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Canada Economics and Global Macro Strategy | North America

BoC Preview: Back-to-Back 50bp Cut

We expect another 50bp cut in December as ongoing labor market slack, soft economic growth, and inflation at target allow the BoC to ease aggressively.

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Economics: At the Bank of Canada's (BoC or the Bank) meeting on Wednesday, December 11 (statement released at 9:45am ET), we expect a 50bp cut by the Bank to lower the policy rate to 3.25%. We also expect the Bank to continue its balance sheet runoff. This meeting will provide an opportunity for the Bank to provide further guidance around the timing and magnitude of future rate cuts. We will also be attentive to how the Bank is thinking about the threat of US tariffs on the Canadian economy.

Global Macro Strategy: Our economists think the BoC will cut its policy rate by 50bp at its December meeting, which is in line with market expectations. We see room for markets to price in more cuts into 1H25 as we expect the BoC will cut rates below neutral by summer 2025. We continue to recommend receiving June 2025 BoC.

A dovish BoC is a key reason why we expect CAD to underperform versus other dollar bloc currencies over the next several months. We see upside risks to USD/CAD going into the meeting, as we expect the BoC to continue to have an incrementally more dovish tone. Besides the guidance on future rate cuts, we expect investors to focus on questions around tariff risks and divergence from the Fed during the press conference.

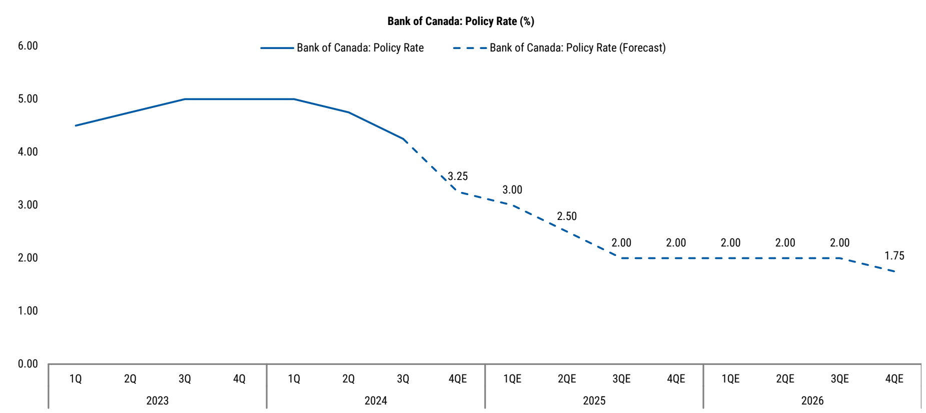
Canada Economics: Another 50bp Cut

Lenoy Dujon

We expect the Bank to cut by 50bp at its December meeting to lower the policy rate to 3.25%. With inflation at target and economic activity soft, we believe the BoC can move aggressively in easing monetary policy to lift economic growth.

Looking ahead, still focused on stimulating the economy, we expect the Bank to cut a further 125bp to reach 2.00% by July 2025, where we expect rates to stay through 3Q26. By 4Q26, spillover from weaker US growth prompts an additional 25bp cut to 1.75% by end-2026 (Exhibit 1 **). We continue to expect QT to end in July 2025.**

Exhibit 1: We expect a 50bp cut in December 2024 and sequential 25bp cuts thereafter to reach 2.00% in 3Q25; we forecast the policy rate to stay at 2.00% through 3Q26. By 4Q26, spillover from weaker US growth leads to an additional 25bp cut to 1.75% by end-2026



Source: Bank of Canada, Morgan Stanley Research forecasts

The labor market conditions remain soft. While employment gains surprised to the upside in November, so did the unemployment rate – rising three tenths to 6.8%, the highest since January 2022. Job growth continues to fail to keep up with the pace of labor supply growth as Canada continues to see high levels of immigration.

3Q24 GDP growth was below the Bank's October 2024 MPR forecast. 3Q24 GDP growth rose 1.0%Q – below the Bank's 3Q24 forecast of 1.5%Q%. While the economy saw pockets of growth in the form of stronger household spending on motor vehicles and financial services, business investment was weak as the effects of tight monetary policy continue to linger.

