CAD

Outlook

MONEX

April 2022

Loonie strength to continue in Q2 on higher oil and BoC support

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By all accounts, Q1 was an eventful period for the Canadian dollar. After starting the year at the 1.27 handle, USDCAD soon dropped below the 1.25 level despite health restrictions still being enforced in both Ontario and Quebec. Unlike in previous lockdown periods, however, the economic damage was largely limited this time around with the growth hit concentrated in high-contact services, as evidenced in January's labour force survey. January's GDP data later confirmed this as it showed the economy expanding by 0.2% that month. At the time, the widely held view that the latest health restrictions would have a limited impact on Canadian growth conditions led markets to price in the probability of a 25bp hike from the Bank of Canada at their January meeting. This resulted in USDCAD hitting a low of 1.2450. the rally in the Canadian dollar proved temporary as the Bank of Canada's decision to hold rates on January 26th prompted an unwind in money market expectations and a retracement in USDCAD back up to the 1.27 range. Soon after, volatility in the USDCAD pair evaporated. Between the 28th of January and the 23rd of February, the currency pair traded within a 1.25% range, up until Russia invaded Ukraine and global market volatility spiked.

> **Upon Russia's invasion of Ukraine,** capital initially flooded into the US dollar, a haven currency, as investors sought safety. This resulted in a **brief spike in USDCAD to 1.2877**, but concerns over commodity supply soon **raised oil prices, hitting the Canadian economy with a positive terms-of-trade shock.**

Over the subsequent weeks, traders paid close attention to geopolitical headlines relating to the war and the economic sanctions imposed in its wake. During this time, commodity markets were heavily disrupted, particularly in energy products like crude oil and natural gas, which acted as a counterweight for the loonie during the period of global risk-off pricing. As market volatility subsided, the focus for CAD traders rested squarely on commodity markets. With rising global commodity benchmarks amid supply concerns due to sanctions on Russia, the loonie recommenced its rally back to the 1.25 handle again towards the end of March.

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With market concerns over geopolitical events having eased, the discourse has quickly shifted towards the global inflation shock and the response by central banks. Under our current base case, we expect both the BoC and the Federal Reserve to embark on aggressive hiking cycles in Q2, with both North American central banks embarking on two successive 50bp hikes while also beginning quantitative tightening. However, in the second half of the year, we expect financial stability concerns to be more pressing for the Bank of Canada, resulting in them lagging the Fed. Under our base case scenario, this slight divergence in monetary policy, which should close up again at the start of 2023, should result in marginal CAD depreciation.

	1-month	3-month	6-month	12-month
USDCAD	1.24	1.23	1.26	1.25
EURCAD	1.364	1.378	1.449	1.463
GBPCAD	1.649	1.661	1.714	1.725

BoC to hike 50bp at next two meetings, slower path in H2

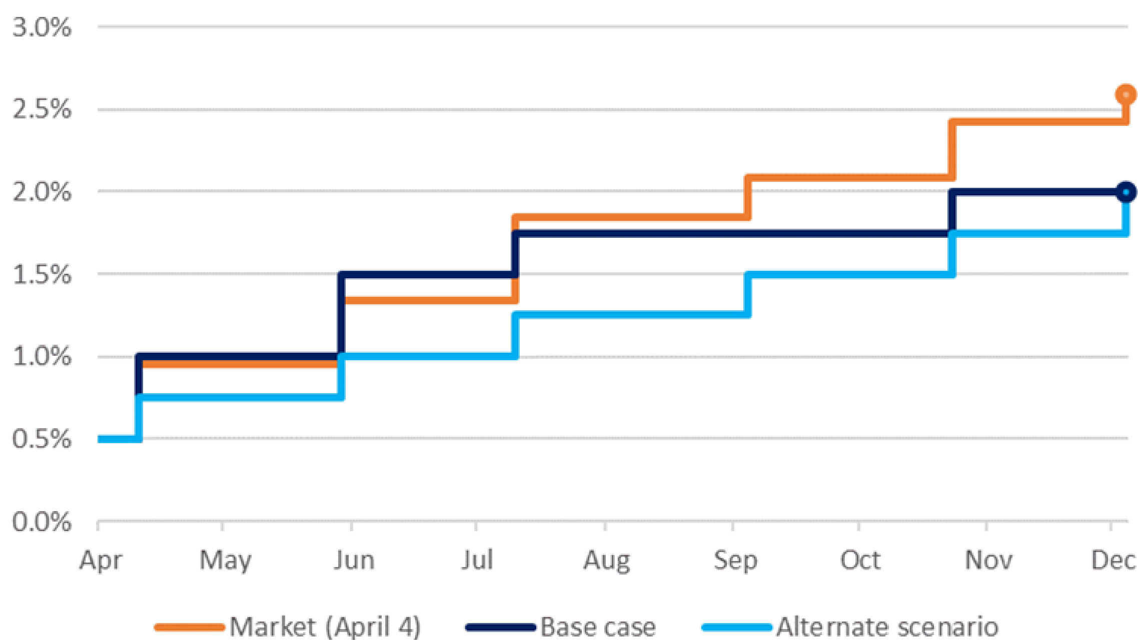
While we're cognisant that money markets have pulled economists by the nose when it comes to the likeliest monetary policy response to recent inflation shocks, we think market pricing of rate hikes is stretched in H2 2022. This is especially the case when viewing the implied path for the Bank of Canada's policy rate. While elevated and broadening inflation pressures at a time when labour markets are historically tight warrants more aggressive near-term tightening to keep medium-term inflation expectations anchored, financial stability concerns in Canada are likely to arise in the second half of the year once the overnight target rate sits at a higher base. For this reason, we believe the BoC will conduct 50bp hikes in both their April and June meetings before tightening increments revert to 25bps. With the overnight target rate at 1.5%, we believe the Bank of Canada will not only reduce the size of policy increases, but also the regularity. Unless there remain signs that above target inflation seriously threatens medium-term expectations and wage pressures in the Canadian economy, we think the Bank of Canada will opt to hike just twice in H2 2022 in two 25bp increments at both MPR meetings in July and October.

