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Canada Economics and Global Macro Strategy | North America

BoC Preview: Still Watching from the Sidelines

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We expect the Bank of Canada to keep its policy rate unchanged at its October meeting at 5.00%, where we expect it to remain for the rest of 2023.

Economics: At its October meeting on Wednesday, October 25 (statement released at 10AM EDT), we expect the Bank of Canada (BoC or the Bank) to keep its policy rate unchanged at 5.00%, and remain there for the rest of the year. In the press conference, we expect Governor Macklem to acknowledge that there are clear signs that monetary policy is working to rebalance supply and demand within the economy, but reiterate that inflation remains too high. We also expect Macklem will reiterate that the recent tightening in financial conditions is not a substitute for monetary policy. In the October Monetary Policy Report (MPR), we expect the Bank to note that geopolitical uncertainty, as a result of the Israel-Hamas conflict, has increased leading to additional uncertainty in its outlook. Relative to its previous projections, we believe the Bank will lower its forecasts for growth in 2023 and 2024, but maintain its 2025 forecast. On inflation, the Bank will highlight that, although inflation continues its decline, it will remain above target in 2023 and 2024 before falling to 2% by 2025.

Global Macro Strategy: Our economist's expectation that the BoC will keep rates unchanged while retaining a tightening bias is consistent with current market pricing. We expect markets to pay close attention to (1) the BoC's updated forecast for when it expects the output gap to close and (2) forecasts and tone around underlying inflation pressures.

We continue to recommend receiving the December 2024 BoC meeting, as we see further evidence that the Canadian economy is slowing down faster than the BoC projected in the July MPR. However, we recommend pairing the received positions with paid January 2024 meeting positions. This flattener position partially hedges global shifts in outright duration. Moreover, Canadian inflation released since the BoC's July forecasts has revealed greater price pressures than the Governing Council anticipated, raising the risk that the BoC will have to deliver on its tightening bias.

We continue to recommend short CAD positions as part of a basket of risk-sensitive currencies against long JPY positions.

Canada Economics

Lenoy Dujon

We expect the Bank to keep its policy rate unchanged at its October meeting and remain there for the rest of the year. Our rationale for the Bank to remain on hold has been a notable slowdown in both economic growth and inflation — **highlighting that the economy is showing further signs of cooling given the recent data**.

Retail sales for August highlighted further slowing in economic activity, as Canadians pulled back on spending. Retail sales in August fell 0.1%M (vs 0.3%M in prior), as sales fell in six of the nine subsectors, including motor vehicle & parts dealers, furniture, and appliance & electronics retailers. **Tighter monetary policy continues to weigh on household consumption as weakness in interest rate–sensitive categories remains evident**. Looking ahead, retail sales were estimated to be flat in September according to Statistics Canada's advance estimate — **highlighting continued weakness in consumption expenditure ahead.**

Consumption weakness comes as 3Q23 GDP is estimated to come in below the Bank's July forecast of 1.5% Q/Q SAAR (MSe 0.5% Q/Q SAAR; Consensus 0.4% Q/Q SAAR). This underscores that the Canadian macro backdrop is much different than 1H23, as economic momentum has slowed since then. Thus, there is less of a need for the bank to do an "insurance hike" to slow activity (and inflation) even further.

The BoC's recent surveys for 3Q23 highlight expectations of further weakness ahead from both consumers and firms. The Canadian Survey of Consumer Expectations (CSCE) for 3Q23 noted that Canadian consumers noted that the impacts of tighter monetary policy on consumption expenditure are far from over. Some consumers state that higher rates will discourage them from purchasing big-ticket items **— a trend already reflected in the latest retail sales report**.

Moreover, the BoC's Business Outlook Survey (BOS) for 3Q23 highlights that firms **see a sluggish outlook ahead as well**. The BoC Business Outlook indicator declined further in 3Q23, to -3.5 (-2.3 prior) — **marking its lowest point since the pandemic**. The decline comes as businesses expect economic activity to slow due to weaker demand expectations**,** coupled with their plans to reduce hiring and capital expenditures.

