Scotiabank

GLOBAL ECONOMICS

SCOTIA FLASH

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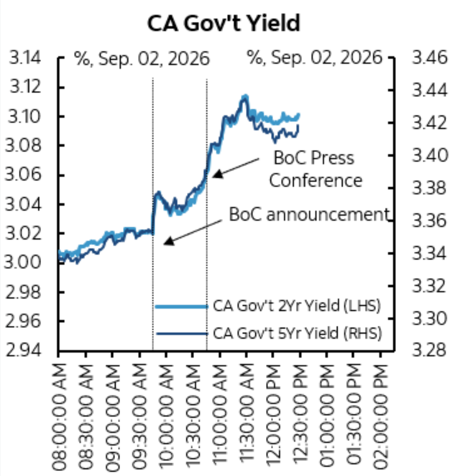
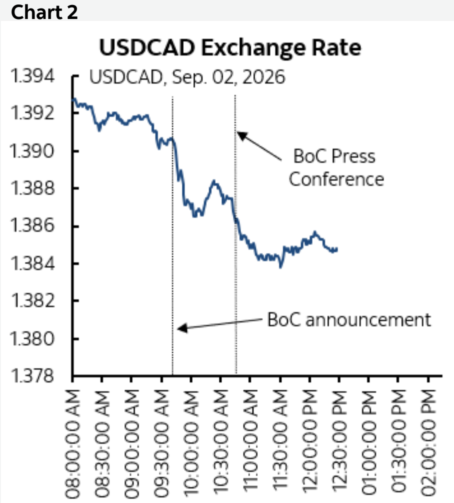
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Bank of Canada Fires A Hawkish Warning Shot

- **The policy rate was unchanged at 2.25% as universally expected**
- **October is a 'live' meeting. Markets now pricing 75–100bps of hikes**
- **The overall tone was incrementally hawkish…**
- **…as the BoC removed reference to the policy rate being "appropriate"…**
- **…and warned that upside risks to inflation have increased…**
- **…but so has uncertainty…**
- **…while nevertheless downplaying tariffs as behaviour has adapted**
- **Fresh inflation forecasts in October were noted as guiding the policy decision**

October's Bank of Canada meeting is 'live' and on watch for hike risk in the wake of updated communications from the Bank of Canada. The communications reinforce conviction in our forecast for at least 75bps of rate hikes starting in Q4 into early 2027.

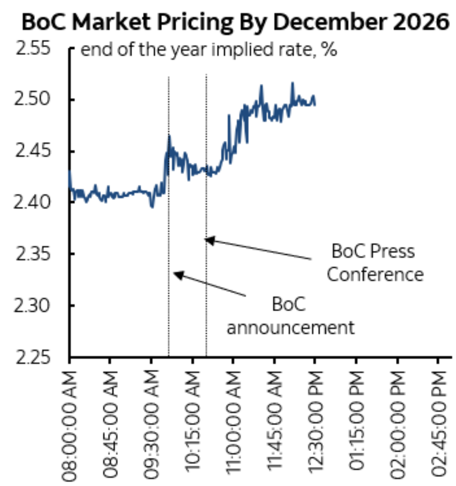
Markets responded to the communications (**here**, **here** and **here**) by pushing the two-year GoC yield higher by 8bps, thereby underperforming other markets including the US. The Canadian dollar appreciated by over half a penny to the USD.

The October meeting is now priced at 10bps of a 25bps hike. December is pricing 22bps of a 25bps hike. Markets are now pricing between 75–100bps of tightening by next summer.

We'll see what happens, but as a reminder, Scotiabank Economics is the only shop that has been forecasting tightening by year-end right back to our November 2025 forecast and way ahead of markets.

Charts 1–3 show intraday market moves around the communications.

Chart 3



Sources: Scotiabank Economics, Bloomberg.

HERE IS WHAT MATTERED

Sometimes it's the silence that says enough and this silence wasn't of the comfortable sort to markets. While the Bank of Canada left its overnight rate unchanged at 2.25% as universally expected, it struck out reference to how "the current policy rate remains appropriate." That omission speaks volumes when combined with the next point.

They also explicitly warned that "upside risks to inflation have increased" in statement codified fashion and in Governor Macklem's opening remarks.