This would result in the policy rate sitting at 2% by the end of 2022. Unchanged from March's meeting, we still expect the BoC to formalise quantitative tightening at April's meeting, which would see the Bank withdraw a net C$57bn of liquidity from Canadian government bond markets this year.

Our year-end expectation for Canada's policy interest rate falls short of market pricing by roughly two hikes.

Current market pricing delivers the same amount of tightening over the course of the year as our alternate scenario, where the Bank acts more rapidly to quell building wage-price pressures in H1, but continues to tighten 25bp at every meeting in H2 as it prioritises getting inflation back to target. However, we believe that credible signs of persistently high inflation, driven in part by stronger domestic price pressures, are needed for this scenario to ensue.

Monex projects a steeper H1, flatter H2 than market pricing for BoC policy rate

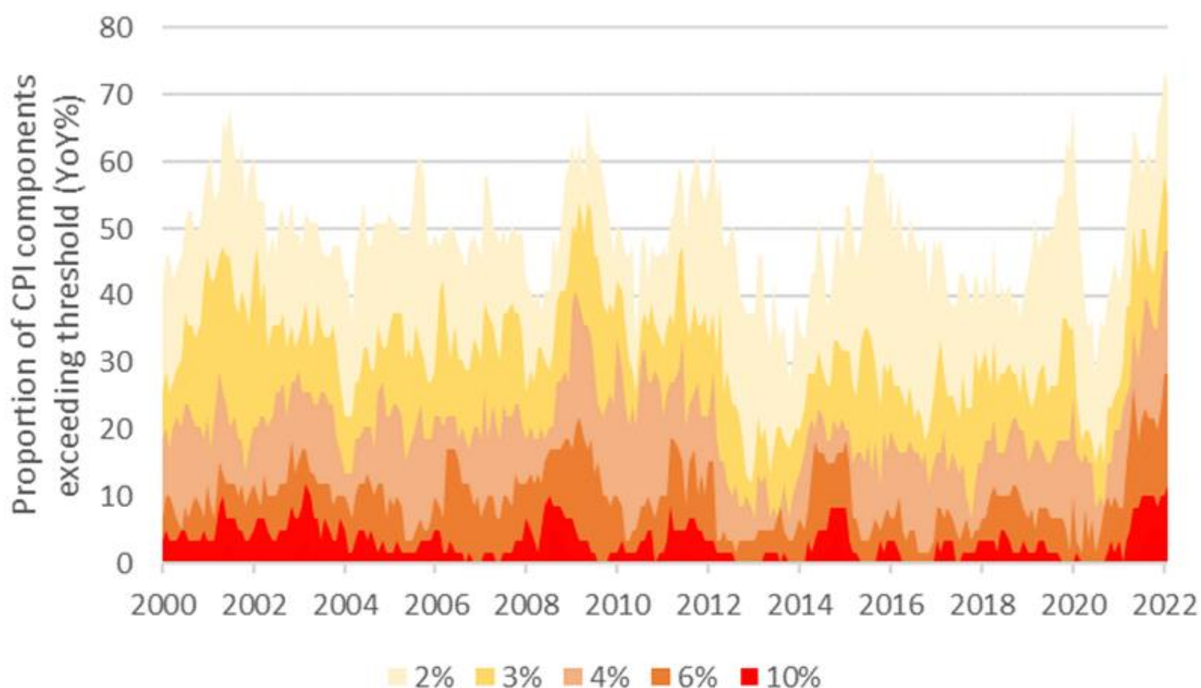


The rationale for our base case in H1 2022 is largely predicated upon inflation and labour market dynamics. Currently, inflation is running well above the 2% target at 5.7% YoY, the highest levels since 1991. Price pressures are broadening too, with more than 70% of CPI components experiencing above-2% inflation, and nearly 12% of components measuring above 10% YoY in February. That is the largest proportion of the 66-component basket at above-10% inflation since March 2003. Back then, the BoC's overnight rate was 250bp higher than current levels, at 3%. Above-target inflation is also becoming persistent, as evidenced by the fact that February was the 12th straight month where inflation had exceeded the Bank of Canada's 2% target, and the 11th month where it exceeded the 3% upper band of the Bank's control range. That makes it the longest lasting upside deviation from target since inflation targeting began in 1991 and double the length of the second-longest episode. The latest inflation surge has consistently taken the Bank of Canada by surprise.

Not only has the Governing Council had to drop language around transitory pressures, but inflation has persistently exceeded the Bank's forecasts. In its last monetary policy report, released in January, the Bank projected a 5.1% year-on-year inflation print for Q1. Even with a flat monthly reading in March, a hyper-conservative scenario considering the lack of Covid restrictions, jump in factory PMIs, and surge in energy prices due to the war in Ukraine, annual headline inflation would already exceed current projections by reaching a pace of 5.3% YoY.

The primary factors influencing the rate of inflation in Canada include: supply chain disruptions, higher global commodity prices, pent-up demand from Covid, fiscal stimulus, and loose monetary policy. In the Bank of Canada's ideal scenario, supply chains, demand levels, and imbalances in global commodity markets normalise, fiscal stimulus is tapered off, and the policy interest rate is raised to a neutral rate of roughly 2.25%. Such a scenario would see inflation expectations remain anchored and inflation revert back to the 2% target over the medium term. This would allow the BoC to leave the policy interest rate at a level consistent with neutral long-term financial conditions.

