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Canada Economics and Global Macro Strategy | North America

BoC Preview: Consecutive Cut

We expect the Bank of Canada to move ahead with its second 25bp cut at the July meeting. The broader data that have come in since the June meeting have been supportive of further easing.

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Economics: At its meeting on Wednesday, July 24 (statement released at 9:45AM ET), we expect the Bank of Canada (BoC or the Bank) to move ahead with its second 25bp rate cut to lower its policy rate to 4.50%. With the broader economic data that have come in so far, coupled with the BoC continuing to express confidence that inflation will return to the 2% target, the Bank is in a good position to move ahead with a consecutive cut. This meeting will also include the Bank's updated economic outlook, as well as an opportunity for the Bank to provide further guidance around the timing of future rate cuts.

Global Macro Strategy: Our economist's expectation that the BoC will deliver a second rate cut is consistent with current market pricing. The focus for investors will therefore be on rate cut guidance, the BoC's updated economic outlook, and tone. We discuss the July meeting and explore three potential paths for pricing of near-term BoC meetings. We remain bearish on CAD and recommend long AUD/CAD and long GBP/CAD positions. We also continue to recommend receiving December 2024 BoC.

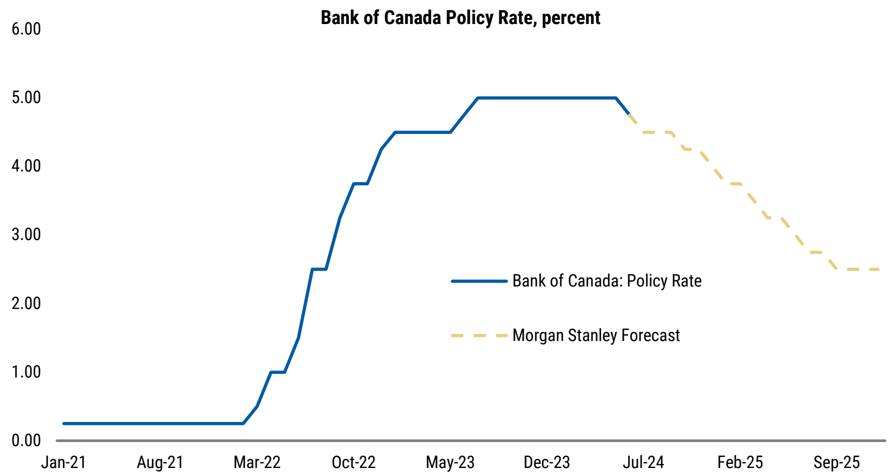
Canada Economics: Back-to-Back

Lenoy Dujon

We expect the Bank to move ahead with a second 25bp cut at its July meeting this week, after cutting for the first time since the pandemic in June 2024 (Exhibit 1). With the broader economic data that have come in so far, coupled with the BoC continuing to express confidence that inflation will return to the 2% target, the Bank is in a good position to move ahead with a second rate cut. We still expect three 25bp cuts this year, but now in July, October, and December to reach 4.00% by end-24.

The Bank's communication remains focused on not wanting to go "too fast" and risk the Bank jeopardizing the pace of progress on inflation seen so far – which lends to a gradual pace, in our view. **Nonetheless, we will be attentive to the Bank's tone as well as any further guidance on the timing of rate cuts going forward.**

