

MNI BoC Review: July 2021

MNI View: Not There Yet on Full Canada Recovery

As expected, the Bank of Canada held its policy rate steady at the lower bound of 0.25% (bank rate at 0.5, deposit rate at 0.25) Wednesday, while tapering weekly bond purchases by CAD1 billion to CAD2 billion a week.

The Bank reiterated their commitment "to holding the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved. Based on our current projection, this happens sometime in the second half of 2022."

The tapering of weekly bond purchases down to CAD2 billion a week reflects the Bank's "increased confidence in the strength of the Canadian economic outlook" and "continued progress towards recovery."

"Decisions regarding further adjustments to the pace of net bond purchases will be guided by the Governing Council's ongoing assessment of the strength and durability of the recovery. If the economy evolves broadly in line with our outlook, then over time it won't need as much QE. Further adjustments to our QE program will continue to be gradual, and we will be deliberate both in our assessment of incoming data and in the communication of our analysis. We will continue to provide the appropriate degree of monetary policy stimulus to support the recovery and achieve the inflation objective."

Key Points to the Monetary Policy Report:

While continued fiscal support, high vaccination rates and a careful approach to reopening has helped economic rebound, the Bank noted "economic growth in the first half of this year was weaker than estimated". Nevertheless, growth "should pick up strongly in the third quarter as the economy reopens. Consumption is expected to lead the rebound with increases in spending on transportation, recreation, and food and accommodation services. The economic recovery is expected to become more broad-based and self-sustaining over the projection horizon."

In Maclem's MPR opening statement, the BoC Governor said Canada "still have some way to go to a complete recovery, and the rebound in economic activity will proceed at different speeds across sectors. The process of reopening the economy won't be entirely smooth."

Macklem cited "supply bottlenecks for some goods and services as demand rebounds faster than supply can ramp back up. These unique circumstances of the pandemic are now helping to push inflation temporarily above our target band."

Inflation Outlook:

Macklem cited a number of temporary factors affecting the outlook for inflation.

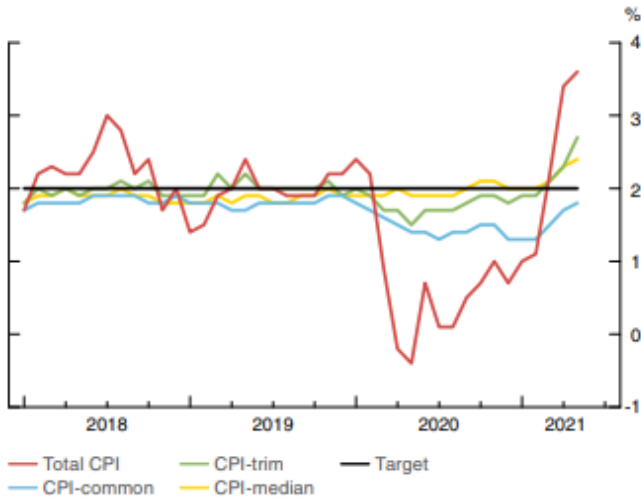
In recent months, consumer price index inflation has risen above the Bank's 1 to 3 percent target range. Three major factors are behind this temporary strength, all related to the pandemic.

- First, gasoline prices rebounded from very low levels a year ago and are now above pre-pandemic levels.
- Second, other prices that had fallen sharply last year with plummeting demand are now recovering to more normal levels with the reopening of the economy.
- And third, disrupted global value chains and pandemic-related supply constraints, including shipping bottlenecks and a global shortage of semi-conductors, have pushed up the prices for cars and some other goods.

Chart 13: Inflation has increased substantially in recent months, but inflation expectations remain stable

Year-over-year percentage change

a. CPI inflation, monthly data



b. 10-year Canadian break-even inflation rate (weekly average of daily data) and inflation expectations (quarterly data)



Source: BOC MPR

Overall, supply bottlenecks are creating sharper movement in prices that is pushing inflation temporarily higher, and these supply issues now look more important than previously thought. As a result, inflation is now projected to be somewhat above the target band through 2021.

