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Investments

Global macroeconomic update

Breaking the glass

At its July policy meeting, the Bank of Canada (BoC) opted to hike rates by 100bps, surprising most on the street and taking the Bank's key rate to 2.5%. Reasons cited were an economy that is currently above capacity (and expected to remain so in the coming quarters), broad-based gains across the inflation basket and the risk of long-term inflation expectations becoming further unglued. Heading into the meeting, the market was fully priced for 75bps while virtually all of those surveyed were also looking for 75bps.

If there is one ideal the BoC – and G10 central banks generally – will not stand for it is long-term inflation expectations becoming unglued. This, as we like to say, is the golden standard in central banking – above full employment, strong growth and even short- and medium-term price stability. The recent acceleration in the monthly inflation data, coupled with the expectations data in the not overly followed Canadian Survey of Consumer Expectations (CSCE) released on July 4, were likely what cemented the BoC into hiking by the largest single meeting amount since 1998. In the CSCE, 5-year forward inflation expectations rose from an already-elevated level of 3.2% to 4.0% year-over-year. This is simply too high. Given the BoC's outsized weight of capacity utilization as an input for policy and its expectations that a strong consumer and a tight labour market would continue to fuel an economy operating above full capacity, the BoC clearly wanted to get to the top end of what it defines as "the neutral rate" for the economy as quickly as possible.

The BoC defines neutral for the Canadian economy as rates between 2-3%; after Wednesday's hike, rates are now in the midpoint of that range and we have little doubt the bank will continue to raise the policy rate to and through the top end of that range well before year-end. BoC Governor Macklem in his own words from the July 13 press conference:

> **By front-loading interest rate increases now, we are trying to avoid the need for even higher interest rates down the road. Front-loaded tightening cycles tend to be followed by softer landings. This argues for getting our policy rate quickly to the top end or slightly above the neutral range.**

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This does not necessarily mean the BoC's policy rate is going to peak at 3.25 or 3.50%, slightly above the top-end of neutral. Rather, Macklem wants to get rates into "moderate" restrictive territory quickly and see how the economy is performing, but it will likely take more given underlying inflation pressures, strength in the labour market and long-term inflation expectations already on the rise. With the BoC's newest forecasts suggesting it sees headline CPI still at 7.5% year-over-year in Q4/22, the risk of more restrictive rates is becoming more likely.

If true, our long-held views of Canadian curve flattening and inversion are likely to persist in the months ahead with slowing growth and risk of a recession as the BoC and other central banks remain resolute in their quest not only to tame near-term inflation, but also to quell longer-term inflation expectations.

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