

## Canada edges towards a rate cut in the second quarter

Subtle dovish shifts in the Bank of Canada's thinking and a weak growth backdrop give us increasing confidence that inflation concerns will fade and the BoC will cut rates in 2Q. There may be room for a rebound in short-term CAD rates in the near term though, and USD/CAD could stabilise, but the loonie remains less attractive than the likes of NOK and AUD



Bank of Canada  
Governor Tiff Macklem

### Dovish hints point to cuts

The Bank of Canada left monetary policy unchanged at today's meeting. The target for the overnight rate remains at 5% and the Bank is continuing with quantitative tightening.

The market has latched onto the mildly dovish shift in the BoC's stance with Governor Macklem stating that "*there was a clear consensus to maintain our policy at 5%*" with the deliberations

*“shifting from whether monetary policy is restrictive enough to how long to maintain the current restrictive stance”*. In this regard the Bank has taken the significant step of removing the line that the Bank *“remains prepared to raise the policy rate further if needed”* from the accompanying statement.

Nonetheless, the Bank remains concerned about the inflation backdrop. It doesn't expect annual CPI to return to the 2% target until 2025 given *“core measures of inflation are not showing sustained declines”*, not helped by wages rising 4-5%. That said, there was acknowledgement that the economy *“has stalled”* with the economy likely stagnating in 1Q 2024. The BoC remains hopeful that it will recover from mid-2024, but 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”*.

Jobs growth does appear to be cooling and remember, too, 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. In our view 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 1Q and get down to 2% in the second quarter, well ahead of what the BoC expects. Consequently we see scope for the BoC to cut rates by 25bp at every meeting from April onwards (the market is pricing this as a 50:50 call right now). This means 150bp of interest rate cuts versus the consensus prediction and market pricing of 100bp of policy easing.

## CAD remains less attractive than other commodity currencies

The Canadian dollar has weakened following the BoC the announcement, although 2-year CAD yields did not move much after having dropped 10bp to 4.0% since yesterday's peak on the back of global factors.

There may be some room for CAD short-term rates to tick back higher in the near term though, mostly following USD rates. From an FX perspective, it's key to remember that CAD has been tracking quite closely the dynamics in US data, and that may remain the case until a broader USD decline emerges and favours pro-cyclical currencies such as CAD. We target a move in USD/CAD below 1.30 in the second half of the year, but still see CAD as less attractive than other pro-cyclical currencies like NOK and AUD this year - also due to our expectations for large rate cuts in Canada.

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