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Canada Economics and Global Macro Strategy | North America

BoC Reaction: Three in a Row

The BoC cut its policy rate by 25bps to 4.25% and made no change to its QT plan. We maintain our call for two additional cuts this year to reach 3.75% by end-2024.

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Economics: As we expected, the Bank of Canada (BoC, or the Bank) moved ahead with its third 25bp cut and lowered its policy rate to 4.25%. Further progress on inflation and a desire to lift economic growth led to the September cut. The Bank reiterated that if inflation continues to ease in line with its July forecasts, "it is reasonable to expect further cuts", though it will continue to take its rate decisions "one at a time." The Bank also continued to press ahead with its current balance sheet normalization plan.

We expect two more 25bp cuts this year to reach 3.75% by end-2024 and sequential cuts until 2.50% in July 2025. We also maintain our call for QT to end in mid-2025.

Global Macro Strategy: Overall, the September meeting provided little new information to investors. However, the press conference illustrated that the Governing Council is more seriously starting to consider scenarios in which a 50bp rate cut can be appropriate at future meetings. We see room for markets to price in a lower terminal rate and continue to recommend receiving June 2025 BoC. We also continue to recommend long GBP/CAD positions.

Canada Economics: Hat Trick

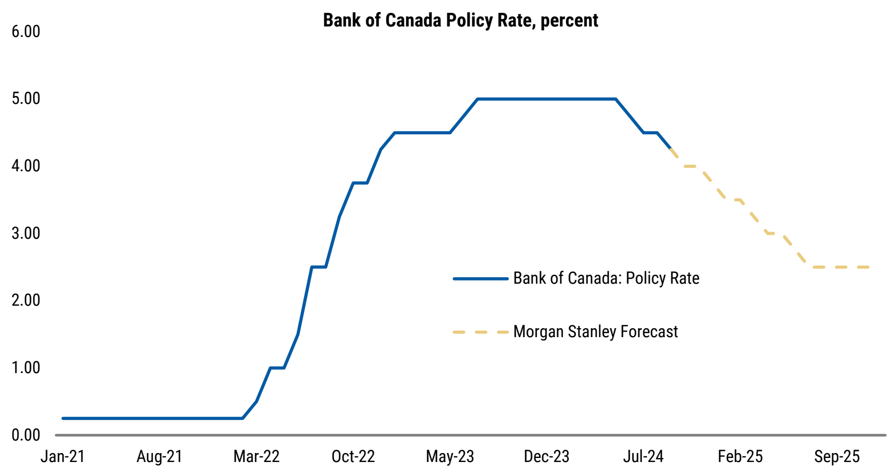
Lenoy Dujon

The Bank cut by 25bps to lower its policy rate to 4.25%. The September cut was fueled by two reasons: 1) Inflation continues to ease in accordance with the Bank's expectations, and 2) The Bank wants to see growth pickup to absorb the excess slack in the economy.

Governor Macklem reiterated that "it is reasonable to expect further cuts in our policy rate", so long as inflation is in line with the Bank's July forecasts. However, the Bank remained tight-lipped on the path of future rate cuts as it will assess the data as it comes and "take [its] monetary policy decisions one at a time."

As the Bank continues to express confidence that inflation will return to the 2% target, we see the BoC continuing to ease monetary policy. Further, with the Bank wanting to lift economic growth to absorb the slack in the economy, we think this aligns with our view that the Bank can put through sequential 25bp cuts through 3Q25 to do so. **We expect two more 25bp cuts this year (October and December) to reach 3.75% by end-2024 and further cuts to 2.50% in July 2025 (Exhibit 1).**

Exhibit 1: We expect the policy rate to fall to 3.75% in 2024, then further to 2.50% in 3Q25



Source: Bank of Canada, Morgan Stanley Research forecasts

There was "strong consensus" for a 25bp cut at the September meeting. However, when asked about a 50bp cut, Macklem acknowledged that the Governing Council discussed different scenarios around the future rate path. If upward pressures on inflation "prove to be stronger" than the Bank expects, or if there is less slack in the economy than the Bank estimates, Macklem said it would be appropriate to "slow the pace of [rate] declines". On the other hand, if inflation is weaker than the Bank expects, it could "take a bigger step" in terms of rate cuts. Nonetheless, the incoming data remain important for the Bank's future decisions.

Macklem reaffirmed that the Bank is focused on symmetrical risks to inflation, as the Governing Council "care[s] as much about inflation being below the target as [they] do above." This comes as the Bank judged that excess supply in the economy "continues to put downward pressure on inflation", but still sees shelter inflation and other services as "holding inflation up". As such, the Bank continues to assess the impact of these two "opposing forces" on inflation.

