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Bank of Canada does some fine tuning

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The Bank of Canada opted to act now rather than wait for a revised forecast, but its rate 25 basis point rate hike had the appearance of to a fine tuning move rather than the start of an extended addition to the prior course of tightening. Although it lifted the overnight rate to 4.75%, it opted not to state that with that additional hike, rates might not yet be high enough to do the job. That suggests that it's again now going to take some time to see how the data evolve.

That said, the economic momentum that it cited as a reason to lift rates today does create risks that a few months from now, the deceleration in the economy might still be insufficient to bring inflation to the 2% target next year. We now expect a follow-up 25 bp hike as a final fine tuning, with September more likely than July due to the need to gather enough additional insights on the lagged impacts of all the rate hikes thus far. Neither of these hikes were in our prior forecast, but the Bank's actions today signalled that it won't be quite as patient as we expected in its wait to see economic slack emerge.

Todays' decision was justified by the unexpected strength in consumption growth and interest-sensitive sectors of the economy, along with the tightness in the labour market. The statement also highlighted concerns that inflation could get stuck materially above the 2% target, given the recent readings on core inflation and persistent excess demand.

Re: Economic forecast — Hiking further adds to the risk that the Bank of Canada gets more than it is bargaining for in terms of the sharpness of the economic slowdown ahead, but we can't claim that an extra 25 or even 50 basis point will prove to be a fatal error that dooms Canada to a hard landing. Indeed, we had already nudged up our Q2 growth forecast a bit for both the US and Canada, so the starting point for the second half is a somewhat healthier backdrop. Still, it will be important for the Bank, and the Fed, to avoid hiking at every meeting to ensure that they can pick up the early signals of a slowdown before overdoing the monetary tightening. Given the need to push inflation lower, we expect that neither the Fed nor the BoC will offer any interest rate relief until late spring 2024.

Re: Markets — The yield on two year Canadian bonds tacked on more than 20 basis points in the wake of the announcement, since this hike was seen as having only a 50% chance going into the decision, and by not waiting until the July MPR, the Bank will be seen as being a bit less patient in terms of a further nudge up in rates. The Canadian dollar only held to a modest gain, as the Fed seems likely to also raise rate in July if it pauses in June, and the economic backdrop needed to support a further hike by the BoC in July or September would likely be positive enough to have the Fed also tack on an additional rate hike later this year. Bond yields in both countries could see further upward pressure from here to September, as markets will price in risks of subsequent hikes for a while, and will also feel the impact of a rush of US Treasury supply as the government replenishes its cash position with the debt ceiling deal now achieved.

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