FMG QuickTake: March 2024 Policy Decision

March 6th 2024

Summary:

- The Bank of Canada left rates unchanged at 5%
- They described an economy that is still cooling
- They see it as "in modest excess supply"
- But they remain focused on ensuring that the inflation issues that we have experienced are fully resolved
- Is that really *fully true?*

Important Takeaways -

- **Where will rates go from here?**
  Down for sure - but the timing? hmm…..
- **Is the BoC about to cut?**
  It is hard to say…but possibly not
- **So when might we get cuts?**
  Well, that's a good question…June appears to be the market's consensus opinion. But it's not a slam dunk…

Observations -

The policy statement was largely balanced - but seemed to lean against the idea that the BoC would be likely to change its policy stance soon:

- *The economy grew in the fourth quarter by more than expected, although the pace remained weak and below potential*
- *Employment continues to grow more slowly than the population, and there are now some signs that wage pressures may be easing.*
- *CPI inflation eased to 2.9% in January*
- *Shelter price inflation remains elevated and is the biggest contributor to inflation*
- *Underlying inflationary pressures persist*
- *The Bank continues to expect inflation to remain close to 3% during the first half of this year before gradually easing.*
- *The Governing Council wants to see further and sustained easing in core inflation and continues to focus on the balance between demand and supply in the economy, inflation expectations, wage growth, and corporate pricing behaviour.*

The fact that the BoC - both in the statement and at the press conference sought to specifically reference shelter within the CPI calculations shows just what a hot button topic it has become. They could have said that they were looking through the shelter numbers - which was something that Gov. Macklem hinted at in comments recently - and that would have been a bullish sign for bonds. But they did not do that. Infact, the good Governor even stressed that certain elements of shelter are stripped from the core number by virtue of their volatility. **As can be seen in the quotes above - they also stressed that underlying inflation is too high regardless of shelter and that too many goods in "the CPI basket" are still rising at over 3% on an annualized basis.**

Conclusions -

The Bank of Canada wants to sound steady and patient. They want (read ***need***) to sound vigilant on inflation. There was enough doubt on the pace of the slowing of prices (and to some extent there is doubt as to whether inflation was still trending lower…) going into this meeting that we always felt how the BoC chose to frame the discussion and what they chose to highlight would be the real insight.

And they chose to push back on the idea that:
1) Inflation is definitely falling and is clearly and definitively "on its way"
2) It is all shelter and that policy needs to look through a component that is as much a tax as anything

The fact that they chose this approach is not that surprising. The real question is - *why* did they choose this approach? Common sense and practicality provides many answers. It is still "early" and the actual numbers on inflation have only just started to look friendly to the rate cut agenda. Plus, they have a reputation to uphold - which is a major consideration in the bigger picture (and rightly so). Perhaps that is why we heard:

- *"Year-over-Year and three-month measures of core inflation are in the 3% to 3.5% range, and the share of CPI components growing above 3% declined but is still above the historical average"*
- *"The Council is still concerned about risks to the outlook for inflation, particularly the persistence in underlying inflation"*

However, the market has run ahead of central banks consistently - lowering mortgage rates, reducing credit spreads and loosening financial conditions. These are all things that a central bank would only be comfortable with if it was not 1) counter to their view on where rates will go in the near term and 2) counterproductive to their efforts to keep activity and demand lower in order to deliver lower inflation. Neither is the case. And so it is a widely held opinion that central banks have micromanaged market expectations in their communications (particularly since the turn of the year) in an effort to dampen optimism for rate cuts and "keep the curve in check". The real question here - the $64,000 dollar one - is:

Is the BoC's tone and apparent intention to continue to downplay imminent rate cut expectations a function of this micromanagement? Or do they actually believe that they are too far from starting the cutting process (because their vigilance bar is higher than the market thinks) to even contemplate a public discussion now?

Market Reaction -

Rates are largely unchanged across the curve. **A hold was expected. Most expected a balanced statement - which was largely delivered.** Any sense that this was a little more hawkish than expected is subtle and buried in a level of nuance that - whilst it did catch our attention - is understandably being broadly ignored by markets.

What Next? -

The reason that the answer to the question that we pose above is of vital importance is the relationship between market expectations, the preferred central bank communication process - and the calendar.

I think that the underlying market assumption that the Boc (and the Fed) *want to ease as soon as they can justify* it is not unfair. However, this does not sound like a central bank that will ease in the coming months without a reasonable degree of more supportive evidence - especially on prices.. It is unlikely that growth and unemployment will deliver data points that materially change the decision tree - and that is certainly the BoC's view right now. And so it is all about CPI (pick your version wisely).

The market is only pricing in a 20% chance of a cut at the next meeting in April. Fair enough. But is still pricing a June cut at 80%. The term to the next meeting in April is a short one. Only 5 weeks away. There is only one CPI report in that 5 weeks. So the burden of proof for any cut in the immediate future would have to be satisfied by the next CPI report joining the last one in being sufficiently and surprisingly weak to justify a change in stance. And even if that happened - that is still only *2 reports*. Is that sufficient evidence for the BoC to finally signal a cut?

And that is *"the thing".* Central bank protocol typically means that a cut - whenever possible - gets signaled ahead of time by a change in bias or at least a statement on the balance of probabilities. **To not follow this protocol would suggest an urgency in the need to move.** Moves that surprise markets are rarely done in a controlled setting. But it would be hard to justify the first rate cut from 5% - the one we have been speculating on for 9 months - as a necessary surprise cut, would it not? So signaling a June cut (or the heightened probability of one) would need to be on the agenda for April's meeting. Only 5 weeks from now. Hmm. Now, there are ways around this, ***and there is a Monetary Policy Report published at the April meeting with updated economic forecasts*** - but it might be that time is running shorter for a June cut than the 80% probability in the market suggests.

Government of Canada Bond Yield Summary								3/6/2024
		Last	1w chg (bps)	12m chg (bps)	3m High	3m Low	% Rank of Current Yld to 3m Range	
GoC Bond Yields	2y	4.070	-11.20	-25.20	4.364	3.786	60%	
	5y	3.432	-13.80	-13.90	3.802	3.174	45%	
	10y	3.347	-14.30	2.90	3.651	3.055	43%	
	30y	3.241	-12.20	7.10	3.479	2.895	46%	
Curves	2s10s	-72.30	-3.10	28.10	-53.00	-85.60	42%	
	5s30s	-19.10	1.60	21.00	-6.50	-33.10	54%	

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