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iFlow

MACRO MORNING BRIEFING

February 12, 2024

A Lot Going On In Canada

Stubborn Inflation, Slowing Growth

- Bank of Canada to remain on hold well into summer
- Governor Macklem admits monetary policy cannot address housing costs
- Cross-border underweights in CAD suggest room to add

Markets not yet ready to price in June rate cut

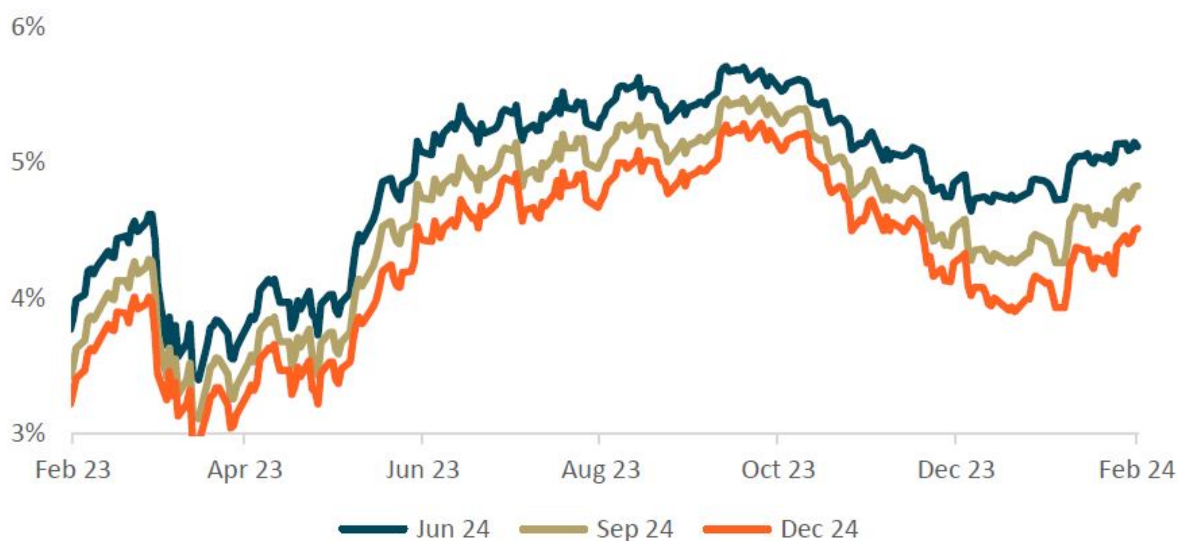
A few weeks ago we published a Bank of Canada preview (see here), highlighting the dilemma facing Ottawa's monetary policy path amid still-stubborn inflation and weakening domestic demand. At the time, we expected the BoC to lean into the inflation story and come out hawkish, while acknowledging growing economic weakness. In our opinion, the BoC indeed leaned hawkish, concentrating on the persistence of inflation and so matching our expectations. However, the reaction in USDCAD was completely opposite of what we had foreseen: CAD weakened on the day, with the currency pair topping 1.35. Since then, it has remained above 1.34. Our expectation has been for CAD to strengthen against the USD based on a more dovish rate view in the US than in Canada but, alas, it hasn't happened.

Also since then, we have seen more evidence of a weaker job market, the Summary of Governing Council Deliberations from the Jan. 24 policy meeting, and an interesting – but equivocal, in our opinion – speech from Governor Macklem. These developments have created a degree of ambiguity about the policy path ahead and, hence, consolidation in USDCAD in a narrow range between 1.34 and 1.35. In assessing this information since the last policy meeting, we remain of the view that the BoC will not be altering rates for a while. This further suggests to us a slightly stronger CAD.

Looking at market-implied rate expectations from bankers' acceptances, we observe a market that is appropriately ambivalent. The chart below shows June BAs hovering near 5%, implying no change in the policy rate into summer. One has to look ahead to the September

BA (currently 4.83%) to see evidence of an expected rate cut. Even December pricing only implies a total of two rate reductions between now and the end of the year. We think this pricing is probably appropriate after analyzing the confluence of data and rhetoric.

