Bank of Canada to step up the pace with a 75bp hike

Given strong growth, a tight jobs market and surging inflation, the Bank of Canada is expected to hike rates by 75bp to 2.25%. This is in line with market expectations and should have a contained impact on the Canadian dollar, which continues to face some downside risks in the near term on the back of a challenging global environment

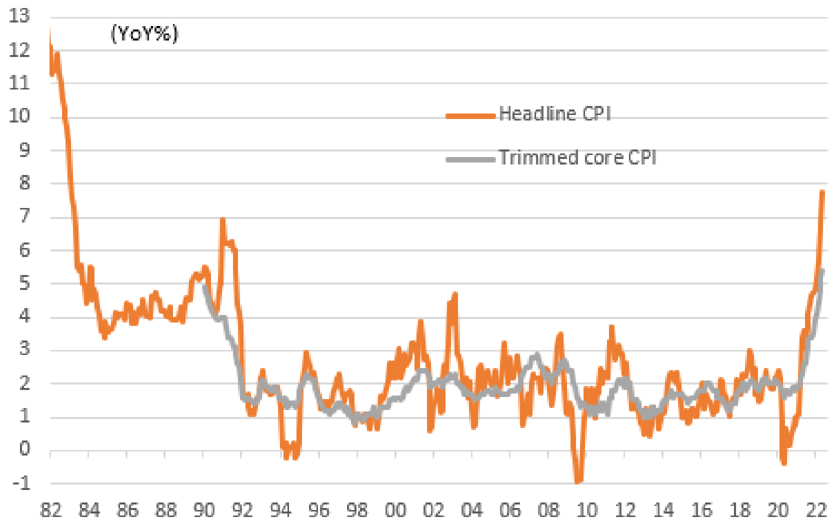
Tiff Macklem, governor of the Bank of Canada

Canada looks set to hit the brakes hard

The Bank of Canada (BoC) has indicated that it sees the “neutral” range for the policy interest rate as 2-3%. Given we are currently at 1.5% and central bankers have expressed a desire to see interest rates move to the top or even beyond that range, we expect the Bank of Canada to follow the Federal Reserve’s lead and implement a 75bp hike at its 13 July meeting.

After all, the economy is growing strongly, has record employment levels, and its inflation is running at 7.7%, the fastest rate since January 1983. The housing market is also red hot while Canada’s strong commodity-producing sectors mean it is far more resilient than most major economies to the spike in prices.

Canada inflation (YoY%)



Source: Macrobond, ING

The BoC is unlikely to be done with just 75bp. At the June policy meeting, the bank warned that "the risk of elevated inflation becoming entrenched has risen" and there was a clear need to "keep inflation expectations well anchored". The latest Bank of Canada survey of consumers and businesses showed that households expect inflation to still be at 5% in two years, while 78% of businesses expect inflation to exceed 3% over the next couple of years, which won't provide the BoC with any comfort. In a decent growth environment, we expect the BoC to follow up with 50bp hikes in September and October with an additional 25bp hike expected for December.

CAD: External factors still in the driver's seat

The BoC's commitment to raising rates aggressively is undoubtedly a positive factor for the Canadian dollar, but also one that may only emerge beyond the short term. That's because markets are already pricing in a 75bp move in July and – even more crucially – CAD is being primarily driven by external factors at the moment.

We think the short-term outlook for CAD remains challenging regardless of the BoC policy, given widespread fears of a global slowdown, USD strength, and oil price instability. That said, as the market appears to be trading more and more on recession fears, North America's lower vulnerability to global headwinds compared to Europe (and partly also thanks to a hawkish BoC) should still keep a lid on CAD weakness. We think a move to 1.31-1.32 in USD/CAD is possible in the near term, but the rally may start losing some steam beyond that point.

We project some recovery in high-beta currencies and some gradual USD depreciation after the summer, and we expect the relatively strong economic/commodity backdrop and the aggressive BoC tightening cycle all to play out in favour of CAD. We expect the loonie to be amongst the best performers once risk sentiment stabilises, and we still target sub 1.2500 levels for 4Q22.

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