Canadians, keep an eye on the Fed

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Highlights

- The Bank of Canada took a hawkish turn at its April policy meeting, pulling forward its first interest rate hike from 2023 to 2022 in reaction to a rapidly improving macro outlook.
- The Federal Reserve has been more tentative with its guidance and has yet to even talk about tapering its quantitative easing program. Markets expect a first US rate hike in early-2023, later than in Canada but well in advance of the Fed's projection of no rate hike before 2024.
- A persistent positive CA-US interest rate differential provides support for the under-valued Canadian dollar. The future direction of CAD/USD depends on whether the Fed converges towards market expectations of an earlier rate lift-off or if investors adjust towards the Fed's guidance.

On April 21st, the Bank of Canada (BoC) announced it would be tapering, i.e. slowing down, its quantitative easing (QE) program. The tapering was widely anticipated: the BoC is approaching a technical ceiling on its holdings of sovereign bonds, currently owning around 40% of all outstanding Government of Canada securities. The more surprising announcement was the pulling forward of its expectation of a first policy rate hike from 2023 to 2022. With large swaths of the Canadian economy still shuttered, the BoC is clearly forward-looking, reacting to its bullish outlook. It is putting faith in its forecasts, which indicate torrid growth and slightly above-target inflation in the next few quarters.

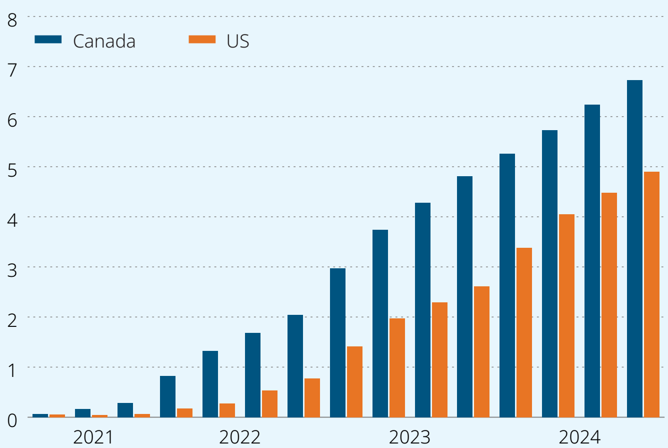
Markets and the central bank are now in lockstep in Canada, both expecting a first hike in the overnight rate in 2022. The same cannot be said south of the border, where the Federal Reserve is signalling that it won't touch its policy rate before 2024, while markets are positioned for a first hike in end-2022 or early 2023 (**Figure 1**). The alignment of expectations for Canadian rates contrasts with greater uncertainty around the timing of US rate hikes. Such a contrast suggests that future Canada-US interest rate differentials could be heavily driven by US policy decisions. But whether Fed guidance will converge to market expectations or vice versa is a tricky call given the different forces at play.

The BoC could end up having a full-year head start to its rate normalization cycle once the Fed begins hiking. We have many reasons to suspect later rate hikes in the US:

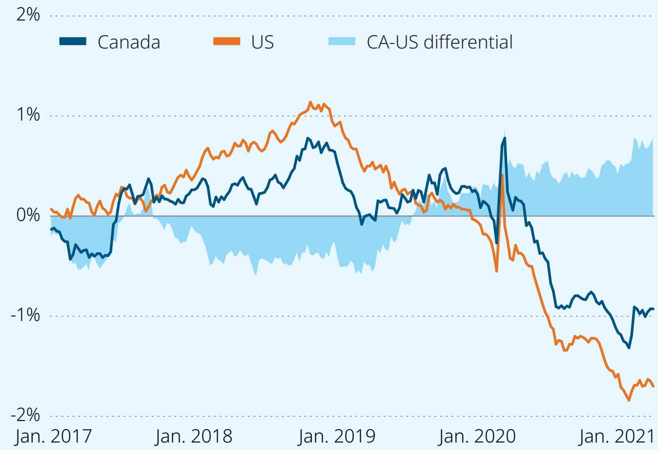
- While the Bank of Canada targets "point" inflation each year, last summer the Fed switched to a monetary framework that targets average inflation over time. As a result, the Fed will be more comfortable letting inflation overshoot its 2% target to compensate for past sluggish inflation.
- The Fed has a dual mandate of stable inflation and maximum employment, the latter with a renewed focus on broad labour market measures like labour force participation and minority employment. With many working age adults having left the labour market entirely during the pandemic, the Fed's employment mandate suggests a later rate hike relative to the BoC.
- Rate hikes are likely to start once QE has been fully tapered. The BoC has already started tapering and could sunset its QE program within a year. The Fed has not even hinted at tapering yet and could keep growing its balance sheet into 2023. Everything else equal, a later start to the Fed's tapering implies a later start to US rate hikes.