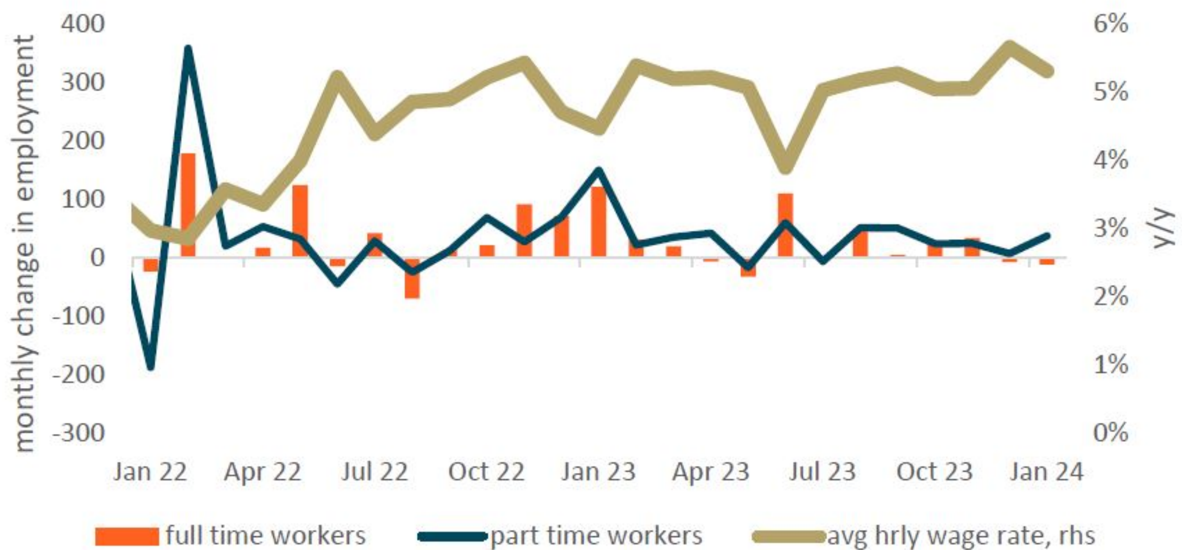
Market Not Ready For A June Cut



Source: BNY Mellon Markets, Bloomberg

This past Friday, Canada's January labor data registered a pretty strong month – on the surface. Total jobs increased by over 37k, well above December's nearly flat reading. But full-time employment was quite weak, -11.6k, and part-time workers increased significantly, +48.9k. Indeed, over the last six months, full-time employment growth has been weak and getting weaker. This suggests continuing slowing in labor demand. Meanwhile, labor-cost growth remains elevated, with full-time employees' average hourly earnings above 5% y/y in 11 of the last 12 months. Finally, labor force participation fell slightly, helping push the unemployment rate lower. Despite the strong headline number, we see this report generally painting a picture of slowing economic growth, albeit with stubbornly high wage increases.

Weakening Employment, Stubborn Wages



Source: BNY Mellon Markets, Statistics Canada

In a speech last Wednesday before the Montreal Council on Foreign Relations, Governor Macklem spoke about the limits of monetary policy and the appropriateness of using a single tool – the policy rate – to address a number of issues facing the Canadian economy. In particular, Macklem indicated that the BoC cannot address a housing shortage that has intensified with high population growth and inward migration, and a persistent lack of supply.

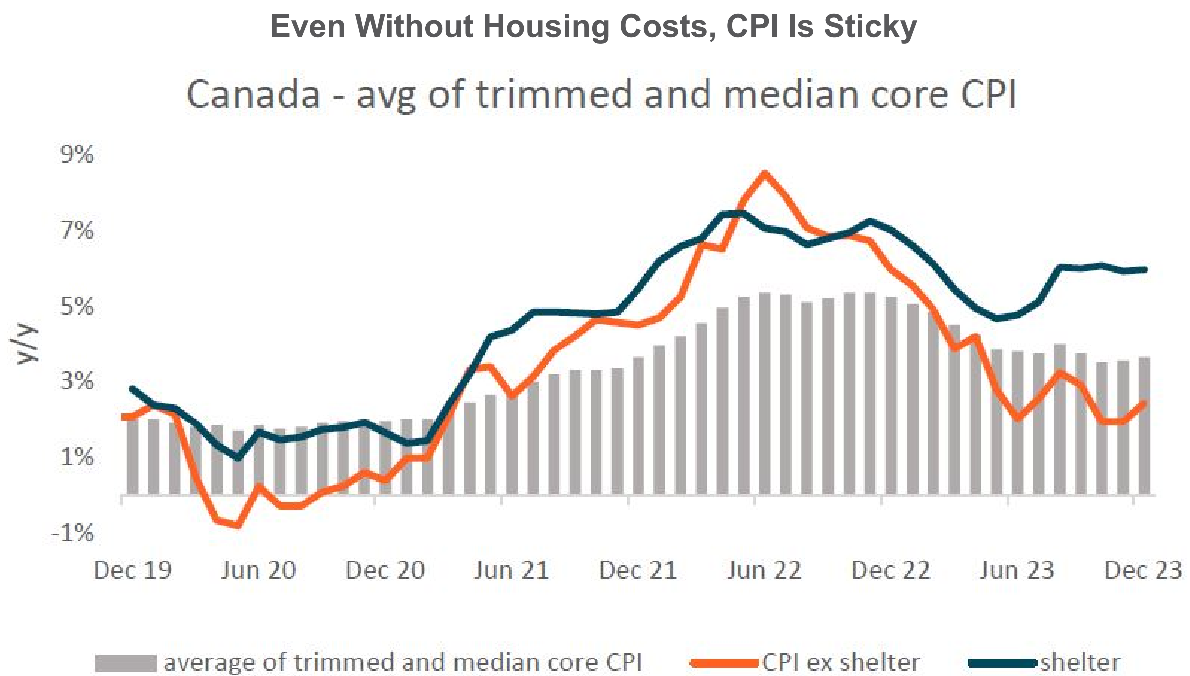
This, plus higher mortgage interest costs thanks to higher policy rates, have pushed housing inflation to very high levels. Short of lowering interest rates to reduce mortgage payments, monetary policy is generally of little use to address housing costs. On the idea of mortgage costs, Macklem and Senior Deputy Governor Rogers seemed to dismiss this course of action to combat overall inflation, but Macklem in particular has indicated there might be more attention paid to CPI inflation ex housing costs, considering the structural issues in the housing market we described above.

