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Bank of Canada keeps its eyes on the home front

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Markets were reminded that the Bank of Canada is going to keep its eyes on the home front, as the central bankers showed no tendency to follow the increasing hawkish tone from their counterparts in Washington. Today's decision to keep rates on hold, but leave open the risk that a further hike might be needed, came as no real surprise. But the absence of any stated concern over a larger gap to US rates, or the resultant recent weakening in the Canadian dollar, adds weight to our view that rates can stay on hold north of the border even as the Fed has signalled another 75 basis points to come.

- The Bank needs a clearer picture of where growth and inflation are headed in order to either opt to hike again or more definitively set aside that prospect. With so little time since it initiated its conditional pause, it simply doesn't have enough data to provide that clarity. Indeed, the statement cited the conflicting signals seen in recent weeks. GDP growth for Q4 came in below their expectations, inflation has been easing off (if still too high), but labour markets remain very tight, with January's employment surge no doubt raising eyebrows at the Bank.
- Other than a reference to the US dollar strengthening (i.e. against other currencies in general), the Bank didn't highlight any concerns about a pass through to Canadian inflation from a weaker loonie. Canadian short term rates had drifted up in recent days as markets judged that a more hawkish Fed, and the resulting foreign exchange rate moves, might drag the Bank of Canada back to the rate hiking table, and today's statement could see a bit of that unwind.
- Overall, the Bank sees the economy's fate as generally in line with its prior views, expecting the slowdown in growth to ease labour market tightness, and pull inflation towards 3% by mid-year. But it needs a sustained slowing in growth to go the rest of the way to its 2% CPI target. The text of the message is partly designed to speak to Canadians as to why a cooler job market would be welcome. While economists typically think about an easing in wage pressures as helpful for business costs, the Bank also mentions that a slower pace for labour income gains also reduces the ability of businesses to pass on higher costs in their prices.
- We expect the economy to evolve largely in line with the Bank's hopes, and therefore see the overnight rate grounded at 4.5% over the balance of the year, which appears to be the central bankers' base case. In the job market, we might just be seeing the final throes of hiring related to last year's increases in labour demand, with that hiring delayed by the difficulty in filling vacant positions. Elsewhere, and to a greater extent than in the US, we're seeing the predicable impacts of higher rates on interest sensitive demand, including no growth in final domestic demand over the last half of 2022.

Implications & actions

Re: Economic forecast — A no-surprise statement from the Bank of Canada relative to our expectations naturally implies no change to our view that we're done with rate hikes on this side of the border.

Re: Markets — Canadian two year yields eased a bit more than Treasuries, but that was just taking back some of the climb we've seen in recent days. For markets, the big news for the week will still be the jobs data for both the US and Canada.

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