September's CPI print allowed the Bank to breathe a sigh of relief prior to next week's meeting, as headline inflation declined on the month to 3.8%Y from 4.0%Y prior. A decline in durable goods, food, and travel-related services prices helped to alleviate price pressures on the month. The closely monitored 3MMA of the CPI-Median and CPI-Trim measures — a key measure observed by the Bank — decelerated from 4.3% to 3.7%, **highlighting some much-needed progress on core inflation, after the bounce in August.**

Though progress is being made, albeit slowly, the Bank is still attentive to inflation dynamics, and **concerns over inflation's stickiness remains top of mind for policymakers.** This comes as **inflation remains above target, and inflation expectations from both consumers and businesses remain high.**

Despite weakening economic activity, the labor market is still showing some strength. The economy generated 63.8k jobs in September, after generating 39.9k jobs the month prior

– netting over 100k jobs during that span. September also brought with it a slight uptick in wage growth, to 5.3%Y from 5.2%Y prior – a level (still) not consistent with the Bank's 2% inflation target. **However, the unemployment rate remained unchanged at 5.5%.**

Nonetheless, **recent labor trends suggest that excess demand in the labor market is cooling**. In the Bank's 3Q23 BOS, firms noted that they plan on slowing hiring, due to their expectations of reduced demand and easing capacity pressures ahead. **Further, a large share of firms noted that they have adequate staffing levels, and fewer businesses plan on filling vacancies.**

Though wage growth at these levels is inconsistent with bringing inflation down to the Bank's 2% inflation target, we expect further easing in wage pressures, **as immigration helps to boost labor supply at a time when labor demand slows.**

Looking ahead to the upcoming October MPR, we believe the Bank will lower its forecasts for growth in 2023 and 2024, relative to its prior forecasts. This comes as we expect growth to slow in 4Q23 and into next year, after surprise strength in 1H23. As highlighted prior, the surveys released by the Bank this week noted that **both consumers and businesses see a weak economic outlook.** On inflation, we expect the Bank will highlight that, **although inflation continues its decline, it will remain above target in 2023 and 2024 before falling to 2% by 2025**. Despite the recent progress in inflation, price pressures still remain persistent.

Going forward, we expect economic growth and inflationary pressures **to continue to slow in the back half of the year and into 2024.** We expect tight monetary policy to continue to weigh on business investment, household spending, and the labor market. Further, we see export growth weakening as global demand slows.

Despite this, we still flag that the BoC will want optionality by maintaining its tightening bias – even if the chance of another hike this year is low at this point in time. The Bank's "Summary of Governing Council Deliberations" from the September meeting highlighted that members of the Governing Council remain **concerned over the lack of progress in underlying inflation**. Specifically, elevated core inflation remaining persistent — **even as there is accumulating evidence that tighter monetary policy is slowing demand.**

Policymakers maintain that given the uncertain future path of core inflation, **"tighter monetary policy should remain an option".** Thus they remain ready to raise the policy rate further if needed. However, we believe we would need to see a resurgence in economic activity, and/or a material increase in inflation, to bring the Bank off the sidelines once again.

Global Macro Strategy

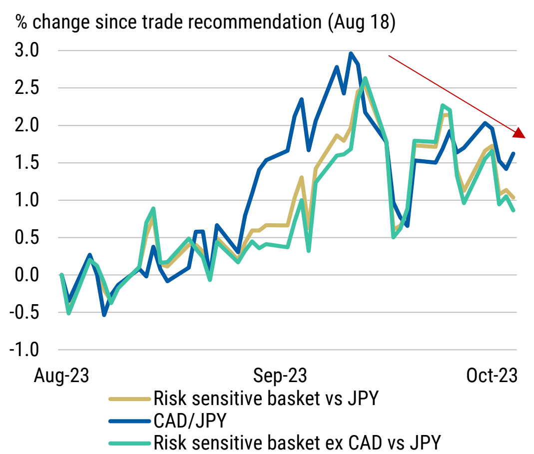
Zoe Strauss, Andrew Watrous

We do not expect the October BoC meeting to be a significant catalyst for USD/CAD. Our economist expects the BoC to keep interest rates unchanged, an outcome consistent with current market pricing. Moreover, OIS pricing suggests the BoC will cut interest rates by only ~25bp through the end of 2024. As a result, we think the "higher-for-longer" message that our economist expects the Governing Council to deliver is already priced in.