The chart below shows the evolution of Canada's CPI since before the pandemic. In recent months, the average of the trimmed and median core CPI has stopped its decline and is actually turning back up. Housing costs, indicated by the dark blue line, have settled down yet remain quite high, leaving the CPI ex shelter much lower, now averaging about 2.5% over the last eight months. It's not going higher, but it is steady – and not falling.

Indeed, on inflation generally, the Summary of Governing Council Deliberations expressed what could only be described as disappointment over a lack of progress getting it lower. "Prices for just over half of CPI components were growing at a rate above 3%, indicating that the drivers of too-high inflation continued to be broad-based." This would imply that the BoC is nowhere near cutting rates, explaining the lack of dovish movement in June BA futures.

This, to us, suggests that policy will remain tight for as long as it takes to see some progress on overall inflation – the BoC is not close to cutting rates.

Even Without Housing Costs, CPI Is Sticky

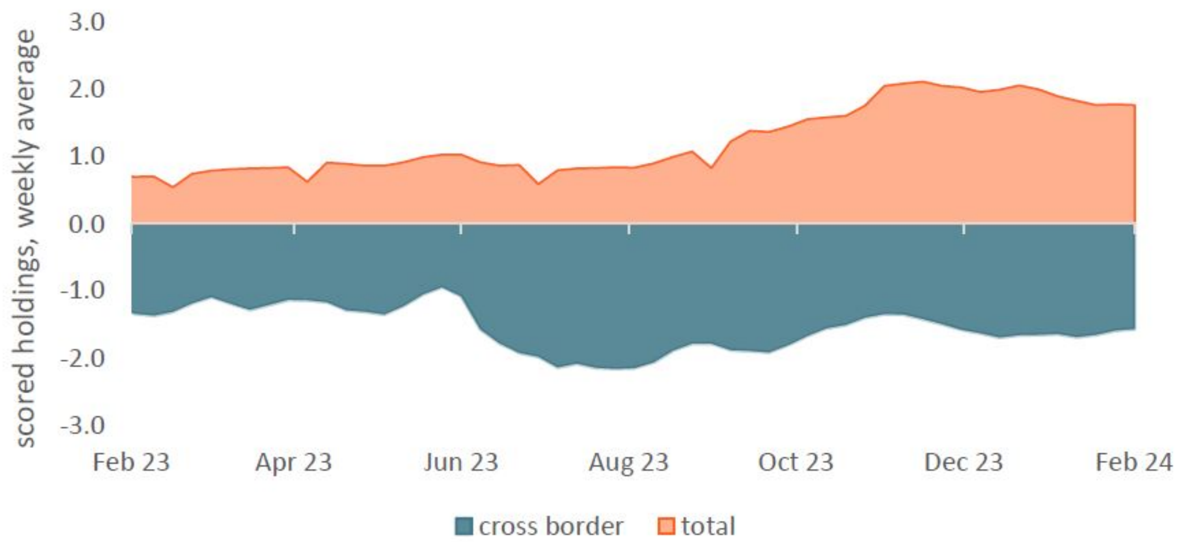


Source: BNY Mellon Markets, Statistics Cananda

What does this mean for CAD? We see it appreciating vs. USD in coming weeks. If we're right that the Federal Reserve will be initiating its rate-cut cycle as early as May 1 (see here), we expect some broad USD weakness starting after the March FOMC, where we think a dovish message will be conveyed to markets, setting up that May cut. As that first US rate cut begins to look increasingly imminent into the spring, weakening the dollar, we see the BoC's reluctance to change policy until well into the summer leading to a lower USDCAD.

Looking at iFlow, we see an interesting but intuitive pattern. Total Canadian dollar holdings are just off record highs, indicating that demand for CAD is very strong. Normally at such levels, we would be reluctant to suggest CAD strength to follow. However, these longs are structural in nature. Canadian asset managers are generally long US assets and are hedging their CAD exposure on US-based investments. On the other hand, cross-border holdings, which largely represent US investors' preference for CAD exposures, are quite low – almost equal to their lowest levels in over a decade. We think the relative policy differentials between the BoC and the Fed will eventually make CAD more attractive to offshore investors, reducing the cross-border underweights and driving up the loonie.

Structural Domestic Overweight In Holdings, But Underweight Cross-Border



Source: BNY Mellon Markets

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