FMG QuickTake: July 2024 Policy Decision

July 24th 2024

Summary:

- The Bank of Canada **cut rates 25 bps** to 4.50%
- Their outlook for inflation continues to seem more confident
- Making further cuts more likely
- In fact, they appear to be **leaning towards more cuts being *necessary*** to deliver the kind of growth (and crucially *per capita growth*) that will mop up the increasing excess supply in the economy

Important Takeaways -

- **Where will rates go from here?**
  Down for sure
- **Will the BoC cut again in September?**
  The market is 65% priced. Just as it was for July after the June cut. So the market is waking up to the probability that the BoC is motivated to *not* back away here. This seems right to us.
  So what could the rest of 2024 look like for cuts?
  Three cuts for sure. One could argue that the prospect of "4 in a row" and a December pause has been heightened dramatically today.

Observations -

Given the market had an 88% probability of a cut in the pricing - this move was no bigger a surprise than the June one. The Bank of Canada attempted to keep expectations within the right lane in the statement and throughout the press conference:

- Governor Macklem : ***"I think that I have been pretty clear. The expected direction of the policy rate is lower. But we are not on a predetermined path"***
- Governor Macklem : (Rates will be) *"declining gradually, but it's probably not gonna be a straight line"*
- The policy statement : *" Monetary policy decisions will be guided by incoming information and our assessment of their implications for the inflation outlook"*

However, the policy statement also made the picture (and we believe the increasing focus) clear:

- *" The economy's potential output is still growing faster than GDP, which means **excess supply has increased**."*
- *" **The economy has moved from excess demand in 2022 to excess supply"***
- *'Excess supply is expected to be slightly larger over the course of the projection horizon"* (2 years)
- *"Growth in the first quarter of 2024 was roughly 1% lower than projected"*
- *"Household spending, including both consumer purchases and housing, has been weak. "*

- *"There are signs of slack in the labour market."*
- *"The breadth of price increases across components of the CPI is now near its historical norm"*

Conclusions -

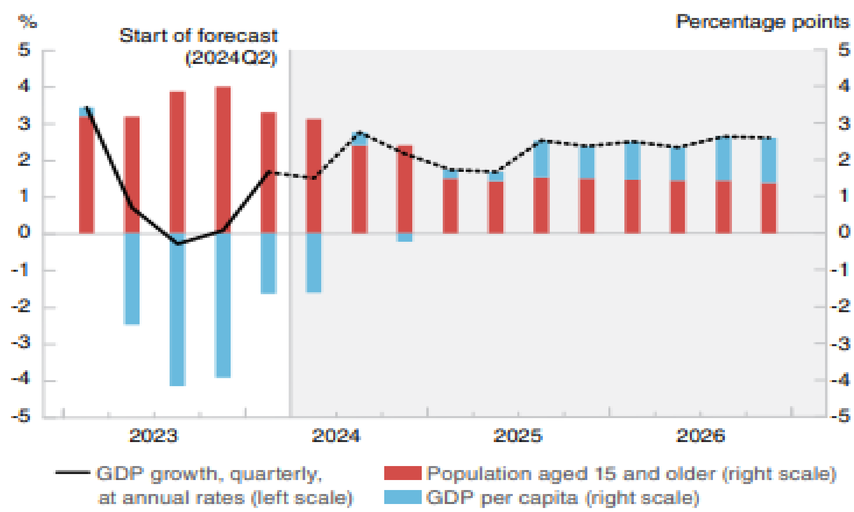
What struck us about the also-released Monetary Policy Report was the increased emphasis on **GDP Per Capita.** That is the measurement of economic activity per person - rather than as a cumulative nationwide number. This solves for the impact of population growth and gives a better picture of the real strength of the economy. While would the BoC need to do this?

- Population growth has been, currently is - and for another year or two will be - an outsized influence on the overall economic performance. More people means more activity - with overall demand picking up and housing increasingly strained.
- And so there is a need to strip this out to see the true impact of the high policy rates that we have had.

Here is the chart that the Bank of Canada provided to emphasis their analysis:

Chart 11: Growth of GDP per capita is expected to strengthen

Contribution to real GDP growth, quarterly data



Note: Data for the population aged 15 and older are from Statistics Canada's quarterly estimates of the population.