The Bank's view on the labor market was unchanged. With the unemployment rate having risen to 6.4% as of July, up from up from 5.7% in January and 5.4% last year, the Bank has judged that the labor market "**continues to slow**".

On monetary policy divergence with the Fed, Governor Macklem did not express concern. Macklem acknowledged that there are limits to this divergence, but they have not "become a constraint" on the Bank's monetary policy decisions. With markets now expecting the Fed to start cutting rates this year, Macklem said that divergence "doesn't look like it is getting bigger". **We expect the Fed's cutting cycle to start in September and continue with 25bp cuts through mid-2025.**

Lastly on QT, the Bank made no change to its current plan 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 expectations for its current QT plan to end in mid-2025.**

Global Macro Strategy: A 'Wake Me Up When September Ends' Moment

Zoe Strauss, Andrew Watrous

The September meeting did not provide investors with much new information. The only significant insight was an acknowledgement during the press conference that the BoC would be willing to cut its policy by more than 25bp at future meetings, if needed.

This dovish bias from the BoC is consistent with our bearish view on CAD. We continue to recommend long GBP/CAD positions and receiving June 2025 BoC.

50bp? For the first time, the BoC provided a bit more guidance on the pace of cuts.

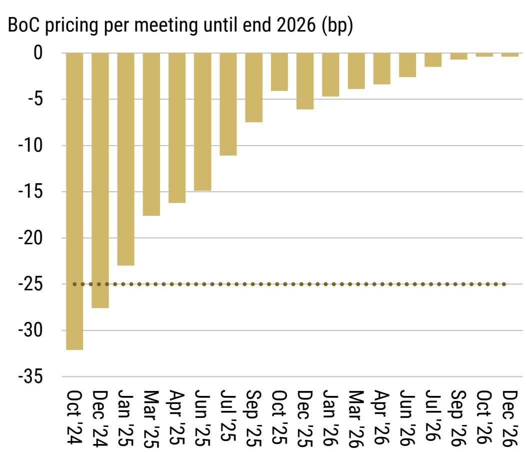
Governor Macklem mentioned during the press conference that there was a strong consensus for a 25bp rate cut – this was in response to a question on whether in a 50bp rate cut was discussed at the September meeting.

Governor Macklem then went on to explain that the Governing Council discussed scenarios for future decisions in terms of when it could be appropriate to slow the pace of cuts, as well reduce its policy rate by more than 25bp.

We think that the explicit acknowledgement of the possibility of a more aggressive rate-cutting cycle will likely keep a risk premium in pricing of near-term BoC meetings embedded, especially since the BoC highlighted downside risks to its 2H growth forecast (Exhibit 2).

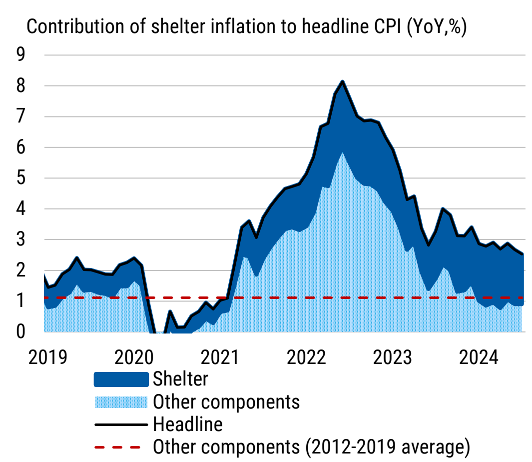
Governor Macklem stressed that the Summary of Deliberations will provide more insights into the scenarios that were discussed. The summary will be released on September 18.

Exhibit 2: The BoC has started discussing scenarios under which a more aggressive pace of rate cuts could be appropriate



Source: MS STIR Desk, Morgan Stanley Research

Exhibit 3: Shelter remains the main upward pressure to inflation



Source: MS STIR Desk, Morgan Stanley Research

Rate cut guidance: The rate cut guidance was kept unchanged in the statement. At the September meeting, the BoC continued to indicate that "…it is reasonable to expect further cuts in our policy rate".

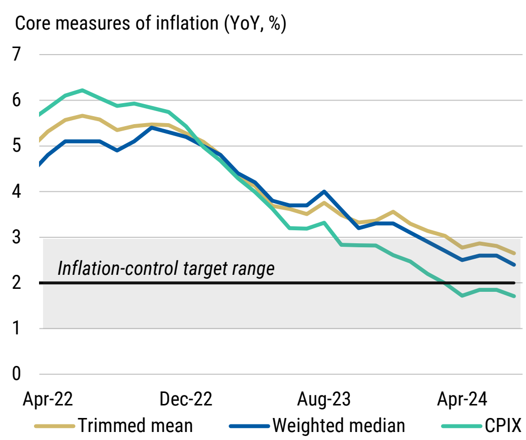
With regards to the timing of rate cuts, the Governing Council reiterated that it would take "monetary policy decisions one at a time."

