June 2, 2025 04:00 AM GMT

Canada Economics and Global Macro Strategy | North America

BoC Preview: Staying on the Sidelines

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We expect the Bank to keep its policy rate unchanged at 2.75%. As economic data have held up for now, coupled with the recent, albeit temporary, de-escalation in trade tensions and hotter core inflation, we think the Bank stays on the sidelines in June.

Economics: At the Bank of Canada's (BoC, or the Bank) meeting on Wednesday, June 4 (statement released at 9:45am ET), we expect the Bank to keep the policy rate unchanged at 2.75%.

As recent economic data have generally held up (so far), coupled with the recent de-escalation in trade tensions between the US and its trading partners, and hotter core inflation, we think the Bank stays on the sidelines to "gain more information about the path forward for US tariffs and their impacts".

We still believe that the Bank can continue to cut the policy rate further later this year, as economic and geopolitical uncertainty remains in the spotlight. We expect two more 25bp cuts in July and October to reach 2.25% by end-25.

Global Macro Strategy: No cut and lack of clear forward guidance would likely not surprise investors. We therefore don't expect the BoC's June meeting to be an important catalyst for CAD and BoC pricing. We continue to recommend short CAD/CHF positions, as we see European safe-haven currencies outperforming in an macro environment of elevated uncertainty. More BoC rate cuts later this year and early 2026, which our economists expect, should weigh on CAD/CHF as well.

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Canada Economics: On Hold...For Now

Lenoy Dujon

We expect the Bank to keep the policy rate unchanged at 2.75% at the June meeting. As recent economic data have held up so far, coupled with the recent, though temporary, de-escalation in trade rhetoric between the US and its trading partners, and sticky inflationary pressures in the Bank's preferred core measures, we think the Bank remains on hold.

While the Bank's communication indicates that it is taking a more gradual approach to monetary policy and monitoring developments in inflation, Governor Macklem reiterated that the BoC will do what it can to help the economy adjust to higher US tariffs.

We still believe that the Bank can continue to cut the policy rate later this year, as economic and geopolitical uncertainty remains in the spotlight. We expect two more 25bp rate cuts in July and October to reach 2.25% by end-25.

We acknowledge that a risk to our view is that as the policy rate is in the 2.25-3.25% neutral range, the Bank could cut rates at an even slower pace, or not at all, versus our baseline. We also flag the risk that cuts could be pulled forward if economic indicators deteriorate faster than we expect.

Reasons to hold in June:

1Q25 GDP holds up for now. GDP growth surprised to the upside vs expectations (Actual: 2.2%Q, MSe:1.3%Q, Consensus: 1.7%Q), and was above the Bank of Canada's (BoC) 1Q25 forecast of 1.8Q%. Growth was primarily driven by exports, which helped to offset softness in other areas of the economy.

Retail sales were resilient despite tariffs and trade policy uncertainty. Headline retail sales were resilient in March despite headwinds from trade policy uncertainty. The rise in core retail sales and the April advance estimate corroborated March's gains.

Headline retail sales rose 0.8% m/m (vs -0.4% prior), while core retail sales - which exclude gasoline stations & fuel vendors, as well as motor vehicle parts dealers – rose 0.2%M, building on February's gains.

Looking at the details, higher sales at motor vehicle and parts (4.8%m/m), building material and garden equipment and supplies dealers (2.6%m/m), furniture, electronics and appliance retailers (2.1%m/m), and clothing and clothing accessories retailers (2.6%m/m) were the key drivers.

The April advance estimate of retail sales suggested that March's strength may continue as it rose 0.5%M.

April inflation data highlighted sticky inflationary pressures in the Bank's core measures. While headline CPI cooled in April, as the removal of the carbon tax led to lower energy prices, the Bank's preferred core measures looked less encouraging.

The Bank of Canada's key underlying core inflation measures saw more inflationary pressures, as they both moved higher on a YoY and three-month basis.: The CPI-Trim rose to 3.1%Y (vs. 2.9%Y), while the CPI-median rose to 3.2%Y (vs 2.8%Y). On a three-month basis: The CPI-Trim rose to 3.2% (vs. 2.9%), and the CPI-median rose to 3.6% (vs. 3.0%).

Labor market generated a (small) gain after hefty losses in March. In contrast to March's job loss of -33k, the labor market generated 7.4k jobs in April as firms used the ongoing pause in the global trade conflict to (cautiously) hire workers.