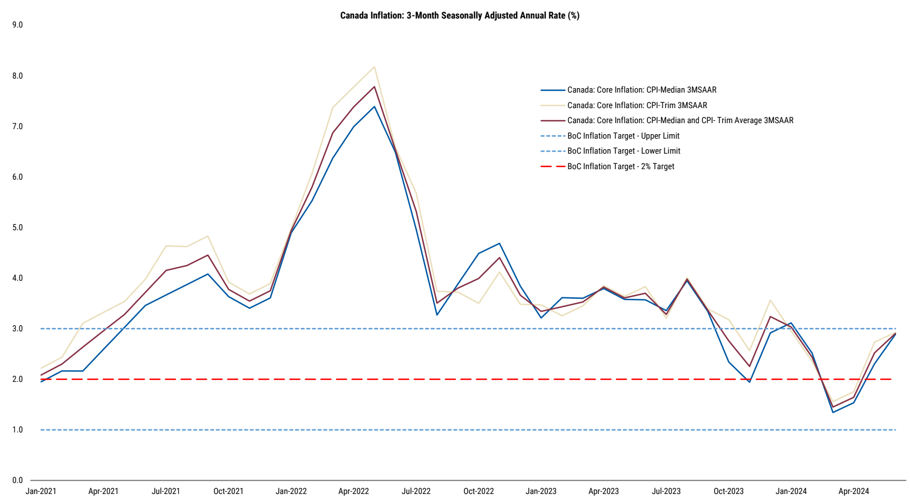
Exhibit 1: We expect a second 25bp cut in July 2024. From 5.00% in 2023, the policy rate still falls to 4.00% in 2024, then further to 2.50% in 3Q25



Source: Bank of Canada, Morgan Stanley Research forecasts

The June CPI print helped inflation get back on track after May's surprise rise. Lower gasoline, goods, and travel services prices helped to push inflation in the right direction. June's print did come with a catch, however, as the Bank's closely monitored three-month annualized pace of CPI-Trim and CPI-Median measures rose for a second month, pushing up the average of the three-month annualized pace of the two measures to 2.9% (vs. 2.5% prior). **Despite the rise, however, they remain within the Bank's 1-3% inflation range** (Exhibit 2).

Exhibit 2: The average of the three-month annualized pace of the two measures, a key BoC inflation measure, rose to 2.9% (vs 2.6% prior) – but still within the Bank's 1-3% inflation range

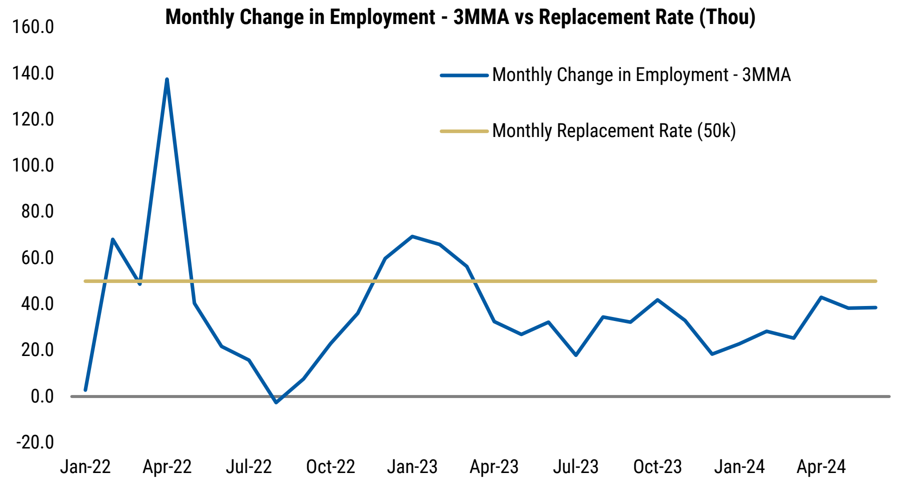


Source: Statistics Canada, Morgan Stanley Research

The Bank's 2Q24 surveys showed that both consumer and business inflation expectations remain subdued, as near-term inflation expectations for consumers declined significantly, while companies report seeing slowing growth in input costs and selling prices. Moreover, the percentage of businesses reporting labor shortages is at an all-time low, while their expectations for wage increases over the next year have slowed.

Job gains continue to run below working-age population growth. **The three-month moving average (3MMA) pace of job gains remains below Statistics Canada's estimated monthly replacement rate of 50k** (Exhibit 3). This, coupled with tepid hiring from businesses, has led to further slack building up in the labor market as the unemployment rate has risen to 6.4% in June, up from 5.7% in January and 5.4% last year.

