Bank of Canada preview: Pausing in September, but set to stay on track for more tapering

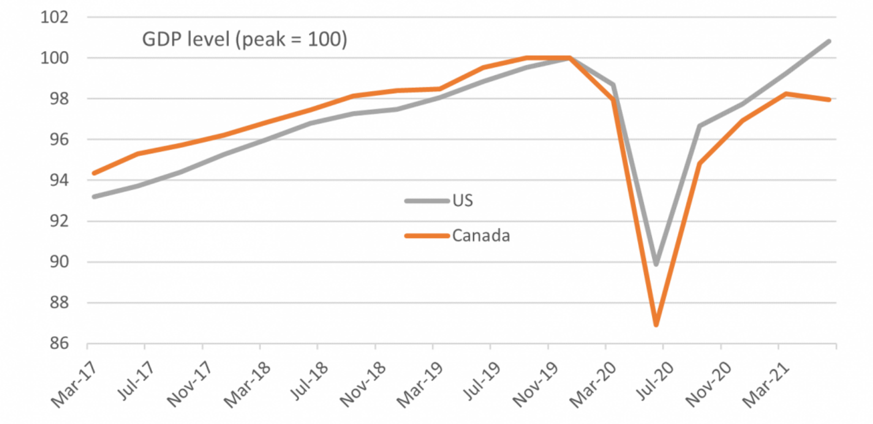
Next week's BoC meeting won't result in any policy changes ahead of the federal election, but softer data of late is unlikely to alter the BoC's course, with policy normalisation well underway. Less supportive domestic drivers (BoC repricing, political uncertainty) may keep CAD capped in September, but we expect the overvalued USD/CAD to decline in 4Q

Source: Shutterstock

A quiet September meeting, but tapering should continue in October

The Bank of Canada is well on the way to policy normalisation. It has already slowed the $5bn of weekly QE asset purchases to $2bn and repeatedly signalled it will start raising rates "in the second half of 2022" when inflation, on the BoC's forecasts, consistently hits 2%.

However, the recent news flow has not been great and we could hear a slightly more dovish take at next Wednesday's policy meeting. After all, a surprise negative 2Q GDP print (-1.1% versus 2.5% expectations) combined with rising Covid cases suggests that the output gap may take longer to close.



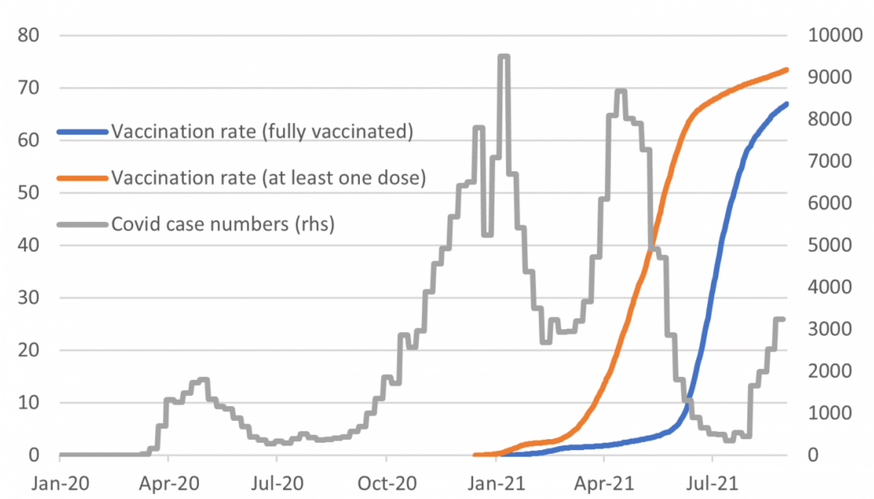
Source: Macrobond, ING

The softer figures combined with the proximity to Canada's federal elections (scheduled for 20 September) means that the BoC will tread delicately. The Bank will acknowledge the risks and undoubtedly leave rates and QE unchanged at this meeting, but we still think it will signal the prospect of rate hikes later next year.

Moreover, the case for further QE tapering is still strong. Inflation is more elevated than expected and could linger at around 4% for a while, double the BoC's target, with supply chain disruptions and high gasoline prices showing little sign of easing.

The jobs market is also strong with employment having rebounded by 2.7mn since the April 2020 low. This means there are now only 246,000 fewer people in work than before the pandemic struck – equivalent to just 1% of February 2020 employment levels.

Vaccination rates are also looking strong and this will hopefully limit the upside for hospitalisations and thereby allow the economy to remain largely open even if case numbers continue to rise.



