ATB Financial Markets Update

FMG QuickTake: BoC July 2023 Policy Decision

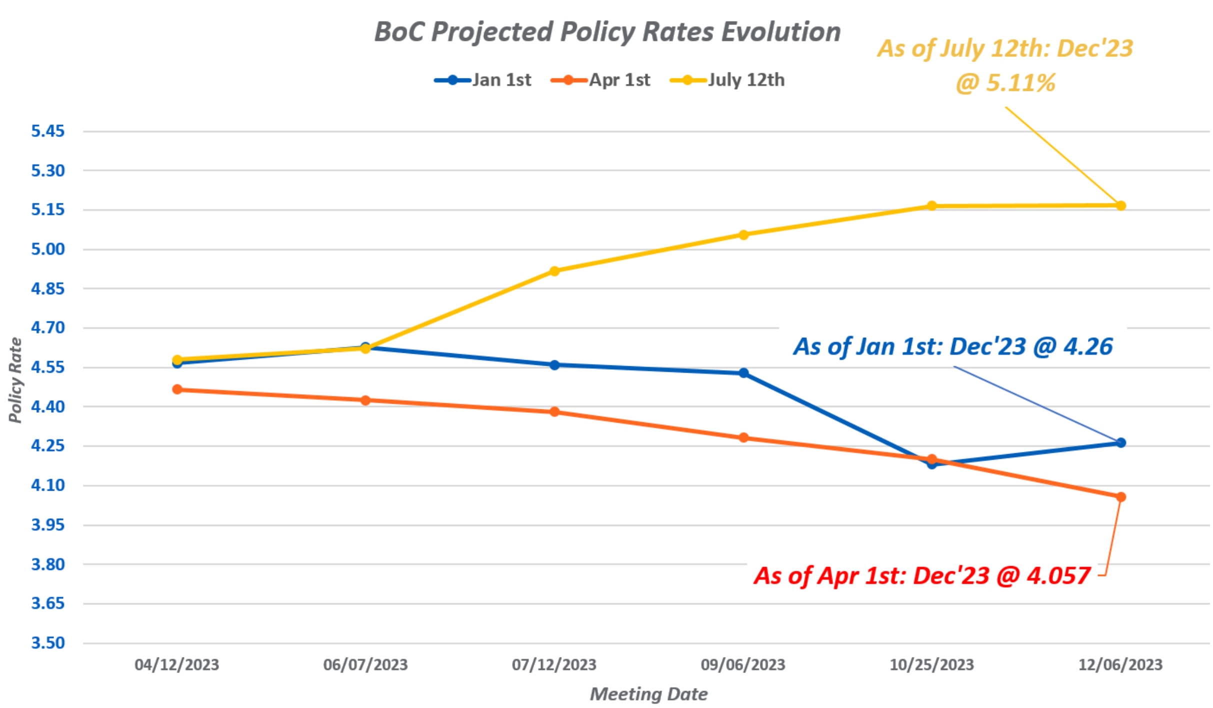
July 12, 2023

Summary:

- **The Bank of Canada (BoC) hiked rates by 25bps to 5.00%**
- The market was pricing a 66% probability of the move ahead of the meeting
- The BoC have concluded that inflation has become somewhat "baked in" at this point
- And that core measures will prove "sticky" and stay above 3% for longer than previously projected
- Dealing with this likely means "*Higher for Longer*"

Important Takeaways -

Sticky Core Inflation. A resilient economy. Updated forecasts. Higher For Longer policy.



- **Where will rates go in 2023?**
  They might stay here - but quite possibly higher still.
- **Is the BoC finished hiking?**
  Still unclear. They are clearly meeting-to-meeting at this stage. If the "data" (read *inflation)* does not behave as hoped - then they remain committed to action.
- **But will this mean quick cuts?**
  Absolutely not. They are not concerned about growth - only inflation - which means *higher for longer*
- **When might we see the cuts?**
  Increasingly drifting to Q3 2024 at the earliest

Observations -

Lots to digest here - with a statement, Monetary Policy Report and a Press Conference. Direct quotes that we highlight:

- *Looking ahead, the next stage in the decline of inflation toward target is expected to take longer and is more uncertain.*
- *Downward momentum in inflation is slowing, largely because demand in Canada continues to outpace supply.*
- *Household spending has been robust, supported by strong demand for labour, population growth and accumulated household savings.*
- *The return of inflation to target is expected to occur two quarters later than previously projected. (Mid 2025)*
- *Inflation is now projected to remain around 3% over the next year. As excess demand dissipates and labour market conditions ease, inflation gradually returns to the 2% target in the middle of 2025.*
- *A considerable amount of uncertainty surrounds the forecast, particularly into 2024 and 2025. Three-month rates of core inflation have stayed in the 3½% to 4% range for some time.*
- *The Governing Council remains concerned that progress towards the 2% target could stall, jeopardizing the return to price stability.*

