ECONOMIC RESEARCH AND STRATEGY

LAURENTIAN BANK SECURITIES

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

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

September 8, 2021

Bank of Canada (Sep. Decision) – Balanced Statement, All Eyes on Tomorrow's Speech

With total CPI inflation running hot this summer and last spring's surprise economic contraction, the Bank of Canada strikes a balanced tone by sticking to its script: the weekly pace of GoCs purchases stays at $2B and the forward guidance regarding a policy rate liftoff during the second half of 2022 remain intact. Today's statement cites the current positive U.S. economic momentum and growing domestic demand from consumers and businesses, in addition to reduced unevenness in the Canadian labour market. Without surprise, the BoC attributes last week's 2021Q2 surprise real GDP contraction to supply chain disruptions disproportionally affecting the auto sector.

So far, market reaction to the statement has been muted. Things could be different tomorrow following Governor Macklem's speech entitled "QE and the reinvestment phase". Governor Macklem speaks at noon on Thursday. His speech might allow market participants to better understand the BoC's preferences regarding balance sheet management. The timing of this speech makes sense for two reasons. First, the Federal Reserve indicated the start of QE tapering before year-end. This gives more leeway for the Bank of Canada to move forward on the next phase of its QE program and avoid a disproportionate gap in its policy stance with the Fed.

Second, Deputy Governor Gravelle mentioned last March that "[they] would arrive at the reinvestment phase of QE some amount of time before [they] start to increase the policy interest rate". This reinvestment phase is almost there as the pace of increase in GoC holdings has slowed markedly since March. Over the next few quarters, we expect that *net* GoC purchases (weekly purchases minus maturing bonds on its balance sheet) will stop being positive. The BoC will have to enter its reinvestment phase in order to keep the size of its balance sheet steady. We estimate that $49B of federal government bonds will roll off the central bank's balance sheet in 2022, versus $22B in 2021, non negligible amounts relative to the entire $1.3T federal market debt. A $1B minimum weekly GoC purchases during the entire year of 2022 would be ideal in our view. However, communications remain a tricky part: it might seem contradictory to continue buying bonds to prevent rates from excessively increasing at the mid and long end of the curve while raising the policy rate at its short end. Tomorrow's speech should clarify this issue.

We also expect Governor Macklem to preserve some flexibility relative to the future path of QE, and thus the size of the BoC's balance sheet. As a comparison, the Reserve Bank of Australia said earlier this week it will maintain its current AUD$4B weekly pace of government bonds purchases until at least mid-Feb 2022 due to the uncertainty tied to the Delta variant. In Canada, acute microprocessors shortages will cause another pullback in auto production during the month of September which will weigh on economic growth in the third quarter. We track real 2021Q3 GDP growth at 3.0% Q/Q AR, significantly lower than the 7.3% BoC July MPR projection. Furthermore, the emergence of new coronavirus variants, including *mu* and *nipah*, poses additional risk to the outlook. Accordingly, we expect the BoC to significantly mark down its projections in the October MPR. In our view, the odds favour another $1B weekly QE tapering in December 2021, or early 2022, instead of October.

Bottom Line: Supply chain bottlenecks and COVID-19 are a concern to the BoC. At least, lower core CPI readings relative to total CPI support its transitory inflation view. The strengthening of the economy during the remaining of 2021 could be weaker than projected in the July MPR, but not enough to prevent Governor Macklem for preparing markets to the upcoming QE reinvestment phase. All eyes on tomorrow's speech at noon.

Sébastien Lavoie | Chief Economist
514 350-2931 | lavoies@vmbl.ca