Trade tensions have (temporarily) cooled between the US and its major trading partners. With the US maintaining its 90-day tariff pause on its trading partners ex China, de-escalating trade tensions with China, and pausing higher tariff levies against the EU, we think the Bank continues to use that window to stay on the sidelines and assess the current economic landscape.

Door still open for cuts later this year:

The Bank remains cautious around future moves, as inflation expectations are now back in the spotlight, and after it put through 225bp of easing in rapid succession since June last year.

Macklem acknowledged that the Bank is in the midst of assessing downward inflationary pressures from softening economic activity with upward inflationary pressures from trade policy uncertainty. He said that the Bank will do what it can to support economic growth, but ensure that inflation remains well controlled and inflation expectations well-anchored.

Faced with ongoing uncertainty, Macklem said that the Bank "will proceed carefully", paying attention to the aforementioned risks. To do so, he noted that it means the BoC is prepared to "act decisively if incoming information points clearly in one direction".

We think softer economic data, elevated economic uncertainty among firms and consumers, and lingering global trade risk could prompt the BoC to gradually move ahead with more rate cuts later this year:

- **Labor market still faces headwinds:** While the labor market managed a gain in April, it remains under pressure as trade-oriented sectors continue to experience the impact of evolving geopolitical risks. Trade policy uncertainty continues to cast a shadow over the labor market, as recent BoC survey data showed that households are starting to worry about job security and firms intend to scale back activity.

- **The Bank's latest surveys show pessimism among households and firms:** Consumer sentiment has been hit by the rising Canada-US trade tensions. Household confidence in the labor market has weakened, as those working in trade-oriented sectors are worried about job losses. Consequently, households are turning cautious about their spending habits.

  Additionally, business sentiment weakened as trade policy uncertainty weighs on corporate investment and hiring plans. Firms also expect higher prices ahead as increased inputs costs will translate into higher selling prices.

- **Lingering global trade risk:** The 90-day delay to US-imposed reciprocal tariffs, coupled with the recent China de-escalation and pause of new actions against the EU, reduces immediate downside risk but prolongs uncertainty.

  The tension among the US, China, and its other trading partners, risks more than a slowdown in trade volumes; it risks a sudden stop in trade flows. We have no evidence that this is happening, but our concern remains high when it comes to the ability of the US, China, and the global economy to withstand months of bilateral tariffs at elevated rates without unintended consequences.

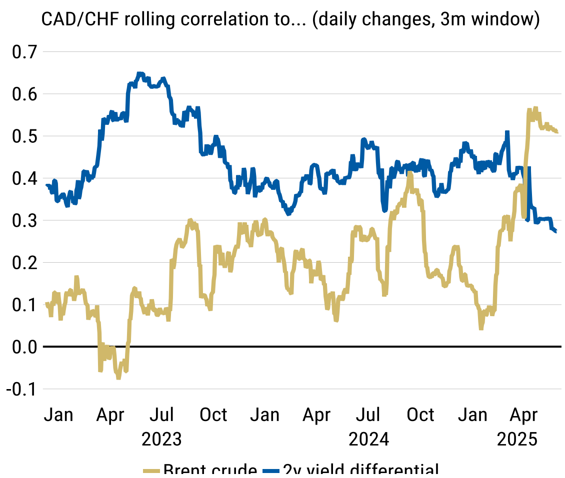
Global Macro Strategy: Repeating the Uncertainty Message

Zoe Strauss, Molly Nickolin, Andrew Watrous

We don't expect the BoC's June meeting to be an important for CAD. We continue to recommend short CAD/CHF positions as we expect European and safe-haven currencies to outperform in G10 over the next months. Lower oil prices and further BoC cuts later this year should weigh on CAD/CHF as well (Exhibit 1).

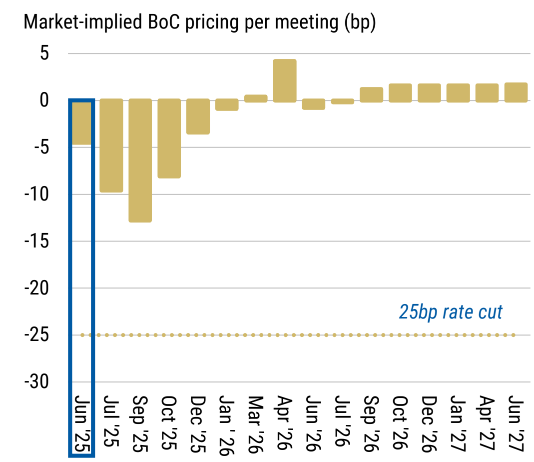
Our economists expect the BoC to keep its policy rate unchanged at 2.75% at the June meeting. Current market pricing is consistent with a relatively low likelihood of a cut (Exhibit 2).