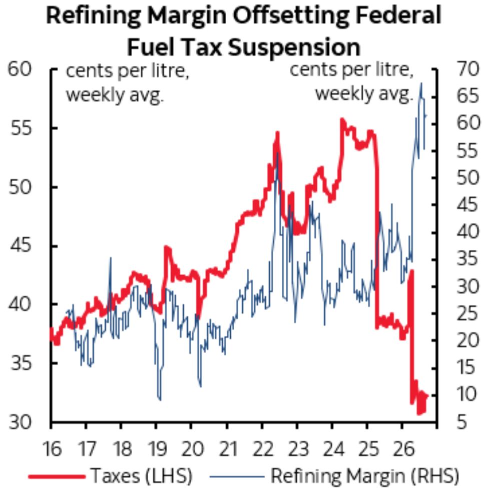
The broad tone somewhat traded off upside risks to inflation alongside more uncertainty over the economic rebound as noted in the concluding paragraph to the statement, but the press conference swept away any doubt over which way the BoC's policy actions would lean in terms of that mixture. The statement and presser made clear that their 2% inflation goal is sacrosanct, that inflation is too high as explicitly noted, and that upside risks have increased and that this will be the BoC's "beacon" for future policy adjustments.

We can otherwise forgive some other stretched truths in the statement, like how the economy and inflation have performed in line with their expectations. No they haven't. Q2 GDP growth of 3.3% surpassed the BoC's 2.8% projection and Q1 was revised up by

0.4 ppts for a net beat to their expectations of nearly a percentage point. Ditto for inflation at 3% y/y whereas the BoC had forecast 2.7% for Q3. They were in line with the direction but these are meaningful overshoots of the BoC's expectations and probably played a role in spooking them somewhat. After all, today was a total narrative shift by the BoC compared to previously.

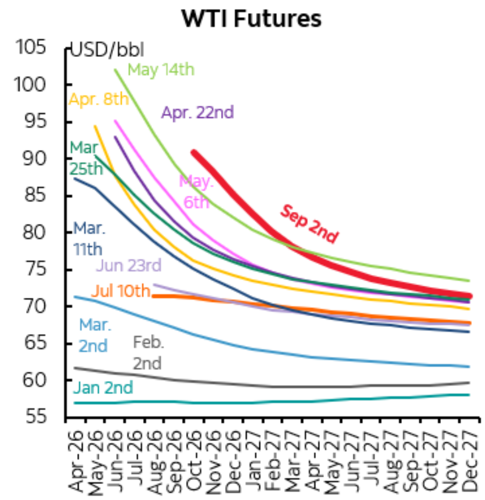
Macklem warned that inflation risk had pivoted higher because the longer the conflict in the Middle East persists, the greater the pass through risk of higher oil into other prices. Chart 4 shows the current WTI futures curve toward the high points of the conflict to date. He should have spoken more broadly about commodity price pressures since it's not just about oil and gas. He also said that the longer the conflict goes on, the longer the upward pressure upon refiners' margins which is definitely happening (chart 5). That makes it all the more curious why Canada just extended the fuel excise tax suspension given that refiners crowded in the space in a tight market.

Chart 4



Sources: Scotiabank Economics, GoC.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

Governor Macklem constantly emphasized that businesses have adjusted to tariffs and uncertainty and that he expects this to continue to be the case. In fact, while he responsibly flagged uncertainty, I thought he went out of his way to downplay the role this would play in guiding future decisions while playing up the cost implications of tariffs.

Macklem put a lot of attention on the next forecast round in October and intimated that the decision will be guided by those forecasts:

"We will have a new forecast at our next meeting. Our interest rate decisions will be guided by the outlook for inflation. That will be front and center in our next decision."

In my opinion, you don't warn, then issue fresh forecasts, only to whiff in the moment. There is a lot more information to digest between now and October 28th, such as data on inflation and jobs and GDP, plus energy market and trade developments, but the BoC very clearly cracked open the door by enough to increase flexibility to tighten as soon as the next meeting if everything cooperates. That's not clear as yet, but the relative risk-reward on October versus December pricing should be attracting more attention toward October.

When asked during the press conference about the risk of multiple back-to-back rate increases, Macklem not only did not bat it away, he responded in the affirmative.

