Sébastien Lavoie • Chief Economist
514 350-2931 • LavoieS@vmbl.ca

Dominique Lapointe, CFA • Senior Economist
514 350-2924 • LapointeD@vmbl.ca

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BoC October Decision – Adaptive Unconventional Monetary Policy

It will take considerable time for the Canadian economy to completely recover from the COVID-19 pandemic. Accordingly, the Bank of Canada (BoC) decided to recalibrate unconventional tools in order to improve economic outcomes. Two modifications announced this morning relate to the pace and composition of purchases made under the Government of Canada Bond Purchase Program (GBPP). First, the GBPP "*purchases will be gradually reduced to at least $4 billion a week*", down from the current pace of $5B. This statement opens the doors to a potential 20% decline in the pace of federal bonds purchases, although the *minimum* threshold could mitigate the actual drop. Governor Macklem explained the vague word "gradually" during the 11AM press conference, stating that the pace of asset purchases would be reduced over a number of weeks.

Second, the purpose of the GBPP changes in tandem with the economic and financial context. Last spring, bonds purchases were deliberately concentrated at the short-end of the yield curve in order to restore market functioning, matching issuance of short-dated debt. The BoC's focus was very effective. Accordingly, close to two-thirds of assets held by the BoC have a maturity below 2 years including treasury bills, as explained in Box 3 of the Monetary Policy Report (*MPR*). Now, the updated strategy is to concentrate purchases towards longer term bonds in order to promote low borrowing costs for households and companies. The *MPR* provides more details about where the maturity structure of BoC future purchases : "*fixed-rate household and corporate borrowing tends to be most closely linked to 3- to 15-year GoC bond yields, although some corporations and utilities borrow at longer maturities*". The idea is to improve the effectiveness of each dollar added to the balance sheet. This will ultimately depend on how the pandemic unfolds. Under the scenario proposed in the *MPR*, consumers, and thus household credit, are the main driver of the "*recuperation phase*", the next step of the recovery following the strong initial reopening of last summer.

Third, Governor Macklem said the BoC does not have to be as active on the QE front at the short end of the curve because of the reinforced forward guidance. Indeed, the BoC refined its message today by explicitly mentioning no change in the overnight rate target for about two more years at least: "*The Governing Council will hold the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved. In our current projection, this does not happen until into 2023*".

Finally, a few additional topics caught our attention during the press conference. Governor Macklem sees no quantitative limits to QE at the moment, as the amount of asset purchases could be increased if the economic and financial situation deteriorates. The fact that the BoC currently holds $260B of federal bonds, nearly a quarter of federal marketable debt, does not appear to be an issue for BoC officials. He also mentioned that negative interest rates would not be helpful in the current context and that the bar would be very high to go there. The BoC did not mention a single word on Yield Curve Control, as targeting quantities of bond purchases appears the preferred and most efficient way to go.

Bottom Line: In this world of extreme uncertainty, the takeaway for borrowers is clear: the BoC will keep interest rates costs low for a long period of time even after the post-pandemic era starts. In our view, one of the most crucial elements of today's deliberation relates to the BoC's view that a different composition of QE purchases will fully compensate for the smaller pace of purchases. The FX market did not interpret it this way, as the CADUSD lost some ground this morning. Longer bonds duration purchases and the absence of a signal to buy 30YR bonds may bring a dose of confidence to initiate 5Y30Y steepeners. Although today's recalibration is different than the Federal Reserve Operation Twist of 2011, let us mention that Fed's staff found an impact of about 0.15bps on U.S. long bond yields.

Finally, as the BoC notes in the *MPR*, "*the uncertainty around the projection remains extraordinarily high*". For instance, the *MPR* scenario does not include additional U.S. stimulus. As of today, U.S. authorities failed to ratify a fiscal package supporting companies and individuals before the November Presidential Elections. Also, we will know before the end of the year if a safe and effective vaccine is soon available. The BoC assumes vaccines will be widely available in mid-2022. Until then, the BoC also assumes localized shutdowns will be sufficient to taper off the viral transmission rate. In our monitoring of the Canadian economy, we already expect a modest contraction for the month of October due to partial lockdowns announced in Ontario, BC and Quebec about a month ago. The Ontario government is looking at the possibility to tighten restrictions in the GTA, which would bring us closer to a W-shaped scenario.