FX trade recommendation: We expect CAD to decline against JPY and continue to recommend short CAD positions as part of a basket of risks-sensitive currencies vs JPY. We think risk demand will be weak as long as geopolitical tensions remain elevated and global growth expectations stay subdued (see USD | Turning neutral for more on the correlation among risk assets, US rates, and the USD).

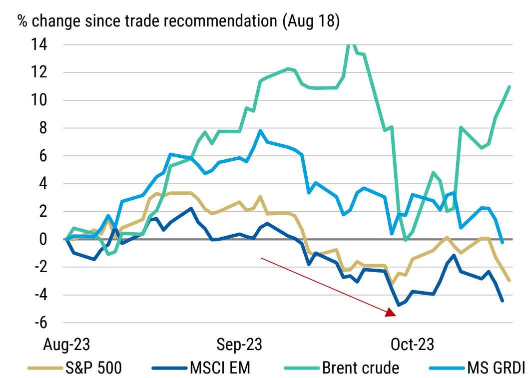
In addition, we expect only limited pass-through from higher oil prices to CAD (see CAD And NOK | Oil Prices Have Risen. Why Aren't NOK And CAD Stronger?).

Exhibit 1: We see room for CAD/JPY to decline further...



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 2: ...as CAD/JPY has performed better than most other risk assets



Source: Bloomberg, Macrobond, Morgan Stanley Research

Rates trade recommendation: We continue to recommend receiving the December 2024 BoC meeting, as economic growth has slowed down more than the BoC projected.

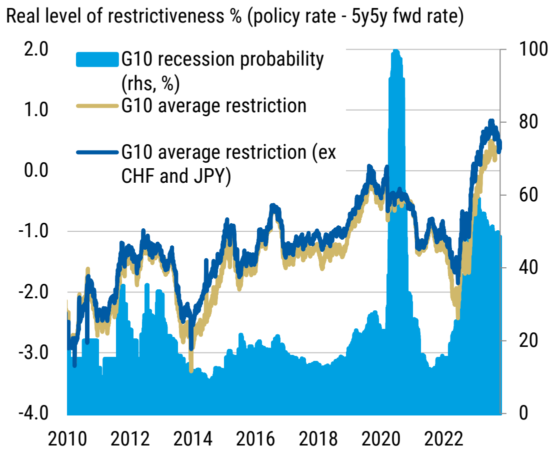
We recommend pairing received December 2024 BoC meeting positions with paid January 2024 meeting positions. This flattener position partially hedges global shifts in outright duration. Our US rates colleagues recommended long 5y USTs but recently turned neutral on duration.

Moreover, adding the paid position is consistent with our US rates colleagues maintaining a long SFRZ4 on U3Z4Z5 fly recommendation, as they continue to see attractive risk/reward for positioning for more/sooner cuts (see Short-Duration Strategy).

Finally, Canadian inflation released since the BoC's July forecasts has revealed faster price pressures than the Governing Council anticipated, raising the risk that the BoC will have to deliver on its tightening bias.

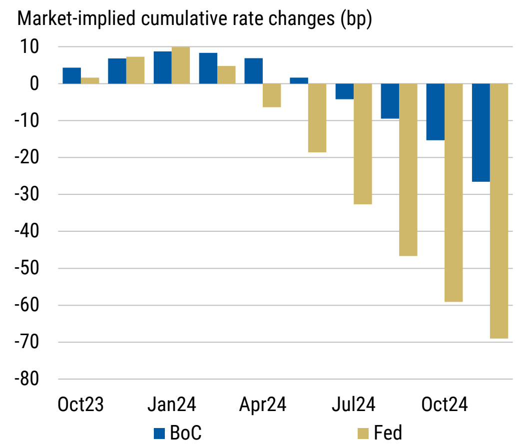
The risk to our received Jan 2024 positions would be a sharper slowdown in economic data and rapid easing in underlying inflation pressures that could soften the BoC's current tightening bias faster than expected.

