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GLOBAL ECONOMICS

SCOTIA FLASH

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The BoC May Already be Regretting What it Did Today

- **No policy changes were announced**
- **The BoC requires more evidence before cutting**
- **Yet Macklem left the door open to going as early as June...**
- **...which seems like a stretch call to us**
- **The BoC totally fudged its estimate of slack...**
- **...by going high on potential GDP for shaky reasons**
- **Macklem seriously overstates BoC independence from the Fed...**
- **...that, after US CPI, faces a higher bar to cut at all this year**

Well, that was a bit of an odd one. At the end of it all through US CPI, the BoC and FOMC minutes, it's clear that the hawks are in charge.

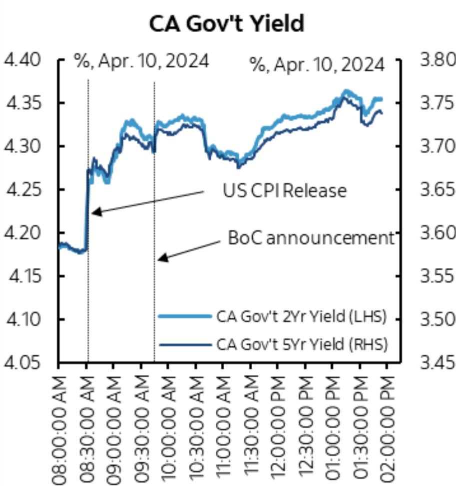
Everything about the overall suite of communications (**here**, **here**, and **here** plus the presser) went roughly in line with our expectations until Governor Macklem said that a cut in June was possible and until it became clear that the BoC was playing games with one key made-up number. And yet markets still ignored him, though rightly so in my opinion.

Markets had a tough time believing his remark. June cut pricing was reduced by about 7bps once the dust settled after US CPI and the full suite of BoC communications. The full forward rate path was revised *higher* to show fewer cuts as the Canada 2s yield is up about 17bps on the day at 4.36% and the Canada 5s yield is 16bps higher at about 3¾%. CAD is 1.2 cents weaker relative to the USD on the day.

The only thing that mattered to 2s was US CPI as they entirely shook off everything about the BoC and/or see it very differently to Macklem's casual remark about June. I am in agreement with how the markets incrementally reacted. In fact, you could argue that markets delivered a message that they see an intensifying credibility problem at the BoC.

Charts 1–3 show the market reactions to both US CPI and the BoC on the day so far.

Chart 1



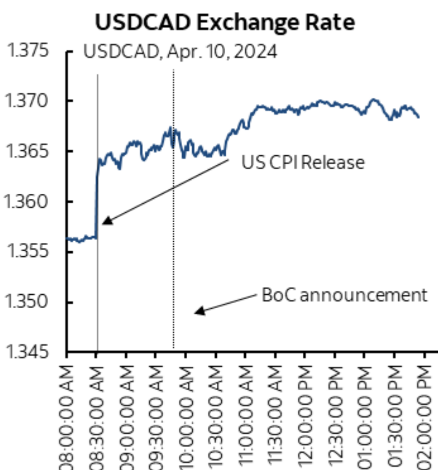
Sources: Scotiabank Economics, Bloomberg.

WHAT THEY DID

Before turning to the issue of June, here's what they did today.

The policy rate was left unchanged at 5% as universally expected. Quantitative tightening was left intact as also universally expected.

Chart 2



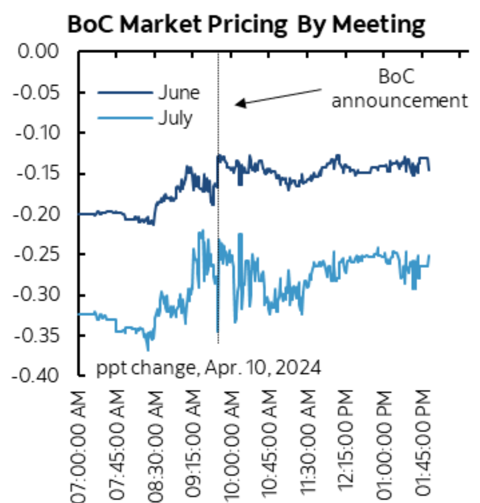
Sources: Scotiabank Economics, Bloomberg.

