Bank of Canada hikes by 50bp and is prepared to hit the accelerator

The Bank of Canada acknowledges that inflation pressures are broadening and intensifying, which justifies a 50bp hike today with warnings that it is prepared to “act more forcefully”. We expect 50bp hikes in July and September, and a 3.5% rate in early 2023. This should prove supportive for the loonie and we target 1.22 as a year-end value for USD/CAD

Source: shutterstock

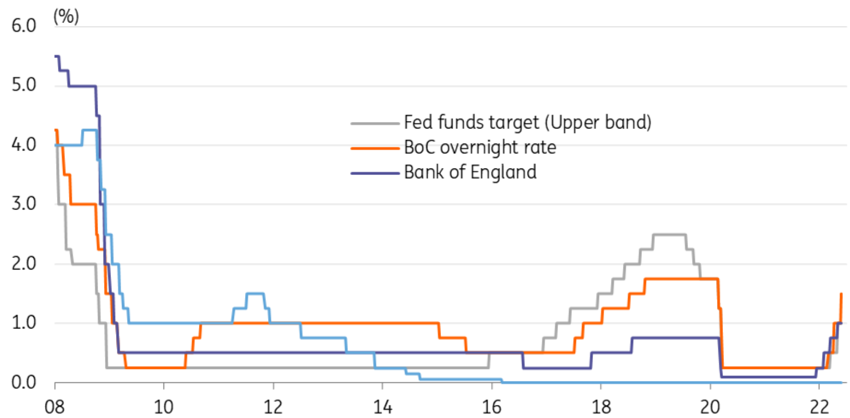
Bank of Canada to keep tightening at a fast pace

The Bank of Canada has raised its policy rate by 50bp to 1.5%, as widely expected. The accompanying statement shows the central bank is laser focused on inflation, commenting that almost 70% of the CPI basket is running in excess of 3% and rising, meaning that "the risk of elevated inflation becoming entrenched has risen."

At the same time, Canada's economy is "strong" and is "clearly operating in excess demand". Consequently "interest rates will need to rise further" with the BoC “prepared to act more forcefully if needed”.

A strong economy, booming jobs market, and elevated inflation argue for another "forceful" 50bp hike at the next meeting and probably the meeting after that. We certainly see greater upside for BoC rates than for the Fed funds rate in the US with the Canadian economy experiencing an even hotter jobs market and property market than in the US while the economy is additionally boosted by its strong commodity producing sectors.

We see the Bank of Canada hiking rates to 3.5% in early 2023, above the 2-3% “neutral range” suggested by some officials. Nonetheless, as in the US, the harder and faster you go to try and get a grip on inflation, the greater the chance of an adverse reaction in the economy. Moreover, the Bank of Canada has tended to move rates more frequently than the US, such as upwards in 2010 and downwards in 2015. Given this we see a strong likelihood that the BoC will start to move the policy rate back towards the 2-3% neutral area in 2H 2023.



Source: ING, Refinitiv

CAD: Monetary tightening story remains supportive

As we were expecting, the combination of a smaller rate increase than market expectations (which were pricing in 70bp of tightening today) and a hawkish forward-looking language (reference to “more forceful” action if necessary) has proven to have very little negative implications for CAD.

> Looking ahead, the notion of fast tightening by the BoC – we expect two more 50bp hikes in July and September – is set to prove supportive for CAD, both in the short-term by offsetting USD appreciation and in the longer term by driving USD/CAD sustainably below 1.25 (we target 1.22 for year-end) in the second half of the year, when the USD strength may start to fade.

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