Exhibit 3: Global growth expectations will likely remain subdued as long as monetary policy remains tight



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 4: Market pricing for the BoC should start to reflect more easing in 2024 as growth expectations continue to deteriorate in Canada



Source: MS STIR Trading Desk, Morgan Stanley Research

October MPR - What to watch: BoC policy is highly focused on excess demand and underlying inflation. We therefore expect markets to be attentive to two things:

(1) The BoC's updated forecast for when it expects the output gap to close

(2) Forecasts and tone around underlying inflation pressures

Exhibit 5: The BoC stated in July that it expects the remaining excess demand in the Canadian economy will be absorbed in early 2024, as we highlighted in bold below

MPR	Key comments on output gap
Jan-23	"The economy is estimated to have been ***in greater excess demand in the second half of 2022 than previously projected*** . As a result, the projection begins with more excess demand and more domestic price pressures."
	"Slower demand growth, combined with improvements in the supply chain, lead the economy into ***modest excess supply in 2023.*** "
Apr-23	"The pace of economic activity in Canada has slowed since mid-2022, but ***demand still exceeds supply*** ."
	"As high interest rates slow demand and supply grows, the economy moves into ***modest excess supply in the second half of 2023*** ."
Jul-23	As ***excess demand dissipates*** and labour market conditions ease, inflation gradually returns to the 2% target in the middle of 2025. This is about ***two quarters later than forecast in the January and April reports.***
	The ***rebalancing of supply and demand is now expected to happen in early 2024*** , three quarters later than previously anticipated

Source: Bank of Canada, Morgan Stanley Research

Receive Dec 2024 BoC based on output gap: The revised growth forecast of the July MPR extended the timing of the closure of the output gap. In July, the BoC projected that the Canadian economy would enter into mild excess supply in the beginning of 2024 (instead of the second half of 2023).

Growth data have surprised to the downside since the BoC last updated its forecasts in July. Incoming data and language in the September statement suggest it is unlikely that the BoC will again delay the timing of the output gap closure.

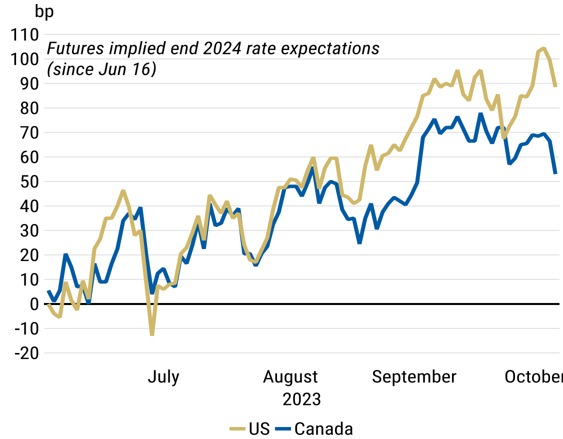
Exhibit 6: Growth has surprised to the downside in Canada relative to the BoC's July MPR forecasts

Real GDP (QoQ% SAAR)	Actual Data	July MPR	Difference (-ve lower than expected)
4Q22	-0.1	-0.1	0.0
1Q23	2.6	3.1	-0.5
2Q23	-0.2	1.5	-1.3
3Q23	0.5	1.5	-1.0

Note: 3Q is MSe for Actual Data. July GDP was 0% , preliminary August GDP 0.1%

Source: Bloomberg, Bank of Canada, Morgan Stanley Research

Exhibit 7: Interest-rate expectations for 2024 have only recently started to decline



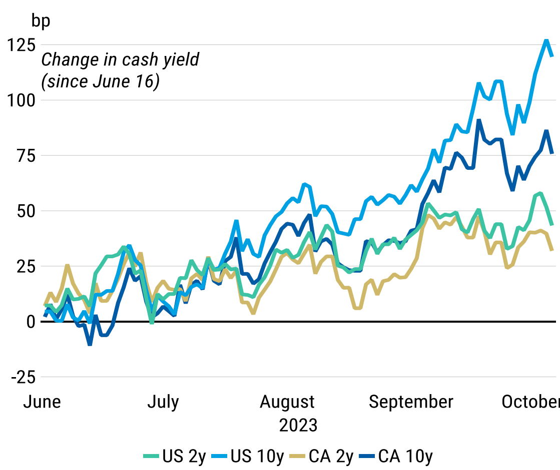
Source: Bloomberg, Macrobond, Morgan Stanley Research

At the September meeting, the BoC removed the word "persistent" to describe the remaining excess demand in the Canadian economy. Instead, the rate announcement noted that "excess demand in the economy is easing." BoC commentary since the September meeting has used similar language to characterize the state of Canadian demand.