Statement guidance made it clear they want more evidence of soft inflation than just the two recent reports before deciding whether to cut. The final paragraph said:

> "While inflation is still too high and risks remain, CPI and core inflation have eased further in recent months. The Council will be looking for evidence that this downward momentum is sustained. "

That suggested they weren't totally convinced that the two soft readings for core inflation in January and February were more than "just a temporary dip" as the Governor's opening comments to his press conference put it.

Chart 3



Sources: Scotiabank Economics, Bloomberg.

That all left us with statement-codified guidance in line with our expectations in terms of being sidelined while waiting for more data.

OTHER STATEMENT CHANGES

Other statement changes are highlighted in the appendix. The changes generally didn't convey a need to rush cuts.

The changes flagged that "overall financial conditions have eased" compared to their prior assessment and due to higher oil prices, narrower corporate credit spreads, and "sharply" higher equities. Cut? Not on that count.

They also noted that the US economy has "again proven stronger" while they revised up global, US and Canadian GDP projections. Also of note is reference to how the output gap will eliminate excess supply over the medium-term. Last, they said that core inflation is still too high but that there are signs it may be slowing while very, very debatedly claiming there are signs wage growth is maybe moderating.

FORECAST REVISIONS

The BoC is now more upbeat on GDP growth especially in terms of dropping the gloomy language they used to have. They revised US growth way higher to 2.7% this year from 1.7% previously. They also revised next year up to 1.8% from 1.2%.

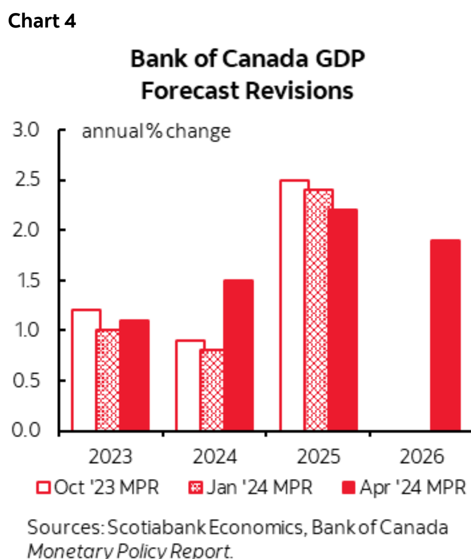
Global growth was revised up to 2.8% from 2.5% in 2024 and 3% in 2025 from 2.7%.

They also revised up Canadian growth from 0.8% this year to about double that at 1.5%, but partially at the expense of next year (2.2%, 2.4% prior). Chart 4.

There may still be upside to the BoC's quarterly projection for Canada. They massively revised Q1 GDP growth higher to 2.8% from 0.5% previously and they are extending that to Q2 that they expect to grow by 1.5%. We think growth is tracking considerably over 3%.

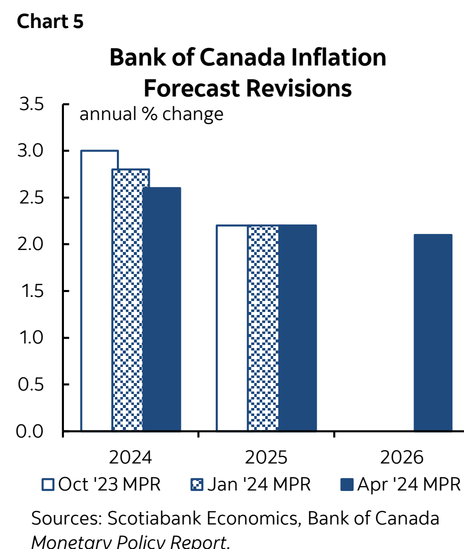
This is all very significant. He didn't say it, but the BoC basically threw out its old narrative that peak rate pain would hit the economy in 2024H1. Not only is there no recession in their forecasts, it's not even really a significant soft patch. That should have been reason to turn more hawkish at the margin and I'll come back to why they didn't in a moment—and why that's open to questioning. But the BoC needs to be held accountable for misjudging the prospects of a rebound because they overplayed the argument that GDP was weak last year only due to tighter monetary policy and not strikes, wildfires, project interruptions, inventory shedding etc. Macklem can dance rather well.