Exhibit 3: Monthly jobs gains (3MMA) have been running below the replacement rate since April 2023



Source: Statistics Canada, Morgan Stanley Research

This meeting will also include the Bank's updated economic outlook. We expect the Bank to continue to highlight that it expects the economy to remain in excess supply for the remainder of 2024 before activity picks up in 2025. Further, we expect the Bank to maintain its expectation of inflation returning to the 2% target by end-2025.

Looking ahead, GDP growth remains slow in 2024 before rebounding in 2025 in our outlook. As the Bank has started easing monetary policy, we expect it to proceed at an orderly pace through September 2025. The pickup in GDP growth we envision primarily reflects stronger consumption, a revival in residential investment, less weakness in non-residential business investment, and export growth driven by strengthening US demand for goods.

Lastly on QT – we don't expect any changes to the Bank's current program. In March, a speech released by Bank of Canada Deputy Governor Toni Gravelle reconfirmed the Bank's commitment to its current QT program to run down its balance sheet until settlement balances reach ~C$20-60 billion. Based on the Bank's maturity profile of its asset holdings, the Bank expects this range to be reached "sometime in 2025." This remains in line with our expectation for its current QT plan to end in mid-2025.

Global Macro Strategy: What can we do with a data-dependent central bank?

Zoe Strauss, Andrew Watrous

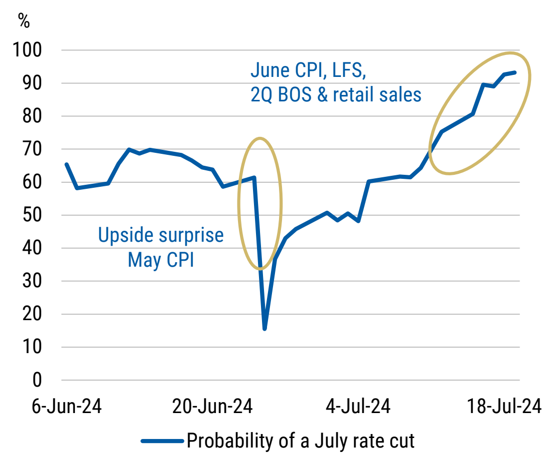
The BoC is widely expected to deliver a second rate cut at its July meeting (~22bp priced as of this writing) (Exhibit 4). Markets will therefore likely focus on rate-cut guidance and the BoC's updated economic outlook and tone instead of the rate decision itself.

We remain bearish on CAD and recommend long AUD/CAD and long GBP/CAD positions as we see room for markets to price in a lower BoC terminal rate than implied by market pricing (Exhibit 5). Our economists see a terminal rate of 2.5% versus market pricing of ~3%.

We also continue to recommend receiving December 2024 BoC.

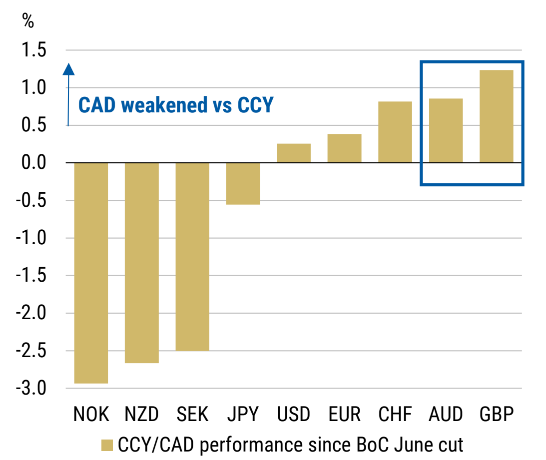
We discuss the July meeting through three scenarios for the near-term market-implied BoC path, as market pricing continues to reflect uncertainty among investors around the timing of future cuts (Exhibit 6).

