to keep CPI inflation close to 5% in the first half of 2022. As supply shortages diminish, inflation is expected to decline reasonably quickly to about 3% by the end of this year and then gradually ease towards the target over the projection period. Near-term inflation expectations have moved up, but longer-run expectations remain anchored on the 2% target. **The Bank will use its monetary policy tools to ensure that higher near-term inflation expectations do not become embedded in ongoing inflation.**

While COVID-19 continues to affect economic activity unevenly across sectors, the Governing Council judges that overall slack in the economy is absorbed, thus satisfying the condition outlined in the Bank's forward guidance on its policy interest rate. The Governing Council therefore decided to end its extraordinary commitment to hold its policy rate at the effective lower bound. Looking ahead, the **Governing Council expects interest rates will need to increase**, with the timing and pace of those increases guided by the Bank's commitment to achieving the 2% inflation target.

The Bank will keep its holdings of Government of Canada bonds on its balance sheet roughly constant at least until it begins to raise the policy interest rate. At that time, the Governing **Council will consider exiting the reinvestment phase and reducing the size of its balance sheet** by allowing roll-off of maturing Government of Canada bonds.

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