Exhibit 1: We see CAD/CHF weakening on lower oil prices and additional BoC rate cuts in 2H25 and 1H26



Source: Bloomberg, Morgan Stanley Research, Morgan Stanley Research

Exhibit 2: Markets are pricing in a low probability of a June cut



Source: MS STIR Desk, Morgan Stanley Research

In addition, investors will likely receive little forward guidance at the May meeting, as both the BoC and other G10 central bank peers have been reluctant to provide clear guidance amid elevated level of policy uncertainty. CAD and BoC pricing will likely not react much to a priced BoC hold and no guidance, especially since tactical CAD positioning appears to be relatively neutral.

At the April meeting, the BoC already did not provide any forward guidance. Instead, it pointed to a few main indicators it will monitor, which are:

- the extent to which higher tariffs reduce demand for Canadian exports;
- how much this spills over into business investment, employment, and household spending;
- how much and how quickly cost increases are passed on to consumer prices;
- and how inflation expectations evolve.

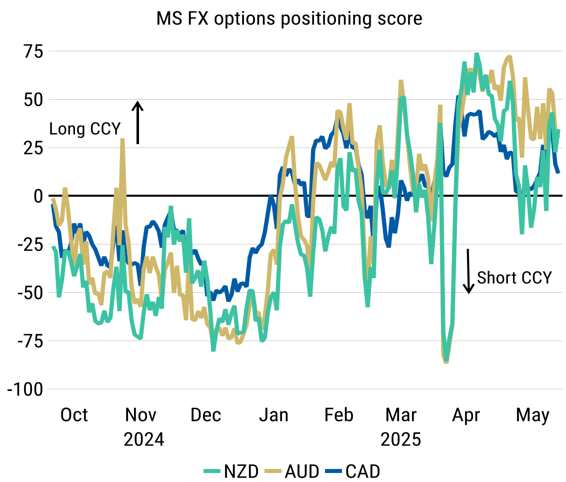
Only limited data have been received on these four fronts since the last decision. However, on net domestic Canadian data have held up since the April meeting.

The two layers of uncertainty that the BoC has mentioned as obstructing its ability to assess the economic outlook are still present as well, namely the uncertainty related to trade policy and uncertainty related to the impact of tariffs.

The combination of data not providing anything conclusive about the four indicators yet, and policy uncertainty not having changed make us believe that the BoC will attempt to sound as non-committal and non-specific as possible. As a result, BoC pricing and CAD should be little impacted by such a tone and message.

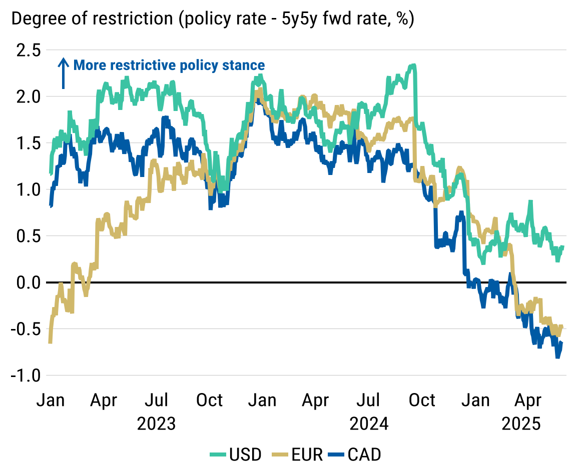
Markets will likely also focus on the BoC's characterization of the likelihood of the two scenarios it provided at the April meeting.

Exhibit 3: Tactical CAD positioning is close to neutral



Source: DTCC, Bloomberg, Morgan Stanley Research

Exhibit 4: The BoC's policy stance has quickly become less restrictive amid its aggressive cutting cycle in 2H24 and early 2025



Source: Bloomberg, Macrobond, Morgan Stanley Research

In scenario 1, the BoC noted that most tariffs are short-lived, while uncertainty in trade policy persists for a period. This would, according to the BoC, imply that uncertainty weighs on growth, but the impact on inflation would likely be relatively muted.