A surprise relative to market pricing would be if the BoC brought its estimate of the output gap closure earlier, which should lower 2024 rate expectations.

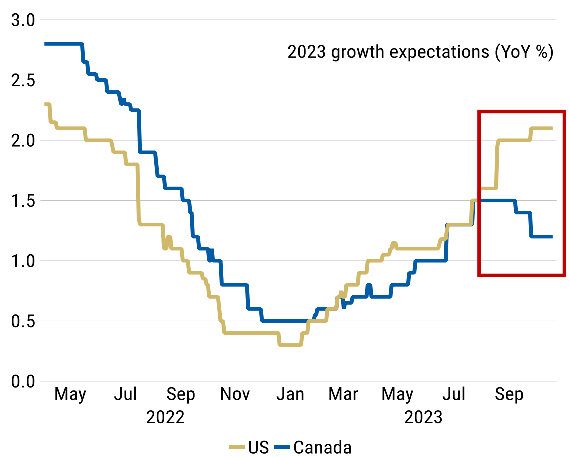
Interest-rate expectations for Canada at the end of 2024 has continued to move higher over the past several months. We attribute the move in Canadian rates to a large extent to spill-overs from the US, where yields moved sharply over the past several months (especially at the long-end of the US yield curve).

Exhibit 8: Canadian yields followed US Treasury yields higher over the past several months



Source: Bloomberg, Macrobond, Morgan Stanley Research

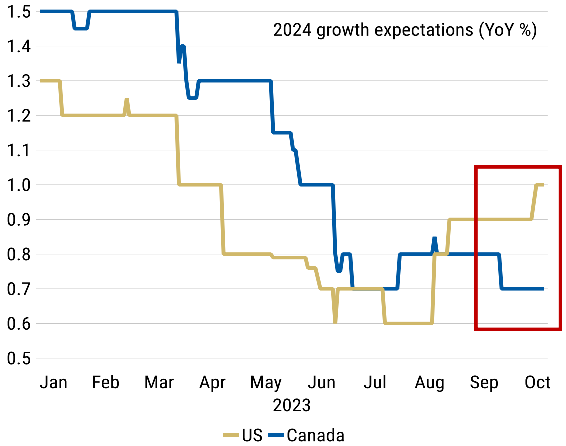
Exhibit 9: Contrary to US growth, Canada's economic outlook started to weaken...



Source: Bloomberg, Macrobond, Morgan Stanley Research

We continue to expect that the growth divergence will start to be reflected in expectations of policy divergence. Market pricing reflecting such a policy divergence should push USD/CAD higher and be reflected in lower CAD rate expectations for 2024. We therefore continue to recommend receiving the Dec 2024 BoC meeting.

Exhibit 10: ...and growth expectations between the US and Canada started to diverge



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 11: Inflation has surprised to the upside compared to the BoC's July forecasts

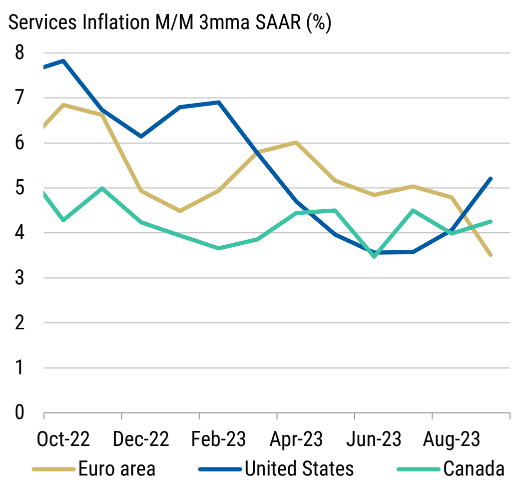
CPI (YoY% SA)	Actual Data	July MPR	Difference (-ve lower than expected)
4Q22	6.6	6.7	-0.1
1Q23	5.2	5.2	0.0
2Q23	3.5	3.6	-0.1
3Q23	3.7	3.3	0.4

