Bank of Canada steps on the gas

In response to the economic and financial market turmoil, the Bank of Canada has increased its QE stimulus to include provincial and corporate bonds. While this will mitigate some of the headwinds for growth, the significance of the energy sector will weigh heavily on recovery prospects. All this means the CAD may stay weaker for longer before recovering

Source: Shutterstock

BoC expands asset purchases by up to CAD 60bn

After having cut interest rates by a total of 150 basis points over three meetings in March to what was termed the “effective lower bound” of 0.25% it is no surprise that the Bank of Canada didn't move rates any lower today.

However, the fact the economy lost a million jobs in March underlines the need for further support and its financial system. Consequently, the central bank's announcement that they will step up their newly instigated quantitative easing efforts by buying provincial and corporate bonds in addition to the CAD 5bn of government securities it is buying weekly.

In an effort to better improve functioning in financial markets whilst also offering support for companies and regional governments the BoC is setting up a Provincial Bond Purchase Program of up to CAD 50bn and a Corporate Bond Purchase Program of up to CAD 10bn (investment grade only). It is also enhancing repo facilities to further help ease pressures in lending markets.

But the economic prognosis remains grim

Separately, the central bank suggests that the peak to trough fall in Canadian economic activity – between 4Q19 and 2Q20 could be anywhere between 15 and 30%.

Canada is obviously impacted as much as everyone else by social distancing and shutdowns in an effort to contain Covid-19. However, its exposure to commodities, particularly, energy, which have seen dramatic price falls intensifies the downside risks for activity. The BoC also admits that the recovery, when it eventually comes, is likely to be uneven and could be protracted. Inflation is likely to fall to zero in the second quarter due to plunging gasoline prices.

> *We would suggest that the pace of recovery in Canada is likely to be slower than in other developed markets given the greater exposure to the energy sector*

We do not disagree with the BoC's prognosis but remain hopeful that the peak to trough fall will be closer to 15% than 30% in GDP. That, however, depends on the pace of re-opening of the economy and if there are any setbacks on the number of Covid-19 cases that could prompt renewed shutdowns.

We would suggest that the pace of recovery in Canada is likely to be slower than in other developed markets given the greater exposure to the energy sector. The collapse in prices and demand means that investment in the sector is likely to continue being cut with employment prospects remaining challenging for some time to come.

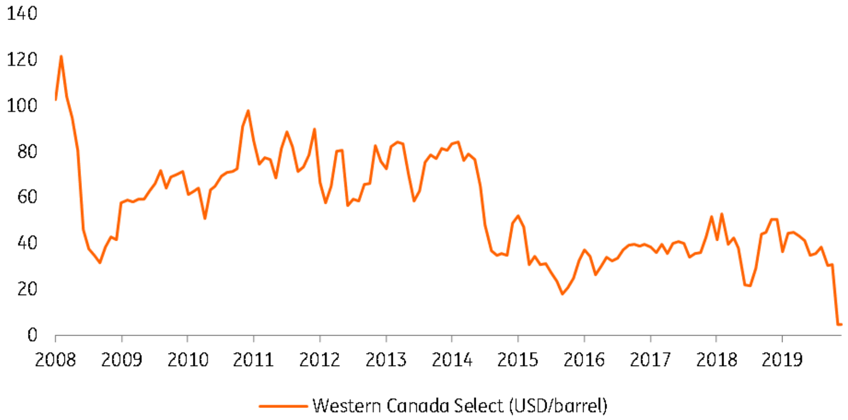
CAD: Not yet ready for a recovery

Despite a quite muted reaction in USD/CAD around the BoC announcement, we keep seeing the balance of risks for CAD tilted to the downside in the short-term.

The root of all evil for the loonie is quite clearly the weak crude prices, that failed to sustainably recover after the new OPEC+ meeting as demand concerns kept rising.

With Western Canada Select crude currently trading around a historically-low 5 USD/bll (chart below), markets are starting to price in a grapple effect on the oil-export-centred Canadian economy. As long as crude prices prove unable to recover, the ability of CAD to rebound will inevitably be limited.

Canadian crude in free-fall



Source: Bloomberg, ING

The move by the central bank was largely priced in, but despite not having an immediate impact on the spot market it clearly displays the determination of the Bank to hold an ultra-dovish monetary stance which should ultimately put a floor below USD/CAD, barring a major USD idiosyncratic drop.

When adding a likely magnified economic impact of slowing global trade flows to a very open economy such as Canada, the risk is that the loonie will remain weaker for longer before sustainably recovering. In the short term, we could see a move back to the 1.45 area but we may have to wait for the summer to see a decisive downtrend below 1.40.

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