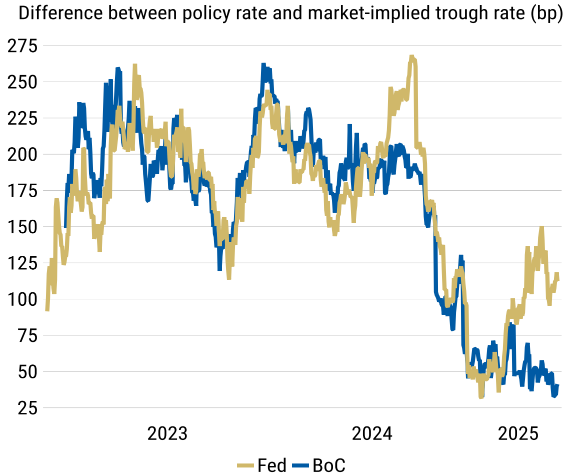
In the BoC's 2nd scenario, a recession happens as tariffs are larger than in scenario 1 and permanent, while inflation moves temporarily up above 3% in 2026.

The BoC had indicated that where US trade policy is relative to scenarios 1 and 2 is a moving target. Given (temporary) tariff exemptions, pauses, and court rulings, the BoC will likely suggest that the current scenario skew slightly more toward scenario 1, while emphasizing that the level of uncertainty remains exceptionally high.

Moving towards scenario 1 is, in our view, a more CAD positive outcome, as a possible recession would likely weigh on CAD as investors would likely price more rate cuts than currently priced.

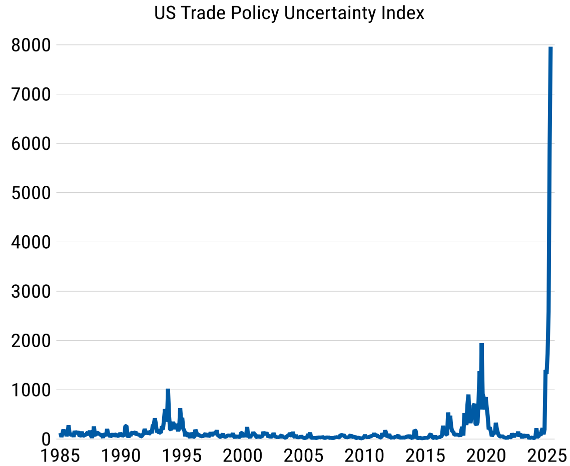
The BoC emphasizing that it has already cut rates substantially and is in a position to wait to see how the tariff landscape will unfold may also be on the margin CAD positive given that investors expect some more BoC easing later this year (Exhibit 4 and Exhibit 5).

Exhibit 5: The BoC's policy rate is much closer to the market-implied trough rate than the equivalent spread for the US



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 6: Measures of trade uncertainty continue to increase



Source: Scott R. Baker, Nick Bloom and Steven J. Davis, Macrobond, Morgan Stanley Research

We see CAD weakening slightly after the decision if the BoC were to emphasize how the mere uncertainty of US policy may severely hinder the Canadian growth recovery later this year, prompting investors to increase the current market-impled easing (Exhibit 6).

For more information on why we expect USD/CAD to decline over the coming months, but CAD to underperform in G10, please see Canada Economics and FX Strategy Mid-Year Outlook: A Rocky Road Ahead.

- **Trade idea: Maintain short CAD/CHF at 0.5963 with a target of 0.555 and stop of 0.61.**

Valuation Methodology and Risks

Below you will find a list of our current trade ideas, entry levels, entry dates, rationales, and risks.

Interest Rate Strategy

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Short CAD/CHF	0.587	Apr-16-2025	Commodity sensitive currencies will likely underperform and safe-havens gain as US policy uncertainty persists. Deteriorating USD sentiment and downside risks to North American growth should spillover to USD proxies like CAD. CAD has been relatively resilient after April 2nd, providing room for CAD to weaken more in line with other commodity currencies.	Trade deals with the US that appear durable, improving risk sentiment and providing clarity on the US policy outlook.

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Not-Rated/Hold	3	0%	0	0%	0%	1	0%
Underweight/Sell	603	16%	76	9%	13%	229	13%
Total	3,774		828			1717	

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