But these temporary effects are forecast to dissipate near the end of this year and inflation is forecast to ease back toward 2 percent in 2022. We expect the factors pushing up inflation to be temporary, but their persistence and magnitude are uncertain, and we will be watching them closely.

Longer term, given our commitment to hold the policy rate at the effective lower bound until slack is absorbed, the economy is projected to move into modest excess demand, so inflation is slightly above target through 2023 before moving toward target in 2024.

Relevant Links

[July 2021 BOC Policy Announcement](#)

[July 2021 MPR Opening Statement](#)

[July 2021 MPR Document](#)

BOC 2021 Policy Schedule:

- Wednesday, January 20* -- steady at 0.25
- Wednesday, March 10 -- steady at 0.25
- Wednesday, April 21* -- steady at 0.25
- Wednesday, June 9 -- steady at 0.25
- Wednesday, July 14* -- steady at 0.25
- Wednesday, September 8
- Wednesday, October 27*
- Wednesday, December 8

*Monetary Policy Report published

Analyst Reviews

BMO: The Bank made few waves with its latest policy announcement and quarterly forecast, mostly landing right in line with consensus on almost all fronts (for a change).

- We expect the tapering process to continue apace, with the Bank winding down its QE by early next year. This will set the stage for rate hikes, likely within the next 12 months of the end of QE, with a good chance of sooner rather than later.
- The "later" risks would be driven by the virus, while the "sooner" risks could arise if inflation remains stubbornly high and/or if growth is juiced more than expected by well-supported consumers.
- Overall, while the perception is that the Bank is quite hawkish, especially compared with the Fed, we ultimately expect very little daylight between the two banks when it comes to rate hike timing.
- After all, the Canadian economy took a deeper hit in the past year, has more ground to make up, and is dealing with less frothy inflation than the U.S., partly due to a strong currency—hardly a recipe for a much more aggressive policy.

CIBC: While the Monetary Policy Report did downgrade growth expectations for this year to 6.0% from 6.5%, that was due to the third wave impacting growth more sharply than had been anticipated in the April iteration of the report.

- Economic activity is still expected to accelerate from here on out with virus cases falling and the economy reopening. The new trimmed GDP forecast is still firmly in line with our own outlook for the year.
- Forecasts for next year were, in contrast, upgraded to account for consumers in 2022 and 2023 spending roughly 20% of the excess savings that have accumulated in the bank accounts of Canadians during the pandemic.
- While we had been warning Canadian central bankers that this was likely to be the case, prior Monetary Policy Reports assumed that none of those extra savings were going to be used for consumption.
- The upgrade means that the economy is still expected to be operating temporarily above its potential in 2023, with inflation also rising slightly above the Bank of Canada's 2% target that year, despite the downgrade to 2021 growth forecasts.

CITI: Overall, we saw the July policy decision as mostly neutral, with little new information learned on the BoC's outlook for the path of policy.

- As expected however, the neutral decision was taken as somewhat dovish by a market that has come to expect a hawkish BoC and was already pricing close to 3 full hikes in 2022.
- While we still expect the time to come for the BoC to again turn more hawkish, the July meeting at the start of the latest reopening period was too soon for this to occur.
- At the press conference, Macklem stressed the importance of continuing to watch recovery period data amidst elevated uncertainty. Incoming data, particularly on employment and inflation, will be key to watch over the coming months, but we still expect data will likely support another hawkish shift by the BoC in the fall.
- At this time, there will likely be more guidance on the timing of possible rate hikes, with risk tilted towards a closing output gap and subsequent hikes earlier than H2-2022.

Desjardins: Economic conditions are continuing to improve, prompting the Bank of Canada to continue the normalization process of its monetary policy.

- Further reductions in quantitative purchases are therefore expected, probably as early as this October, when the next Monetary Policy Report is released. We also expect the first rate hike to occur in fall 2022.