Balance of risks: The BoC repeated its balanced risk approach to inflation, which is an adjustment the BoC made in July.

The final paragraph of the rate announcement repeated that "excess supply in the economy continues to put downward pressure on inflation, while price increases in shelter and some other services are holding inflation up."

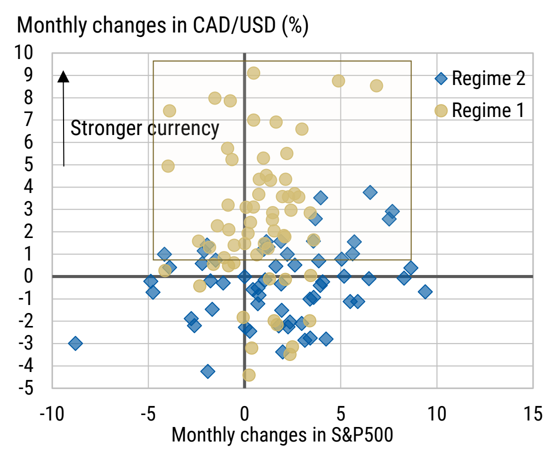
The Governing Council is assessing the impact of these two "opposing forces" on inflation.

Exhibit 4: Core inflation measures continue to ease



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 5: Until the summer, FX traded mostly in Regime 2 YTD, but we now see risks of entering the USD Bear Regime (Regime 1), where CAD/USD tends to strengthen



Source: Bloomberg, Macrobond, Morgan Stanley Research

Inflation progress: The BoC acknowledged the recent progress on inflation without giving any update on the outlook from here – partly because the September decision was a non-forecast meeting.

The BoC continued to emphasize that"… shelter price inflation is still too high. It remains the biggest contributor to overall inflation, despite some early signs of easing" (Exhibit 3).

At the same time, the Governing Council also concluded that "..there is little evidence of broad-based price pressures" (Exhibit 4).

Labor market: The rate announcement and opening statement put a bit less emphasis on the labor market relative to the July documents.

Markets initially therefore interpreted the rate announcement and opening statement as marginally hawkish (Canadian 2y yields reversed their initial decline slightly after the 9:45am EDT release).

However, the overall tone around the slack in the labor market remained the same, even if the BoC did not decide to spend as many words on the status of the labor market.

As mentioned above, Governor Macklem's remarks during the press conference were more explicit than at the July meeting regarding the Council's willingness to cut by 50bp if growth data disappoint. Canadian 2-year yields started to head back lower during Governor Macklem's comments.

Bottom line – the September meeting did not provide investors with materially new information. So what to watch next?

For BoC rate expectations, we are mostly focused on labor market and growth data (both domestic and in the US).

Canadian inflation data remain important, but we think these data carry a slightly lower weight for investors' expectations right now, given the BoC's confidence in bringing inflation back to target over the medium term.

For USD/CAD, we are more focused on risks around the broad USD as opposed to BoC expectations at the moment.

We recently discussed that the USD's balance of risks has shifted from bullish to bearish after FOMC Chair Powell's Jackson Hole speech. That is, risks of the USD Bear Regime (Regime 1) of our Real Yield USD Framework have increased. CAD tends to strengthen versus the USD in this regime (Exhibit 5).

We recommend long GBP/CAD positions as a way to express our expectation of BoE-BoC divergence.

- **Trade idea: Maintain receive June 2025 BoC at 2.97**
- **Trade idea: Maintain long GBP/CAD at 1.7767 with a target of 1.80 and stop of 1.70**

Fixed Income Valuation Methodology and Risks

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Receive June 2025 BoC	3.19%	9-Aug-24	We believe markets can price in a deeper BoC cutting cycle into 2025. In addition, developments in the Canadian labor market, and the BoC's increased focus on slack in the labor market, should increase the possibility that markets will price in a higher risk premium of front-loaded policy normalization.	A sharp rebound in economic activity in Canada coupled with upside surprises in CPI data.
Long GBP/CAD	1.73	21-Jun-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.

Source: Morgan Stanley Research

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Equal-weight/Hold	1736	47%	351	46%	20%	793	47%
Not-Rated/Hold	4	0%	0	0%	0%	1	0%
Underweight/Sell	573	15%	76	10%	13%	230	14%
Total	3,731		765			1673	

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