LAURENTIAN BANK SECURITIES

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July 14, 2021

Bank of Canada Decision – Stronger Economic Outlook Leads to Additional QE Tapering

As expected by markets, the gradual and measured process of QE withdrawal continues. The weekly pace of GoCs purchases from the BoC will move down from $3B to $2B.

The $1B tapering announcement reflects the BoC's increased confidence in the global economic outlook. The BoC revised up the level of world real GDP by 0.3pp and Canadian real GDP by about 0.75pp over the forecast horizon ending in 2023. The BoC pegs real GDP growth projection of 4.6% in 2022 and 3.3% 2023, relative to 6.0% this year. The breakdown profile of real GDP provided in Box 2 of the *Monetary Policy Report (MPR)* shows robust economic momentum in every single quarters going forward, reflecting two key assumptions: 1- the end of lockdown measures in Canada excluding some border restrictions in 2021Q3; 2- achieving broad immunity in Canada during 2021Q3, in late 2021 for the U.S., and in 2022 for most emerging markets. "*Progress on vaccinations and easing containment restrictions all point to a strong pickup in the second half of this year*", says the BoC. In terms of GDP-expenditure components underlying the upbeat Canadian forecasts, consumer spending will lead the way in terms of positive contribution to economic growth over the 2021-23 period. Business investment will improve in 2022 and 2023 relative to 2021, while housing activity is projected to take a step back in 2022-23 after an outsized positive contribution this year.

The BoC did not go as far as completely ending QE as the Reserve Bank of New Zealand announced overnight. The latter has the extra mandate to lean against rapid home prices appreciation. We agree with the BoC's general view that the on-going CPI surge above the 1%-to-3% BoC band is largely transitory. Chart 12 of the *MPR* breakdowns the three main temporary drivers boosting CPI inflation now and for the next few months. First, supply constraints for goods products coming from bottlenecks is the most important factor, counting for slightly less than half of the increase in total CPI. Second, the energy price surge counts for about 1pp of the run-up in total CPI. However, news about an agreement between Saudi Arabia and United Arab Emirates could ease upward pressures in global oil markets. Third, exceeding demand in services as sectors reopen will gain ground in the next months as prices normalize and consumers re-orient spending, boosting total CPI inflation by a maximum of about 1pp. On top of this valuable analysis provided from the BoC, we see the stronger USDCAD mitigating the increase in imports prices. Overall, the BoC pegs total CPI inflation to average 3% this year before temporary factors dissipate and persistent slack in labour market conditions bring down CPI to 2.4% next year and 2.2% in 2022.

The next tapering move and policy rate liftoff will depend on many factors, first and foremost the path of the recovery. Another $1B taper this Fall and an initial 0.25bps policy rate hike in late 2022 could occur if the BoC base case scenario materializes. The first chart of the *MPR* shows Canada leads all other countries when it comes to the percentage of the population that has received at least one dose of COVID-19 vaccine. Still, the adverse impact of a wave of infections this Fall is one downside risk cited in the *MPR*. Furthermore, the BoC admits uncertainty relative to the persistence and magnitude of the factors driving up the CPI, particularly relative to additional supply bottlenecks and costs pressures. The BoC would not tolerate to see CPI inflation running about 3% over a long period. The odds of seeing an earlier-than-expected policy rate liftoff in 2022 have been increasing since the release of the April *MPR*.

Our last words go to the informative *MPR* section on the BoC's balance sheet evolution. Despite the first $1B tapering of the GBPP effective since late April, the BoC's ownership of total GoCs edged up to 44% from 42%. Around $18B in bond purchases have maturing since the GBPP started, resulting from 7 maturities averaging close to $2.5B each. This being said, bond maturities will pick up in frequency and size. Combined with the lower pace of QE, the percentage of GoCs held by the BoC will start to stabilize soon. It will mean the end of the shrinking net supply to digest for market participants, supportive of our call for moderately higher interest rates across the yield curve going forward.

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