Bank of Canada prepares for a trade war

The BoC cut rates by 25bp as expected today. Rates would be at or close to the bottom given some improvement in the economic outlook, but the huge question mark of a US-Canada trade war is leaving the door open for more cuts. Ultimately, the relative growth-inflation impact of tariffs will determine the BoC's reaction. We expect more USD/CAD upside

Governor of the Bank of Canada, Tiff Macklem

BoC cuts and ends QT

The Bank of Canada has cut the overnight rate by 25bp to 3.0%. Cumulative easing now amounts to 200bp since June. The BoC has also announced an end to its quantitative tightening programme, which had been used to shrink its balance sheet. Instead, it will restart gradual asset purchases so its balance sheet stabilises as a proportion of GDP.

For context, Canada's economic activity has been disappointing as of late, with fourth-quarter GDP expected to come in at an annualised 1.5% rate after 1% growth in the third quarter. At the same time, the unemployment rate has been trending upwards to stand at 6.7% versus a 2022 low of 4.8%. Inflation is currently close to the 2% target – hence why the BoC has been able to enact "substantial" policy easing. Despite all the gloom, the central bank has tried to cling to some positives, stating that "past cuts to interest rates have started to boost the economy".

Elevated uncertainty on trade

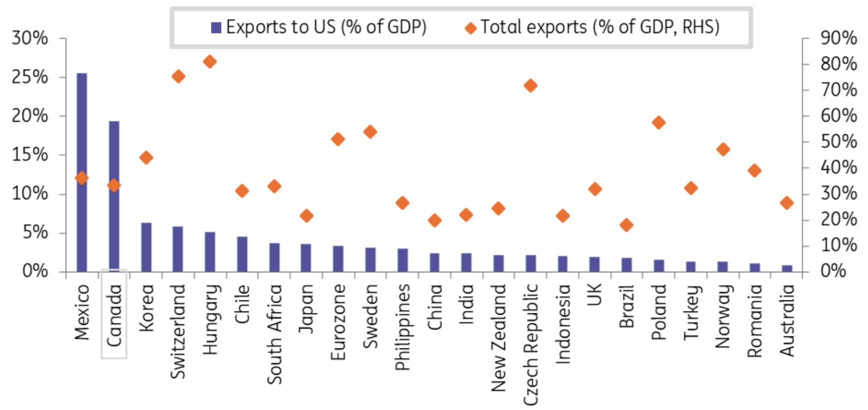
Nonetheless, given the uncertain outlook for tariffs with the US, the BoC also stated that “the scope and duration of a possible trade conflict are impossible to predict” and so its baseline assumption for its forecasts assumes no new tariffs. If there is no threat of tariffs, it believes that “the upside and downside risks around the outlook are reasonably balanced”. In this environment, it assessed that “the economy is expected to strengthen gradually and inflation to stay close to target”. This hints that we are probably at or close to the bottom for interest rates.

However, we argue that the risks for the Canadian economy remain skewed to the downside. Household debt remains very high by international standards and the structure of Canada’s mortgage market means that many households are yet to feel relief from lower rates. But the biggest concern is President Donald Trump’s threat of 25% tariffs on imports from Canada into the US from as soon as 1 February – this weekend!

It is of huge concern to business leaders and politicians alike. The US is by far and away Canada’s most important trading partner, taking in 76% of Canada’s exports with the value equivalent to around 20% of Canadian GDP. The proposed tariffs will undoubtedly hurt the competitiveness of Canadian products, with a clear risk that substitution away from Canadian-sourced items leads to an economic downturn and potential recession.

In an environment where the BoC has talked about excess spare capacity, the risks that the BoC cuts the overnight rate below 2.75% – our current forecast for the bottom – are high. As discussed by Governor Tiff Macklem at today’s press conference, should the negative growth impact of a trade war come in faster on more forcefully than the upward effect on inflation, the BoC can ease further.

Canada highly exposed to US tariffs



Source: Macrobond

USD/CAD remains attractive in the dips

Markets initially read the statement as modestly hawkish, probably as the BoC seemed to stress the inflation impact from risks (estimated at up to 0.8 percentage points), but later assessed Macklem’s press conference as slightly more dovish. Still, markets are not repricing rate expectations, with the CAD 2-year OIS rate at only marginally lower at 2.65%.

Macklem was also asked about the weak Canadian dollar in the press conference. While admitting the exchange rate feeds into forecasts, he gave few indications that monetary policy can be materially influenced by the loonie's levels.

USD/CAD oscillated around the statement release and press conference, ultimately returning to pre-meeting levels and a third of a percent higher on the day. We continue to see upside risks beyond the 1.45 level unless Trump scales back the threat of a 25% tariff before the weekend.

Author

James Knightley
Chief International Economist, US
james.knightley@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com