Chart 4



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

Chart 5



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

Inflation forecasts were revised lower this year but that's largely a marking-to-market exercise (chart 5). They left the path thereafter unchanged.

NO APPETITE FOR A CUT TODAY

Some on the street had been suggesting that the BoC should be cutting today. They had no allies on the Governing Council. When Macklem was asked whether they discussed cutting rates today, he said "There was a clear consensus to hold at 5%. We agreed we wanted more time to see that inflation progress is durable. We also agreed it would be appropriate to cut if we are on that path with further evidence. That said there is diversity of opinions on Gov Council but for the decision today there was a clear consensus to hold today."

A JUNE CUT? YOU DON'T SAY?

Clearly when the Governor says that June is basically a 'live' meeting then that's material information. When asked directly about whether a cut in June was within the realm of possibilities he said:

> "Yes, it's in the realm of possibilities. We've been pretty clear we like what we've been seeing since January. Inflation and core inflation have come down. Things are moving in the right direction. We're encouraged by that progress. We need to see that

progress continue. If things evolve broadly in line with the outlook we published today then we will be more confident we are on the right path and it will be more appropriate to cut our interest rates."

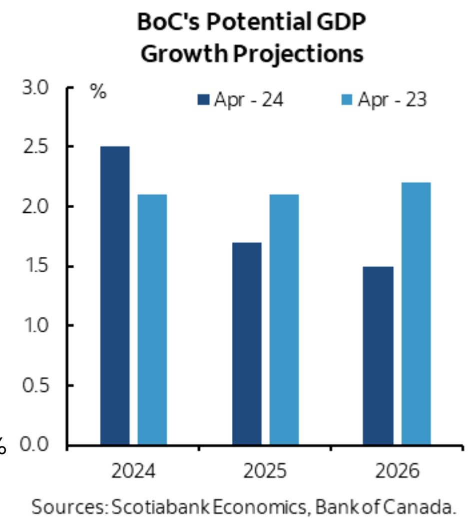
In my opinion, a cut in June requires absolute perfection between now and then which means there is a material risk that Macklem was somewhat careless today. Like no crazy Spring housing market when the signs point toward a robust season. That Freeland doesn't ramp it up next week and add more growth upside in yet another expansionary Budget before what will probably be another one in an election year next year. That the next two core inflation readings are soft when they might have been temporarily soft over the past couple of months. That Q1 GDP 5 days before the June decision doesn't face further upside to their conservative estimate today. That the Fed doesn't go less dovish or more hawkish after this morning's CPI. That US CPI is irrelevant to Canadian CPI. That oil stabilizes. And that CAD doesn't totally crater.

Piece of cake, huh?! Hmph. I'll believe it when I see it and think there is high risk of another policy error.

One possibility is that if they do cut in June—whether or not the data goes their way—and if Fed cuts are pushed down and out, then maybe that's it for the year. Or one more. Markets are basically saying they'll only cut twice this year and so they're leaning in that direction. Leaning, in other words, in the direction of only token easing because they're not buying the case for a whole lot to be done this year.

What I'm conveying is that I would be really careful toward pricing the path after June especially if it turns out to be premature which I think it strongly risks becoming. Governor Macklem's BoC has been a walking policy accident throughout his tenure in my opinion by ignored all the signs of soaring inflation and then having to deliver bigger hikes than had he acted sooner. Prematurely easing now on the back of such remarkably thin evidence could be an extension of this track record.

Chart 6



Sources: Scotiabank Economics, Bank of Canada.

So onto watching data. But remember, he only that said June was possible. It could very easily turn out not to be.

THE BANK OF CANADA'S POTENTIAL GROWTH ASSUMPTIONS LOOK RATHER SKETCHY

So what gives? How can you sharply revise growth higher everywhere—which should mean less slack—and yet expedite possible talk of a cut as soon as June?

