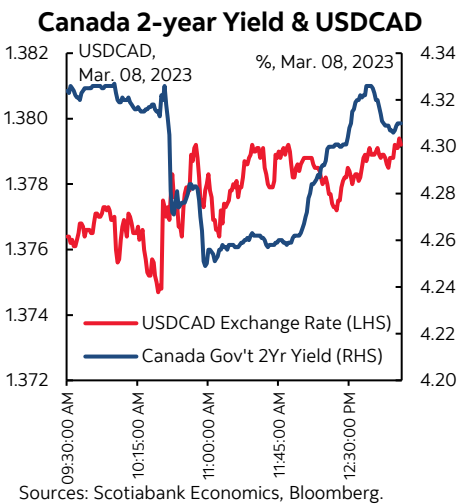


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Chart 1



The BoC's Homemade C\$ Problem

- The policy rate was left on hold as expected
- The BoC still warns that rates may go move higher if needed...
- ...but the rest of the statement indicates they don't really believe it...
- ...and so financial conditions eased...
- ...and CAD remains a one way weakening bet
- Developments will come to challenge what the BoC did today

BoC overnight rate, %:

Actual: 4.5

Scotia: 4.5

Consensus: 4.5

Prior: 4.5

The Bank of Canada left its policy rate unchanged at 4.5% as universally expected including by Scotiabank Economics.

The bias may prove to be a different matter altogether. As the Fed contemplates a potentially more hawkish data dependent turn, the Bank of Canada took a step in the opposite direction in this morning's statement.

The result was a mild easing of financial conditions marked by a rally in shorter-term Canadian rates as the two-year Government of Canada bond yield moved lower while the two-year US yield is higher on the day. CAD depreciated as USDCAD marches toward 1.39 in the aftermath. That would match the level that triggered Macklem's caution last October that rates would have to compensate. See chart 1 for intraday movements.

CAD depreciation would have been even greater had Chair Powell not reined in some of yesterday's rally in the USD and the sell-off in shorter term US rates by emphasizing in his testimony before the House this morning that "no decisions have been made" as the Fed watches key upcoming reports like payrolls and CPI. That was clear in the conditionality he placed on forward guidance yesterday but I guess markets needed to hear it more clearly. Should those US reports land broadly in line with expectations, then CAD's vulnerability could be higher as the figures roll in partly on the Fed bets and partly on the interpretation of the BoC's statement today.

On balance, I think the BoC is vulnerable going forward and still position the risk to the policy rate moving higher. Explaining why requires parsing through the key changes in the statement starting with hawkish signals and then how the statement took them back.

OPEN TO FURTHER HIKES, BUT NOT REALLY

The BoC repeated guidance that it "is prepared to increase the policy rate further if needed to return to the 2% target. The problem is that the rest of the statement indicated they really don't believe it but perhaps felt they had to throw it in to a further premature easing of financial conditions. The rest of the statement watered down this commitment.

ACKNOWLEDGED EXTERNAL STRENGTHS

The statement did say that they think developments for growth and inflation in the US and Europe "are both somewhat higher than expected" in the January MPR. They go on to note that "...labour markets remain tight, and elevated core inflation is persisting." Other external references are unchanged and continue to note upside risk to commodity prices due to China's rebound and the war in Ukraine.

March 8, 2023

LOOKING THROUGH Q4 GDP

The BoC did encouragingly acknowledge that Q4 GDP wasn't as weak under the hood as the headline indicated which is encouraging since had they not done so then it would have signalled greater concern and dovishness. They did so by noting:

"In Canada, economic growth came in flat in the fourth quarter of 2022, lower than the Bank projected. With consumption, government spending and net exports all increasing, the weaker-than-expected GDP was largely because of a sizeable slowdown in inventory investment."

That's consistent with how I viewed the figures. They could have also gone one step further, however, and noted the list of temporary distortions to December GDP that made it a negative when absent a US oil spill that shut Canadian oil flows, two train derailments and harsher than usual weather effects the month would have been a solid plus, but they either chose not to or neglected to do so.

STRONG DOMESTIC LABOUR MARKETS

The statement noted that labour markets remain "very tight" and that job growth has been "surprisingly strong." They reference wage growth at 4–5% using y/y figures, and how "productivity has declined in recent quarters." That is also relatively hawkish.

EXCESS DEMAND IS GONE ALREADY?