Exhibit 4: Markets have fully priced in a July cut over the past weeks



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 5: We recommend long AUD/CAD and long GBP/CAD positions



Source: Bloomberg, Macrobond, Morgan Stanley Research

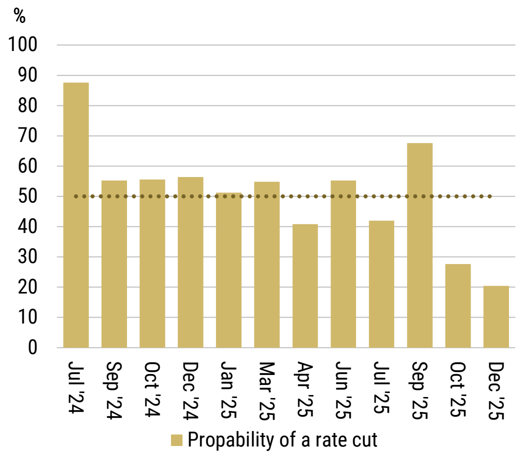
1. Straight to terminal:

The BoC's current guidance on rate cuts is that "it is reasonable to expect further cuts" to its policy rate, while taking decisions "one meeting at a time." As a result, investors have not felt comfortable to price in a high likelihood of back-to-back cuts (except for the June and July cuts).

We think developments in the labor market will be key in determining whether markets increasingly move to price in a rate path that implies the BoC could deliver further consecutive cuts.

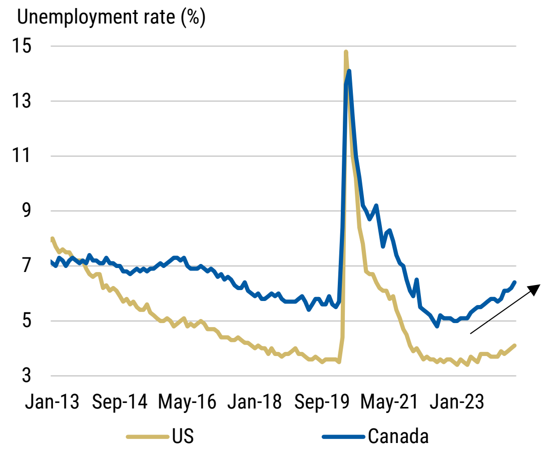
The Canadian labor market has loosened at a relatively fast pace in recent months (Exhibit 7 and Exhibit 8), and the BoC has incrementally put more emphasis in its communications on the implications of the labor market developments in achieving its inflation objective.

Exhibit 6: Market pricing for BoC meetings after July reflects relatively low investor conviction about the timing of future cuts



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 7: The unemployment rate has increased quite rapidly in Canada



Source: Bloomberg, Macrobond, Morgan Stanley Research

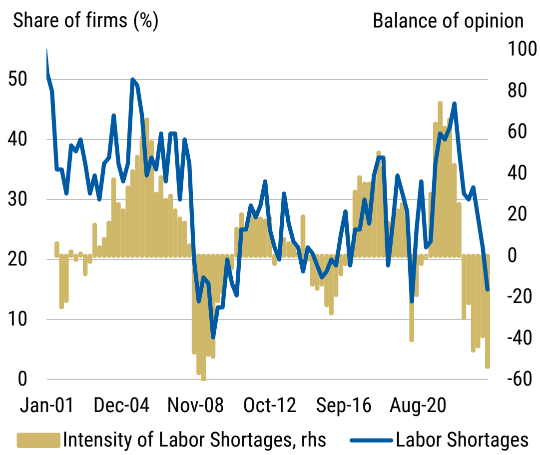
For example, Governor Macklem argued in late June that "[the slack in the labor market]...suggests the economy has room to grow and add more jobs without creating new inflationary pressures."

In other words, the BoC appears to increasingly link its confidence in achieving its inflation target and its reaction function to developments in the labor market. We think that, despite the lack of guidance, markets could become more comfortable in pricing in back-to-back cuts if we see further deterioration in the labor market.

We would therefore interpret an emphasis on the increasing slack in the labor market at the July meeting as a dovish outcome, even if the rate guidance should remain unchanged.

