ATB FMG QuickTake: Federal Reserve Policy Decision

Dec 6th 2023

Summary:

- The Bank of Canada left rates unchanged at 5%
- They described an economy that is clearly cooling - in all the ways that they would actually like
- They have moved to suggest that it is now “in balance”
- But they remain focused on ensuring that the inflation issues that we have experienced are fully resolved

Important Takeaways -

- **Where will rates go from here?**
  Probably nowhere for a little while
- **Is the BoC finished hiking?**
  Almost certainly
- **But will this mean quick cuts?**
  Well, that’s a good question……

Observations -

There are many indications that the BoC feels that we are on the path back to a more “normal” inflationary and rates environment. Indeed, the first 80% of the statement is littered with such observations:

- *Higher interest rates are clearly restraining spending*
- *Consumption growth in the last two quarters was close to zero, and business investment has been volatile but essentially flat over the past year.*
- *The labour market continues to ease: Job creation has been slower than labour force growth, job vacancies have declined further, and the unemployment rate has risen modestly.*
- *The slowdown in the economy is reducing inflationary pressures in a broadening range of goods and services prices.*
- *Overall, these data and indicators for the fourth quarter suggest the economy is no longer in excess demand. With further signs that monetary policy is moderating spending and relieving price pressures, Governing Council decided to hold the policy rate at 5%.*

However, there are some balancing, “bigger picture”, strategic-level offsets to these observations:

- *Wages are still rising by 4-5%*
- *Shelter price inflation has picked up, reflecting faster growth in rent and other housing costs*
- *Governing Council is still concerned about risks to the outlook for inflation*

These are consistent with the guidance that the BoC has previously given. They have repeatedly spoken of their concern that wages and pricing behaviours have been driving some level of "wage-price spiral" - and that they fear that the post-pandemic economy may be a little different. More specifically, it may have more latent inflation pressures. They have said that they would be more vigilant than in previous cycles as a result. These comments seem consistent with that.

Conclusions -

The Bank of Canada appears more confident that actions to date are "working". They are clearly encouraged by the cooling of the latent demand - and getting the economy "in balance" by year end will bring some holiday cheer to them, one suspects. That said, they are aware of what the market is pricing with regard to their next actions - ie eases, both quickly and often - and are attempting to stem that tide by remaining with a soft tightening bias (consistent with "Higher for Longer" guidance).

Market Reaction -

Rates are unchanged in the very near term maturities - but lower further out. This move is no doubt being helped by the tone of the US market - which is very much buying into the idea that policy rates are on their way to pre-pandemic levels (or close to, at the very least). However, if the market chooses to study the thoughts of the BoC selectively - which it almost always does (such is the nature of markets) - then there is plenty here to focus on that is "dovish" irrespective of the US market. That is all the market really needs to hear.

Government of Canada Bond Yield Summary							12/6/2023
		Last	1w chg (bps)	12m chg (bps)	3m High	3m Low	% Rank of Current Yld to 3m Range
GoC Bond Yields	2y	4.064	-13.00	27.60	4.973	4.064	0%
	5y	3.390	-24.00	38.80	4.418	3.390	0%
	10y	3.270	-28.40	49.50	4.244	3.270	0%
	30y	3.086	-27.10	31.30	3.997	3.086	0%
Curves	2s10s	-79.40	-15.40	21.90	-57.40	-106.30	38%
	5s30s	-30.40	-3.10	-7.50	-21.70	-57.80	72%

What Next? -

Are reputations created lazily or honestly?

The market wants to believe that things will turn out broadly as they always have. Looking at this with history as a guide, so much time has elapsed since the last hike, and the resulting slowing of the economy could add up to a scenario where the next move is a pivot towards cutting - and soon. Simply put, the market thinks that central banks - at this stage of the cycle - tend to get caught up paying too much attention to the broad data - GDP, Unemployment and CPI - that tend to lag. They focus on the distance between where we were and where they are told we might be now. The market will always focus on the distance between where *it thinks we are now* - and where the speed and direction of travel suggests *we could go.*

And historically, the market has been wise to do so - central banks have tended to catch up and eventually justify the discord. But for some time now, both the Fed and the BoC have told us 3 things in all messaging:

1. This time may be different - inflation may be more baked in

2. Therefore we need “higher for longer” - especially if rates were hiked to “just enough” levels based on historical comparisons
3. We have to be more vigilant on inflation as it can reignite - and that is way more damaging long term

What the BoC did today is consistent with those points. And yet the market persists with the conviction that the pivot starts - with the probable signaling of an easing bias - in 6 weeks. Indeed, rates have moved lower post-announcement. Is the market right to assume that central banks will pivot swiftly here again - just as they always have - or is that lazy thinking that pays no attention to the base guidance? January will be fascinating.

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