GS: The BoC significantly upgraded its cumulative growth forecast by 0.7pp by the end of 2022, despite a near term downgrade.

- The BoC, however, still expects the output gap to close in 2022H2 following an upgrade to potential output. The Governing Council sharply upgraded its 2021 and 2022 inflation projections but stuck to its view that the strength will be transitory.
- As expected, the statement increased the focus on upside inflation risk by noting that the "persistence and magnitude" of the transitory factors pushing up inflation "are uncertain and will be monitored closely".
- As we had expected, the BoC tapered asset purchases further and kept the liftoff projection in 2022H2. The non-realization of the hawkish risk scenario of an earlier liftoff likely explains the somewhat dovish market reaction. We continue to project liftoff in 2022Q3, but believe that further inflation beats would lead to a Q2 liftoff.

JPM: Although the Bank lowered its forecast for annual real GDP growth to 6.0% in 2021 (4.9%Q4/Q4) from 6.5% in the April MPR, the Bank sounded generally upbeat on the 2H21 and 2022 growth outlooks.

- The Bank continues to see generally solid growth after 2021's strong rebound. While we don't expect the Bank to raise the policy rate until 4Q22, a solid economic outlook supports further tapering of the government bond buying program in 2H21.
- Governor Macklem's press conference was fairly straight forward in echoing the general stance of the Monetary Policy Report. The Bank continues to believe that the factors currently pushing up monthly CPI are transitory (principally base effects and energy prices).
- However, the Bank expressed some heightened concerns around the durability of higher inflation—"The factors pushing up inflation are transitory, but their persistence and magnitude are uncertain and will be monitored closely."
- The Bank noted that it has incorporated the panoply of supply-side bottlenecks, re-opening pressures, and pent-up demand into its inflation expectations.

RBS: The BoC continues to put considerable attention on the labour market recovery.

- The MPR highlighted that the employment rate is still considerably below pre-pandemic levels for non-university graduates and long-term unemployment remains very elevated.
- It also noted that wage pressures have thus far been subdued and total hours worked is still 4% below the Feb-2020 level. Inflation forecasts were greatly upgraded for the coming quarters (e.g. from 2.2% to 3.5% for 2021-Q4), though qualitatively the BoC still sees the rise as transitory and likely to reverse back towards 2% late next year.
- An inflation overshoot in 2023 (at 2.4% in 2023-Q4) is maintained from the April MPR, with this due to the extraordinary forward guidance on rate.
- The full-year BoC inflation projections now match our own for 2021 (3.0%) and 2022 (2.4%). For the GDP projection, the BoC lowered 2021 growth by 0.5pp to 6.0%, in part reflecting a lower Q2 forecast of 2.0% annualized (from 3.5%), but this was more than offset by a 0.9pp increase for 2022 (from 3.7% to 4.6%).

- The GDP projection changes leave our own forecast slightly higher in 2021 (6.3% vs 6.0%) and lower in 2022 (4.0% vs 4.6%), but still roughly equivalent. Potential growth estimates have been revised up again, to 1.8% on average for 2021-2023 from 1.6% in the April MPR, with the level of slack estimated at 2-3% as of 2021-Q2.

Scotiabank: While the BoC broadly met expectations for this meeting including by tapering again, the BoC's full communications continue to indicate that a push toward a neutral policy rate will begin in earnest within about a year and perhaps sooner.

- The OIS market and BAX futures are pricing the commencement of rate hikes next year and today's communications generally add to our conviction for a material flattening of the broad rates curve and higher borrowing costs ahead for Canadians. The bigger shift is likely into the October 27th MPR.
- By that point they'll have new pandemic-era inflation figures with revised spending weights compared to the soon to be past due stamp on the inflation measures they used to forecast inflation today, more evidence of a growth rebound in Q3 and likely herd immunity levels of vaccination by the end of July or early August.
- We'll see about election timing but there is a growing sense the writ will be dropped for an election to occur before then. It will take time to further inform the narrative around this path, but the strong message is that the BoC expects a broad return to equilibrium conditions within the medium term which implies a return toward a neutral policy rate stance.
- The BoC's neutral rate range of 1.75–2.75% was updated for the pandemic era last Fall, and is a guidepost for where the policy rate should come to rest into 2023.