Inflation remains firmly in the Bank's 1-3% inflation range. While headline CPI for October rose 2.0%Y, up from September's pace of 1.6%Y, it remains contained. Deputy Governor Mendes reiterated that the Bank's inflation target is symmetrical and that it is “equally concerned with inflation above or below 2%.”

Recent BoC communication shows a Bank that is still ready to act on the (soft) data. Governor Macklem has said that he wants to lift growth in an effort to "stick the landing". The Bank anticipates reducing "the policy rate further", especially as it remains focused on supporting growth and keeping inflation around target.

Lastly on QT – we expect no change to the Bank's current program. Since confirming its current plan in March, the Bank has pressed ahead with its balance sheet runoff. Based on the 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 July 2025.

Risk of tariffs: In November 2024, President-elect Trump said he plans to impose a 25% tariff on all Canadian (and Mexican) goods entering the US on January 20, 2025. He prefaced the proposal by expressing concerns about migration and drugs illegally entering the US. However, it is unclear whether he intends to proceed with the idea as described, or whether it perhaps was a negotiating tactic meant to extract certain concessions from the two countries.

Like the Fed, the BoC noted that it will not incorporate the possibility of tariffs into its monetary policy decisions until any tariffs are actually implemented. While there is uncertainty around these tariff proposals at this time, we will be attentive to any additional tariff commentary the Bank may provide.

Global Macro Strategy: Why Have One 50, When You Can Have Two 50s?

Zoe Strauss, Andrew Watrous

Market pricing is consistent with a roughly ~88% probability of a 50bp rate cut, which our economists expect the BoC to deliver at the December meeting.

We see upside risks to USD/CAD going into the meeting, as we expect the BoC to continue to have an incrementally more dovish tone. We believe CAD will underperform in G10 over the coming months, as further BoC cuts will make CAD's carry profile less attractive (Exhibit 2).

We think that investors will mostly focus on the press conference. The following three topics will likely be the main areas that investors will pay attention to:

(1) Guidance on where the BoC sees the trough rate;

(2) The BoC's thinking around the monetary policy implications of potential trade tensions;

(3) Divergence from the Fed.

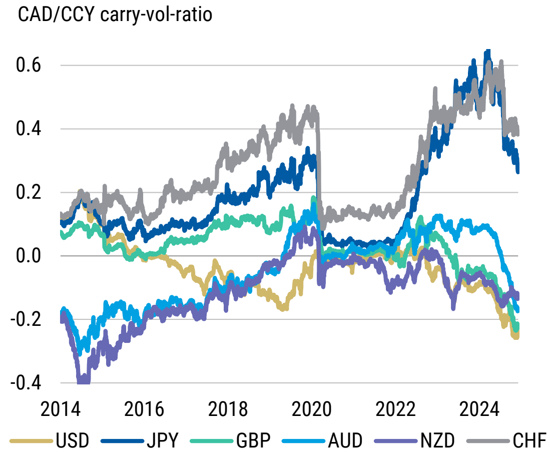
(1) Trough rate: So far, the BoC's rationale behind rate cuts has focused on the fact the policy rate does not need to be *as restrictive* as it has been. Consistent with such guidance, market pricing has indicated over the past several months that the BoC will not cut rates below neutral (Exhibit 3).

However, growth continues to surprise to the downside relative to the BoC's own forecasts (e.g., 1% annualized QoQ in 3Q, versus 1.5% projected by the BoC). We think that the BoC will cut below neutral in 2025 in order for demand to pick up.

The statement will likely continue to contain relatively vague forward guidance, as it did in October ("*the timing and pace of further reductions in the policy rate will be guided by incoming information and our assessment of its implications for the inflation outlook. We will take decisions one meeting at a time*"). However, we will pay attention to whether Governor Macklem acknowledges during the press conference that policy may potentially have to become slightly accommodative in 2025.

