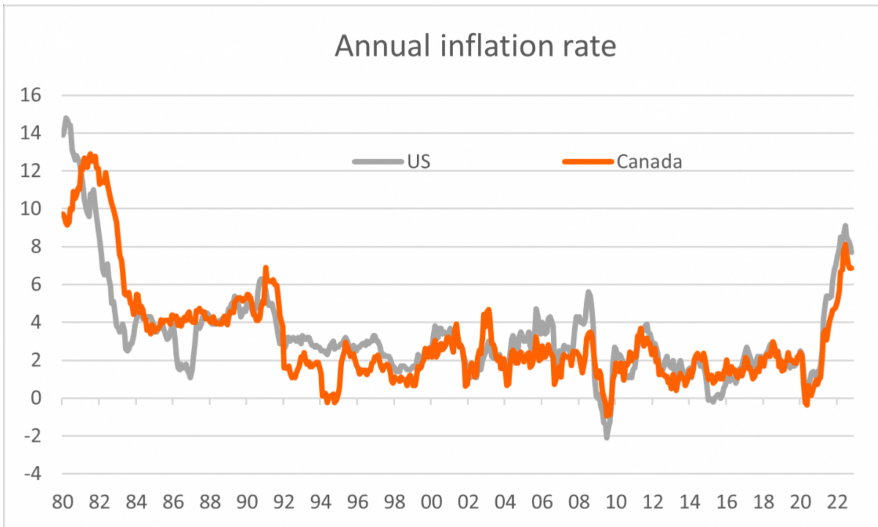
Bank of Canada preview: Odds favour 50bp, but the peak looks near

Elevated inflation, robust economic activity and a super-tight jobs market argue for another 50bp rate hike. However, recession fears are rising and policy is in restrictive territory, meaning that the top in rates looks close. Markets are pricing in only 32bp at the moment, so a 50bp would likely send CAD higher, but the FX reaction should be short-lived

A very close call

The Bank of Canada (BoC) has raised interest rates a cumulative 350bp since the first move in early March and we look for a further 50bp hike on Wednesday. Third-quarter GDP came in at 2.9% annualised, nearly double the consensus forecast rate, while inflation at 6.9% continues to run at more than three times the 2% target. Then we had last Friday's 108,300 increase in Canadian employment, meaning that there are now 523,000 more Canadians in work than there were before the pandemic struck in February 2020.

Inflation is lower in Canada than in the US



Source: Refinitiv, ING

At its latest meeting the BoC acknowledged that some effects of its tighter policy were being seen, citing softer housing while weak external demand is also impacting the Canadian economy. But with demand continuing to outstrip the economy's supply capacity, inflation pressures show little sign of softening as quickly as the Bank of Canada would like. The bank also warned that "price pressures remain broadly based, with two-thirds of CPI components increasing more than 5% over the past year". That story has not changed and with central banks globally warning that the risk of doing too little to fight inflation outweighs the risk of doing too much the BoC is likely to signal that further tightening remains possible.

> For now, we expect a final 25bp rate hike in early 2023, but this is not a strong call. The housing market is particularly vulnerable, with the mortgage market structure meaning Canadians are more impacted by rising rates than American homeowners. We are also seeing signals in Europe and the US that inflation is showing more signs of softening and, if replicated in Canada, this may argue against that final hike.

FX: Not many long-term implications for CAD

Markets are pricing in only 32bp for tomorrow's BoC announcement, so a 50bp rate hike would be received as a hawkish surprise and likely trigger a CAD rally. However, we expect the post-meeting FX impact to be rather short-lived, as external factors remain more important for CAD.

The recent fragility in risk sentiment shows that downside risks for all high-beta currencies remain elevated. At the same time, CAD is considerably less directly exposed to swings in China's sentiment compared to many other pro-cyclical currencies. The tightening supply picture in the crude market does leave room for a recovery in prices and this should be a positive development for the loonie.

We think USD/CAD could end the year around 1.37 as the USD strengthening is partly offset by a potential recovery in oil prices.

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