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The hitchhiker's guide to BoC watching in this easing cycle

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Market participants have a love-hate relationship with the way the Bank of Canada (BoC) communicates. Some dislike the Bank's willingness to surprise, rather than guide the market ahead of its pronouncements. Others like that they give one consistent message, unlike the differences of opinion seen in Fed speeches, even if that message isn't always particularly riveting.

The BoC will tell you instead of spoon-feeding markets in advance as the Fed often does, everyone should be watching the same data and coming to their own judgement. In general, we see that as a better approach, but it's not as straightforward as they present it, and certainly makes BoC-watching more complicated than Fed-watching. How the Bank assesses the data and the future evolution of risks to the outlook isn't always spelled out clearly, particularly from the perspective of those who are newer to that game. In this guide, we outline what to look out for, and how to read the tea leaves in this easing cycle. Those tea leaves point to another big step in December, enroute to a bit below neutral next year.

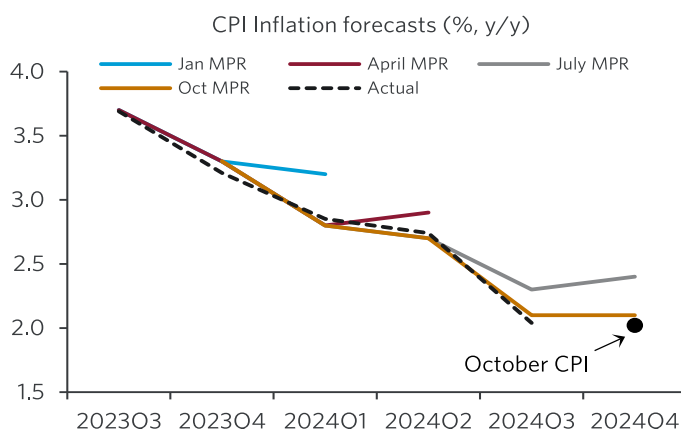
Shock minus control

The core of the Bank's communication strategy is to let the data do most of the talking about where monetary policy is headed. And the first step is to compare what the incoming data implies about how on-the-mark or off-the-mark the BoC's latest projection seems to be. The Governor has been fairly explicit with that type of guidance throughout the easing cycle.

In BoC speak, any potential gap between incoming GDP and inflation data and the published projection is called the "shock minus control". The Bank will dissect this gap, assessing whether its persistent or temporary in nature, and the Monetary Policy Report (MPR) is framed around the shock minus control between the current projection and the previous one.

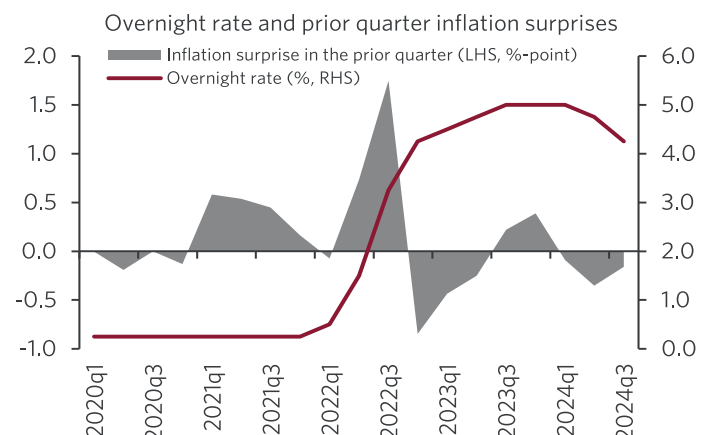
So what does the shock minus control tell us these days? The story here is all about inflation (Chart 1). Inflation has come down faster than the BoC expected, by an average of 0.2%-points at the start of the forecast over the first three MPRs of 2024. That's not massive, but its material. From 2012 to 2019, the average error was close to zero and the BoC never had three consecutive one-sided errors.

Chart 1: Inflation has consistently come below BoC forecasts over the past year



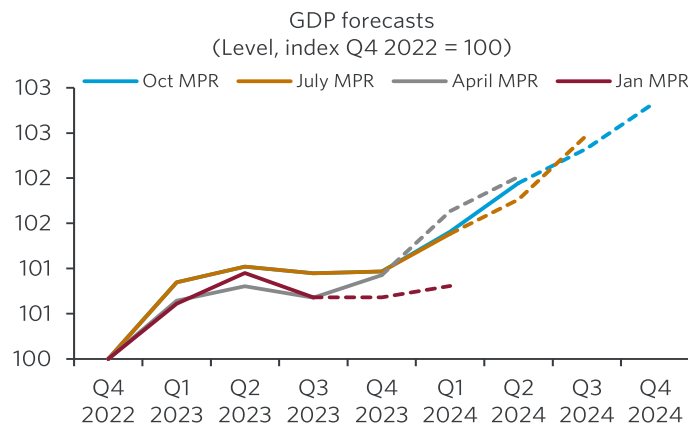
Source: Bank of Canada, Statistics Canada, CIBC

Chart 2: BoC inflation forecast errors have likely influenced the size and direction of policy moves



Source: Bank of Canada, Statistics Canada, CIBC

Chart 3: But since April, the BoC's GDP forecast have mostly been on the mark



Note: Dotted lines indicate BoC forecasts.

