LAURENTIAN BANK SECURITIES

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Bank of Canada Decision (April Decision) – Central Bank Tries to Break Inflation Psychology

With inflation running at almost 6% in 2022H1 and excess demand in the economy, there is a sense of urgency at the BoC to act quickly before inflation expectations become embedded in consumers and businesses' psychology. The pair of business and consumer surveys published by the BoC a week and a half ago was particularly concerning with respect to the establishment of a wage-price spiral and the risk of seeing elevated short-term inflation expectations feeding into longer term ones. Diffusion is also concerning as two-thirds of the CPI items grow at least 3% relative to a year ago.

Thus, today's 50 basis points policy rate hike should be followed by at least another 50bps move in June and a series of 25bps hikes thereafter. Sitting at 1.00%, the overnight rate target remains too low, below neutral territory. In fact, the median estimate of Canada's neutral rate has been revised up by 25bps in the April Monetary Policy Report (MPR), to 2.50%. Accordingly, we see the policy rate at 2.25% by year-end. The ongoing upward path for the policy rate will be supplemented by quantitative tightening (QT) starting next week. GoCs secondary market purchases are over. Our understanding is that there will be no caps on the GoCs roll off. More than $100B in GoCs purchased during the 2020-21 QE effort will roll off the BoC balance sheet. Details provided in the April *Monetary Policy Report* (*MPR*) indicates GoCs will drop by 40% over the next two years, resulting in a significant increase in net bond supply relative to previous years.

The April *MPR* basically echoes the Federal Reserve's "best case" scenario released in March. The BoC is confident that higher interest rates and easing supply chain issues will bring inflation down to the 2% target by 2024, without preventing the real economy from contracting. The *MPR* projects CPI inflation to be cut by half, from 5.3% in 2022 to 2.8% in 2023, and 2.1% in 2024. The BoC's upward revision to inflation, from 4.2% to 5.3% this year includes a 0.7pp shock tied to the Russian invasion of Ukraine fueling energy and food prices and exacerbating global supply chain bottlenecks. The BoC forecasts real GDP growth at a solid pace of 4.2%, 3.2% and 2.2% in 2022, 2023 and 2024, respectively. That being said, the central bank will have to balance the risks posed by elevated inflation expectations and the impact of highest interest rates on sectors of the Canadian economy. For instance, a BoC analytical note finds that a 100bps interest rate shock has a peak negative effect of 5.1% on housing activity and that 75% of that impact is felt after five quarters.

Bottom Line: Canadians and markets will find out if the optimistic *MPR* scenario materializes itself with the policy rate moving closer to the neutral rate. However, hawkish comments by Governor Macklem at his press conference strongly suggests that he is willing to push interest rates into restrictive territory (above 3%) if necessary to control inflation. After all, as he said appropriately, the target is inflation, not interest rates. Thus, it will be surprising if the BoC adopts the BoE and the ECB's mindset of letting CPI inflation running above target by recognizing that they cannot do much against supply side constraints and the energy-food crisis caused by the war and the pandemic (see charts).

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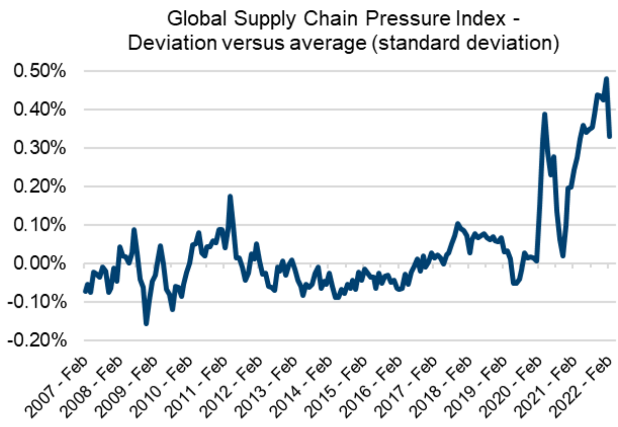
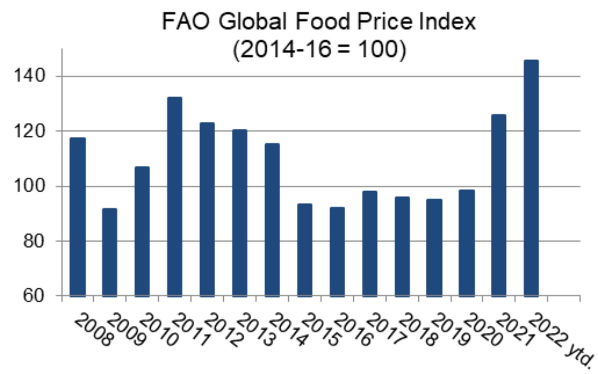


Source: New York Federal Reserve.



Source: Food and Agriculture Organization, United Nations