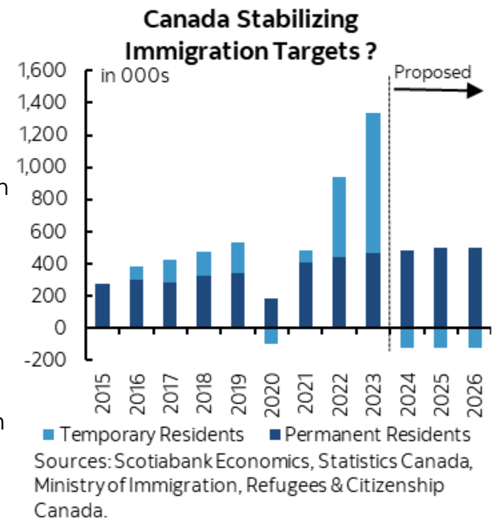
Because they're *not* saying there is less slack. They are saying the output gap remains in a –0.5% to –1.5% range in 2024Q1 "which is roughly unchanged compared with the estimate for the fourth quarter of 2023."

How convenient. It never happened, that growth surprise. Pfft, didn't see that. Nothing changed.

How did they arrive at that conclusion? By fudging a variable that nobody can really estimate.

Enter the granddaddy of all fudge factors in central banking: potential GDP. I never trust these estimates as they are largely guesswork. And yet, the BoC went high compared to what we thought they might do and that explains much of the controversy behind the BoC's overall communications today.

Chart 7



Sources: Scotiabank Economics, Statistics Canada, Ministry of Immigration, Refugees & Citizenship Canada.

The BoC now says that the economy's noninflationary speed limit to growth this year is between 2.1–2.8% versus previously being biased lower in a range from 1.0–3.2%. Their base case potential growth assumption is 2.5% this year which is up from 2.1% previously (chart 6). That's significant because it cancels out the implications of much stronger actual GDP growth compared to what they had anticipated for 2023Q4 and 2024Q1.

The rationale for sharply revising potential GDP higher is population growth. They are saying that effect is temporary and so that's why they revised down their estimate for potential growth in 2025 (1.7% from 2.1%) and 2026 (1.5% from 2.2%). The reason it's temporary is because—as I've flagged—the government's targeted reduction in nonpermanent residents will weigh on population growth.

Did they go high on potential now and too low in future in order to make their numbers sing in terms of estimated economic slack? This has a strong feeling of doing just that.

The reason I think that is because they're treating nonpermanent residents that drove so much of the population surge over the past year (chart 7) as a boon to the economy's speed limit that is on par with what permanent residents would have driven. It's like they are treating the two types of immigration as equivalent in terms of the broad population count. Well I'm not buying it and I think the BoC needs to be strongly called out on this.

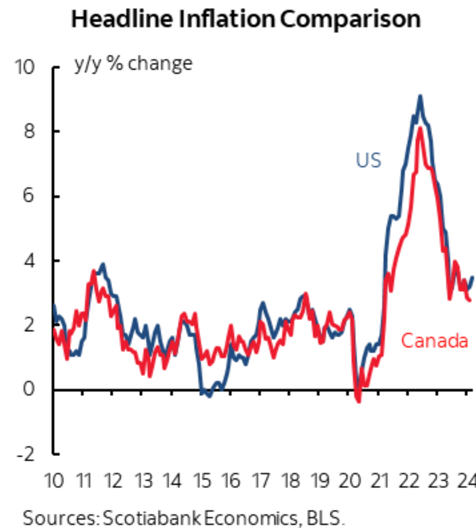
Nonpermanent residents include temporary foreign workers, international students and asylum seekers. They are nowhere close to being substitutes for the resident population and permanent resident immigration in terms of contributing to potential output growth and yet that seems to be the assumption the BoC is going with.

In my view, the economy has *less* slack now than the BoC is conveying through their output gap fudging. That's less disinflationary. I'm concerned that the BoC is conveying a deep confirmation bias and concerned about the optics of being under political pressure to sound dovish when there is scant evidence in favour of doing so.

