

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.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the

Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.