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GLOBAL ECONOMICS

SCOTIA FLASH

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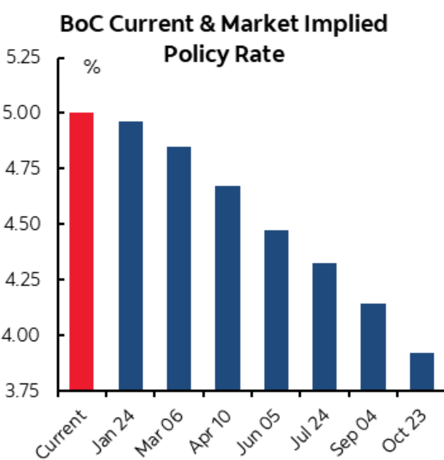
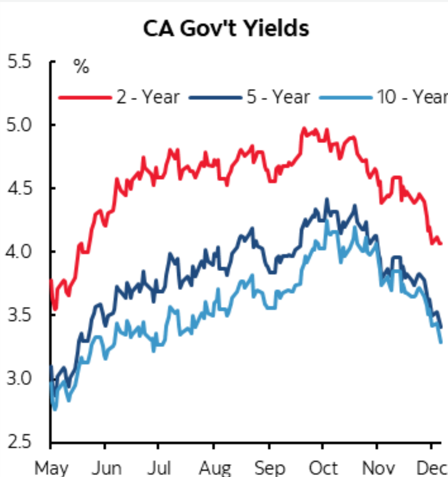
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

The BoC Needs Assertiveness Training

- **BoC holds, retains hike bias**
- **'Further and sustained' inflation progress pushes back on H1 rate cuts**
- **Markets didn't listen, 5-year yield at lowest since May**
- **The BoC and markets are combining to resurrect housing and fiscal imbalances…**
- **…while lessening how monetary policy works to tighten through mortgage resets**
- **Easing now sounds great…**
- **…but could well thwart prospects of more material easing later**
- **For real estate, it's cash now, versus sustainability concerns**
- **Tomorrow's BoC speech may be key**

The Bank of Canada was hawkish mainly by using patient language toward timing rate cuts. It just wasn't convincingly hawkish enough to markets that, left to their own devices, are on the path toward reigniting housing imbalances, tamping down how monetary policy works through mortgage resets, inflaming further government spending and driving concomitant inflationary pressures. The BoC needs to adopt a more assertive stance lest they repeat past mistakes by failing to stand in the way of a broadly based easing of financial conditions.

WHAT THEY DID

The BoC held the overnight rate at 5% as unanimously expected but mildly leaned against market pricing for early rate cuts in a statement that had a somewhat hawkish overall tone. They left QT and the balance sheet unwinding plan intact as expected. Communications are to be continued tomorrow when Deputy Governor Gravelle delivers a potentially important speech. Details will follow thoughts on how markets are managing the messaging and why the associated risks matter very much to the outlook.

HOW MARKETS RESPONDED

Markets responded by retaining unchanged cut pricing and driving a bull flattener move across the yield curve.

Market pricing for rate cuts was unaffected with a continued bias toward a strong probability of a cut as soon as the March meeting and more than a 25bps cut priced by the April meeting (chart 1).

The two-year yield is flat to pre-statement levels and flat on the day. The 5-year GoC yield rallied a bit further and is now at its lowest since May 18th during the booming housing market. The Canada 10-year yield is at its lowest since late June. That matters to governments along with the rest of the curve. See chart 2.

The present yield curve is offering little term premia over reasonable assumptions about a likely higher neutral rate than the BoC has previously published (2.5%) in light of Governor Macklem's remarks that it is likely higher now. Entirely lost is the move earlier this Fall toward steeper curves.

WHY IT MATTERS…

Should the BoC care about what markets are doing? Absolutely.

In fact, the BoC and markets are combining efforts to ignite another booming housing market, renewed macroeconomic imbalances, lessened efficacy of monetary policy working through mortgage resets, emboldening governments to spend more, and triggering spillover effects upon broader inflation.