Sources: Statistics Canada and Bank of Canada calculations, estimates and projections

Regular readers of our commentaries will know that we have been flagging this is increasingly important. Why? Well, firstly because it's reality and it's not going away. But also because ***if you wanted to move your focus away from purely inflation and towards growth-support - even though the CPI rate is above target and the GDP numbers are still positive - then this is the metric that you would flag.***

The Bank of Canada NEEDS growth. It is forecasting a continued soft landing, with growth accelerating in absolute - *but also per capita* - later in 2025 and into 2026 to mop up all that excess supply and put a floor in the fall of inflation around that desired 2% rate. As they said, ***"growth in GDP per person is expected to increase gradually over 2025 and to reach 1% in 2026". That is the forecast***. That is what that chart above shows.

But the reality that they are seeing now?

- The output gap has widened since April
- Governor Macklem : *"Surveys of consumer spending are pretty soft"*
- Governor Macklem : *"Households are feeling the pinch"*

All of this should be a green light for falling inflation. **If we see a general and controlled fall in inflation further from here, then the BoC can pivot to more confidence in being more pro-growth than anti-inflation. That *continued soft landing depends upon it.*** To quote the MPR:

- *GDP growth is forecast to increase in the second half of 2024 and through 2025. This reflects stronger exports and a recovery in household spending and business investment **<u>as borrowing costs ease</u>**. Residential investment is expected to grow robustly.*

All the ingredients were there for the Bank of Canada to cautiously signal a further desire to follow this cut with more. And that is what they did. They are telling us that is their desired path. We would be foolish to deny that.

Market Reaction -

Rates are lower and curve has "bull steepened"

Yields are lower across the curve - more so in nearer maturities - as extended policy easing is priced in for the shorter run, along with increased confidence in that soft landing and reignition of growth in the long run.

- 2 year yields down 10 bps
- 5 year yields down 6 bps
- 10 year yields down 4 bps

What Next? -

<u>Data</u> is the big one. More specifically, **inflation data**. The BoC have eloquently and clearly highlighted the *"competing forces*'' in the inflation picture. Goods prices are behaving increasingly as one would expect and hope. Services (driven by higher wages for workers in labour intensive sectors) and Rents/Shelter costs are not.

At least, not yet. And that is the key. Will population growth further weaken the job market and help control wages? But will it also spur the costs of rent and housing? Will demand for homes broaden and reignite as mortgage rates fall? Will higher rates, despite the cuts, continue to slow aggregate demand just enough to allow the output gap to do its work on inflation? All of this will be **key to how much, and how quickly the BoC can cut from here.**

The Federal Reserve - While the BoC remains independent, and we do not believe that they are limited in cutting by what their southern cousins do *yet* - It would be helpful if "The Fed" were more sanguine on the US economy and signal that they are adding back the cut for 2024 that they removed a few months ago. In the Monetary Policy Report, the Bank of Canada downgraded US Growth in 2024 to 2.3% from 2.7% in their April forecast. This would be of comfort to them. But will The Fed agree? Will the more dovish overtones that Chair Powell has been emitting of late come through? **The market fully expects a September Fed cut. If they signal it on July 31st, then the BoC (barring a nasty CPI surprise in Canada) are a lock to cut again.**

NB: " R star" Neutral Rate Guidance - the policy setting that allows the economy to grow at long term trend (~2%) with the long term desired level of inflation (2%). The BoC estimates of this are still **2.25% to 3.25%**. This is the range that one would expect the overnight policy rate to be within when inflation "normalizes" as expected. The market currently has a policy rate of 2.75% priced in for 2027 and 2028. ***So there is a lot of success already priced into the curve.*** The market is likely to push yields a little lower from here - but a lot of the lifting has been done.

Government of Canada Bond Yield Summary							7/24/2024
		Last	1w chg (bps)	12m chg (bps)	3m High	3m Low	% Rank of Current Yld to 3m Range
GoC Bond Yields	2y	3.630	-7.70	-107.70	4.348	3.630	0%
	5y	3.306	-4.30	-61.90	3.905	3.281	2%
	10y	3.391	1.20	-12.40	3.868	3.262	20%
	30y	3.420	6.80	8.00	3.743	3.190	49%
Curves	2s10s	-23.90	8.90	95.30	-23.90	-63.60	100%
	5s30s	11.40	11.10	69.90	11.40	-22.90	100%

Mark Johnson, MBA
Managing Director, Interest Rates Sales
mjohnson4@atb.com

JP Dore, ERP
Director, Interest Rates Sales
jdore@atb.com

Travis Chernichen, CFA, CAIA
Director, Interest Rates Sales
tchernichen@atb.com

Chelsey Deng
Analyst
cdeng@atb.com