As for the dovish take-back, first up is that they suddenly think that after one GDP report the Canadian economy has wiped out excess demand. We can see that through omission since gone are two references in the prior statement to how the economy remains in excess demand. If that's an oversight, then it's a pair of pretty big ones and not something that I believe in. Let's see if they fudge potential GDP and update neutral rate estimates.

NOT WORD ON A LIKELY Q1 REBOUND

Second, the BoC may be leaving guidance on Q1 GDP to the April MPR, but what concerns me is the line about how they expect "weak economic growth for the next couple of quarters." Eventually that's possible, but if they include Q1 in "the next couple of quarters" then that might be inappropriate.

That's because I think Q1 could rebound much more quickly than the 0.5% q/q SAAR growth forecast they had in the January MPR after the Q4 disappointment when it was flat versus their 1.3% forecast. They may have to punt some of the Q4 disappointment into a stronger Q1. This morning's trade figures offer a strong net addition being tracked in terms of Q1 GDP. The reversal of temporary effects on December GDP may support this rebound. The biggest inventory drag effect on GDP growth in 40+ years could also stabilize or be a net addition to growth in Q1.

But meh, they didn't even reference Q1 tracking. I think they may be vulnerable to an upside surprise. That could also mean that while it's highly unlikely that the economy is no longer in a state of excess demand, a Q1 GDP rebound would make striking out such references all the more curious in nature.

PRICING POWER WILL EASE?

Third, they indicate that they expect pricing power to diminish. This comes in the following remark:

"With weak economic growth for the next couple of quarters, pressures in product and labour markets are expected to ease. This should moderate wage growth and also increase competitive pressures, making it more difficult for businesses to pass on higher costs to consumers."

If Q1 GDP rebounds and given ongoing strength in the job market and awful productivity then the case for sustained evolution of core inflationary pressures toward the 2% headline target may be stated prematurely here.

NO SIGNS THEY ARE FUSSED BY CAD

A further case for this argument is that apparently, CAD isn't enough of a concern to the BoC just yet. We'll see what SDG Rogers says about it tomorrow if anything. The only reference was to strike out how the C\$ "has been relatively stable against the US dollar" and replace it with "...the US dollar has strengthened."

If the Fed is on the march to 6% and the BoC is turning dovish at the margin then CAD has 1.40 in its sights. That will challenge the BoC's assertion that it will be more difficult to pass on cost pressures. I think they did a misstep here and are sitting ducks to currency traders.

March 8, 2023

STILL SUBSCRIBING TO THE BASE EFFECT HOAX

The BoC says that 3% inflation by mid-year lies ahead. They've learned nothing about putting too much stock in base effect distortions. That's what misled them in 2021 when they dismissed inflation as driven by weakness the prior year and nothing more. Now they're emphasizing how year-ago base effects will drag inflation lower.

"Both will need to come down further, as will short-term inflation expectations, to return inflation to the 2% target."

CONCLUSION

In all likelihood the BoC probably continues to think that the key risks surround services inflation, productivity and wage growth as Governor Macklem emphasized in his recent speech in Quebec City. There were not many statement-codified indications of this, however, and there were enough curious twists that lead me to think this story isn't over yet. Apparently markets continue to agree as they continue to price a full quarter point rate hike by summer. If the BoC comes back at all, then it won't be for just a quarter point in my view, but putting down such a market placeholder remains prudent between binary options of no change and 50–75bps of further hikes.

Please also see the attached statement comparison.

March 8, 2023

RELEASE DATE: March 8, 2023

The Bank of Canada today held its target for the overnight rate at 4½%, with the Bank Rate at 4¾% and the deposit rate at 4½%. The Bank is also continuing its policy of quantitative tightening.

Global economic developments have evolved broadly in line with the outlook in the January Monetary Policy Report (MPR). Global growth continues to slow, and inflation, while still too high, is coming down due primarily to lower energy prices. **In the United States and Europe, near-term outlooks for growth and inflation are both somewhat higher than expected in January. In particular, labour markets remain tight, and elevated core inflation is persisting.** Growth in China is rebounding in the first quarter. Commodity prices have evolved roughly in line with the Bank's expectations, but the strength of China's recovery and the impact of Russia's war in Ukraine remain key sources of upside risk. **Financial conditions have tightened since January, and the US dollar has strengthened.**

In Canada, economic growth came in flat in the fourth quarter of 2022, lower than the Bank projected. With consumption, government spending and net exports all increasing, the weaker-than-expected GDP was largely because of a sizeable slowdown in inventory investment. Restrictive monetary policy continues to weigh on household spending, and business investment has weakened alongside slowing domestic and foreign demand.

