ECONOMIC RESEARCH AND STRATEGY

LAURENTIAN BANK SECURITIES

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Bank of Canada (Oct. Decision) – Faster Withdrawal of Monetary Policy Easing Coming Up

BoC officials will fiercely fight inflation if needed. The new Monetary Policy Report includes a red-hot 3.4% CPI inflation forecast for 2022, following an equally high 3.4% surge this year. The BoC acknowledging higher-than-expected inflation reflects Canadians' concerns about some erosion in their purchasing power. Accordingly, today's decision marks a bold change in the monetary outlook. Echoing the increase in rates across the yield curve since September, the withdrawal of monetary policy easing will happen faster than previously believed by many BoC watchers.

The forward guidance for the policy rate liftoff is now 2022Q2/2022Q3 instead of 2022H2. Moreover, quantitative easing will end on November 1st as the Bank of Canada will enter the "reinvestment phase" of its bond purchase program. Going forward, the central bank will keep the size of its balance sheet steady by 1- Replacing maturing bonds with \$1B-\$2B monthly purchases in the primary market; 2- Making secondary market purchases of \$2.5B-\$3.5B per month.

The post-market reaction to the hawkish statement is significant, to say the least. The 2-year bond yield soars by close to 20bps and now trades above the 1.00% mark for the first time since the pre-pandemic period. The 5-year bond yield briefly went north of 1.50%, before settling down around 1.40%. The USDCAD currently trades close to 0.5% lower, at 1.23.

The swift change in the BoC's tone reflects multiple factors. As mentioned above, the central bank recognizes that inflation is significantly above its target and the factor driving it are more persistent than expected. The global energy crunch and pandemic-related supply dislocations in tradable goods show no signs of abating. The BoC sees inflation peaking at 4.8% 2021Q4, similar to our forecast, before coming down toward the 2% target in late-2022. Second, the BoC cites a still robust global recovery underway, reflecting vaccination progress. Third, the continuous improvement in labour market conditions, particularly the reduction in the uneven impact that the pandemic has on workers, did not go unnoticed.

Bottom Line: The Canadian economy is moving closer to a full recovery. Normal times are coming back, calling for the end of QE. More importantly, an important deterioration in the purchasing power of Canadians won't be tolerated. Before today's statement, we pegged the peak of the overnight rate target at 1.00% in early 2023. The indication of a possible liftoff in 2022Q2/Q3 likely implies a rate target of 1.00% before the end of 2022. Furthermore, if the recovery turns out to be stronger than the MPR's optimistic annual real GDP growth projections of 4.3% in 2022 and 3.7% in 2023, the policy rate could end up at, or close to, the 1.75% pre-pandemic level by late-2022 or early 2023.

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