Inflation pressures clearly broadening throughout the CPI basket; prices accelerating past BoC 1-3% tolerance band for 6 in 10 components



In an alarming development that could make such a soft landing more challenging, recent survey evidence from the Q1 Business Outlook Survey (BOS) and Canadian Survey of Consumer Expectations (CSCE) suggests consumers' and firms' inflation expectations are surging further above target. Of the firms surveyed, 70% expect inflation above 3% over the next two years, up from 67% in Q4, while 35.3% of respondents expect it will take 2-3 years for the BoC to bring inflation back to the 2% target. This was the most common response in the Q1 survey and further highlighted expectations that CPI will take longer to return to target. Meanwhile, the labour market is tightening with the unemployment rate falling to 5.5%, near the record low of 5.4% seen in May 2019. The BOS also finds that 40% of firms are finding difficulty hiring, while the CSCE showed workers switching jobs at higher rates, which tends to raise wages as workers' salaries get marked to market by switching jobs.

This evidence suggests that **wage pressures will likely rise further**, risking the formation of a wage-price spiral that would **result in inflation persistently tracking above the BoC's 2% target over the medium term.**

By hiking 50bp in April, the BoC will be seen as more active in tackling growing domestic inflation pressures, which should improve confidence that they will bring inflation back to target. In essence, the decision to hike by 50bps can be viewed as an insurance policy against a wage-price spiral, a highly persistent inflationary dynamic that typically requires destructively tight monetary policy to correct.

Other factors compounding the case for the BoC front-loading their hiking cycle include the strong growth backdrop that provides a cushion for the economy as higher interest rates destroy demand, and Deputy Governor Sharon Kozicki's recent comments that the possibility of a 50bp hike in April would be explicitly deliberated. From a risk-management point of view, an early cycle 50bp hike is likely to add less stress to household balance sheets than a late cycle one, when interest payments will have risen, thus reducing the damage to growth. For context, real GDP is tracking for 2.8% QoQ growth in Q1, which is reasonably stronger than the Bank of Canada's 2.0% estimate from its January Monetary Policy Report. Growth estimates for 2022 as a whole, from both the private sector and BoC, are similar at 3.9% and 4.0% YoY, double the average rate of growth in the Canadian economy. This suggests that current growth conditions are suitable for a larger tightening in monetary policy. Estimates of the growth impact from interest rate hikes are outlined in the BoC's white paper for ToTEM III, the latest iteration of its workhorse DSGE model. The model suggests that a 2.25% increase in nominal interest rate would reduce real GDP growth by 0.6 to 1pp at peak impact. With the nominal increase in line with current market pricing, the magnitude of the growth impact is notable, considering it would reduce 15 to 25% of expected annual output growth in 2022, and 30 to 50% of growth in an average year.