We also think that the updated estimates of the output gap will be an important indicator for investors contemplating whether the BoC will continue to cut at consecutive meetings. Growth has surprised to the downside relative to the BoC's April forecasts, suggesting that the size of the negative output gap was larger in late 2023/early 2024 than previously thought (Exhibit 9).

Exhibit 8: 2Q BOS provided further evidence of slack building in the labor market



Source: Bank of Canada, Bloomberg, Morgan Stanley Research

Exhibit 9: Growth data was revised lower for 4Q23 and surprised to the downside in 1Q24 vs. the BoC's forecasts

Real GDP (QoQ% SAAR)	Actual Data	April MPR	Difference (-ve lower than expected)
3Q23	-0.3	-0.5	0.2
4Q23	0.1	1.0	-0.9
1Q24	1.7	2.8	-1.1
2Q24	1.3	1.5	-0.2

Note: Actual data for 2Q24 is a Morgan Stanley forecast

Source: Bank of Canada, Bloomberg, Morgan Stanley Research

2. In a cutting cycle, but slowing down the pace:

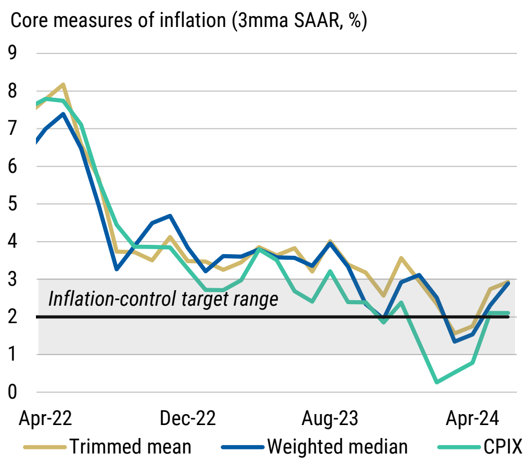
Our economist expects the BoC to keep rates unchanged at its September meeting (see BoC Update: We See Back-to-Back Cuts in July).

Including language in the July opening statement, or explaining in the press conference, that one should not expect the same pace of cuts going forward may be a signal that the BoC's current base case could be to cut only at forecast meetings in the near future.

A slower pace of cuts would be consistent with what other G10 central banks are doing (see ECB and Riksbank) and could be communicated to markets as ECB President Lagarde did when talking about needing "time to assess inflation uncertainties." The slight uptick in the three-month moving average of the BoC's core measure could be used to support this argument (Exhibit 10).

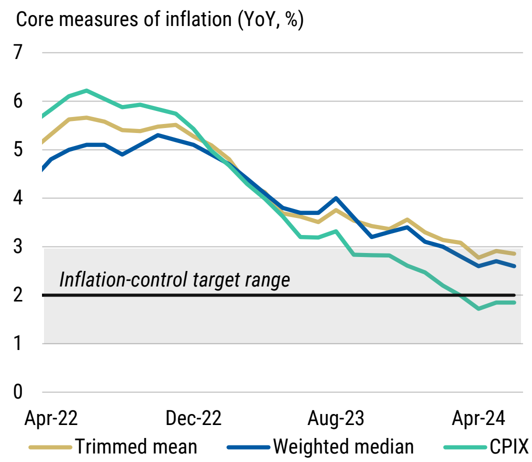
Other language we are attentive to as a potential signal of a slower pace is commentary around the amount of data we will receive from now until September versus until October, given that we will receive one additional CPI print before September (see similar comments from the ECB and the Fed on the amount of incoming data in their communication and linking it to future policy meetings).

Exhibit 10: The last two monthly prints have put upward pressure on the 3-month moving average in core inflation...