TD: The Bank of Canada did not rock the boat at the July policy meeting.

- The QE taper to \$2bn/week was broadly expected and forward guidance for rates and future QE adjustments was unchanged from June. The policy statement itself was constructive as the Bank noted increased confidence in the recovery.
- The Bank still views stronger inflation as transitory and 2022 GDP growth saw a large upgrade.
- At the same time, the BoC at several points acknowledged a level of uncertainty in their outlook. FX: There isn't much new news on the BoC front since CAD has been pricing most of these developments since April. That likely reflects the bulk of the USDCAD rally on the announcement, implying a large bit of front-running. USDCAD is probably getting closer to a fade point, but more patience is needed on that front.
- TD considers tapering as "WAM neutral. The continued tapering should reinforce to the market that the net supply profile in Canada is getting more pronounced.
- There is a lot of net supply, in duration terms, coming to the market as we head in to the Fall. This is a relative steepener for the Canadian rates curve and should pressure swap spreads tighter.
- Forward guidance was functionally unchanged, with the Bank stating that there is significant slack in the economy, and pledging to keep the overnight rate at the lower bound until slack is absorbed in 2022H2.
- Decisions on QE remain subject to the outlook. We continue to look for the BoC to lift rates in October 2022, and we look for a taper to \$1bn/week in GoC purchases at the October 2021 interest rate announcement.

MNI POLICY TEAM STATE OF PLAY: BOC Set to Limit QE to Steady Balance Sheet

By Greg Quinn

OTTAWA (MNI) - Bank of Canada Governor Tiff Macklem said Wednesday his growing confidence in a durable economic rebound means there will likely be less need for asset purchases in the future, and the next move for policymakers is towards a phase that stabilizes the size of the central bank's balance sheet.

"If that plays out," on a strong economic rebound, "there will be future adjustments," Macklem said in response to a question from MNI at a press conference Wednesday. Earlier the BOC [slowed QE](#) to CAD2 billion a week from CAD3 billion, and affirmed the conditions to raise interest rates from their record low 0.25% should emerge in the second half of 2022.

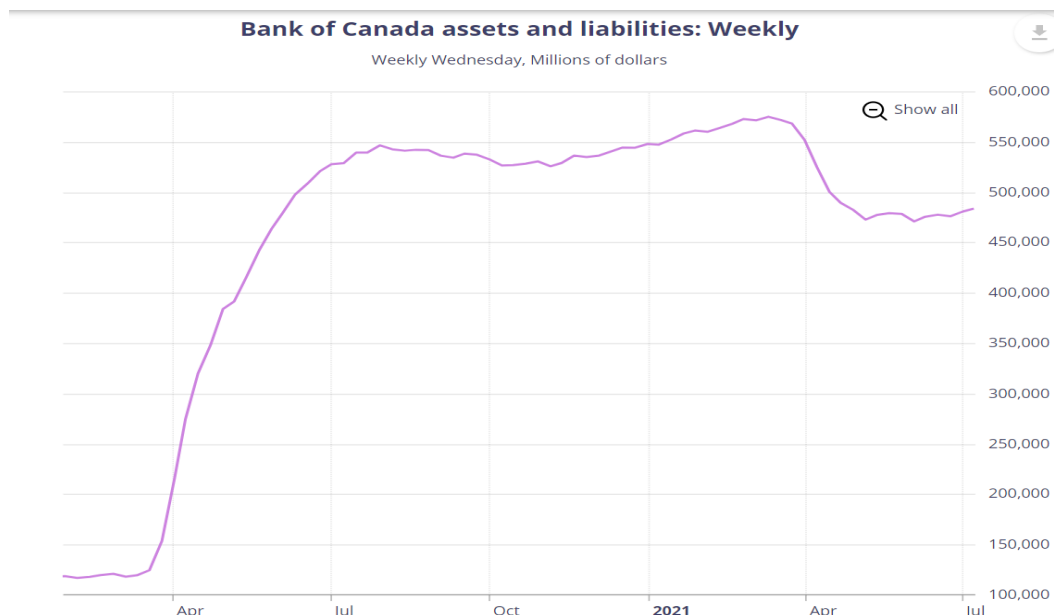
"As we adjust QE down further, we will eventually reach a point where our gross purchases will be roughly equal to the maturities," he said. That would still leave a large balance sheet without adding new stimulus, Macklem said.