Figure 1 | Markets are expecting an early and persistent lead in Bank of Canada's hiking cycle

Cumulative number of rate hikes priced in each quarter



5-year real yields and the widening differential



Notes: Via Bloomberg as of April 26 2021. Left chart is derived from OIS curves. Each rate hike assumed to be 25 basis points.

But certain macro risks could force the Fed's hand, pushing it to raise interest rates earlier. The US economy is flush with liquidity after about US $2.8 trillion in fiscal stimulus since December. The Fed has been very clear it would look past any transitory inflationary pressures. However, if cash-rich consumers start generating more persistent demand-driven inflation, the Fed could accelerate tapering and bring forward its first rate hike. That said, the US economy has only recovered 60% of the jobs it shed during the pandemic compared to 90% in Canada[1], so the greater job market slack in the US should help to absorb demand-driven inflation pressures. But with an unprecedented savings overhang from 2020 estimated at over US $1.5 trillion, we can't dismiss the prospect of the Fed having to step in sooner than expected to quell inflationary pressures, although it is far from our base case (see our January commentary).

An earlier Canadian hiking cycle means a persistently higher real interest rate in Canada versus the US, especially given slightly higher inflation expectations for the US. This would be in stark contrast to the pre-crisis period from 2015 to 2019, when the CA-US differential was negative with Canadian real interest rates well below those in the US. The 5-year CA-US real yield differential has gone from about -0.5 p.p. in early 2019 to +0.8 p.p. today (Figure 1). This higher relative yield has contributed to the recent strength of the Canadian dollar. Any shift of market expectations for the Fed's first interest rate hike towards the Fed's guidance of 2024 would prop up this positive real rate differential, further supporting the loonie's strength.

Future moves in CAD/USD could thus be driven heavily by risks in US monetary policy. Now, will Canada maintain its head start in the hiking cycle? In the aftermath of the Great Recession in 2009, the BoC also started hiking sooner than the Fed. But it quickly paused its normalization cycle when growth failed to pick up in the early 2010s, before eventually cutting rates again when oil prices crashed in 2014. The BoC's current decision to tighten policy earlier than other major central banks may cool the Canadian economy's reopening momentum, resulting in the Fed eventually catching up in its hiking cycle, especially if the BoC's bullish growth forecast for 2021 doesn't materialize as expected. But until then, the BoC's stance is supportive for the Canadian dollar, with currency risk coming from uncertainty around Fed policy. And to monitor that risk, Canadian investors should turn their attention from Ottawa to Washington.

