Bank of Canada preview: on hold as trade tensions come to a head

We expect the Bank of Canada to maintain interest rates at 2.75% on 30 July, remaining cautious amid trade uncertainty. But one or two additional cuts later in the year remain quite likely, and we think market pricing is too hawkish. We continue to expect some pressure on the Canadian dollar on the back of worsening domestic drivers

Bank of Canada Governor Tiff Macklem

Treading cautiously amid trade questions

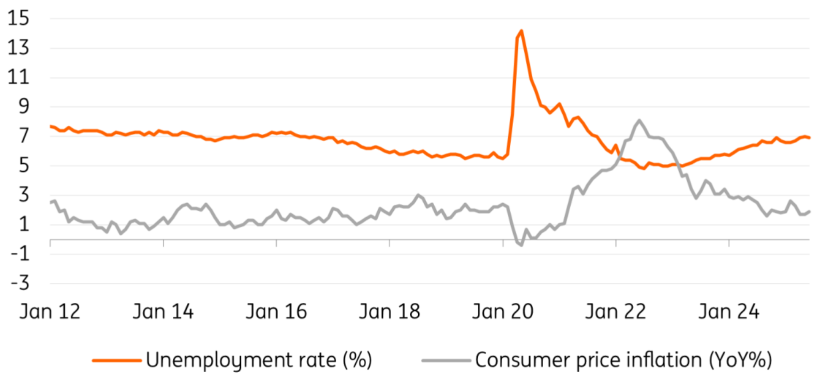
In response to unexpectedly positive data and renewed trade tensions, the Bank of Canada is likely to hold interest rates at 2.75% at its 30 July meeting. In June, unemployment fell to 6.9%, with total employment rising by 83.1k. Even though headline CPI has increased to 1.9%, the month-on-month rate is benign at 0.1%, with the Bank of Canada's consumer and business surveys also improving. Compared to the first quarter, consumer job loss fears and inflation expectations have decreased, with fewer firms reporting direct impacts from tariffs.

The Bank of Canada has maintained a cautious outlook amid tariff uncertainty. Following a brief period of declining trade tensions, President Trump's announcement of potential 35% tariffs, effective 1 August, would rock sentiment further if a deal is not agreed.

United States-Mexico-Canada Agreement (USMCA) compliant goods will be exempt from blanket tariffs; however, securing a certificate and proving 60-75% of the goods' content is North American-made can be challenging. In addition, sector-specific tariffs are not exempt, with 50% tariffs on steel, aluminium, and copper, and 25% tariffs on autos. With trade talks ongoing, the future of Canadian tariffs remains uncertain.

In his most recent speech, Bank of Canada Governor Tiff Macklem suggested a hesitancy to cut rates amid trade unpredictability and potential inflationary impacts. Considering these concerns, coupled with elevated employment levels, we expect the Bank to continue to hold rates. Nonetheless, with the risks skewed toward more economic weakness, we think risks are towards two, rather than just one, rate cut before the end of the year.

Unemployment and CPI in Canada



Source: ING, Refinitiv

We still see upside risks for USD/CAD

USD/CAD has followed the USD's depreciation over the past week, but lagged other G10 peers. In our view, there is still some complacency in the FX market around US-Canada trade relationships, and the balance of risks for the loonie remains tilted to the downside.

We expect CAD weakness to play out both in the crosses (other commodity currencies like AUD or NOK look more solid) and versus USD, which we expect to find some support from a hawkish Fed repricing throughout the remainder of the third quarter.

Even for this BoC meeting, markets may be underestimating the chance of a dovish-leaning stance. Policymakers have moved their attention increasingly to growth risks now that inflation is below target, and uncertainty around US-Canada trade deals means 6bp priced in for the September BoC meeting now appears way too conservative. We continue to target a return to 1.380 in USD/CAD in the near term.

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