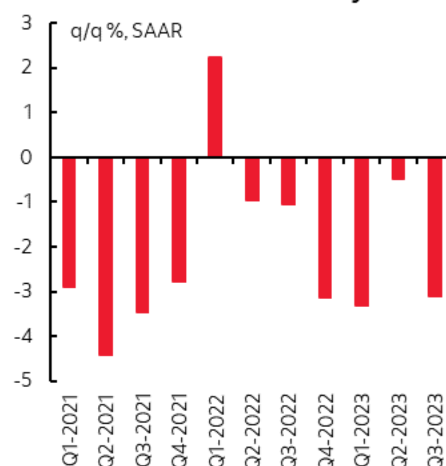
...TO HOUSING....

Why such concern about housing? Because there is too much bearishness in relation to the facts. The five-year GoC yield is a key driver of the mortgage market given that a majority of mortgages are fixed rate mortgages and mostly 5-year fixed with the 5-year GoC yield a key driver of that. The 5-year yield is dropping on the eve of the annual seasonality in mortgage pre-approvals that begins over Winter and grants borrowers rate pledges to go shopping into the Spring housing market that is key in Canada.

Canada has generated 430k jobs this year. Wage growth is soaring and collective bargaining agreements are cementing wage gains at rates well above the 2% inflation target for years to come. Productivity is in awful shape including this morning's update for Q3 such that the combination of aggressive pay gains and tumbling labour productivity are adding to inflation risk (chart 3). Canadians, simply put, are getting paid more for producing less.

Canada now has two years of wildly excessive immigration relative to its ability to house them and relative to infrastructure shortfalls. The BoC's line that immigration would contain wage pressures is a total, complete, bust.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Housing inventories are lean especially in the all-important new build segment given the need to expand the tight housing stock. First-time homebuyers have had extra time to save for a downpayment on mildly cheaper homes. Generational wealth transfers are helping with the financing.

Now we have a sustained easing of financial conditions including the key benchmark for the housing market. The BoC is at high risk of doing it again. That may please some with a bias toward maximizing near-term cash flow derived from housing and mortgage markets. I fear that much of my industry has a sky-high preference for near-term rewards; I suppose they have a high implicit discount rate on future earnings. Their incentive schemes are too skewed toward near-term outcomes. My concern remains that if we reignite pressures, then prospects for more meaningful and sustainable policy easing may be thwarted. All firms serving the housing and mortgage markets should be focused upon earnings sustainability and stability in a longer-run sense, not just the short-term which is a major reason why I lean back against people who suggest to me that a booming Spring housing market would be welcome news.

...TO MORTGAGE RESETS...

Why the concern about lessening pressures on mortgage refinancing? The five-year yield is welcome news to people who might contemplate early renewal of fixed rate mortgages and therefore push out mortgage resets to address another day. The 100bps easing in 5s from the peak, should it continue, is rapidly eroding what were often exaggerated concerns about the impact of mortgage resets in the first place and lessening one of the key ways in which monetary policy had been tightening conditions. If it continues, then the gravy trade for all those big mortgages taken out at low rates in the pandemic would be to lock and load.

...TO FISCAL POLICY...

Why such concern about government spending? The lower the cost of debt financing, the less concern about interest expense in their outlooks compared to the lagging assumptions they put in their Fall updates. If lower yields are sustained, then the Winter budget season could well inflame further increases in short-term spending. One obvious candidate is the Federal government given an election on or before October 2025 and the de facto coalition's exceptionally poor polling. Think governments will prudently tuck away downward revisions to projected interest expense? Oh folks, folks, folks, there's swampland out there with your name on it.

...AND TO HOPES FOR DEEPER AND SUSTAINABLE EASING

This combination of renewed potential imbalances in housing and fiscal policy plus spillover effects are being courted by a complicit BoC. Its higher for longer message and previous efforts to reach further up along the curve were not apparent in this statement. They may be tomorrow, but will markets listen to subtle, nuanced messages? Probably not; they've been deaf thus far. Or should the BoC take more assertive action? I lean toward the latter. The further this runs, the more credible the threat of renewed hiking becomes and while I'd rather not see that I think it's a risk we cannot credibly dismiss. They could alternatively set the guideposts for an updated overall framework of thinking around combined balance sheet and policy rate tools which is what I'm hoping to hear tomorrow even if in nuanced fashion during the press conference or more explicitly so.