All of which is a total narrative shift by the BoC. What happened is captured by domestic data upsides, higher energy and other commodity prices for longer, and unspoken assumptions about additional fiscal policy actions.

Please see the attached statement comparison that follows the press conference transcript. We will soon be issuing fresh forecasts.

PRESS CONFERENCE TRANSCRIPT

The following is an attempt at providing a full transcript of the Q&A part of the press conference. Any errors or omissions are to be blamed on my typing abilities in keeping up.

Q1. Are you more concerned with inflation than any drag on growth from the trade conflict?

A1. We highlighted both risks. We're concerned about both risks. Momentum is encouraging. There is still slack. New American trade actions create uncertainty. Inflation is 3% which remains too high. It is very concentrated in gasoline and energy. CPI ex-gasoline is 2.2%. But the conflict in the Middle East is going on. The longer it goes on, the greater is the risk that higher energy prices start to spill into other prices and you get more generalized inflation. The risks are shifting and we are prepared to adjust monetary policy as needed. The most important thing that is going to guide our decision going forward is our inflation forecast and the risks around that. It includes slack, higher oil prices, the potential for that to spill over. We'll be updating that forecast at our next meeting. That will really guide our decisions. Our beacon is our 2% inflation target. We are committed to it.

Q2. Counter tariffs go into effect on Sept 8th. How do you judge this?

A2. They will add costs. Those costs could feed through to consumer prices. The counter-tariffs are mostly on intermediate inputs. Not many of them will directly impact CPI. That means the effect is less direct and it takes more time to pass through. We will be refining our estimates. Our assessment at this point is that the inflationary impact of the retaliatory tariffs is modest. The bigger issue is what's going on in the Middle East.

Q3. You previously said further rate cuts may be needed if the US imposes further restrictions. Do you see that happening in the near future if trade tensions drag on or intensify?

A3. When the US first imposed tariffs we did cut and held it low to support the economy. The tariffs have weight on growth. We saw the economy rebound in the second quarter. Businesses are telling us they are adapting to tariffs and shifting their supply chains. You can see that in the data. Exports and investment have come up, hiring has been stronger. There is a new challenge with the breakdown in trade discussions with the US. That makes that rebound more uncertain. But, as I stressed, we have to keep our eye on inflation. The conflict in the Middle East is key and the longer it goes on the greater the risk to inflation.

Q4. How are you thinking about how trade tensions play out for the Canadian economy and would they go back to last year's scenarios in terms of downside risks?

A4. We're coming into this with the Canadian economy on a better footing. Businesses have adapted. They're getting on and finding ways to do business. These tariffs are very steep but they are applied to a relatively narrow base. The businesses they hit will get hit hard. You will see some impact on growth particularly in Q4. But overall they hit about 5% of our exports to the US (ed. even less total) and we don't expect them to be a big effect. There could be escalation. There could be other outcomes. Canada and the US were close to a deal. Canada is applying counter tariffs in order to get tariffs rolled back. We'll have to assess their impact on the sustainability of this recovery.

Q5. Has the balance of risks been maintained?

A5. I've answered that question so the SDG can answer. Rogers speaking now: risks to growth primarily through trade tensions, risks to inflation that come primarily out of the Middle East. They're both pretty dynamic and there is uncertainty about how these risks transmit through the economy and inflation. Our mandate is to preserve price stability and that's what we are going to be focused upon.

Q6. Does the recent bond rout indicate a healthy repricing of risks? Or are there risks embedded within it? And are US Treasury actions appropriate?

A6. Underneath it all we have high levels of sovereign debt globally with rising issuance but it's not the only factor. The build out of AI infrastructure is driving corporate bond issuance higher. The situation in the Middle East has become worse. Central banks and markets are more concerned about inflation. All these things are working simultaneously. Canada's curve is below the US for many reasons. We are seeing some spillover of global bond yields into Canada. Perhaps the more serious issues are around financial stability. [ed. passed to Rogers again.]. Rogers: the vulnerability we have spoken about comes when leveraged positions get reversed quickly and spill over from repo markets into core markets. We don't see that happening now. We see a repricing of risk.

Q7. Can you outline how much lower the growth path has been because of tariffs? Is there not higher risk of contagion with these new tariffs?

