ECONOMIC RESEARCH
AND STRATEGY

LAURENTIAN BANK SECURITIES

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Bank of Canada (April Decision) – Soft QE Tapering Begins

The withdrawal of extraordinary accommodative measures at the Bank of Canada started earlier this year with the discontinuation of all its market functioning facilities. More confident about the underlying strength of the recovery, the central bank announced this morning the next logical chapter of its strategy: QE tapering.

The vaccination rollout put the global and Canadian economies on a stronger and more sustainable footing than before. Also, the adaptation to lockdown measures and robust fiscal tailwinds brought by provincial and federal governments are among factors cited by the BoC that will propel 2021 real GDP growth to a sizzling 6.5%, higher than our 5.8% forecast. Without explicitly using the words “V-shaped”, the BoC highlights stronger growth despite elevated restrictions. Accordingly, now is the appropriate time to gently ease off the gas pedal on the Canada Bond Purchase Program (GBPP): starting next week, the BoC will purchase $3B of GoCs per week instead of $4B. At $3B, the pace of purchases stays strong. GoCs held on the central bank’s balance sheet, representing more than 40% of the stock of federal debt, will keep growing in the coming months.

Future economic developments will determine the right moment to bring down further the pace of QE. The BoC could not radically go down from $4B to zero net purchases due to the uneven nature of the recovery, particularly on the job market. While focusing on a more upbeat guidance, the central bank keeps its options open. It would be premature to call for the complete unwinding of QE by the Fall since COVID-19 variants and containment measures will prevent a complete return to work for many women and young workers in the most adversely affected sectors.

From a communication standpoint, it was simpler to explain to market participant the first taper move today with the release of the new MPR. But it does not have to be the case in the future. In our view, today’s $1B cut indicates a preference for $1B incremental steps in the future. Thus, the next move could be to taper further weekly purchases from $3B to $2B in late July, or after the September 8th meeting.

Robust economic growth in the making also led the BoC to revise up its inflation outlook, opening the door for a possible first rate hike in the second half of 2022, instead of 2023 as previously suggested in the January and March statements. The three core CPI inflation measures reported earlier this morning by Statistics Canada averaged 1.9% y/y in March. Total CPI inflation stood at 2.2% and will rise closer to the upper limit of the 1%-to-3% band in the coming months due to the unusually low prices observed a year ago during the first wave of the pandemic. Over time, the BoC is confident that CPI inflation will return to its 2% target in 2022, before moving up to 2.4% by the end of 2023.

Bottom Line: The QE fading phase should consolidate the outperformance of the Canadian dollar this year. Combined to a net increase of GoC bonds in the market, it should also lead to a moderate increase in nominal interest rates over the next 12-18 months. Future taper moves and the timing of the policy rate liftoff from the current 0.25% level will be based on improving outcomes, particularly a large range of labour market indicators such as women and youth employment rate. That is despite the fact that the BoC does not have an official inclusive maximisation employment mandate like the Federal Reserve.

Finally, critics arguing that the Bank of Canada has been financing the federal government's gargantuan deficits since it started quantitative easing last year should be put to rest. A massive Federal $286B bond supply program in FY 2021-22 announced on Monday, heavily geared toward the long-term, did not prevent QE tapering this morning. Furthermore, Governor Macklem mentioned during his usual press conference that the maturity of GoCs purchases within QE will remain the same.

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