Source: Bank of Canada, Statistics Canada

Given those inflation results, it's no surprise they stepped up the pace of rate cuts in October. That would be consistent with the tightening cycle when inflation forecast errors likely influenced the direction and pace of policy rate moves (Chart 2). Rapid tightening came after the enormous positive surprises, the pace of tightening slowed after seeing price gains come below predictions, and then the fine-tuning and "higher-for-longer" phase in 2023 came as forecasts underestimated the persistence of inflation yet again.

The early tracking for Q4 seems roughly in line with the latest projection after the October CPI report saw headline inflation at 2.0%. However core inflation, for which the Bank restarted publishing forecasts in July and will be key to track going forward, may surprise slightly on the upside in the quarter. We don't have enough history on the BoC's core inflation forecasts to know for sure, but given the record on headline and the downward trajectory of core measures, our guess is that core has also surprised them on the downside for most of the year.

Of course, the Bank does not need further downside surprises to cut rates at a moderate pace. The Governor has made clear the base case already assumes a gradual easing path. Headline and core inflation surprises will matter for the pace of easing going forward, but so will other forces.

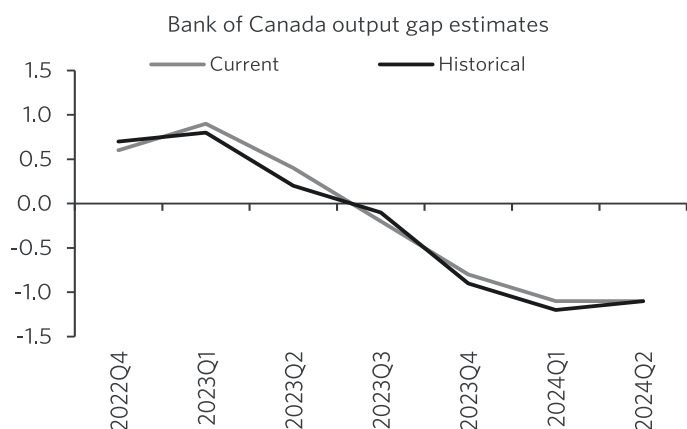
Table 1: Evolution of BoC's view on inflation risks

	Balance of risks
Jan MPR	The Bank sees both upside and downside risks to this outlook ... the Bank remains particularly concerned about the upside risks
April MPR	... While members were still more concerned about the upside risks to the inflation outlook, they viewed both the upside and downside risks as less acute
July MPR	Members agreed they now needed to be as focused on the downside risks as the upside risks ... downside risks to the outlook for inflation had also increased
Oct MPR	Overall, we view the risks around our inflation forecast as reasonably balanced ... we are now equally concerned about inflation coming in higher or lower than expected

Source: Bank of Canada, CIBC

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Chart 4: The output gap still points to material slack in the economy



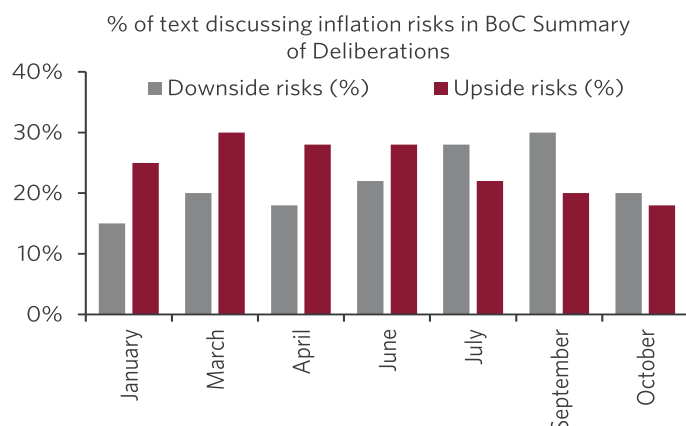
Source: Bank of Canada, CIBC

GDP > Labour

Central bankers in Ottawa, like their counterparts elsewhere, also pay a lot of attention to how the pace of economic activity evolves relative to their expectations and the overall level of slack in the economy. They closely watch the job market, but in its communications, the BoC appears to attach more weight to the level of GDP versus potential when assessing inflation risks than the Fed does. That's evident from the fact that they put so much emphasis on the GDP-based output gap as their main measure of slack and don't publish any real-time forecasts of any labour metric. The new digital MPR also guides users to vintage forecasts of GDP and inflation, consistent on that same emphasis. That emphasis on GDP-based slack, rather than the labour market, does leave the Bank a bit more exposed to risks of large revisions to GDP, and to estimates of potential GDP that have become more volatile during the pandemic (See: [When enough is enough: How to judge where the Bank of Canada sees it](#)).

