Bank of Canada set to resume rate cuts

The Bank of Canada is set to resume cutting interest rates in the wake of a large GDP contraction in the second quarter and rising unemployment. Tariffs will continue to weigh on the economy, and with inflation broadly in line with target, we look for a 25bp cut on Wednesday, with a further 25bp cut in the fourth quarter. CAD should remain weak in the crosses

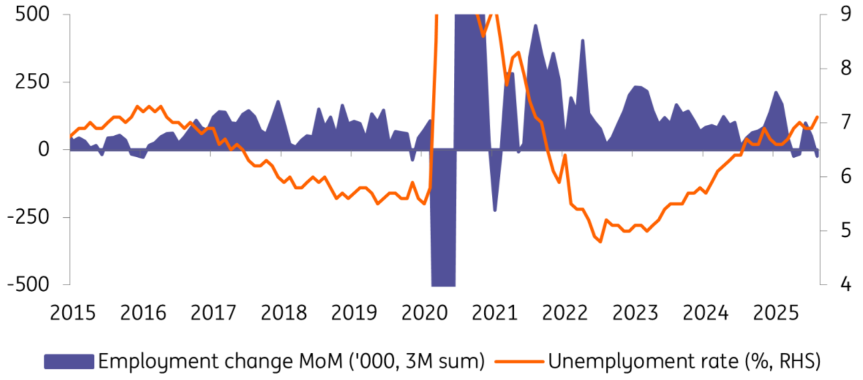
Bank of Canada building in Ottawa, Ontario

Another cut as labour market slows

At the previous BoC meeting in July, the central bank held rates steady at 2.75% and suggested that the economy was “showing some resilience, and ongoing pressures on underlying inflation”. Nonetheless, “If a weakening economy puts further downward pressure on inflation and the upward price pressures from the trade disruptions are contained, there may be a need for a reduction in the policy interest rate”. That now appears to be the case.

The economy contracted at a 1.6% annualised rate in 2Q while first quarter GDP was revised down to 2% from 2.2%. Consumer spending was robust, but a huge drop in exports following the implementation of tariffs and a drop in business investment led to a much weaker than predicted outcome. Meanwhile, unemployment rose to 7.1% in August, its highest rate since August 2021, with the economy having lost more than 100,000 jobs over the past two months.

Canadian jobs market creaking



Source: ING, Macrobond

Inflation pick-up not concerning

Core inflation is back up to 3%, but headline inflation is below 2%, and a cooling economy and weaker jobs market with subdued wages suggest that price fears should gradually ease. The BoC estimates that the nominal neutral policy rate is in the 2.25-3.25% range, so right now we are in the middle of that at 2.75%.

There is certainly scope for them to move rates lower, and we therefore expect a 25bp cut on Wednesday. We expect a further 25bp cut in December, taking the policy rate to the bottom end of the neutral range, as the BoC seeks to avert recessionary forces from taking hold.

CAD to continue lagging

Our view on the Canadian dollar has been one of underperformance in the crosses, with only small benefits coming from the weaker USD. That view is unchanged in light of our call for two more BoC cuts, considering markets are pricing in around 41bp for now.

We forecast only a very gradual descent for USD/CAD, entirely driven by lower USD as CAD remains unattractive relative to most of the G10. We target 1.37 for year-end and 1.35 for mid-2026.

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