WHY THE BOC CAN'T JUST IGNORE US INFLATION AND THE FEDERAL RESERVE

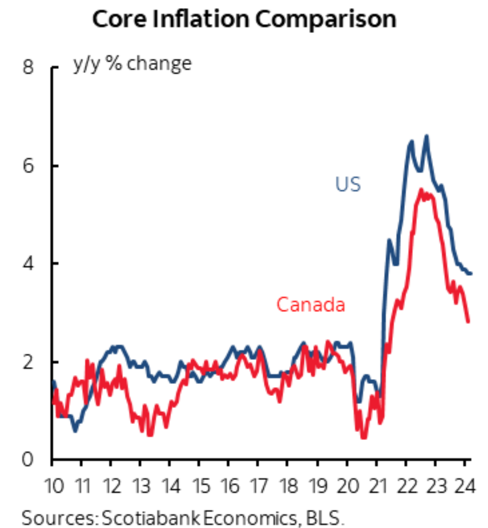
In terms of the data watch, near the top of the list is next week's Canadian CPI. I went with 0.7% m/m NSA and 3% y/y. It's nearly impossible to estimate the trimmed mean and weighted median gauges.

Chart 8



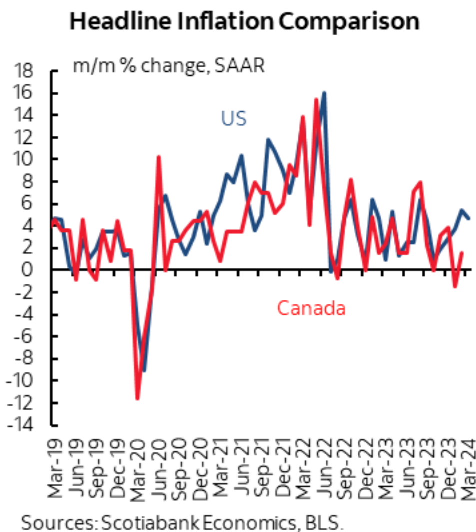
Sources: Scotiabank Economics, BLS.

Chart 9



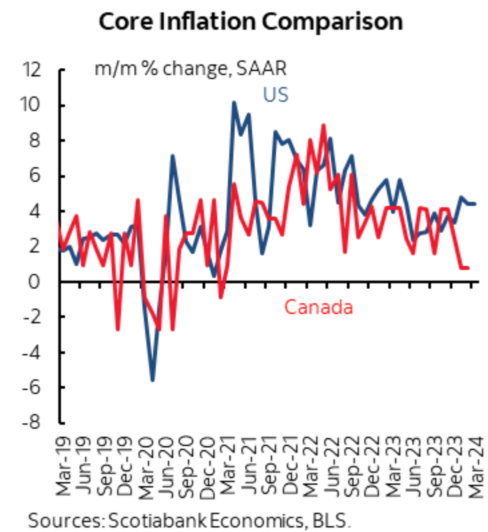
Sources: Scotiabank Economics, BLS.

Chart 10



Sources: Scotiabank Economics, BLS.

Chart 11



Sources: Scotiabank Economics, BLS.

If there is one thing one needs to understand about Canada then it is very much the fact that it is not fully independent of the United States. Nor is the BoC fully independent of the Fed whatever Macklem says. Enter the implications of US CPI.

When asked to comment about the implications to Canada from another strong US inflation reading this morning and whether that may reduce the odds of BoC easing, Macklem appallingly said "We haven't had a chance to look at US CPI." How many staff do you have working for you?? How many people can you call??

Macklem went on to say:

> "With respect to Canada, we're focused upon where we think inflation in Canada is headed. Inflation is still too high. We do see some downward momentum. We're looking for that to be sustained. Yes, developments in the US can impact upon us. US price changes can be imported into Canada but less so through services, so I don't see a big imported inflation effect. I do want to emphasize we have our own monetary policy in Canada and a flexible exchange rate and we're geared toward what's happening to inflation in Canada."

Now for the evidence in charts 8–11. It's not a perfect correlation, but it's pretty close to being so! That's especially true for y/y rates of inflation. There is more noise in the comparison of m/m readings, but what we're seeing of late is a relatively wide divergence.

And in any event, what the Fed does matters to the BoC. Pushing out Fed rate cuts makes it more difficult for the BoC to ease without causing CAD to crater.