Source: Bloomberg, Bank of Canada, Morgan Stanley Research

Pay Jan 2024 BoC based on underlying inflation: Inflation data has been higher than projected by the BoC. The downside surprise in the September CPI did not offset the strong (core) CPI in July and August.

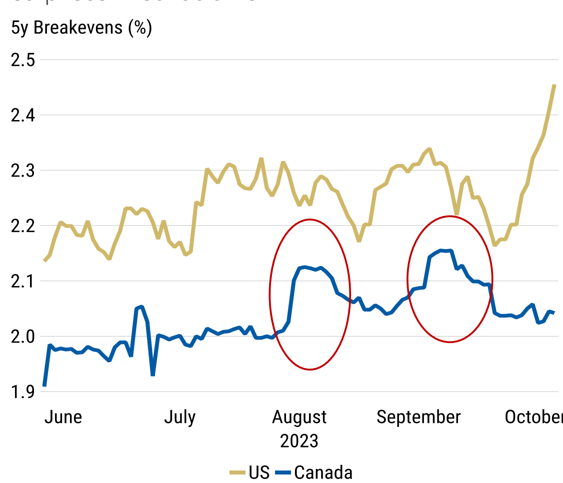
Meanwhile, the BoC has continued to stress concerns around underlying inflation in its communication (see comments from Governor Macklem at the annual IMF meetings and the speech from Deputy Governor Vincent).

Exhibit 12: Services inflation has moved sideways for the past year in Canada



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 13: Inflation expectations rose after upside surprises in Canadian CPI



Source: Bloomberg, Macrobond, Morgan Stanley Research

In contrast to recent comments from some FOMC participants, Governor Macklem has stated that tighter financial conditions are "not a substitute" for interest rate increases to bring inflation back to target.

We recommend paying Jan 2024 BoC meeting to reflect upside risks to underlying inflation. Weaker growth than the BoC expected has in recent months still translated into higher inflation than the MPR had projected. This dynamic raises the risk that the BoC has to deliver on its tightening bias.

- **Trade idea: Maintain pay January 2024 BoC at 5.09**
- **Trade idea: Maintain receive December 2024 BoC at 4.77**
- **Trade idea: Maintain long JPY against equal-weight risk currency basket (NOK, SEK, CAD, AUD, and NZD), with a target of 10% gain and stop of 5% loss**

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Receive Dec 2024 BoC	4.29%	16-Jun-23	The BoC resumed its tightening cycle in June after pausing in March 2023. We expect that, as the BoC tightens further, more easing will be required, reflected in more cuts priced in 2024. Market pricing implies around half the amount of rate cuts in 2024 that our economist expects.	Upside surprises to the inflation and growth outlooks could keep the BoC more restrictive for longer.
Pay Jan 2024 BoC	5.09	20-Oct-23	We recommend pairing received December 2024 BoC meeting positions with paid January 2024 meeting positions. This flattener position partially hedges global shifts in outright duration. Moreover, Canadian inflation released since the BoC's July forecasts have revealed faster price pressures than the Governing Council anticipated, raising the risk that the BoC will have to deliver on its tightening bias.	A sharper slowdown in Canada's economic data and rapid easing in underlying inflation pressures may soften the BoC's current tightening bias faster than expected.
Long JPY against equal-weight risk currency basket (NOK, SEK, CAD, AUD, and NZD)	100	18-Aug-23	Risk-off moves amid heightened geopolitical uncertainties and downside risks to global growth expectations can induce potential unwinding of JPY carry trades.	A rebound in risk sentiment and global growth expectations.

Source: Morgan Stanley Research

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Not-Rated/Hold	3	0%	0	0%	0%	1	0%
Underweight/Sell	608	17%	68	10%	11%	225	15%
Total	3,634		652			1543	

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