1 US employment data from the Bureau of Labour Statistics, Canadian data from Statistics Canada, as of April 30 2021.

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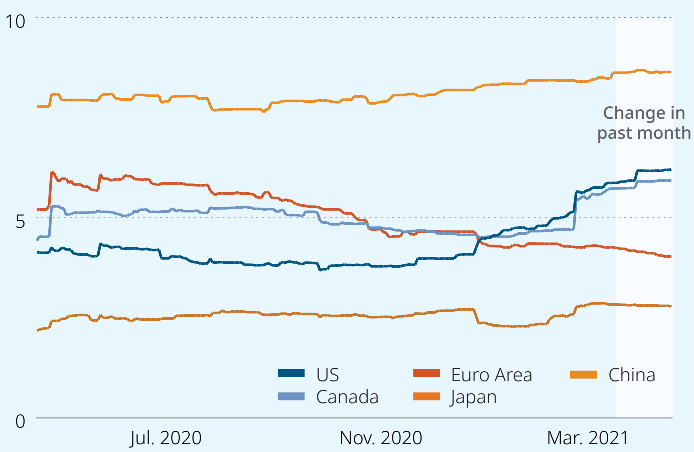
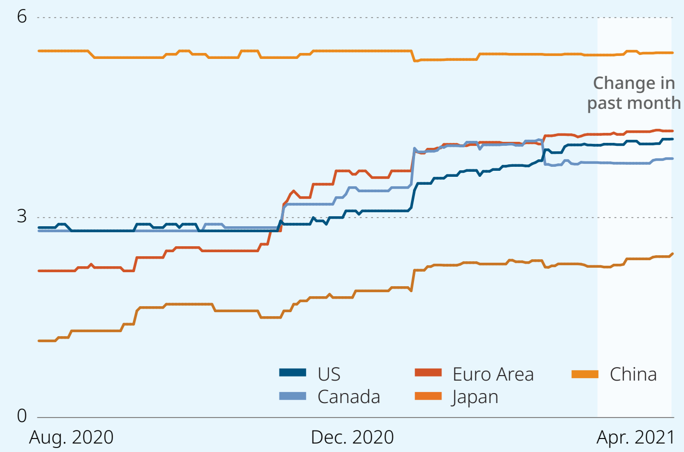
Global macro update

- **US** growth and inflation expectations keep inching up as the economy reopens and higher frequency data releases (retail sales, employment, PMIs) surprise to the upside. However, vaccination numbers seem to have crested at around 3 million doses per day as vaccine hesitancy starts to bite, suggesting that the US immunity edge could start melting as other countries ramp up their efforts.
- The Bank of Canada published surprisingly solid forecasts in its April Monetary Policy Report, including 6.5% GDP growth for **Canada** in 2021, significantly above private forecasters' 6% growth projection.
- With the Tokyo Olympics three months away, **Japan's** government has accelerated the pace of its vaccination campaign in April. Unfortunately, it is starting from a very low base, with less than 2% of Japanese citizens having received a vaccine to date. Japan is expected to be one of the last major countries to bounce back to its pre-pandemic GDP level.

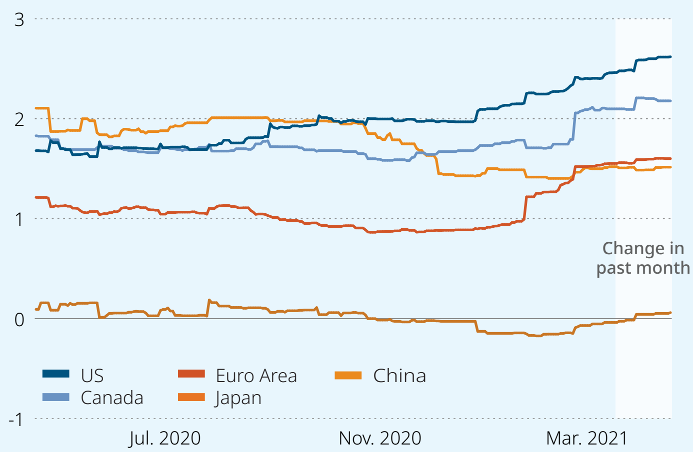
2021 real GDP growth forecast (%, consensus)



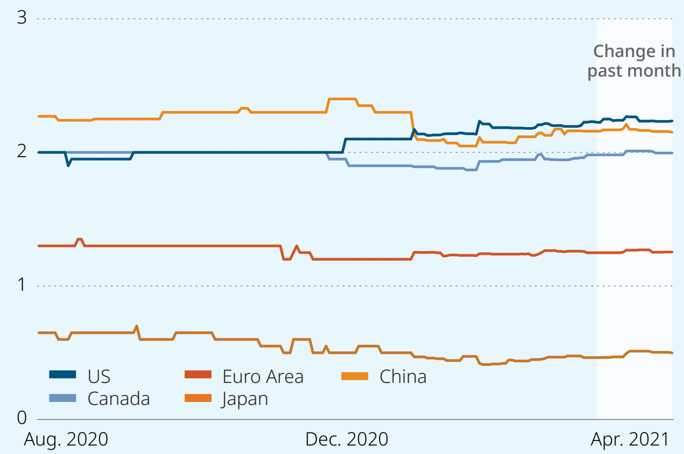
2022 real GDP growth forecast (%, consensus)