Nevertheless, growth conditions are currently robust enough to sustain significant monetary tightening, helping tilt the balance of risks in favour of a larger April rate hike.

Surging home prices have raised financial stability concerns, as more expensive homes have led to households taking on more leverage. Average home prices jumped 20.6% YoY Canada-wide in February according to CREA. In the notably frothy housing markets of Toronto and Vancouver, prices rose 35.9% and 20.8%. The Bank has spoken for years about its concerns over rising housing prices, because financial vulnerabilities arise as indebtedness grows. Preventing the situation from worsening will be a key reason for the Bank of Canada to forcefully raise interest rates by 50bps next meeting, and the decision is bolstered by robust household balance sheets.

Thanks to Covid-related fiscal transfers, **households now have a higher-than-trend stock of savings; household deposits are C$12,000 higher on average** relative to where the pre-pandemic trend suggests they should be.

In addition, credit scores increased in Q1 as households maintained lower balances and fell behind on fewer payments. These positive developments signal household financial resilience, indicating an ability to sustain a moderate rise in interest rates.

Overall, the Bank of Canada is substantially behind the curve on inflation and would do well to pivot quickly toward a more neutral policy rate. We think that a front-loaded pace of hikes, with 50bp moves at the next two meetings, is the best way for the Bank to abate inflation given that the growth risks stemming from larger rate hikes will rise once the policy rate has risen further from the effective lower bound. Furthermore, such actions help keep inflation expectations anchored, lowering the likelihood that a wage-price spiral will form, which would require substantial demand destruction over the course of the monetary policy tightening cycle to bring inflation back under control.

BoC hiking to slow in H2 as financial stability risks warrant prudence

Under our base case scenario, the overnight policy rate is set to enter the second half of 2022 at 1.5%. Given that the BoC hasn't hiked more than 125bps in one year since the turn of the millennium, let alone in one half of a year, and the fact that concerns over housing market stability have increased due to the pandemic, we think the BoC will take more cautious steps when hiking towards the neutral range. Our view is that a further 50bp worth of hikes will be delivered in two 25bp increments over the course of the six months. Out of the four meetings in H2, the Bank is likely to relay the subsequent hikes at both MPR meetings, where all forms of communication channels are at their disposal. The synchronisation of policy changes with MPR meetings has long been a tendency of the BoC as greater communication allows for improved policy transmission.

A larger share of the Canadian bond market is exposed to variable rates than previously, supporting BoC caution in H2

Under the base case for H2, however, the BoC is set to underdeliver on market expectations, which currently see interest rates ending the year at 2.6%. This is unlikely to be a concern for the Governing Council considering pricing in money markets is aggressive for most G10 economies given the current global inflation backdrop. Instead, the BoC are likely to prioritise observing the pass-through of their previous actions to the real economy, and most importantly, to the housing market. Given high levels of leverage and the exposure of current mortgages with high loan-to-value ratios to adjustments in interest rates, the BoC will want to tread carefully not only with the level at which rates are raised to, but more importantly the pace in which they are raised.

Given this priority, but accounting for our expectation that inflation will still track well above the BoC's 2% target towards year end, we think the BoC will balance these objectives by taking a more gradual tightening stance.

Risks

The key upside risk to our outlook is that the inflation surge proves more resilient to a front-loaded tightening cycle. That could result in the overnight rate being increased further in H2 to match market pricing of 2.6% by December, 60bps above our base case scenario. Indicators such as inflation in services excluding housing, market-based inflation breakevens, core CPI, and wage growth will be crucial to assess whether heightened inflation pressures have grown more persistent. If the Bank decides to follow current market pricing, that policy would likely lead to a stronger loonie over H2 than we currently expect.

In our main downside scenario, the Bank eschews larger rate hikes in favour of 25bp moves. This could come from a cautious desire not to surprise Canadians, given that it has not pursued a 50bp hike in about two decades. Furthermore, given that our policy expectations are more front-loaded than market pricing, two consecutive 50bp hikes could be misinterpreted by the market as a signal that overall tightening will be far greater than currently priced. This would create unnecessary financial volatility as the flatter H2 rate profile would deliver a dovish surprise. Other important downside risks that could shift the Bank of Canada's policy stance include a deterioration in global growth expectations, and household vulnerabilities associated with high debt-to-disposable income levels, both of which could see the Bank follow a more dovish rate path than markets currently imply.