The labour market remains very tight. Employment growth has been surprisingly strong, the unemployment rate remains near historic lows, and job vacancies are elevated. Wages continue to grow at 4% to 5%, while **productivity has declined in recent quarters.**

Inflation eased to 5.9% in January, reflecting lower price increases for energy, durable goods and some services. Price increases for food and shelter remain high, causing continued hardship for Canadians. **With weak economic growth for the next couple of quarters, pressures in product and labour markets are expected to ease. This should moderate wage growth and also increase competitive pressures, making it more difficult for businesses to pass on higher costs to consumers.**

Overall, the latest data remains in line with the Bank's expectation that CPI inflation will come down to around 3% in the middle of this year. Year-over-year measures of core inflation ticked down to about 5%, and 3-month measures are around 3½%. Both will need to come down further, as will short-term inflation expectations, to return inflation to the 2% target.

At its January decision, the Governing Council indicated that it expected to hold the policy interest rate at its current level, conditional on economic developments evolving broadly in line with the MPR outlook. Based on its assessment of recent data, Governing Council decided to maintain the policy rate at 4½%. Quantitative tightening is complementing this restrictive stance. Governing Council will continue to assess economic developments and the impact of past interest rate increases, and is prepared to increase the policy rate further if needed to return inflation to the 2% target. The Bank remains resolute in its commitment to restoring price stability for Canadians.

RELEASE DATE: January 25, 2023

The Bank of Canada today increased its target for the overnight rate to 4½%, with the Bank Rate at 4¾% and the deposit rate at 4½%. The Bank is also continuing its policy of quantitative tightening.

Global inflation remains high and broad-based. Inflation is coming down in many countries, largely reflecting lower energy prices as well as improvements in global supply chains. **In the United States and Europe, economies are slowing but proving more resilient than was expected at the time of the Bank's October Monetary Policy Report (MPR).** China's abrupt lifting of COVID-19 restrictions has prompted an upward revision to the growth forecast for China and poses an upside risk to commodity prices. Russia's war on Ukraine remains a significant source of uncertainty. **Financial conditions remain restrictive but have eased since October, and the Canadian dollar has been relatively stable against the US dollar.**

The Bank estimates the global economy grew by about 3½% in 2022, and will slow to about 2% in 2023 and 2½% in 2024. This projection is slightly higher than October's.

In Canada, recent economic growth has been stronger than expected and the economy remains in excess demand. Labour markets are still tight: the unemployment rate is near historic lows and businesses are reporting ongoing difficulty finding workers. However, there is growing evidence that restrictive monetary policy is slowing activity, especially household spending. Consumption growth has moderated from the first half of 2022 and housing market activity has declined substantially. As the effects of interest rate increases continue to work through the economy, spending on consumer services and business investment are expected to slow. Meanwhile, weaker foreign demand will likely weigh on exports. This overall slowdown in activity will allow supply to catch up with demand.

The Bank estimates Canada's economy grew by 3.6% in 2022, slightly stronger than was projected in October. Growth is expected to stall through the middle of 2023, picking up later in the year. The Bank expects GDP growth of about 1% in 2023 and about 2% in 2024, little changed from the October outlook.

Inflation has declined from 8.1% in June to 6.3% in December, reflecting lower gasoline prices and, more recently, moderating prices for durable goods. Despite this progress, Canadians are still feeling the hardship of high inflation in their essential household expenses, with persistent price increases for food and shelter. Short-term inflation expectations remain elevated. Year-over-year measures of core inflation are still around 5%, but 3-month measures of core inflation have come down, suggesting that core inflation has peaked.

Inflation is projected to come down significantly this year. Lower energy prices, improvements in global supply conditions, and the effects of higher interest rates on demand are expected to bring CPI inflation down to around 3% in the middle of this year and back to the 2% target in 2024.

With persistent excess demand putting continued upward pressure on many prices, Governing Council decided to increase the policy interest rate by a further 25 basis points. The Bank's ongoing program of quantitative tightening is complementing the restrictive stance of the policy rate. If economic developments evolve broadly in line with the MPR outlook, Governing Council expects to hold the policy rate at its current level while it assesses the impact of the cumulative interest rate increases. Governing Council is prepared to increase the policy rate further if needed to return inflation to the 2% target, and remains resolute in its commitment to restoring price stability for Canadians.

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