2021 inflation forecast (%, consensus)



2022 inflation forecast (%, consensus)



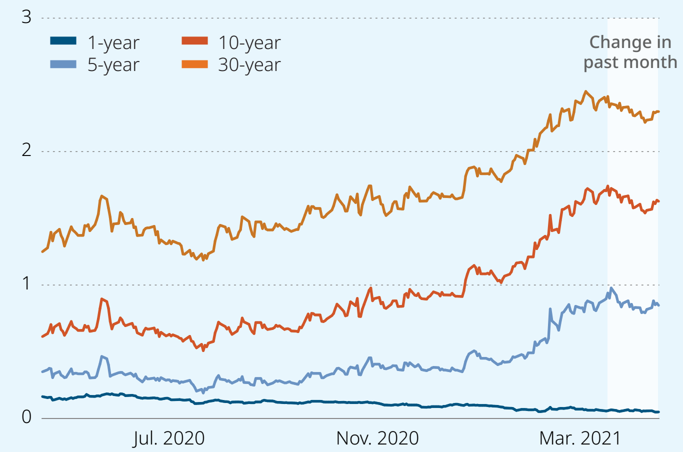
Source: 2021 forecast survey from Consensus Economics, 2022 forecast survey from Bloomberg, as of April 30 2021.

Capital markets update

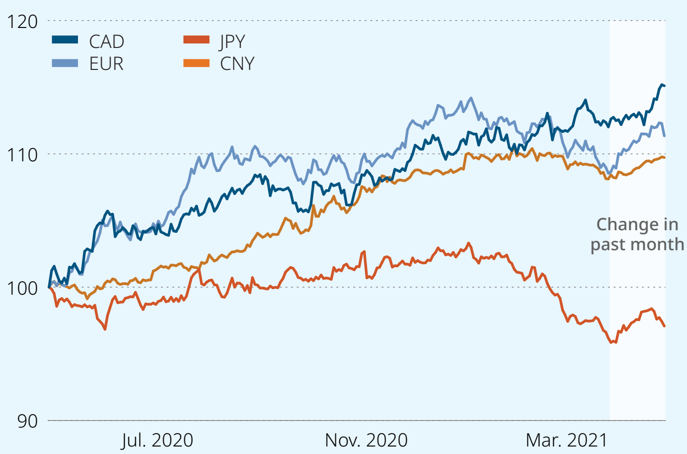
- After almost two months of yield curve steepening, **US bonds** rallied back to early-March yields. The macro story for the rally is unclear: a combination of rebounding Treasury purchases from foreign investors, hedging flows from record corporate bond issuance and a surge in Covid cases in developing countries likely contributed to the bull flattening in April.
- Consistent with the stabilization in nominal yields and lower real yields, the **US dollar** lost ground in April. The **euro** and **yen** gained against the greenback, both bouncing back from recent lulls.
- The **Canadian dollar** ended the month on a strong note, as the Bank of Canada's bullish update on the Canadian economy and pulling forward of rate hike expectations sent the CAD higher. With **oil prices** mostly flat on the month, energy did not play a major role in the CAD appreciation this time around.