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 11: ....but the 12-month measure still shows a "sustained" decline in the trend in core inflation



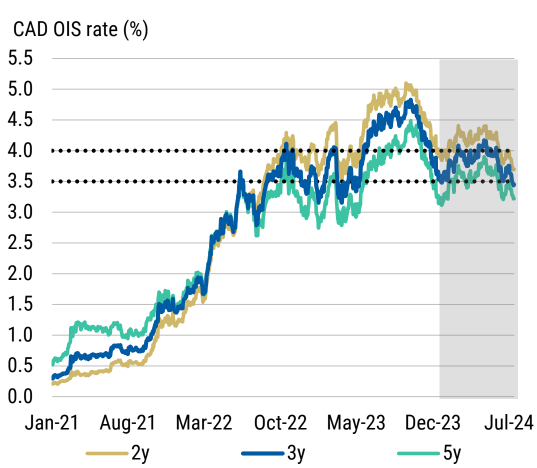
Source: Bloomberg, Macrobond, Morgan Stanley Research

We think that in the "slowdown" scenario, the market-implied BoC path should shift to look more like the ECB's implied path, where markets are attributing a higher chance of a cut at forecast meetings over the coming months.

That being said, we still see more room for front-end Canadian rate expectations to decline further in the coming months, including if the market-implied timing of near-term cuts adjusts (see Canada Mid-Year Outlook for more information).

Our expectation of lower Canadian rates also ties into our bearish CAD view, which is largely based on the erosion of carry in Canada (see Exhibit 13 and Exhibit 14 for how the carry/vol profile at the start of 2024 compared to that as of July 19, and our report The Bay of Fundy-ing).

Exhibit 12: Canada rate expectations have been stuck at ~3.5-4% for the most part of this year



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 13: CAD's carry/vol profile at the start of 2024...

Carry/Vol	USD	EUR	JPY	GBP	Long CAD	AUD	NZD	NOK	SEK	CHF
USD	X	-0.3	-0.5	0.0	-0.1	-0.1	0.0	-0.1	-0.1	-0.6
EUR	0.3	X	-0.5	0.4	0.2	0.1	0.2	0.1	0.0	-0.4
JPY	0.5	0.5	X	0.5	0.6	0.4	0.6	0.4	0.4	0.3
GBP	0.0	-0.4	-0.5	X	-0.1	-0.2	0.0	-0.1	-0.2	-0.6
CAD	0.1	-0.2	-0.6	0.1	X	-0.1	0.1	0.0	-0.1	-0.6
AUD	0.1	-0.1	-0.4	0.2	0.1	X	0.2	0.0	0.0	-0.3
NZD	0.0	-0.2	-0.6	0.0	-0.1	-0.2	X	-0.1	-0.2	-0.5
NOK	0.1	-0.1	-0.4	0.1	0.0	0.0	0.1	X	-0.1	-0.3
SEK	0.1	0.0	-0.4	0.2	0.1	0.0	0.2	0.1	X	-0.3
CHF	0.6	0.4	-0.3	0.6	0.6	0.3	0.5	0.3	0.3	X

Source: Bloomberg, Macrobond, Morgan Stanley Research

3. More easing before an assessment period:

A final scenario we think markets will start to contemplate is the BoC continuing to cut at upcoming meetings, then pause for some months to assess the impact of its rate cuts before continuing the cutting cycle.

This could, for example, imply that markets will price in a higher chance of consecutive cuts until October and reduce the likelihood for the end-2024/early-2025 meetings (i.e, assess the impact of policy normalization after 100bp of cuts).

We believe that developments in the housing market will be key to watch whether markets could shift toward pricing in a higher probability of an assessment period at some point in the cutting cycle.

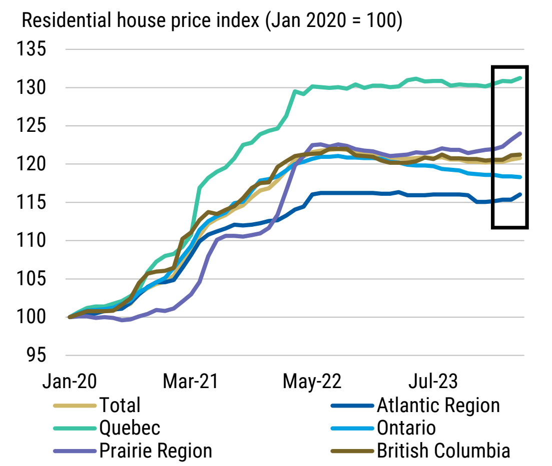
The BoC has indicated that a sharp rebound in house prices – and the implications it could have for growth and shelter inflation – is a key upside risk to its inflation outlook (Exhibit 15).