The Governor wouldn't say if asset purchases will end before interest rates rise, a debate that has emerged in other countries where central banks are moving ahead with QE amid rising inflation. The BOC's holdings of federal government bonds climbed to 44% of total issuance, a stockpile that, as it grew, as led to investor complaints about possible trading frictions.

THIRD ROUND OF TAPERING

The BOC's third taper from the original CAD5 billion pace underlines the economy's recovery, with Macklem telling reporters there was a "strong consensus" among bank officials about the rebound's strength.

Comments about re-investing proceeds of maturing debt are in line with a March [speech](#) by Deputy Governor Toni Gravelle laying out the idea of stabilizing the balance sheet. Total assets have already shrunk with the repos and treasury bills the BOC bought last year to fight a trading squeeze rolling off the books.



Source: BOC

The BOC's stockpile of bonds is nearing the point where maturing assets will become a bigger influence over the size of the balance sheet, the BOC suggested in its [Monetary Policy Report](#), without elaborating. It's unclear what pace of QE would be needed to hold the value of a balance sheet that has shrunk to CAD485 billion from a peak of CAD575 billion in March. Before the pandemic, the balance sheet was just CAD120 billion, thanks to Canada avoiding QE purchases in the 2008 global financial crisis.

Former BOC Governor David Dodge [told MNI](#) in April that Macklem would keep tapering to avoid distorting fixed-income markets. Other former officials had [told MNI](#) the pace of the rebound justified moves like today's and a path to ending QE, or at least net new purchases, later this year.

SETTING RATE-HIKE STAGE

Today analysts at Bank of Montreal, Desjardins and ING said QE will largely wind down around the end of this year. Shrinking QE also solidifies predictions the BOC will meet its guidance of a rate hike in the second half of next year, if not a little sooner. Trading in BAX contracts [suggests](#) a 61% chance an increase could come by next March.

"We expect the tapering process to continue apace, with the Bank winding down its QE by early next year. This will set the stage for rate hikes," Bank of Montreal chief economist Doug Porter wrote in a research note. "While the perception is that the Bank is quite hawkish, especially compared with the Fed, we ultimately expect very little daylight between the two banks when it comes to rate hike timing," given the depths of Canada's pandemic slump, he said.

Governor Macklem also said changes to asset purchases would be gradual and stressed it depends on the recovery coming along about as the BOC projected. Earlier in the pandemic the BOC had said it would maintain QE until the economic recovery was well underway, and Gravelle in March said reinvesting assets would be "easing our foot off the accelerator, not hitting the brakes."

Macklem also told reporters that removing stimulus will be conditioned by the BOC's single mandate to reach 2% inflation, even as he's watching for a broad job recovery. "We have one target, and that's inflation," he said.

-- MNI Ottawa Bureau | +1 613-314-9647 | greg.quinn@marketnews.com

Unauthorized disclosure, publication, redistribution or further dissemination of this information may result in criminal prosecution or other severe penalties. Any such authorization requires the prior written consent of Market News International. Redistribution of this information, even at the instruction of your employer, may result in personal liability or criminal action unless such redistribution is expressly authorized in writing by Market News International. Violators will be prosecuted. This information has been obtained or derived from sources believed to be reliable, but we make no representation or warranty as to its accuracy or completeness. This is not an offer or solicitation of an offer to buy/sell. Copyright © 2021 Market News International, Inc. All rights reserved