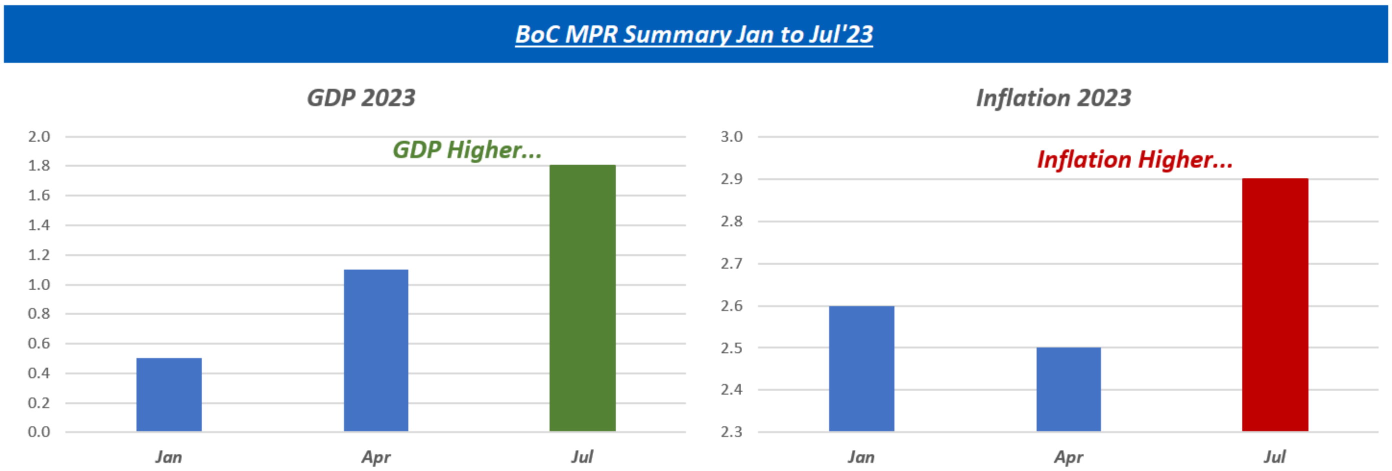
Clearly the BoC remains concerned that the dynamics around inflation have changed. Indeed, if anything they sound increasingly concerned that the mission - while not *impossible* - is proving increasingly difficult. (Not sure if "*Mission Very Difficult" looks* as good on a billboard). If they are worried that they will have to be more draconian on Monetary Policy for longer than previously hoped - then are they now more concerned about growth and the homeowner also? It appears not:

- *Real GDP growth is estimated to have slowed in the second quarter of 2023 to 1.5% and is projected to moderate to an average of about 1% through the second half of 2023 and the first half of 2024.*
- *Economic activity is projected to pick up in the second half of 2024 as the effects of monetary policy tightening on growth fade*
- *The financial positions of many households remain healthy, due in part to strong labour markets and the buildup of large liquid savings since the beginning of the COVID-19 pandemic.*
- *While delinquency rates have been rising, most continue to be below pre-pandemic levels. In particular, the delinquency rates on mortgage loans are near all time lows.*

Conclusions -

A full 18 months into the hiking cycle, The Bank of Canada's focus and concern is more binary than anyone could have predicted. They are purely concerned with, and focused upon, inflation, and *Core Inflation* to be precise.

Look at the evolution of the projections for CPI and GDP in the Monetary Policy Reports from Jan, Apr, and July



Simply put, actions to date have not had the impact that the BoC projected that they would - based on history. But, as we have written many times over the past year in our various ATB Financial Markets publications - history may not be very helpful if the pandemic and the policy responses changed both the economic paradigm and the rules of the game. With the economy and job market proving extraordinarily resilient, the previously only theorized concept of inflation expectations starting to be self-fulfilling has started to look a very real threat.

Six weeks ago - post June hike - the BoC said, "*The Bank continues to expect CPI inflation to ease to around 3% in the summer, as lower energy prices feed through and last year's large price gains fall out of the yearly data. However, with three-month measures of core inflation running in the 3½-4% range for several months and excess demand persisting, **concerns have increased that CPI inflation could get stuck materially above the 2% target.**"*

Today (to reiterate) we got:

- *Looking ahead, the next stage in the decline of inflation toward target is expected to **take longer and is more uncertain.***
- *The Governing Council remains concerned that **progress towards the 2% target could stall, jeopardizing the return to price stability.***

The Bank of Canada has not been lulled into a false sense of security by the falling headline CPI numbers. They are looking at the behaviour of Core CPI - what it tells them about the dynamics of the economy in 2023 (and not 1993) and how it threatens to shape the future. *And the signs are concerning for their 2% mandate.*

Market Reaction -

Fascinating. The US CPI report was released 30 minutes before the BoC hike was announced. It was expected to fall significantly across all measures - and did not disappoint. The Core reading for June fell to 4.8% YoY (even more than than the 5% print expected). North American markets took this as a positive sign and sent yields lower. Despite the hawkish overtones, the Canadian market could not retrace this move after the hike. The fact that it was largely expected and that Governor Macklem admitted in the press conference that The Governing Council did discuss holding steady and looking for more data has overshadowed the more hawkish tones in the Monetary Policy Report.

Government of Canada Bond Yield Summary							7/12/2023
		Last	1w chg (bps)	12m chg (bps)	3m High	3m Low	% Rank of Current Yld to 3m Range
GoC Bond Yields	2y	4.642	-10.90	143.50	4.805	3.547	88%
	5y	3.779	-13.60	66.90	3.990	2.874	89%
	10y	3.409	-7.70	22.10	3.573	2.764	88%
	30y	3.252	0.40	15.70	3.340	2.918	82%
Curves	2s10s	-123.30	3.20	-121.40	-76.10	-131.80	22%
	5s30s	-52.70	14.00	-51.20	8.60	-66.70	20%

What Next? -

The BoC suggested that it is now "data dependent". In reality, that means that it is all about inflation and what continues to keep it elevated.

To use the concluding summary paragraph of the Policy Statement:

"The Governing Council will continue to assess the dynamics of core inflation and the outlook for CPI inflation. In particular, we will be evaluating whether the evolution of ***excess demand, inflation expectations, wage growth and corporate pricing behaviour*** *are consistent with achieving the 2% inflation target".*

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