Exhibit 14: ...vs. carry/vol profile now

Carry/Vol	Long USD	EUR	JPY	GBP	CAD	AUD	NZD	NOK	SEK	CHF
USD	X	-0.3	-0.6	0.0	-0.2	-0.1	0.0	-0.1	-0.2	-0.7
EUR	0.3	X	-0.4	0.4	0.2	0.2	0.3	0.1	0.0	-0.5
JPY	0.6	0.4	X	0.6	0.5	0.5	0.6	0.5	0.3	0.2
GBP	0.0	-0.4	-0.6	X	-0.2	-0.1	0.0	-0.1	-0.2	-0.8
CAD	0.2	-0.2	-0.5	0.2	X	0.0	0.2	0.0	-0.1	-0.6
AUD	0.1	-0.2	-0.5	0.1	0.0	X	0.2	0.0	-0.1	-0.5
NZD	0.0	-0.3	-0.6	0.0	-0.2	-0.2	X	-0.1	-0.3	-0.6
NOK	0.1	-0.1	-0.5	0.1	0.0	0.0	0.1	X	-0.2	-0.4
SEK	0.2	0.0	-0.3	0.2	0.1	0.1	0.3	0.2	X	-0.3
CHF	0.7	0.5	-0.2	0.8	0.6	0.5	0.6	0.4	0.3	X

Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 15: House prices have edged up slightly over the past months



Source: Bloomberg, Macrobond, Morgan Stanley Research

We don't expect the BoC to signal an assessment period at its July meeting. Rather, we think this scenario could come into focus the more back-to-back cuts the BoC delivers – especially if other G10 central banks follow a more cautious cutting approach.

- **Trade idea: Maintain long AUD/CAD at 0.9187 with a target of 0.9650 and stop of 0.8700**
- **Trade idea: Maintain long GBP/CAD at 1.7738 with a target of 1.80 and stop of 1.70**
- **Trade idea: Maintain receive December 2024 BoC at 4.16**

Valuation methodology and risks

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Long AUD/CAD	0.907	30-May-24	Our global strategy outlook paints a relatively positive outlook for risk assets. AUD's higher beta to risk demand suggests AUD should outperform CAD. We like long AUD/CAD positions form a macro perspective, too: In our view, markets are underestimating the pace of BoC cuts, while the RBA has one of the least restrictive stances in G10. Our economists expect an August rate hike from the RBA.	Moving into Regime 3 of our USD Real Yield Framework, which sees the dollar gaining broadly and risk-sensitive currencies underperforming. This could occur if the Fed were to put rate hikes back on the table
Long GBP/CAD	1.73	21-June-24	We think increasing divergence between BoC and BoE pricing could increase GBP/CAD's attractiveness as a carry trade, pushing the pair higher.	BoC and BoE rates converge as the BoE cuts faster than expected or higher inflation in Canada limits BoC rate cuts.
Receive December 2024 BoC	4.51	30-May-24	Our economists expect the BoC to deliver four 25bp rate cuts this year, almost double the amount that markets are currently pricing. We think markets will price in more easing from the BoC as investors focus on the macro fundamentals in Canada and the BoC's willingness to diverge from the Fed.	Domestic inflation data in the coming months provide evidence that the recent deceleration in inflation was not "sustained." Markets continuing to see the BoC cutting as much as the Fed is another risk.

Source: Morgan Stanley Research

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Equal-weight/Hold	1741	46%	340	45%	20%	774	46%
Not-Rated/Hold	3	0%	0	0%	0%	1	0%
Underweight/Sell	570	15%	71	9%	12%	224	13%
Total	3,754		753			1676	

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