While inflation has mostly disappointed and GDP has roughly come in as expected (Chart 3), there is still material slack in the economy (Chart 4). Given inflation has been coming down over that stretch, that raises the question of whether the Bank is understating the full extent of slack in the economy, or if

Chart 5: Text-analysis using AI suggests that the BoC is talking more about downside than upside inflation risks



Source: Bank of Canada, ChatGPT 4.0, CIBC prompt

its models and judgments are getting the right relationship between slack (or other drivers) and inflation.

No risk, no reward

The data on the ground and the base case outlook is important, but it isn't the only focus for the BoC. Its Governing Council looks at a range of other forward-looking information to complement its models, and one of the big areas of focus is on "risks" — these are the forces that their models or surveys can't capture well, but matter a lot for the inflation outlook, such as how house prices will respond to rate cuts or how geopolitical forces affect Canadian inflation.

What investors need to pay attention to most about the Bank's inflation risks are what changes they make and when. For example, Table 1 lays out the balance of risks in each of the MPRs from this year. You can see how changes in the risk bias in April gave another signal that the Bank was ready to start cutting at the next meeting and how the tone of the risk bias has been softening throughout the year.

But still, it's hard to believe with the BoC's forecasts consistently missing the mark, Governing Council truly believes the downside and upside risks are "reasonably balanced" now, especially when one of the upside risks to inflation are geopolitical forces that have been playing out for over a year with little effect on Canada.

We think there is something more there, and parsing through the summary of deliberations suggests that might be the case. We fed the text of the all the minutes from this year to our in-house AI tool that is based on ChatGPT 4.0 and focused it on the last two sections: "Considerations for monetary policy" and "The policy decision" where Governing Council lays out the meat of their deliberations, including on risks. We asked it to identify the share of the text discussing "downside risks to inflation, weaker inflation or weaker than expected inflation" and prompting with similar language for upside risks.

The results are shown in Chart 5, and show the BoC may be increasingly spending more time talking about the downside risks than the upside risks. Discussions of downside risks reached their peak in September, presaging the 50bp cut in October.

October looks more balanced, probably because they did not want to further feed a dovish frenzy after accelerating the pace of rate cuts. But still, the results suggest they are talking more about downside risks and increasingly less about forces that could push inflation up, with the share of the text devoted upside risks in October at the lowest we've seen all year. Announced cuts to immigration and the Trump election victory both came after the October MPR, and only add to the downside column.

Silence of the doves

If they're really more worried about downside risks to inflation and growth, then why don't they just say that? In general, the BoC's style has never been to be explicit about how it interprets the data, and they have always been allergic to the near-term forward guidance of the Fed.

Letting the data speak is a long-standing tradition that predates Macklem. In part, that may reflect a greater risk of putting your foot in your mouth. Canadian data is more volatile and can be subject to large revisions in short-order. And as a small-open economy and commodity exporter, the BoC has to watch US and other global developments just as carefully.

The Fed also has a far greater ability to influence financial conditions with its words and has a more complete set of communication tools to do so. Up north, we're at the mercy of spillovers from US and global financial conditions. While we think it wouldn't hurt them to give a bit more in their communication, particularly the speeches, we see the merits of a "wait-and-see" attitude in the Canadian context.

What to expect when you're expecting (inflation to come down)

In the end, a cautious communications approach from our central bankers is perhaps consistent with Canadians' generally more reserved approach to public speaking. A book of famous Canadian speeches might be a bit thinner than an American version that could quote the passion of Lincoln at Gettysburg, M.L. King's fiery remarks on the Washington mall, or Kennedy's inspiring inaugural address.

But on substance, rather than style, the blander approach seems to be working these days, with the BoC clearly understanding that economy needs significant rate relief. All of the rate cuts this cycle have been fairly well anticipated by markets. After that last FOMC meeting, even Powell looks like he's ready to take a page out of Macklem's book and tone down the forward guidance.

While the October CPI report makes the December decision a closer call in terms of 25bp vs 50bp, the bigger picture is that

the Bank needs to bring policy to an accommodative position. Looking at the factors we've cited as key to their process, headline inflation is at target, the range of underlying inflation measures (CPIX, CPI-trim, CPI-median) are centred near 2%, slack is not being absorbed, and downside risks have increased. Added to that, inflation expectations are anchored, five-year bond yields have risen and energy prices have come down again. For us, that still warrants some urgency to get rates down quickly. Our call is for another 50bp cut in December and the overnight rate to come down to 2.25% by the middle of next year, and stay there for some time to allow growth and the job market to heal.

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