A7. We've seen growth rebound in Q2. That is evidence that businesses and workers are adjusting. If we could magically roll back tariffs we could get back to a higher growth path. That's not in our control. What is in our control are the investments and structural reforms we do in Canada. We need to diversify our exports, improve productivity, integrate our domestic markets. Monetary policy can't do that. It's not in our control. We have to take that path for potential growth as given but the higher that path is the more the economy can growth without building inflation.

Q8. Why did you drop reference to the policy rate being appropriate?

A8. Since our July meeting, the data has been broadly in line with our forecast. The risks around the forecasts are shifting. The upside risks to inflation have increased. The durability of the rebound is more uncertain. We will have a new forecast at our next meeting. Our interest rate decisions will be guided by the outlook for inflation. That will be front and center in our next decision.

Q9. Could consecutive rate increases be required?

A9. There are a number of scenarios and range of possible outcomes. The best outcome would be resolution in the Middle East and tariffs get rolled back. That's not the only outcome, both could become more complicated. Certainly if we felt that inflation was going to remain too high then we would raise interest rates and would be prepared to do multiple increases but that's not the only outcome. Our objective is to get inflation back to 2%.

Q10. Why are markets pricing three hikes and how much will you factor markets into future decisions?

A10. [Rogers answering]. Markets are pricing in a number of things. We take these factors into account. We talk about market conditions. They all feed into our rate decision.

Q11. Borrowing costs have increased which seem to be doing some tightening. How does this all affect your policy decisions in coming months?

A11. Macklem. I think I have answered that question. We will take into account financial conditions. To the extent that higher interest rates reflect expectations about monetary policy, if that's what we think, then we're prepared to do that. If monetary policy doesn't do what is needed then markets will reprice. The fact that markets understand our reaction function and that the upside risks to inflation increase the higher oil prices are for longer then it gets attention in markets but doesn't mean we don't need to do something.

Q12. How are you thinking about the long-term effects of tariffs and what the US is doing to itself even if things go back to normal between Canada and the US?

A12. This US administration likes protectionism. If rationality prevails then we can get back to a better place. Governments should do what's good for their citizens. It would be nice if we could go back to where we were but I don't think we can count on that. Certainly what we've seen over the past year is that businesses have gone from shock and anger to denial to adapting and moving on and that's what we're seeing. You are seeing the Canadian economy and businesses adapting. The Canadian economy is coping and it is responding. Yes this new round of tariffs are a setback but I have no doubt Canadian businesses will adapt and find new ways of doing business.

RELEASE DATE: SEPTEMBER 2, 2026

The Bank of Canada today held its target for the overnight rate at 2.25%, with the Bank Rate at 2.5% and the deposit rate at 2.20%.

The continuing conflict in the Middle East is keeping energy prices high. As well, new US tariffs and Canadian counter-measures have been announced following the breakdown of trade talks between Canada and the United States. Both situations remain fluid.

In the United States, economic growth continues to be solid, driven by consumer spending and AI-related investment. Growth in the euro area was stronger than expected in the second quarter, while China's economy slowed. Overall, the global economy has shown resilience in the face of geopolitical headwinds, with growth broadly consistent with the July *Monetary Policy Report* (MPR) projection. With still-high oil prices and elevated margins for refined energy products, inflation in most countries remains high.

Financial conditions have tightened since July. Long-term bond yields have moved up globally, including in Canada. The Canadian dollar has appreciated slightly on US-dollar weakness.

As expected, ***Canadian economic activity strengthened in the second quarter, with GDP up by 3.3%***, following very weak growth in the first quarter. ***While some of the recent strength reflected temporary factors, the pick-up in activity was broad-based.*** Consumption showed solid gains. Following several weak quarters, there was some rebound in housing activity. Exports and business investment were up sharply. ***Labour market conditions have improved in recent months,*** with the unemployment rate edging down to 6.4% in July. ***Still, demand for labour remains subdued and indicators point to continued excess supply in the economy.***

Overall, recent data reaffirm Governing Council's view of a broadening recovery in Canada's economy. However, uncertainty is high and new US tariffs and threats of further action pose risks to the sustainability of the recovery.