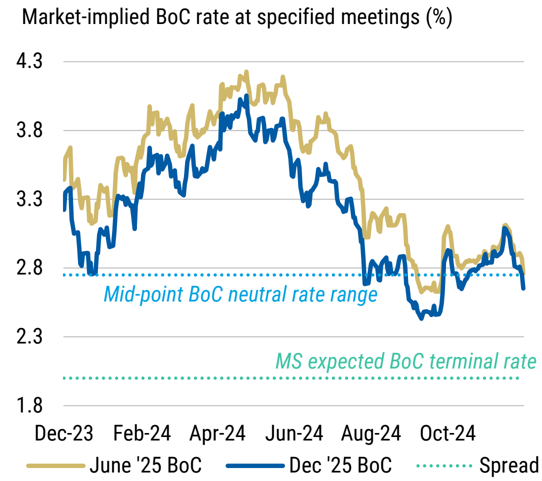
We continue to recommend receiving June 2025 BoC based on our expectation that the BoC will soon start to guide for rates to possibly move below neutral.

Exhibit 2: CAD's carry profile should weigh on the currency, especially against USD, GBP, AUD, and NZD



Source: Morgan Stanley STIR Desk, Morgan Stanley Research

Exhibit 3: Markets do not expect the BoC to cut rates below neutral



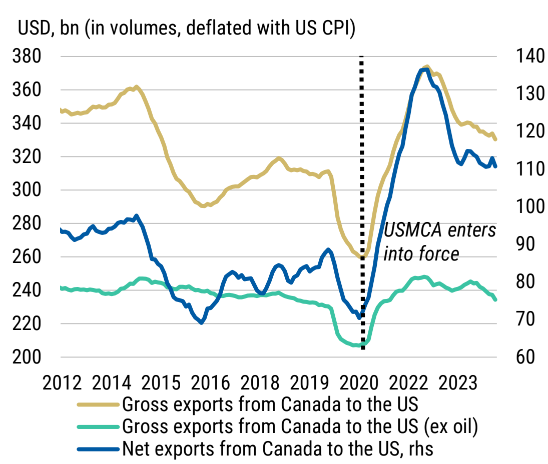
Source: Morgan Stanley STIR Desk, Morgan Stanley Research

(2) Tariff risks: We think Governor Macklem may receive questions on the implications for monetary policy given potential trade tensions. Recent headlines suggested that the incoming US administration may impose tariffs of 25% on all imports from Canada, which - if implemented - could have significant implications for Canadian growth expectations (Exhibit 4).

Deputy Governor Mendes mentioned after these headlines that the BoC would only incorporate any potential policies in its outlook if any proposed US tariffs are enacted. Other central bankers in G10 have made similar comments while highlighting the potential upside risks and downside risks to growth from tariffs.

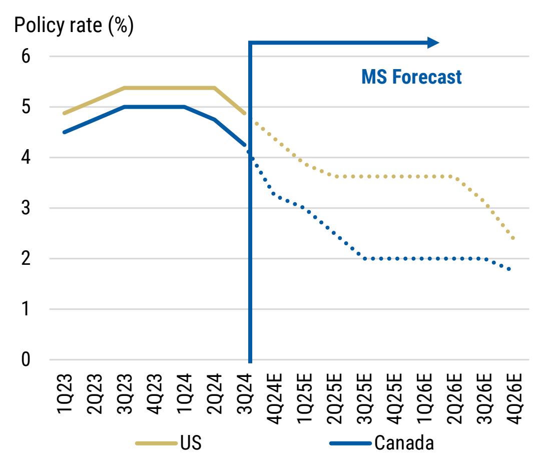
Similarly, the Governor may not provide specific guidance on whether he believes the growth or price impact of potential tariffs will be more important for near-term policy decisions. However, we think Canadian rate expectations should evolve differently compared to the trade escalations in 2018/19.

Exhibit 4: Canada has significant trade exposure to the US



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 5: We expect the BoC to continue to cut as the Fed pauses



Source: Macrobond, Morgan Stanley Research forecasts

In 2019, the Fed and other central banks started to cut rates, and a slowdown in global trade was cited as a key factor. In contrast, the BoC did not lower its policy rate during that period (see, for example, July and October 2019 MPRs).

