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Bank of Canada sits tight, and finds that patience is a virtue

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The Bank of Canada's current motto is "don't just do something, sit there," and patience should indeed be a virtue in getting inflation down to target without inflicting more pain on the economy than necessary. By including a warning that a further hike could still be required if the economy remains too heated, they are still far from being in line with market hopes for a rate cut later this year, and consistent with our view that we'll have to wait until 2024 to get any interest rate relief.

- As widely expected, the Bank left the overnight rate at 4.5%, and if there was a theme in their statement and the Monetary Policy Report, it was to do as little tinkering as possible with the overall outlook. The inflation outlook was essentially unchanged with the CPI reaching the 2% target late next year, the neutral rate of interest remained at 2.5%, and Q1 growth was just enough to leave the output gap where it stood in Q4. While there were revisions to potential GDP, a footnote explains that these had already been incorporated into the prior outlook. As evidence of that, the medium-term projection still has real GDP reaching roughly the same level as in the last outlook in order to bring inflation back to target.
- Despite an upside surprise in Q1 growth, the Bank remains hopeful that their desired slowdown is coming, citing expectations for a cooling internationally, and the lagged impacts of higher interest rates on Canadian households and business investment. So much of the upward revision in the 2023 growth outlook, with raised the pace to 1.4% from 1.0%, came from the better start to the year.
- Still, what's encouraging is that the Bank doesn't see an outright recession as necessary to get inflation back to target, only a slowing to "weak" but still-positive growth over the balance of the year. To get to the prior forecast for the level of real GDP, the Bank has trimmed its growth pace for 2024 by a half point to 1.3%, but that would include a pick-up on Q4/Q4 basis from what they expect over the rest of this year.
- The Bank might be a touch too pessimistic about the room for non-inflationary growth beyond 2023, even if our current 5% jobless rate is inconsistent with 2% inflation. Some of the observed weakness in productivity likely still owes to supply chain issues that should improve in the years ahead, rather than representing a permanent haircut to the level of GDP. Labour force growth could remain healthy if immigration and the use of temporary foreign workers continues to add elbow room. But in the near term, our growth forecasts are not far off those of the Bank, and still not quite meeting the definition of a full-blown recession.
- The Bank's messaging still has a hawkish tilt, despite its decision to leave interest rates on hold. The emphasis in the statement is on the cup being only half full when it comes to having the ingredients needed to meet its inflation targets. Labour markets are still too tight, wages gains are elevated, the economy is in excess demand, and while headline inflation has eased a lot, some of the underlying measures are inconsistent with a sustained 2% inflation rate. The interest rate decision notes that the committee is still judging whether policy is tight enough, not whether it is too tight. That needn't indicate a lot of risk of an actual rate hike in June if, as we expect, the growth numbers decelerate in upcoming months. But the messaging might help the Bank by countering the recent downward drift in bond yields, which threatens to provide a premature easing in term borrowing costs across the economy.

Re: Economic forecast — We'll stick to our view that the Bank of Canada will in fact "just sit there" over the balance of this year, neither following through on the implicit warning of a possible hike, nor meeting market expectations for an easing before year end.

Re: Markets — Canadian yields were modestly higher in the half hour following the release, but US Treasuries were also moving in that direction. The loonie got only a very temporary lift. The market has clearly heard, but is not yet believing, the Bank's reminder that there's still a chance of a return to rate hikes later this year.

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