

Bank of Canada set for lift-off

We look for the Bank of Canada to raise interest rates 25bp on 26 Jan. Activity is strong, the economy is seeing record employment and inflation is at 30-year highs. Covid containment measures are also set to be eased at the end of the month and this should signal the green light to hike rates. Expect a positive impact on CAD, although external risks are mounting



Source: Shutterstock

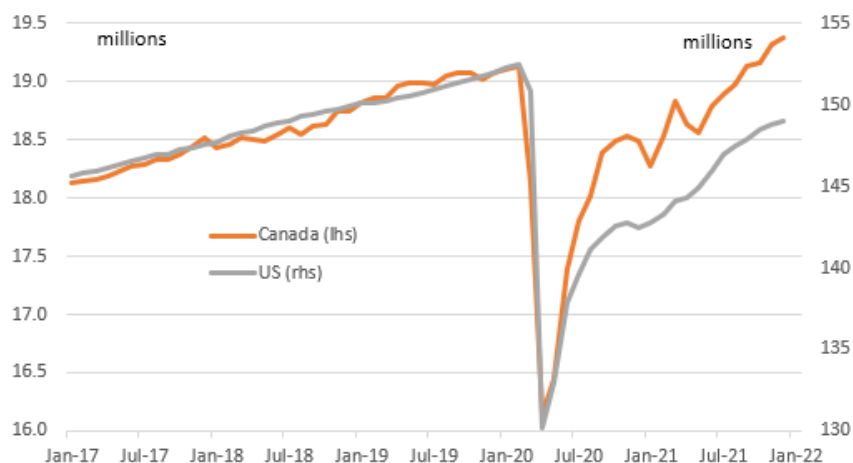
Strong economic recovery boosts the case for action

The Bank of Canada cut rates to 0.25% and initiated a C\$5bn per week asset purchase programme in support of the economy as Covid containment measures were brought in to stem the pandemic. As the economy recovered, the Bank of Canada was among the first to start pulling back on the stimulus by tapering the asset purchases down to C\$4bn per week in late 2020, before going to \$3bn in April 2021 and C\$2bn in July 2021. Asset purchases were then abruptly concluded last October with maturing assets reinvested, thus maintaining the size of the balance sheet.

Since then, the economy has battled both the Delta and the Omicron waves, but has continued to add jobs in impressive numbers. The chart below shows that the Canadian jobs market has

performed far more impressively than that of the US. In fact, employment is now at a record level of 19.4mn with the unemployment rate back below 6% even though the economy, as of the third quarter, was still 1.4% smaller than in 4Q 2019. This lost output will soon be recovered with the latest Bank of Canada' 4Q Business Outlook Survey reporting sentiment at a record high as companies highlighted a "broadening recovery in demand". Notably, investment and hiring intentions are at record highs, which is consistent with our own GDP forecast of 3.5% for 2022 after 4.5% in 2021.

Employment levels (millions)



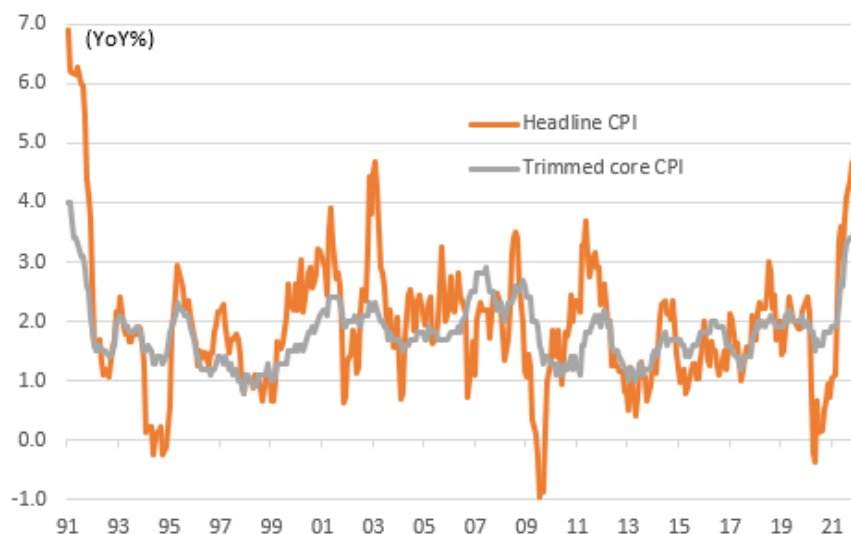
Source: Macrobond, ING

Inflation and easing restrictions gives BoC the green light

At the same time, inflation is on the up with prices rising at their fastest rate for more than 30 years. The same BoC survey suggests no let-up in inflation pressures anytime soon with respondents saying they expect supply disruptions through the second half of 2022 while labour shortages are constraining output. In this environment where the economic outlook is robust, the jobs market is red hot and inflation is at generational highs, we see little reason for the BoC to delay tightening monetary policy.

Furthermore, Ontario has announced a three-step plan to allow a full reopening from Covid restrictions, starting from 31 January, which should be the final green light for the central bank to hike rates 25bp. At least three more hikes are likely this year while we could also potentially hear the BoC mulling the possibility of shrinking its balance sheet later in the year.

Canada inflation (YoY%)

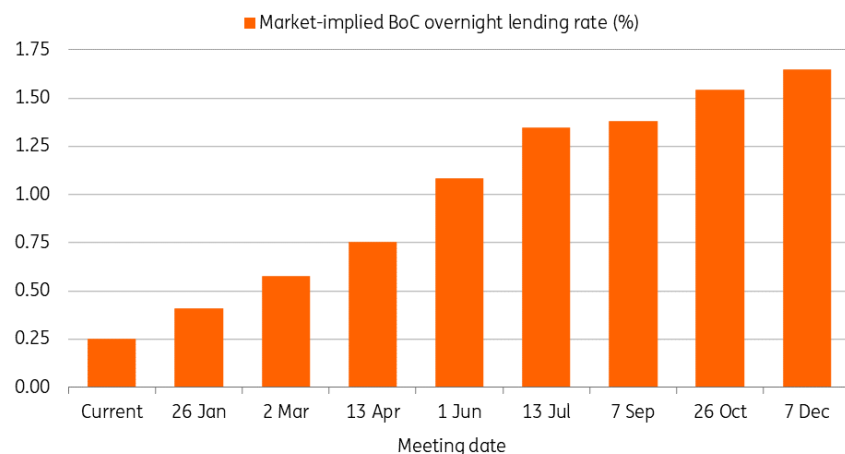


Source: Macrobond, ING

FX: Rate hike to support CAD, but watch for external risks

Markets are currently pricing in around a 70% implied probability that the BoC will hike rates on Wednesday. This means that there is some decent room for Canada's dollar to benefit from a rate hike, as this would also legitimise the current aggressive tightening expectations by the markets, which are pricing in around 125bp worth of hikes in 2022 (chart below).

Markets expecting five BoC hikes in 2022



Source: ING, Refinitiv

We think that we could see USD/CAD move back below 1.25 on Wednesday due to the combination of a potentially USD-negative FOMC announcement ([as discussed here](#)) and the CAD-positive BoC rate hike. That said, it is not a given that the pair will be trading at current levels into Wednesday, as the fragile global risk environment – currently impacted by geopolitical tensions in Ukraine and prospects of Fed tightening – risks propping the pair higher in the short-run.

At the same time, CAD – unlike other high-beta currencies like the Australian and New Zealand dollars – can count on its positive exposure to the oil rally, with crude prices that have proven resilient in spite of adverse swings in global risk appetite.

Author

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 www.ing.com.