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Bank of Canada: No spring break for borrowers

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There was no move today, but the Bank of Canada made it clear that there will be no spring break for borrowers if news on the pandemic unfolds as it expects. As we expected, in what looks to have been a close decision, the Bank either judged that a fresh pandemic wave wasn't the opportune time to start a rate hike cycle, or it simply wanted to use this announcement to formally end its forward guidance before pulling the trigger. Still, it left no doubts that a rate hike lies in store for March if news on the pandemic and its economic consequences has improved by that point. And the Bank will "consider", and in our view likely go ahead with, a move to let its balance sheet decline by not reinvesting all of its maturing bonds once it starts raising rates. So while rates dipped a bit today on the "no hike" decision, borrowers won't be breathing that easy for long.

- Under the earlier forward guidance, the Bank pledged to leave rates on hold until slack was absorbed, a condition that it now sees as having been met. There's a bit of a fudge factor in that statement, however. It talks about the economy having a lot of momentum "as it entered 2022," and refers to measures that indicate an absence of disinflationary slack. It estimated the Q4 output gap as between -75% and +0.25%, with the midpoint of that range close enough to zero to say that slack had disappeared. But would still be true as of February, given that it concedes that "Omicron is weighting on activity in the first quarter"? What's clear is that the acceleration it sees after Q1 would make up for that lost ground in a hurry, all of which is, of course, resting on the assumption that the Omicron wave isn't followed by yet another Covid shock.
- While real GDP remains miles below its pre-Covid trend, the Bank has plenty of grounds to conclude that the gap reflects pandemic-related headwinds to potential output, and that labour markets entered the year near full employment. It also said that "supply has been revised down", implying that bottlenecks and shortages are putting a larger than expected squeeze on the economy's near term potential. It's counting on a relaxation of those supply hurdles to assist it in bringing inflation down from about 5% in the first half to 3% by the end of 2022, but even that year-end pace is nearly a full percentage point higher than its prior projection. Hence its conclusion that "interest rates will need to increase" so that, with the usually lags, demand growth will moderate sufficiently to get the CPI down to only a hair above its 2% target by the end of 2023.
- How aggressively the Bank will raise rates will depend in part on how much of a growth slowdown it sees as necessary to achieve that inflation outcome. On that score, there's one factor suggesting that it still sees room to take a moderate path towards tighter policy. Because it sees supply disruptions coming to an end by the close of 2022, that leaves room for GDP to grow much faster than what we would typically see as its trend non-inflationary potential. Indeed, its growth forecast has an average quarterly pace of 4.2% this year, which sees GDP up 4.6% year over year for 2022 as a whole, and has GDP still seeing a 3.5% gain for 2023.
- The other factor that in our view leans towards a gradualist approach is that the Bank's forecast, like others, not only assumes that the Omicron wave will prove short lived, but implicitly assumes that the coast is clear after that. That’s clear not only in its assumptions on the supply side, but also in its projection for robust services growth over the balance of 2022. We're not quite as sure on that front, and also expect that the Bank's call for a 2% growth rate in Q1 2022 will prove to be on the high side for demand, given restraints on services activity. Our GDP growth rate for 2022 as a whole is 0.5% below that of the Bank, and largely reflects our expectations for a slower start.

Implications & actions

Re: Economic forecast — With a March hike looking highly likely if there's a deceleration in Omicron cases, our "March or April" call for the first move now becomes a much clearer expectation for the first hike to come in March. That leaves a bit too many decision days over the balance of the year to stick with our 75 bp projection for the year's hikes as a whole, so we now see four quarter point moves this year. That said, we remain comfortable with our call for 150 bps in hikes for 2022 and 2023 combined, so we're merely moving forward one of those moves into this year, and still see rates cresting at a bit over 2% in 2024.

Re: Markets — Yields initially fell on the "no hike" decision, but erased that move as the press conference tone seemed decidedly hawkish. Really, today's announcement was only about timing, and market participants are likely to stick to their prior views on the extent of rate hikes and quantitative tightening in the next couple of years.

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