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October 23, 2024

Bank of Canada: A bolder step on a more certain road

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If a half point rate reduction can be deemed to be a non-event, this was it. The recent data has allowed the Bank of Canada to more decisively plant the victory flag in its battle to get inflation to its 2% target on a sustainable basis. On that more certain road, there's no real logic in taking baby steps towards getting interest rates to a level that won't needlessly hold back economic growth. While in its practice, the Bank eschewed any references to the size of further interest rate moves ahead, with the current 3.75% rate still in restrictive territory, it would take a major turn of events to stand in the way of another 50 basis point reduction in December, driven by the same logic as today's decision. We're retaining our call for that additional cut this year. Thereafter, as it probes for how low it needs to go to ignite growth, we look for further quarter point reductions that will get the overnight rate to 2.25%, or slightly stimulative, by the second quarter of 2025.

- The Bank made few changes to its Canadian economic outlook, beyond shaving a couple of decimal places off the near term path for the CPI ahead, leaving intact its prior estimates for economic slack (an output gap in Q3 of -0.75% to -1.75%), potential growth (the economy's non-inflationary speed limit of just under 2% in the next two years) and the neutral policy rate (a range centred on 2.75%). Hitting its somewhat downgraded forecast for 1.75% average growth in the second half will need a pickup from what monthly GDP data have signalled of late, so there's a bit of downside risk to that call, and the growth outcome is one of the factors that the Governor mentioned in the press conference that will feed into the Bank's decision at the next meeting.
- Thereafter, the expectation for growth to average 2.2% over the next two years, little changed from the prior forecast, doesn't stand in the way of further interest rate cuts, as the improved outlook is tied to easing monetary conditions. Our own forecast is less optimistic than the Bank's for 2025, with more of a pickup in 2026 to reach roughly the same end point. Both projections rely on a rebound in consumer spending per capita, after a long run of softness. But CIBC's forecast sees more of the housing acceleration delayed until 2026, with multiple unit starts in 2025 likely held back by weak preconstruction sales this year. We are pencilling in more of a slowdown in labour force growth, but our projections offset that by allowing for a greater rebound in productivity after two years of outright declines.
- On the inflation front, the Bank has taken solace from survey data that shows businesses planning for cooler wage growth ahead, and expects shelter inflation to gradually abate. Factors that are pushing headline CPI below 2%, joined by core measures that exclude mortgage interest, are also expected to provide less downward pressure as the economy picks up pace in the Bank's forecast. As a result, it sees inflation ahead as hugging to either side of 2%. Mission Accomplished, although we could see further sub-2% inflation reports until growth actually picks up.
- In the press conference, the Governor addressed the issue of financial conditions, and the spillover into Canadian term borrowing rates from the recent increase in longer term rates in the US. He noted that they do look at the rates that businesses and households are actually facing (i.e. further out the yield curve) in deciding where the overnight rate needs to sit. Unless US bond yields revert, that could also lean towards a 50 bp cut in December. Geopolitical uncertainty tied to tariff policy in the US and other global events will also factor into BoC decisions, but only as it's clear that these risks are materializing.

Re: Economic forecast — Our overall GDP projection ahead isn't far off that of the Bank of Canada, although we have more of the pickup delayed until 2026 due to a lag in the response in homebuilding. We're allowing for somewhat slower

population growth, but see more room for productivity to rebound after two years of outright declines. Today's announcement matched our expectations, and therefore doesn't alter either our economic or financial market outlooks. But we are watching US policy developments more closely these days, given risks to trade policies, fiscal outcomes and their spillover into Canada.

Re: Markets — Today's decision won't raise any eyebrows for markets, being well priced in after the last set of CPI data.

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