LAURENTIAN BANK SECURITIES

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Bank of Canada (March Decision): Fighting Inflation in a Volatile World

The Bank of Canada raised its overnight rate target from 0.25% to 0.50% today. This marks the first policy rate hike since October 2018 and the first move since March 2020, when the BoC brought down the rate target to its 0.25% notional zero lower bound in response to COVID-19.

The context in which the beginning of this new hiking cycle occurs is unusual in several ways. First, total CPI inflation sat at 5.1% y/y in January 2022, the highest in more than three decades. Since the Bank of Canada first implemented its inflation targeting framework in 1991, it is the first time it starts raising rates with inflation significantly and persistently above its 2% target. The central bank currently fights both actual inflationary pressures stemming from pandemic-related distortions and supply chain issues and upcoming inflationary pressures from an economy operating at full capacity and labour market conditions consistent with full employment. Combining these, today's statement highlights the risk that persistently elevated price pressures eventually de-anchor inflation expectations and ultimately lead to a forceful and disruptive monetary response. Hence the need to embark on a steady but firm tightening path in our opinion.

Three additional rate hikes in 2022 and two more in 2023, with upside risks

Statistics Canada revealed yesterday that the Canadian economy grew faster than expected last quarter and that GDP managed to grow a respectable 0.2% m/m in January, despite Omicron-related shutdowns. Hence, growth in the first quarter looks more solid than previously expected by both the Bank of Canada and our team. Consequently, the BoC Governing Council expects that "interest rates will need to rise further". Combined to acute price pressure, the economic backdrop warrants two consecutive 25bps rate hikes in April and June. Then, as suggested by Governor Macklem in media appearances, the BoC will become more data-dependant, possibly assessing how the economy and financial conditions adapt before continuing the hiking cycle. Resuming rate hikes in the second half of this year, we forecast the overnight rate target to reach 1.75% in the first quarter of 2023, slightly below the BoC's 2.25% estimate of the neutral rate. A faster and more aggressive pace of hiking could occur if long-term inflation expectations significantly rise above their current levels.

COVID-19 and the war in Ukraine could alter the economy and the path for rate hikes

Second, unsettling world events leave the economic and financial backdrop highly volatile and subject to wild swings. The Bank of Canada notes that the Omicron wave of infection fades out more quickly than expected. While the basecase scenario remains that advanced economies reopen permanently, "the virus continues to circulate and the possibility of new variants remains a concern". The invasion of Ukraine by Russia also poses a threat to the BoC's outlook and is rightly labelled as a "major source of uncertainty". Already, economic sanctions imposed on Russia and transport disruptions caused by the war put upward pressure on energy and agricultural commodity prices, which will push Canada's total CPI inflation above the BoC and our own forecast in 2022. On one hand, this could lead to more rate hikes. On the other hand, if the conflict ultimately causes an abrupt tightening in financial conditions and a large loss of consumer and business confidence, it could lead to fewer rate hikes.

The reinvestment phase continues but more clarity on QT is expected

The Bank of Canada did not announce this morning the end of its GBPP reinvestment phase and the beginning of quantitative tightening. Like in January, the statement mentions that the Governing Council will consider when to end the reinvestment phase and allow its balance sheet to shrink. More clarity on the matter, including the timing and pace of QT, could be given by Governor Macklem in its speech tomorrow at 11:30AM. Indeed, it is the only BoC communication before the April 13th decision.

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