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The longer the BoC distances itself from market actions, however, the more likely it is putting future easing at risk. It tends to be aloof to markets, but at the banks of the Rubicon it clearly cannot afford to be now.

STATEMENT DETAILS—HOW THEY SIGNALLED NEAR-TERM PATIENCE

Key is the concluding paragraph that sends a patient signal to markets even if it isn't being listened to or isn't patient enough.

Retained was the reference to a willingness to "raise the policy rate further if needed" versus some folks' expectations that they might have struck that out. Forward guidance is therefore unchanged, and it probably cannot change at this point without triggering a further tsunami of cut bets.

The second key is in the final paragraph where they say they are "still concerned about risks to the outlook for inflation" which may be a tad softer than previously saying "progress towards price stability is slow and inflationary risks have increased."

Third key is that they want to see "further and sustained easing in core inflation." Further progress on core inflation says much more than just one month, and sustained says they won't ease until they have confidence that the progress will be sustained. That's a two-step process that requires a lot of data. This is how the BoC is trying to lean against near-term rate cuts in my view, but market participants are failing to grasp such subtleties.

It has caught the BoC's attention that "financial conditions have also eased, with long-term interest rates unwinding some of the sharp increases seen earlier in the autumn." Some? Have another look. Try all and then some as observed earlier in this note.

For a fuller statement comparison please see the appendix.

WHAT GRAVELLE MIGHT SAY

Today was a light, statement-only affair—and a short statement at that! The dialogue will continue tomorrow.

Deputy Governor Toni Gravelle is tasked with delivering the Economic Progress Report that customarily follows non-MPR meetings. His speech highlights will arrive at 12:35pmET tomorrow. He will host audience Q&A after reading the speech. He will then hold a press conference at about 2:10pmET.

The public guidance offered by Deputy Governors matters more under Governor Macklem than previous Governors, a point I made in this morning's note.

Will he matter this time to markets? We'll see, but I wrote about what may be top of mind matters for the head of the BoC's markets and payments divisions to consider in my Global Week Ahead (**here**). I won't repeat that here but stand by its contents.

If Gravelle doesn't seize that brass ring, well, maybe today's market actions around the BoC will be a lessen to the more powerful central banks that are on tap to make decisions next week.

RELEASE DATE: December 6, 2023

The Bank of Canada today held its target for the overnight rate at 5%, with the Bank Rate at 5¼% and the deposit rate at 5%. The Bank is continuing its policy of quantitative tightening.

The global economy continues to slow and inflation has eased further. In the United States, growth has been stronger than expected, led by robust consumer spending, but is likely to weaken in the months ahead as past policy rate increases work their way through the economy. Growth in the euro area has weakened and, combined with lower energy prices, this has reduced inflationary pressures. ***Oil prices are about $10-per-barrel lower than was assumed in the October Monetary Policy Report (MPR). Financial conditions have also eased, with long-term interest rates unwinding some of the sharp increases seen earlier in the autumn. The US dollar has weakened against most currencies, including Canada's.***

In Canada, economic growth stalled through the middle quarters of 2023. Real GDP contracted at a rate of 1.1% in the third quarter, following growth of 1.4% in the second quarter. Higher interest rates are clearly restraining spending: consumption growth in the last two quarters was close to zero, and business investment has been volatile but essentially flat over the past year. Exports and inventory adjustment subtracted from GDP growth in the third quarter, while government spending and new home construction provided a boost. ***The labour market continues to ease: job creation has been slower than labour force growth, job vacancies have declined further, and the unemployment rate has risen modestly. Even so, wages are still rising by 4-5%.*** Overall, these data and indicators for the fourth quarter ***suggest the economy is no longer in excess demand.***

The slowdown in the economy is reducing inflationary pressures in a broadening range of goods and services prices. Combined with the drop in gasoline prices, this contributed to the easing of CPI inflation to 3.1% in October. However, shelter price inflation has picked up, reflecting faster growth in rent and other housing costs along with the continued contribution from elevated mortgage interest costs. In recent months, the Bank's preferred measures of core inflation have been around 3½-4%, with the October data coming in towards the lower end of this range.

