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

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

9 December 2020

Bank of Canada (Dec. Decision) - No change in forward guidance - look for an eventful 2021

Several developments occurred since the last BoC decision on October 28th, including: 1- The elevated effectiveness of vaccines; 2- The $70B-$100B federal stimulus plan post-COVID that reinforces the outlook; 3- a worsening second wave of infections that led to lockdowns, increasing the odds of a real GDP contraction in 2020Q4 and 2021Q1; 4- The election of Joe Biden as U.S. President but a Republican-controlled Senate.

Ultimately, BoC officials are comfortable to carry on with the same tools and message for the time being. First, short-term market rates will remain at record-low levels for a long time. The BoC reiterates its message to keep the overnight rate at 0.25% until the 2% CPI inflation target is "sustainably achieved"; not before 2023 according to the central bank. Second, the pace and composition of QE remain intact despite more T-bills and less bond supply, as announced in the federal update from last November. BoC assets have been relatively stable over the last three months, between $530B and $540B. The steady increase in federal and provincial bonds has been offset by declining balances for T-bills and repurchase agreements.

Thus, no new actions were taken today. But some of the wording changed. For instance, an important addition at the end of the statement mentions that the goal of forward guidance and QE is to "keep interest rates low across the yield curve", which does not add anything fundamentally new to our understanding of the BoC behavior. On the FX side, the BoC sees the recent appreciation of the Canadian dollar as tied to a lower global value for the greenback due to vaccines hopes fueling global market sentiment. We look forward to Deputy Governor Paul Beaudry's speech tomorrow (1:30PM) for a possible reference to Type One/Type Two currency appreciation. Indeed, the statement includes two separate sentences explaining the recent strength of the Canadian dollar: "Stronger demand is pushing up prices for most commodities, including oil. A broad-based decline in the US exchange rate has contributed to a further appreciation of the Canadian dollar".

As we look forward to 2021, two upcoming developments need to be monitored. First, if a smooth vaccination campaign leads to herd immunity before 2022, central bankers will have to discuss at some point the possibility of softening the pace of asset purchases. This will have to be done without causing a spike in long-term interest rates.

But, the future of QE in Canada could also be tied to the renewal of the BoC mandate to be concluded in 2021. In the U.S., the Federal Reserve profoundly changed his approach earlier this year by moving to an average inflation targeting framework and emphasizing an inclusive labour market recovery. In Europe, ECB President Christine Lagarde mentioned in late September, as part of the ECB'S internal strategic review, the possibility of letting inflation run above 2% to compensate for low inflation in the past. Investors should pay attention to tomorrow's ECB decision and Lagarde's press conference thereafter. The story is the same for BoC Governor Tiff Macklem: a policy rate at the zero lower bound, inflation consistently below target and a new reality call for a shift in monetary policy. We are of the view that the BoC will abandon its 3-decade old 2% inflation target at the conclusion of its mandate renewal in 2021. The most optimal framework remains unclear, but it could include a form of increased tolerance for inflation above 2% and could aim for more inclusive labour market goals, similar to the Federal Reserve.

Before the Holidays, investors should pay attention to Governor Macklem's speech on December 15th. An important market risk for 2021 is not an increase in CPI inflation itself, but a change in long-term market-based inflation expectations driven by a shift in monetary policymakers' approach to inflation.

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