

Article | 19 January 2024

# Bank of Canada preview: Too early for a radical pivot

Core inflation came in hotter than expected in December which rules out the Bank of Canada shifting meaningfully in a dovish direction at the January meeting. However, higher interest rates are biting and we continue to look for rate cuts from the second quarter onwards. USdependent BoC rate expectations and the Canadian dollar may not move much for now



### Hot inflation warrants caution before dovish turn

The Bank of Canada is widely expected to leave the target for the overnight rate at 5% when it meets next week. Policymakers continue to talk of their willingness to "raise the policy rate further if needed", and inflation does indeed continue to run hotter than the BoC would like, but we see little prospect of any additional policy tightening from here. Instead, the next move is expected to be an interest rate cut, most probably at the April meeting.

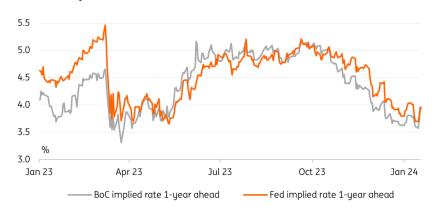
The latest BoC Business Outlook Survey reported softening demand and "less favourable business conditions" in the fourth quarter with high interest rates having "negatively impacted a majority of firms", leading to "most firms" not planning to "add new staff". Job growth does appear to be

Article | 19 January 2024

cooling and the Canadian economy contracted in the third quarter and is expected to post sub 1% growth for the fourth quarter. Also remember that Canadian mortgage rates will continue to ratchet higher for an increasing number of borrowers as their mortgage rates reset after their fixed period ends. This will intensify the financial pressure on households, dampening both consumer spending and inflationary pressures. Unemployment is also expected to rise given the slowdown in job creation and high immigration and population growth rates.

Given this backdrop, we expect Canadian headline inflation to slow to 2.7% in the first quarter and get down to 2% in the second versus the consensus forecast of 2.6%. As such, we see scope for the BoC to cut rates by 25bp at every meeting from April onwards – 150bp of interest rate cuts versus the consensus prediction and market pricing of 100bp of policy easing.

## Rate expectations in US and Canada



ING, Refinitiv

# Fighting market doves is still hard

Markets currently price in 95/100bp of easing by the Bank of Canada this year. As shown in the chart above, the pricing for rate cuts in the US and Canada has followed a very similar path. The implied timing for the first rate cut is also comparable: May for the Fed (March is 50% priced in), June for the BoC (April is 45% priced in). That is despite the communication by the Federal Reserve which has already pivoted (via Dot Plots) to the easing discussion while the BoC officially still retains a tightening bias.

In practice, even if the BoC chooses – as we suspect – to delay a radical dovish pivot and stay a bit more hawkish than the Fed, pricing for the BoC will not diverge too much from that of the Fed. So, the room for a rebound in CAD short-term rates appears more tied to USD rates than BoC communication.

## FX: USD/CAD to stabilise

In FX, the story isn't much different. The Canadian dollar has been a de-facto proxy for US-related sentiment, acting less and less as a traditional commodity currency – that would normally be hit by strong US data – thus outperforming the rest of high-beta G10 FX since the start of the year. The rebound in USD/CAD to 1.35 is in line with a restrengthening of the USD primarily due to risk sentiment, positioning and seasonal factors, rather than a divergence in Fed-BoC policy patterns. In fact, the USD-CAD two-year swap rate gap has widened further in favour of CAD so far in January, from 20bp to 32bp.

Article | 19 January 2024

We expect the impact on CAD from this BoC policy meeting to be modestly positive as expectations of a radical dovish shift are scaled back. However, Governor Tiff Macklem already introduced the idea of rate cuts in a speech this month and will need to acknowledge the downward path for the policy rate to a certain extent. While waiting for the Fed meeting a week later and the crucial US CPI numbers for January, US-dependent rate expectations in Canada may not move much. USD/CAD may trace back to 1.34, but we don't see much further downside for the pair this quarter as USD shows the last bits of strength.

#### **Authors**

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

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

#### **Disclaimer**

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies). The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

 $Additional\ information\ is\ available\ on\ request.\ For\ more\ information\ about\ ING\ Group,\ please\ visit\ \underline{http://www.ing.com}.$ 

Article | 19 January 2024