ECONOMIC RESEARCH AND STRATEGY

LAURENTIAN BANK SECURITIES

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BoC Decision – Policy Rate in Restrictive Territory, More Hikes Ahead

The Bank of Canada increased the overnight rate target by 75 basis points to 3.25% this morning. The policy rate, modestly in restrictive territory relative to the neutral estimate of 2.50%, becomes a mild headwind to economic momentum and CPI inflation.

The BoC lies at great distance from pronouncing "mission accomplished" as the global inflation problem broadens. In Canada, core CPI inflation measures range between 5% and 5.5% without showing signs of fading, short-term inflation expectations are too high and the risk of shifting in a higher inflation regime for the next 5-10 years exists.

Besides the slowing Chinese economy that could meaningfully ease the global commodity squeeze, the NY Federal Reserve reported this morning in a separate report a major easing in global supply pressures for the month of August. Thus, goods CPI inflation will cool down further, leading the much-needed moderation of services CPI inflation by several months. Despite short-term encouraging signs, it is still uncertain if CPI inflation will go back to 2% over the medium-term. Ultimately, this very uncomfortable situation for inflation fighters on Bank Street in Ottawa led to the addition of two specific sentences at the end of today's statement: "*the Governing Council still judges that the policy interest rate will need to rise further… As the effects of tighter monetary policy work through the economy, we will be assessing how much higher interest rates need to go to return inflation to target*."

We have a lot to say about these two sentences. First, the deliberate absence of guidance relative to a softer pace of tightening, as some market participants expected today, means there are plenty of options on the table for the October-December meetings, including another 75bps hike. Second, it is too early to pinpoint the terminal rate although the BoC appears on its way to bring the policy rate to at least 3.75% before year-end. Third, once the peak in the overnight rate target is reached, market participants should not bring back the false hope that the policy rate will decline during 2023. This market idea was notably priced in earlier this summer in respect to the U.S. fed funds rate.

Fourth, since the Canadian policy rate now stands in restrictive territory, it makes sense for the BoC to wonder how much additional hikes will be necessary to cool down inflation. No one can completely dismiss the hawkish view of US economist Larry Summers and the World Bank; both say the U.S. policy rate after CPI inflation must move out of negative territory and reach at least 0%. If we apply this idea to Canada, the overnight rate target could easily surpass 4% in early 2023. This being said, we see the terminal rate to end up closer to 4% than 3%, or 5%. Indeed, the recent abrupt weakening in goods consumption and housing activity suggests a front-loaded impact of monetary policy tightening on borrowing and purchase decisions from households, although the cumulative impact on monthly

interest payments takes a longer period to filter through. Accordingly, most of the tightening appears behind us, not in front. A 2018 BoC research staff paper indicates 75% of the adverse impact of a 100bps monetary policy shock is usually reached after 7 quarters for household consumption and 5 quarters for housing activity. We think the adjustment has been faster in 2022 for several reasons: higher private debt burden today versus previous tightening periods; the nonlinear response, or psychological impact, of bold 50-75-100 bps hikes keeping several potential borrowers on the sidelines; and the fast-lightening transmission of hawkish central banks' communication to market financial conditions.

Bottom Line: Financial markets will extract additional colours with the speech of Senior Deputy Governor Carolyn Rogers tomorrow 11:40AM, followed by the media Q&A at 1PM. Similar to Fed Chair Powell at Jackson Hole, we expect her to refer to the big long-term costs of high inflation, an implicit way to say the short-term pain of a fast tightening in monetary conditions is in some ways the lesser of the two evils for the economic well-being of Canadians.

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