CPI inflation has been hovering around 3% in recent months, mainly because of persistently higher gasoline prices. ***So far, there has been little evidence of higher energy prices spreading to other components of inflation: excluding gasoline, inflation was 2.2% and measures of core inflation remained close to 2% in July.*** However, with the Middle East conflict still ongoing and little progress reopening the Strait of Hormuz, ***upside risks to the Bank's inflation forecast have increased.*** The longer that high oil prices and elevated refinery margins persist, the greater the risk of spillover to the prices of other goods and services. New US tariffs and Canadian counter-tariffs will also raise costs for some businesses and could feed into consumer prices over time.

With the economy and inflation evolving broadly as forecast in the July MPR, Governing Council agreed to leave the policy rate unchanged. ***However, the upside risks to inflation have increased, while new tariffs make growth prospects more uncertain. Governing Council will assess the sustainability of the economic rebound and the outlook for inflation, and is prepared to adjust monetary policy as needed.*** The Bank remains committed to maintaining Canadians' confidence in price stability through this period of global upheaval.

RELEASE DATE: JULY 15, 2026

The Bank of Canada today held its target for the overnight rate at 2.25%, with the Bank Rate at 2.5% and the deposit rate at 2.20%.

Canada's economy is showing signs of improvement. Growth is picking up and inflation is projected to ease gradually from its recent spike. There are still important risks and uncertainties related to the war in the Middle East and US trade policy.

Since the April Monetary Policy Report (MPR), global economic prospects have been dented by higher oil prices stemming from the Middle East conflict. At the same time, the build-out of artificial intelligence (AI) is supporting economic activity in a growing number of countries. Oil prices are still lower than their peak in April but the situation in the Middle East remains volatile. The path for global inflation is highly dependent on how the conflict unfolds.

The US economy is growing at about 2½%, mostly because of strong consumption and booming AI investment. China's economy is expanding solidly thanks to robust exports. Economic activity in the euro area has been weighed down by high energy prices, but is expected to strengthen in the second half of the year if energy prices come down as anticipated.

The Bank projects global GDP growth will slow to 2¾% in 2026, mostly because of the effects of the Middle East conflict, and recover to around 3¼% in 2027 and 2028.

Financial conditions in Canada have eased since April and global equity markets have been buoyant. US bond yields have risen, while those in Canada are little changed. This differential has contributed to the depreciation of the Canadian dollar.

Canada's GDP data over the past year was choppy and growth stalled as the economy adjusted to new tariffs, high uncertainty and slower population growth. Labour market conditions have remained soft, reflecting ongoing economic slack. The unemployment rate was 6.5% in June and has hovered in a range of 6½%-7% since the end of 2024. There are clear signs that economic growth has resumed in the second quarter, with growth estimated at 2½%. While this largely reflects the unwinding of temporary factors, sources of economic growth appear to be broadening.

Recent indicators point to continued solid consumer spending. Housing activity has been weak but looks to be stabilizing. Export growth has resumed and is expected to continue to strengthen, albeit on a lower path. Business investment is projected to pick up modestly, boosted in the near term by the oil and gas sector. Although the Canada-US-Mexico Agreement is now subject to annual reviews, more businesses report they are finding ways to navigate through the uncertainty. Government spending also contributes to higher economic activity over the projection.

Following GDP growth of 0.7% in 2026, the Bank projects the economy will grow by 1.8% in both 2027 and 2028. As the recovery proceeds, economic slack will be gradually absorbed.

CPI inflation rose further to 3.2% in May, mainly because of higher gasoline prices linked to the war in the Middle East. Excluding gasoline, inflation was 2.2% and measures of core inflation remained close to 2%. Near-term inflation expectations are sensitive to changes in gasoline prices but longer-term inflation expectations remain well anchored. War-related cost pressures are still working their way through some consumer prices but are being offset by downward pressure on other prices from continued economic slack. CPI inflation is expected to stay elevated in June and then ease gradually in the coming months, returning to around 2% in early 2027, although this forecast is dependent on the path for oil and gasoline prices. Inflation is forecast to average around 2% in 2027 and 2028, albeit with some monthly fluctuations because of base-year effects.

Governing Council judges the current policy rate remains appropriate to sustain the economic recovery and bring inflation back to the 2% target, in line with the MPR projections. Uncertainty is still high. Governing Council will continue to assess the strength of the Canadian economy and the outlook for inflation, and is prepared to adjust monetary policy as needed. The Bank is committed to maintaining Canadians' confidence in price stability through this period of global upheaval.