Developments in the Russia-Ukraine conflict and in global supply chain pressures will be important factors **driving global economic growth in 2022.**

Evidence of financial stress among mortgage holders, who are far more indebted in Canada than in the US, will be a clear signal for the Bank of Canada to pause its tightening cycle. Highlighting this is the vast disparity between debt-to-disposable income ratios in Canada, at 1.82, and the US, at 0.86. Furthermore, the distribution of mortgage debt to income has risen in Canada since 2019. The main reason we expect a flatter rate path in H2 is that the BoC will likely want to assess the effects of its policy on household balance sheets, and in doing so, will need time to gather data on key financial vulnerability metrics. Furthermore, the transmission of the Bank's monetary policy to the housing market has ambiguous effects, which is one reason for more caution in the second half of the year than we currently anticipate.

Risks to our forecasts are elevated but broadly balanced

Our latest USDCAD forecasts have been adjusted downward over the course of Q2, owing to continued supportive pricing in commodities and our expectation that the Bank of Canada will join the Federal Reserve in aggressively raising rates. Over the course of the second half of the year, however, our forecasts only factor in marginal CAD depreciation despite our expectation that rate differentials are set to widen between the US and Canada, especially over extremely short tenors. While this will place some pressure on the Canadian dollar as higher near-term rates in the US offer more favourable returns for capital, we expect longer-dated yield spreads to remain somewhat contained as neutral interest rates are fairly aligned between the US and Canadian economies. Since the Federal Reserve and Bank of Canada will likely complete their tightening cycles within two years' time, this should see spreads in US-Canada two-year yields remain contained in the near-term, resulting in a more muted impact on the Canadian dollar. During the second half of the year, we also anticipate that global risk conditions will improve. While global growth may remain tenuous—consensus forecasts for 2022 have fallen by 0.5% since mid-2021—especially if the war continues to pose substantial growth risks to the eurozone economy, a stabilisation in risk conditions should result in a minor unwind in the dollar's haven bid. We expect this to partially offset the pressures from widening yield differentials. Heading into 2023, our view is that the Federal Reserve's hiking cycle will be largely complete. Owing to the BoC's caution in H2, the Bank of Canada will remain further from the mid-point of their estimated neutral range, resulting in continued policy tightening into the next year.

> At this point, as policy rates for Canada and the US converge and global growth conditions normalise, **we expect USDCAD to revert back to more sustainable levels**

Risks to our currency outlook are plentiful, and partly relate to the risks to our BoC view. Firstly, should the Canadian central bank undershoot our tightening forecast in Q2, the Governing Council are likely to embark on more successive 25bp interest rate hikes throughout the year. The differing path to the same 2% year-end goal will likely weigh on the Canadian dollar in the near-term, especially as the Federal Reserve is likely to hike in 50bp increments in our base case. Such a policy stance, in our view, runs the risk of inflation sitting above the BoC's target for longer. While this will likely result in markets pricing a higher terminal rate for the BoC over the expected normalisation horizon, this will likely be met with increased concerns over future growth conditions. Should the BoC exceed our expectations and hike interest rates more aggressively this year such that the overnight policy rate ends the year closer to market expectations of 2.6%, the Canadian dollar is likely to reach much stronger levels than our 6-month forecasts currently suggest. Across the border, we expect further US dollar upside will be limited if the Federal Reserve meets market expectations,

largely due to our view that the Fed's more aggressive hiking cycle is better factored into global market pricing than other implied policy paths for G10 central banks. A sustained leg higher in the US dollar over the medium term will require that the market reassess the Fed's most probable terminal rate.

Outside of monetary factors, pricing in commodity markets and global cross-asset market volatility provide the most prominent risks, especially given the fluid nature of current geopolitical conditions. While oil prices have been supportive of the CAD rally over the course of March, further upside in WTI will likely be limited barring a substantial realignment in current structural imbalances. Should oil prices moderate more than investors currently expect, the risks to our USDCAD forecasts will be largely tilted to the upside. Meanwhile, the impact of the overall risk environment on CAD has been unstable over the past month, largely due to the rise in market volatility coinciding with higher oil prices. This makes the prospective impact of a material de-escalation in geopolitical tensions difficult to gauge for CAD. While the degree of risks to our CAD forecasts are elevated, we view the balance of risks as broadly equal across the whole forecast horizon.

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