THE BOC IS NEVERTHELESS STILL GUARDED

Notwithstanding the June reference, the BoC is still being clear it is watching more data before deciding when to cut. It said "While inflation is still too high and risks remain, CPI and core inflation have eased further in recent months. The Council will be looking for evidence that this downward momentum is sustained."

NEUTRAL RATE REVISED HIGHER

The BoC revised up its estimate of the neutral policy rate range from 2–3% to 2.25% to 3.25% which implies a mid-point estimate of 2.75% that is 25bps higher. This is a longer-run guidepost that, as Macklem explained, is of little consequence to nearer term rate decisions.

CAD A RISK

Governor Macklem was asked “how worried are you about a weaker CAD stoking inflation pressures?” and said:

> “Overall the C$ has been reasonably stable. If the C$ does move then that's something we will take into account. It will tend to make our exports more competitive. There will be some direct pass through into imported goods. But the flexible exchange rate is what allows us to run monetary policy to what we need in Canada.”

Reasonably stable? Oh my. Recall that USDCAD entered the year at about 1.323 and is now approaching 1.37. My goodness Governor, you have a bias indeed.

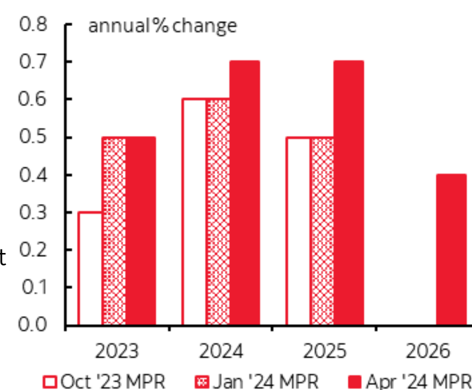
ACKNOWLEDGEMENT OF RISING OIL PRICES

When asked how the BoC may react to changes in commodity prices and their influences upon inflation, here’s where the hawk resurfaced. Macklem reiterated the BoC’s line that a positive terms of trade shock (export to import prices) including higher oil prices benefits growth in Canada.

FISCAL CONTRIBUTIONS TO GROWTH—TO BE CONTINUED

Part of the reason for upgrading growth projects was due to a stronger contribution from government spending. They now figure that government spending across all levels will add 0.7 ppts to 2024 GDP growth (0.6% previously) and 0.7% to 2025 growth (0.5% previously) and then a further 0.4 ppts in 2026 (chart 12). These figures may appear lower than our estimates but part of the reason is because they revised up overall growth through other drivers like consumption and exports and so the contribution from government spending was more muted than it would have been if they hadn’t revised up overall growth. I’m sure governments will appreciate having some shade thrown at them.

Chart 12



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

Governor Macklem made it clear they’ve assumed nothing about the Federal Budget next Tuesday. Finance Minister Freeland chose to follow the BoC—in my opinion—because she didn’t want to give the BoC an opportunity to react to what her government delivered. How very Ottawa-like. The divisions between government and the central bank have always been more blurred in Canada than elsewhere and openly acknowledged by past Governors that have emphasized the importance of policy coordination between government and the BoC. Governor Macklem made it clear he would incorporate the Budget’s effects in the next forecasts in July which will also be when the political reaction to the Budget has died down.

It would be the height of naïveté to assume that anything they do next week would be the end. The current government is in the dumps in terms of polling and with an election to be held by no later than October 2025. Governments in the dumps don't turn fiscally neutral/hawkish. The longer they are polling poorly, the more they panic, and the more goodies that get offered. That may mean that Tuesday’s debt management plans should be taken as an interim assessment ahead of an election.

RELEASE DATE: April 10, 2024

The Bank of Canada today held its target for the overnight rate at 5%, with the Bank Rate at 5¼% and the deposit rate at 5%. The Bank is continuing its policy of quantitative tightening.

