Bank of Canada bets on disinflationary path

As widely expected, the Bank of Canada kept rates unchanged at 4.5% today. The Bank observed that restrictive monetary policy is already showing its effect on the Canadian economy, and sees a path for a return to 3% inflation by mid-2023. The option for a new hike is open, but we doubt that will be necessary, and the next move should be a cut

Bank of Canada building in Ottawa

A stark contrast to the Fed communication

The contrast between the Bank of Canada (BoC) and the renewed hawkishness at the Federal Reserve is increasingly stark. Today, the BoC confirmed that rates most likely peaked in January with "restrictive monetary policy" weighing on household spending and investment. While BoC acknowledged that the labour market "remains very tight", it doesn't have the same fears as the Federal Reserve that this will keep inflation pressures elevated. Indeed, BoC argued that "weak economic growth for the next couple of quarters" and increasing "competitive pressures" will bear down on inflation and allow it to "come down to around 3% in the middle of this year".

Consequently, it repeated the line that should economic conditions evolve broadly in line with expectations then it will continue to hold the policy rate "at its current level", but reserved the right to "increase the policy rate further if needed to return inflation to the 2% target".

We don't think the central bank will need to. Canada's high household debt levels and greater exposure to interest rates rate hikes via a higher prevalence of variable rate borrowing make the economy more at risk of a deeper downturn than the US. For example, in the US the 30Y fixed rate mortgage is the most common borrowing method while in Canada it is five years or less before they face a change in interest rate. As such, the next move is more likely to be an interest cut in our view.

Markets scale back tightening bets

The Canadian dollar traded marginally on the soft side after the BoC announcement, probably as some investors were expecting some stronger concerns about potentially stickier inflation like in the US. The conviction call on the disinflationary path (inflation at 3% by mid-2023) clearly suggests there is no real discussion about a resumption of monetary tightening at the moment.

We are observing some unwinding of tightening bets at the time of writing. The CAD 2Y swap rate is trading around 10bp lower than pre-announcement, and the OIS curve is no longer pricing in a 25bp rate hike at the July meeting. This is no game changer for our medium-term (bearish) view on USD/CAD, which was not based on a hawkish surprise or additional tightening by BoC. However, it may trigger a bit more loonie underperformance in the near term.

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