Bank of Canada hikes again as inflation fears linger

The BoC hiked rates to 5% as broadly expected with the tone of the statement suggesting we will need to see significant softening in activity and inflation to deter it from hiking again in September. Markets are pricing a 75% chance of a move and that looks about right. USD/CAD could now break below 1.3000 quite soon

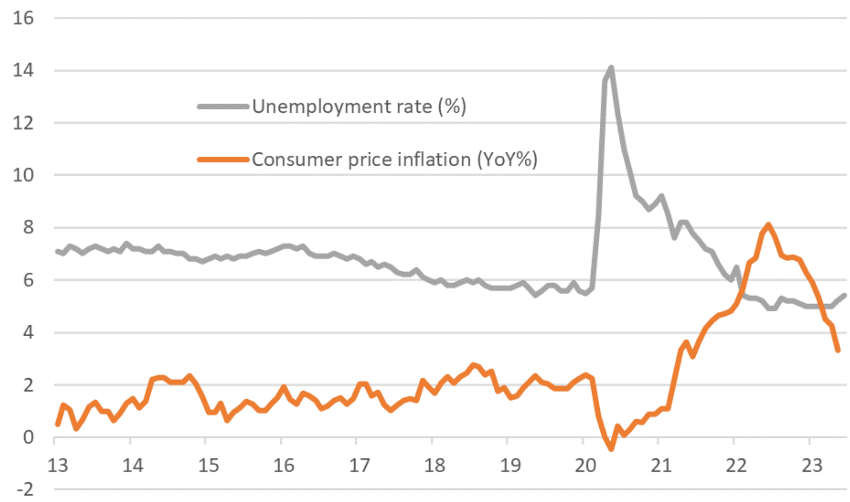
Second hike in a row after a long pause

The Bank of Canada has raised rates a further 25 basis points today, leaving it at 5%. This follows a five-month pause between the January hike and the restart of policy tightening in June, triggered by concerns that demand was proving to be more resilient and inflation more persistent than the BoC had expected. This argument was used again today with the BoC stating that "three-month rates of core inflation running around 3½-4% since last September, underlying price pressures appear to be more persistent than anticipated. This is reinforced by the Bank's business surveys, which find businesses are still increasing their prices more frequently than normal".

The BoC also place a heavy emphasis on the strength in consumer demand and the tightness in the labour market, which is keeping wage pressures elevated. It sees inflation staying around 3% for the next year before only returning to target in 2025. The BoC offer little in the way of forward guidance, merely stating that the "Governing Council will continue to assess the dynamics of core inflation and the outlook for CPI inflation. In particular, we will be evaluating whether the evolution of excess demand, inflation expectations, wage growth and corporate pricing behaviour are consistent with achieving the 2% inflation target".

The chart above shows that inflation and the unemployment rate are moving in the direction the BoC would like to see, but clearly it isn't happening quickly enough and may not be sustainable enough for the BoC to keep rates at 5%. The market is currently pricing around a 75% chance of another hike at the September meeting and we feel this is about right. The tone of the statement suggests the BoC are not convinced it has done enough yet so we will need to see significant softness in activity, labour and inflation numbers to prevent another move.

Canada's CPI and unemployment



Source: ING, Macrobond

CAD: On track to hit sub-1.30 levels

The market reaction to the BoC hike was – as we had expected – positive for the loonie, although the proximity to the surprisingly soft CPI print in the US meant that CAD lagged other pro-cyclical currencies on the day. That, once again, boils down to the rather tight correlation of the loonie with incoming data from the US.

Looking beyond the very short-term impact, the extra hike by the BoC and no pushback against further moves in the future means that CAD can keep benefitting from an attractive carry. It's worth remembering that the loonie has the best volatility-adjusted carry in the G10 space. We don't necessarily see this as the inception of a broader USD downtrend, but the close USD-CAD correlation also means that CAD is more shielded in the event of a USD rebound than other pro-cyclical currencies. A move below 1.3000 is surely possible in the coming weeks, although we may need to wait the fourth quarter of this year to see USD/CAD sustainably trade around 1.27/1.28.

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