Bank of Canada preview: Dovish pressure mounting

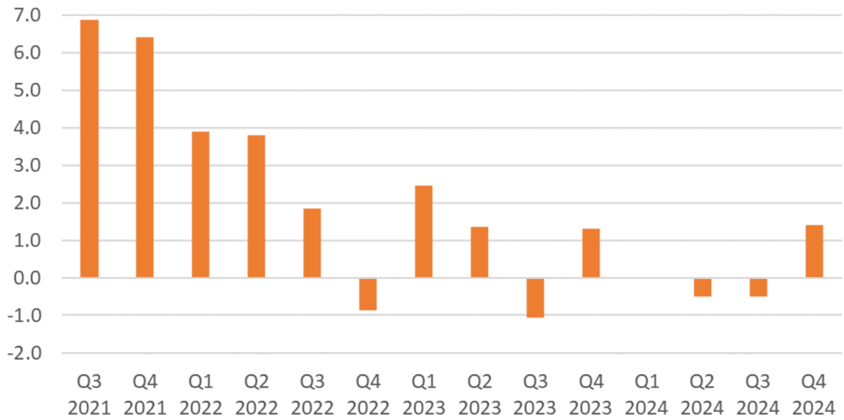
The Bank of Canada is set to leave the policy rate unchanged at 5% next week, but the commentary is turning more dovish and we expect the BoC to start cutting in 2Q24. Markets are already positioned for BoC easing next year, and there is modest room for a hawkish (although short-lived) market reaction. CAD should be less appealing than other commodity FX in 2024

Holding rates as economic challenges intensify

The Bank of Canada is widely expected to hold the target for the overnight rate at 5% at the upcoming policy meeting on 6 December. At the October policy meeting, the accompanying statement warned that “progress towards price stability is slow and inflationary risks have increased, and [the BoC] is prepared to raise the policy rate further if needed”. However, since that meeting the activity data has softened, the labour market has shown evidence of some cooling and inflation has continued to slow. Consequently, the threshold for a rate hike does not appear to have been met.

Moreover, Governor Tiff Macklem has since conceded that “the excess demand in the economy that made it too easy to raise prices is now gone" and that the "economy is approaching balance". The economy contracted at an annualised rate -1.1% rate in the third quarter, with month-on-month increases having effectively stalled since June. Meanwhile, the unemployment rate is trending higher and wage pressures appear to be topping out. Macklem admitted that this softening in activity means "more downward pressure on inflation is in the pipeline". We agree and expect CPI to slow to 2% in the second quarter of 2024, especially if gasoline prices remain at the current low levels.

Canada's quarterly GDP annualised



Source: ING, Refinitiv

Tightening hitting households, we expect large easing in 2024

Meanwhile, the legacy of BoC rate hikes is being felt by more-and-more households since the structure of the residential mortgage market means that most people face an adjustment to their borrowing rate on a three-to-five-year basis (rather than 30 years in the US). Home sales surged in the second half of 2020 through 2021 and those people that took out mortgages at ultra-low interest rates will be refinancing at much more costly rates over the next 12-18 months.

This will increasingly weigh on activity and help to dampen price pressures further. Given this situation we feel the BoC will cut sooner and more aggressively than the market and consensus are expecting. We look for 150bp of rate cuts in 2024, starting at the April policy meeting.

Market impact shouldn't be big this time

The preference of the BoC to keep the policy message hawkish is clear, given lingering risks to the disinflation outlook. However, with the ongoing dovish repricing of Fed rate expectations, and the growth outlook in Canada deteriorating, we suspect markets will take a reiterated threat of another hike by the BoC less seriously.

Governor Tiff Macklem would have likely taken the opportunity of a post-meeting press conference to push back against rate cut speculation, but this is an in-between meeting, with only a statement release and no press event. One possibility is that the BoC de-emphasises the threat of another hike and emphasises a "higher-for-longer" narrative to hinder dovish speculation.

Markets are pricing in 100bp of cuts in 2024 in Canada, so it is likely that expectations are leaning towards a softening of the hawkish tone by the BoC at this meeting. Ultimately, data – and the spill-over from Fed pricing – remain significantly more important for the CAD swap curve. CAD may rise on a hawkish hold, but don't expect the FX impact to be very long-lasting: we don't see the loonie as a particularly attractive currency into the first months of next year given its very high correlation to US data, which we expect to deteriorate in 1H24. Other commodity currencies like AUD and NOK are more appealing.

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