Equity indices (one year ago=100)

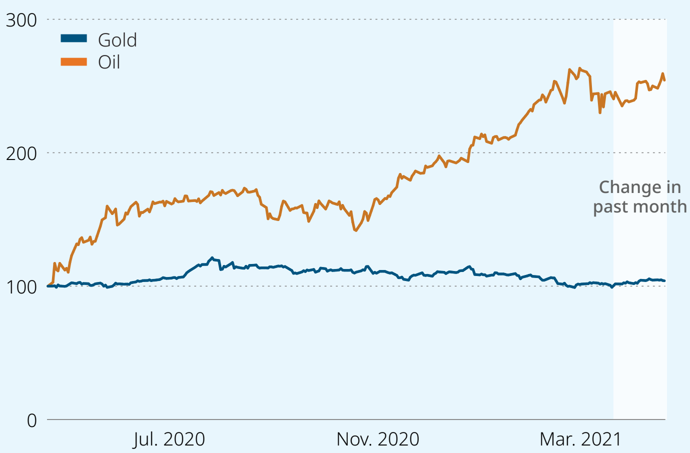
US Treasury yields (%)



Currencies (relative to USD, one year ago=100)



Commodity prices (in USD, one year ago=100)



Source: Via Bloomberg as of April 30 2021.

What we'll be watching in May

May 12: US CPI release

- US inflation numbers will hold the spotlight for the next few quarters. Year-on-year CPI inflation could cross the 3% psychological barrier this month, due in part to "base effects" rolling out of the calculation.
- Oil-derived goods are the main culprits hiding behind year-on-year inflation momentum: the "energy commodities" component of CPI was up 22% year-on-year in March.

May 16: China retail sales release

- In China, the economic recovery has been mostly driven by investments, both from businesses and the government, not by household consumption. China is now hoping for a hand-off from investment to consumption, and retail sales numbers could be an early indication of the outcome of that strategy.

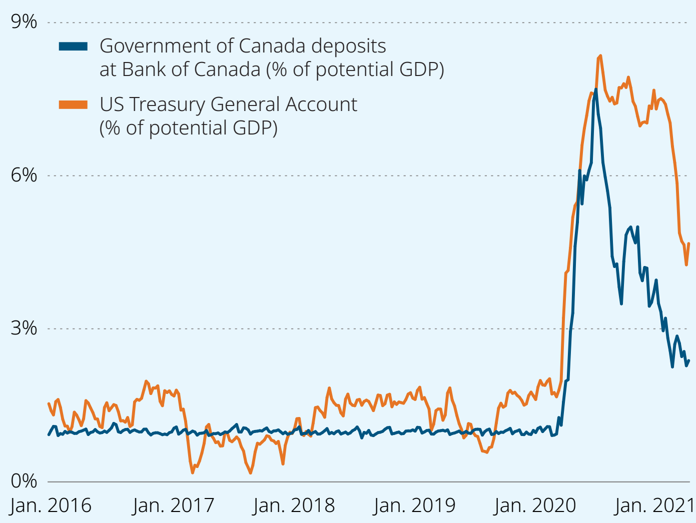
May 17: Canada housing starts release

- The 335k housing starts in Canada last month were an all-time record, handily beating out the previous record of 312k starts from… January 2021!
- In a different context, the currently soaring price of lumber could curb new projects. But many homebuyers have already locked in prices with contractors. And with demand heavily outweighing supply in the market, those that had not hedged out materials inflation seem willing to absorb higher building costs.

Emerging theme

- The US government has been drawing down its **cash account at the Fed** at a slower pace than we expected. With stimulus cheques out the door, the Treasury General Account (TGA) still holds above US $1 trillion.
- This suggests continued **downward pressure on short-term rates**, as the unwinding of the TGA could lead to large bank deposits and a slower issuance of Treasury bills for banks to park those deposits.
- In Canada, the **federal government's cash account** at the Bank of Canada is closer to pre-crisis levels. At the current pace, excess deposits would be exhausted around the end of 2021.
- **The Canadian budget** did not detail whether the government is aiming to draw down its cash reserves to pre-crisis levels in the short term. It did acknowledge the need to issue short-term debt to allow investors to manage excess liquidity. While Finance will extend the average maturity of its issuance in 2021-2022, mostly by selling fewer short bonds, it plans to issue a record number of bills.