The Bank expects the global economy to continue growing at a rate of about 3%, with inflation in most advanced economies easing gradually. ***The US economy has again proven stronger than anticipated, buoyed by resilient consumption and robust business and government spending. US GDP growth is expected to slow*** in the second half of this year, but remain stronger than forecast in January. The euro area is projected to gradually recover from current weak growth. ***Global oil prices have moved up,*** averaging about $5 higher than assumed in the January *Monetary Policy Report* (MPR). Since January, bond yields have increased but, with narrower corporate credit spreads and sharply higher equity markets, ***overall financial conditions have eased.***

The Bank has revised up its forecast for global GDP growth to 2¾% in 2024 and about 3% in 2025 and 2026. Inflation continues to slow across most advanced economies, although progress will likely be bumpy. Inflation rates are projected to reach central bank targets in 2025.

In Canada, economic growth stalled in the second half of last year and the economy moved into excess supply. A broad range of indicators suggest that labour market conditions continue to ease. Employment has been growing more slowly than the working-age population and the unemployment rate has risen gradually, reaching 6.1% in March. There are some recent signs that wage pressures are moderating.

Economic growth is forecast to pick up in 2024. This largely reflects both strong population growth and a recovery in spending by households. Residential investment is strengthening, responding to continued robust demand for housing. ***The contribution to growth from spending by governments has also increased.*** Business investment is projected to recover gradually after considerable weakness in the second half of last year. The Bank expects exports to continue to grow solidly through 2024.

Overall, the Bank forecasts GDP growth of 1.5% in 2024, 2.2% in 2025, and 1.9% in 2026. ***The strengthening economy will gradually absorb excess supply through 2025 and into 2026.***

CPI inflation slowed to 2.8% in February, with easing in price pressures becoming more broad-based across goods and services. However, shelter price inflation is still very elevated, driven by growth in rent and mortgage interest costs. ***Core measures of inflation, which had been running around 3½%, slowed to just over 3% in February, and 3-month annualized rates are suggesting downward momentum. The Bank expects CPI inflation to be close to 3% during the first half of this year, move below 2½% in the second half, and reach the 2% inflation target in 2025.***

Based on the outlook, Governing Council decided to hold the policy rate at 5% and to continue to normalize the Bank's balance sheet. ***While inflation is still too high and risks remain, CPI and core inflation have eased further in recent months. The Council will be looking for evidence that this downward momentum is sustained.*** Governing Council is particularly watching the evolution of core inflation, and continues to focus on the balance between demand and supply in the economy, inflation expectations, wage growth, and corporate pricing behaviour. The Bank remains resolute in its commitment to restoring price stability for Canadians.

RELEASE DATE: March 6, 2024

The Bank of Canada today held its target for the overnight rate at 5%, with the Bank Rate at 5¼% and the deposit rate at 5%. The Bank is continuing its policy of quantitative tightening.

Global economic growth slowed in the fourth quarter. US GDP growth also slowed but remained surprisingly robust and broad-based, with solid contributions from consumption and exports. Euro area economic growth was flat at the end of the year after contracting in the third quarter. Inflation in the United States and the euro area continued to ease. Bond yields have increased since January while corporate credit spreads have narrowed. Equity markets have risen sharply. Global oil prices are slightly higher than what was assumed in the January *Monetary Policy Report* (MPR).

In Canada, the economy grew in the fourth quarter by more than expected, although the pace remained weak and below potential. Real GDP expanded by 1% after contracting 0.5% in the third quarter. Consumption was up a modest 1%, and final domestic demand contracted with a large decline in business investment. A strong increase in exports boosted growth. Employment continues to grow more slowly than the population, ***and there are now some signs that wage pressures may be easing.*** Overall, the data point to an economy in modest excess supply.

CPI inflation eased to 2.9% in January, as goods price inflation moderated further. Shelter price inflation remains elevated and is the biggest contributor to inflation. Underlying inflationary pressures persist: year-over-year and three-month measures of core inflation are in the 3% to 3.5% range, and the share of CPI components growing above 3% declined but is still above the historical average. The Bank continues to expect inflation to remain close to 3% during the first half of this year before gradually easing.

Governing Council decided to hold the policy rate at 5% and to continue to normalize the Bank's balance sheet. The Council is still concerned about risks to the outlook for inflation, particularly the persistence in underlying inflation. Governing Council wants to see further and sustained easing in core inflation and continues to focus on the balance between demand and supply in the economy, inflation expectations, wage growth, and corporate pricing behaviour. The Bank remains resolute in its commitment to restoring price stability for Canadians.

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