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January 24, 2024

Bank of Canada signals relief, but not just yet

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The Bank of Canada isn't ready, willing or able to bring interest rate relief just yet, but dangled some hints that lower rates are on the way later this year. The overnight target of 5% was, as expected, left unchanged, as was the schedule for quantitative tightening. The statement dropped the earlier reference to a potential need to hike if inflation failed to cool, changing it into a less hawkish comment that they remain "concerned" about persistent core inflation. But in a growth and inflation forecast that's little changed for the next two years, it sees weak growth in the first half of 2024 forecast with more disinflationary slack emerging, and an output gap estimate centred on -0.75% as of the end of 2023. The pick-up in growth projected for the back half of the year is likely tied to their own expectations for lower rates at that time, since the Governor noted that the meeting has shifted from a discussion of whether rates are high enough, to one about how long they need to keep rates at 5%. That's a dovish tilt, but is still consistent with our call for a first rate cut in June, with as much at 150 bps of cuts on tap this year if, as we expect, we'll need that to get the economy moving again after its current stall.

- The central bank is counting on the Philips Curve, the historical relationship between economic slack and inflation, to work its magic on inflation in the coming year, with one important exception: shelter costs. In the MPR's projections for the year-on-year pace for the CPI, shelter costs will be the key counterweight to a declining inflation contribution from energy, food and core goods, thereby holding inflation to roughly 3% over the course of this year. But that won't be a barrier to cutting rates before the middle of 2024, since the cures for shelter inflation don't rest on beating up on the economy. Instead, the Bank cites slower population growth as central to moderating rent inflation, and an easing in the impact of mortgage renewals on the costs of home ownership. The latter will actually require rate cuts from the Bank this year.
- Wage inflation is seen as too hot to be consistent with a sustained 2% inflation rate, generating growth in real purchasing power and rising unit labour costs. But the Bank expects increased labour market slack to cool those fires, and also notes that higher unit labour costs can sometimes be absorbed by weaker profit margins. That prospect seems likely given the weak outlook for final domestic demand projected for the next few quarters.
- The economic growth forecast for Canada was left essentially unchanged, in contrast to the upside surprises seen in the US. Relative to our own view, the Bank's call for zero growth in Q4 is somewhat more pessimistic (we're at 0.8%), but we're projecting a negative Q1 pace versus the 0.5% annualized growth the Bank sees. In total, then, we see the economy at the end of Q1 as being in roughly the same position as the Bank's forecast, and therefore don't anticipate the downside surprise that would be needed for a March rate cut. Its 0.8% growth rate for 2024 as a whole is only two ticks above our own call.
- But the Bank seems to be counting on rate cuts, which we see as beginning in June, in its projections for a pick up in growth in latter half of the year, and for much better growth in 2025, tying that improvement to "the recent easing in financial conditions." That easing relates to the fall in bond yields that has been driven by market expectations for rate cuts in 2024, and would be reversed if the Bank failed to live up to those expectations.
- Overall, the rate announcement, policy report, and opening remarks at the Governor's press conference underscore that this is a central bank team that is still concerned about sticky inflation, but isn't blind to the downside risks to growth from sustained high interest rates, and is counting on a lacklustre economy to ease inflation over time. That still means that Canadians will have to live through some economic disappointments in upcoming quarters, with the

Bank not in a hurry to trigger an upsurge in growth until it gets a bit more comfortable with the underlying pace of inflation. But its projections for better growth later this year, as well as the shift in its deliberations towards a focus on how long they need to keep rates at this level, are clear signs that its own outlook includes some meaningful interest rate cuts taking hold in the back half of the year.

Re: Economic forecast — We see no reason to alter our call for the first (quarter point) cut to come in June, and for the Bank to surpass market expectations by delivering a total of 150 basis points in cuts by the end of this year. The second cut could well be a 50 basis point move to really get the ball rolling, given that rates will still be at elevated levels at that point. We'll need that relief to drive the pick-up in growth that the Bank projects, and avoid a much harder landing. The timing of the first cut can come well before we see a 2% inflation rate if, as we expect, by mid-year most of gap between actual inflation and the Bank's target lies in the shelter component. So an April cut, while not our base case, would be on the table if growth or inflation come in weaker than we expect.

Re: Markets — Today's statement might have been a touch more dovish than some would have expected, but didn't push 2-year yields lower as it coincided with some firmer-than-expected PMI readings in the US.

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