Government are drawing down their cash accounts



Source: Bloomberg April 26, 2021

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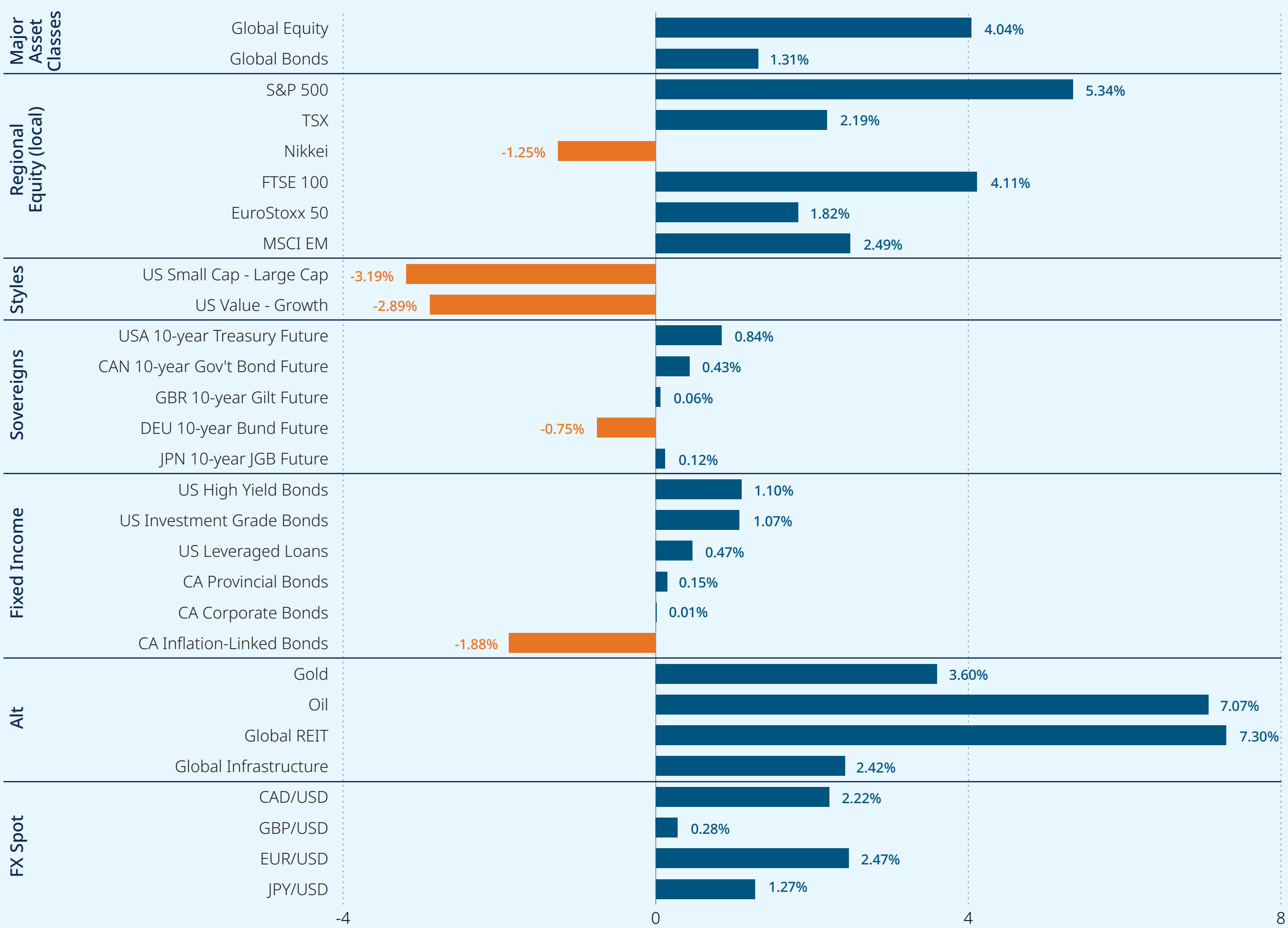
Appendix:
Capital market returns in April



Source: Market data from Bloomberg as of April 30. Index returns are for the period: 2021-04-01 to 2021-04-30. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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