However, we don't think that the 2019 episode is a particularly good precedent for how BoC expectations may evolve this time around based on the following:

- Canadian growth was relatively strong in 2019. The output gap had just started to move into negative territory, whereas now the economy has been in excess supply for over a year.
- Policy was already in an accommodative stance, whereas the current policy stance is still restrictive.
- Downside risks to growth may be seen as greater this time if the potential tariffs are broad-based.
- Inflation is back at target ,and we think it will remain there. Moreover, CPI ex-mortgage interest costs has been running at or below 2% for almost a year. In other words, with inflation being under control, the bar is being set higher for markets to price out cuts from concerns around inflation than if inflation was still running above target.

We therefore think Canadian rate expectations will likely focus more on the growth aspect than the inflation part of tariffs.

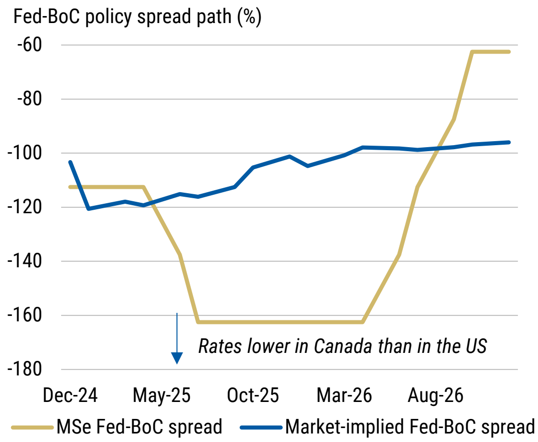
(3) Divergence: The BoC has delivered 125bp of rate cuts since it started its cutting cycle in June, compared to 75bp of rate cuts from the Fed. Throughout this divergence, the BoC has consistently said that it is not close to the limit of diverging from the Fed. Another 50bp rate cut would widen that spread even further (Exhibit 5 , Exhibit 6).

The question around the BoC's divergence "limit" comes up in relation to the exchange rate, as a weaker currency places upward pressure on imported inflation. USD/CAD has increased by ~3% since the beginning of the BoC's cutting cycle (Exhibit 7).

The central bank's consistent use of the same language around divergence suggests to us that either: 1) the BoC believes the pass-through of a weaker currency is limited (which would be consistent with previous BoC staff research on exchange rate pass-through to consumer prices); or 2) the BoC may welcome a slightly weaker currency to counterbalance some of the downward pressure on inflation.

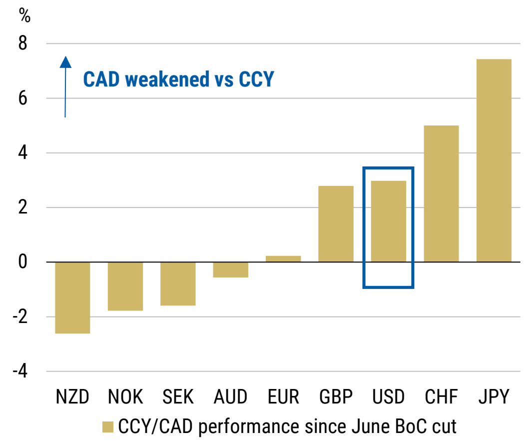
In either case, we interpret the continuity of the BoC's guidance on divergence as a sign that markets can price in further Fed-BoC divergence into 1H25. We therefore expect GoC bonds to outperform US Treasuries over the coming months. (For a more details, please see 2025 Canada Economics & Global Macro Strategy Outlook: The Year of Accommodation.)

Exhibit 6: Market pricing expects the Fed-BoC policy rate to reach ~120bp in early 2025, compared to our expectation of 162.5bp



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 7: CAD has weakened around 3% since the BoC started cutting rates



Source: MS STIR Desk, Morgan Stanley Research

- **Trade idea: Maintain receive June 2025 BoC at 2.76%**

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.

Source: Morgan Stanley Research

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Not-Rated/Hold	5	0%	0	0%	0%	1	0%
Underweight/Sell	593	16%	73	9%	12%	228	13%
Total	3,749		796			1694	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

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