With ***further*** signs that monetary policy is moderating spending and relieving price pressures, Governing Council decided to hold the policy rate at 5% and to continue to normalize the Bank's balance sheet. Governing Council is ***still*** concerned ***about risks to the outlook for inflation*** and remains prepared to raise the policy rate further if needed. Governing Council wants to see ***further and sustained easing in core inflation***, and continues to focus on the balance between demand and supply in the economy, inflation expectations, wage growth, and corporate pricing behaviour. The Bank remains resolute in its commitment to restoring price stability for Canadians.

RELEASE DATE: October 25, 2023

The Bank of Canada today held its target for the overnight rate at 5%, with the Bank Rate at 5¼% and the deposit rate at 5%. The Bank is continuing its policy of quantitative tightening.

The global economy is slowing and growth is forecast to moderate further as past increases in policy rates and the recent surge in global bond yields weigh on demand. The Bank projects global GDP growth of 2.9% this year, 2.3% in 2024 and 2.6% in 2025. While this global growth outlook is little changed from the July Monetary Policy Report (MPR), the composition has shifted, with the US economy proving stronger and economic activity in China weaker than expected. Growth in the euro area has slowed further. ***Inflation has been easing in most economies***, as supply bottlenecks resolve and weaker demand relieves price pressures. However, with underlying inflation persisting, central banks continue to be vigilant. Oil prices are higher than was assumed in July, and the war in Israel and Gaza is a new source of geopolitical uncertainty.

In Canada, there is growing evidence that past interest rate increases are dampening economic activity and relieving price pressures. Consumption has been subdued, with softer demand for housing, durable goods and many services. Weaker demand and higher borrowing costs are weighing on business investment. The surge in Canada's population is easing labour market pressures in some sectors while adding to housing demand and consumption. In the labour market, recent job gains have been below labour force growth and job vacancies have continued to ease. However, the labour market remains on the tight side and wage pressures persist. Overall, a range of indicators suggest that supply and demand in the economy are now approaching balance.

After averaging 1% over the past year, economic growth is expected to continue to be weak for the next year before increasing in late 2024 and through 2025. The near-term weakness in growth reflects both the broadening impact of past increases in interest rates and slower foreign demand. The subsequent pickup is driven by household spending as well as stronger exports and business investment in response to improving foreign demand. Spending by governments contributes materially to growth over the forecast horizon. Overall, the Bank expects the Canadian economy to grow by 1.2% this year, 0.9% in 2024 and 2.5% in 2025.

CPI inflation has been volatile in recent months—2.8% in June, 4.0% in August, and 3.8% in September. Higher interest rates are moderating inflation in many goods that people buy on credit, and this is spreading to services. Food inflation is easing from very high rates. However, in addition to elevated mortgage interest costs, inflation in rent and other housing costs remains high. Near-term inflation expectations and corporate pricing behaviour are normalizing only gradually, and wages are still growing around 4% to 5%. The Bank's preferred measures of core inflation show little downward momentum.

In the Bank's October projection, CPI inflation is expected to average about 3½% through the middle of next year before gradually easing to 2% in 2025. Inflation returns to target about the same time as in the July projection, but the near-term path is higher because of energy prices and ongoing persistence in core inflation.

With ***clearer*** signs that monetary policy is moderating spending and relieving price pressures, Governing Council decided to hold the policy rate at 5% and to continue to normalize the Bank's balance sheet. However, Governing Council is concerned ***that progress towards price stability is slow and inflationary risks have increased***, and is prepared to raise the policy rate further if needed. ***Governing Council wants to see downward momentum in core inflation***, and continues to be focused on the balance between demand and supply in the economy, inflation expectations, wage growth and corporate pricing behaviour. The Bank remains resolute in its commitment to restoring price stability for Canadians.

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