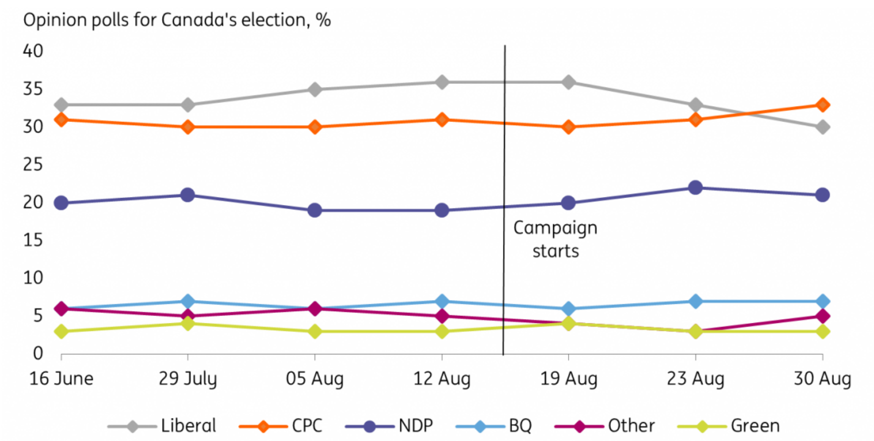
Source: Macrobond, ING

It is also important to remember that fiscal policy will continue to provide support to the economy while 10Y bond yields have fallen 35bp since May, which is also providing stimulus. In an environment where inflation is already above target and Canada's booming housing market is leading to fears of a bubble forming, there is still a strong case for dialling back the stimulus again in October. We still favour QE being reduced to $1bn per week at that policy meeting.

CAD: Going through a softer period, but expect 4Q strength

The loonie suffered this week from some repricing of rate expectations in Canada, as the weak 2Q GDP data likely prompted some speculation that the Bank of Canada could ultimately turn more cautious on tapering/tightening. As discussed above, this is not what we expect to happen given that the still-strong economic backdrop warrants a further unwinding of stimulus in October. But the "in between" September meeting may not do much to mute such speculation and may fail to provide solid support to the Canadian dollar in the short term.

What may also be contributing to CAD's recent underperformance against other pro-cyclical currencies is some political risk premium that is being built up, as Prime Minister Justin Trudeau's Liberal Party has seen quite a sharp drop in opinion polls after announcing snap elections in mid-August in an attempt to secure a full majority in the House.



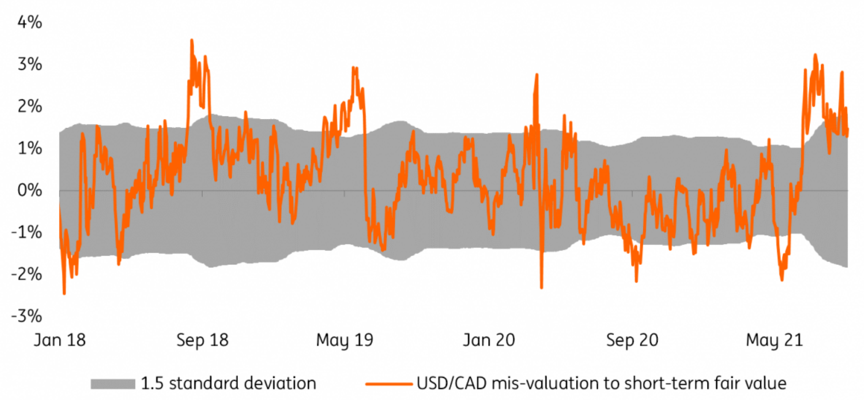
Source: Angus Reid Institute, ING

As shown in the chart above, it not only seems that the Liberals will fall short of securing a full majority of the seats in parliament, but a media website (338canada.com), which gathers data from various pollsters, is projecting the Conservative Party (PCP) to win 142 seats, with the Liberals only receiving 129. Currently, the polls-implied probability of a CPC-plurality government is 53%, against only a 36% probability of a Liberal-plurality government. The chances of a Liberal-majority government (originally the outcome sought by Trudeau) are forecasted to be only 2%.

We'll discuss the potential implications for the Canadian economy and CAD of different election outcomes as we get closer to the 20 September election. For now, we think uncertainty about the outcome and a higher risk of political instability in Canada is likely contributing to the choppy sentiment for CAD.

Even if we continue to see broad resilience in oil prices, doubts about the BoC's policy direction and political uncertainty may keep CAD's gains capped in September. However, we do not see this being the case in the longer run, when we expect: a) the BoC tapering to continue, allowing markets to cement views around a 2022 tightening, b) global risk appetite to stabilise and the US dollar to show some seasonal weakness later in the year, and, c) oil prices to stay supported.

All these factors may allow CAD to recover some lost ground and drive USD/CAD sustainably below 1.25 in 4Q21 (we target 1.22 by year-end). Currently, USD/CAD is scoring as 1.5% overvalued, according to our short-term financial fair value model (chart below), which takes into account rate differentials, relative equity performance, risk sentiment and commodity factors.



Source: ING

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