WELLS FARGO

International Commentary — June 6, 2022

Canada's Solid Growth Supports Forceful Monetary Tightening

Summary

- Even with a downside surprise in Q1 GDP, Canada's economy looks to have started 2022 on a solid note. Much of the apparent softness in Q1 stemmed from a large decline in exports. In contrast, gains in consumer and investment spending led to a sturdy increase in final domestic demand.
- The GDP report also showed encouraging details on the consumer front, with gains in both household disposable income and the household saving rate, which should be supportive of economic growth much of this year.
- The solid growth and rapid inflation trends prompted a second straight 50 bps rate hike from the Bank of Canada (BoC) at its June meeting, along with a forceful statement in which the central bank said it is willing to act more forcefully if needed.
- We now expect a more extended series of 50 bps rate increases to be delivered at the July, September and October announcements. We see the BoC's policy rate ending 2022 at 3.25%, and peaking at 3.75% in 2023. Solid growth and aggressive monetary tightening trends suggests the risks are tilted towards more Canadian dollar strength than our existing USD/CAD exchange rate target of CAD1.2500.

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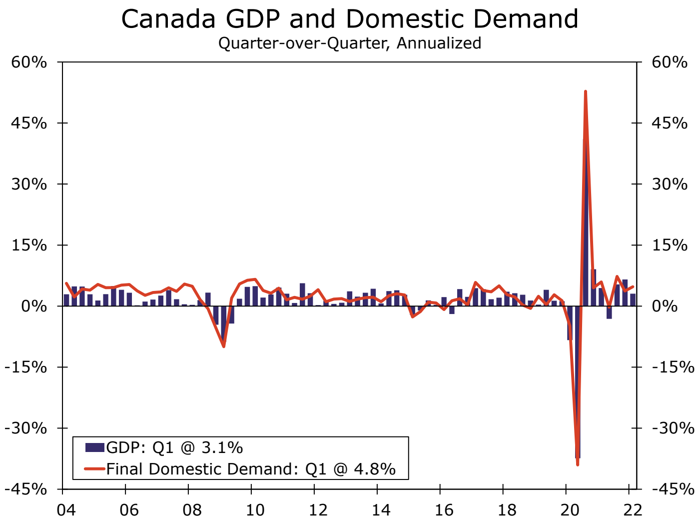
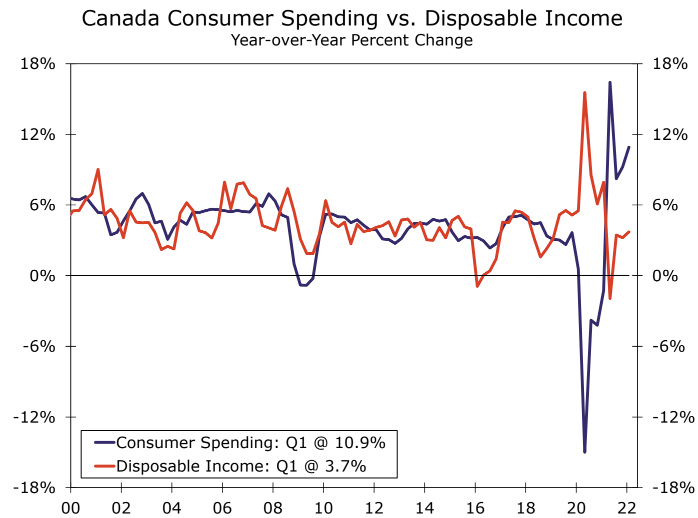
Canada's Economy Starts 2022 on a Solid Note

Canada's first quarter GDP figures were released last week and, while Q1 growth surprised to the downside, still suggested the economy started the year on a relatively solid note. Q1 GDP grew at a 3.1% quarter-over-quarter annualized pace, a slowdown from Q4 and well below the 5.2% growth pace forecast by the consensus. That said, much of the apparent softness in the economy was due to a large drop in exports, which subtracted significantly from Q1 growth. In contrast, both consumer spending and business investment enjoyed sizable increases. As a result, final domestic demand grew by 4.8% quarter-over-quarter annualized, indicative of underlying strength in the economy during the early part of 2022.

The GDP report also contained encouraging details regarding consumer fundamentals that suggest a relatively sturdy pace of growth can continue during 2022. Helped by employment and wage gains early this year, household disposable income rose 3.3% quarter-over-quarter (not annualized) in Q1 and by 3.7% year-over-over. With the growth in household income outpacing the increase in consumer spending, the household savings rate also increased to 8.1%, and remains well above levels that prevailed prior to the pandemic. These household fundamentals should be supportive of the consumer sector and indeed the broader economy, and is an important factor underlying our 2022 GDP growth forecast of 3.9%, which would be only a moderate slowdown from the pace of growth seen in 2021.



Source: Datastream and Wells Fargo Economics



Source: Datastream and Wells Fargo Economics

Bank of Canada Continues Along its Hawkish Path

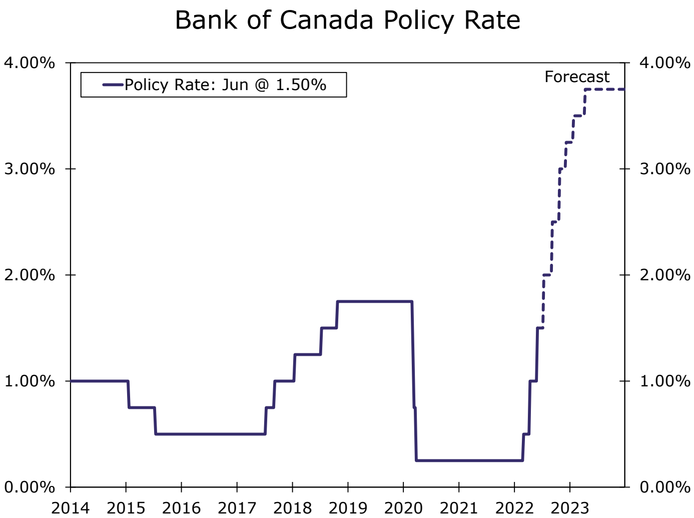
The other notable event last week was of course the Bank of Canada's (BoC) latest monetary policy announcement. As widely expected, the BoC delivered an "outsized" 50 bps rate increase for the second meeting in a row, taking its policy rate to 1.50%. Perhaps even more notable however was the hawkish statement that accompanied the rate increase. The central bank noted that the April CPI, at 6.8% year-over-year, was well above its forecasts and would likely move even higher still, adding that the "risk of elevated inflation becoming entrenched has risen." Meanwhile, the BOC described the economy as strong and 'clearly operating in excess demand. As a result, central bank policymakers said that interest rates would need to rise further and, in fact, the BoC said it is **"prepared to act more forcefully if needed to meet its commitment to achieve the 2% inflation target."**

That last comment was especially noteworthy, potentially indicating a more extended series of 50 bps rate increases, or an even larger 75 bps rate hike. Overall, given growth and inflation trends, we believe the Bank of Canada will deliver on its more forceful tightening. And while both of the scenarios described above are plausible, we lean towards a more extended series of 50 bps rate increase. Accordingly:

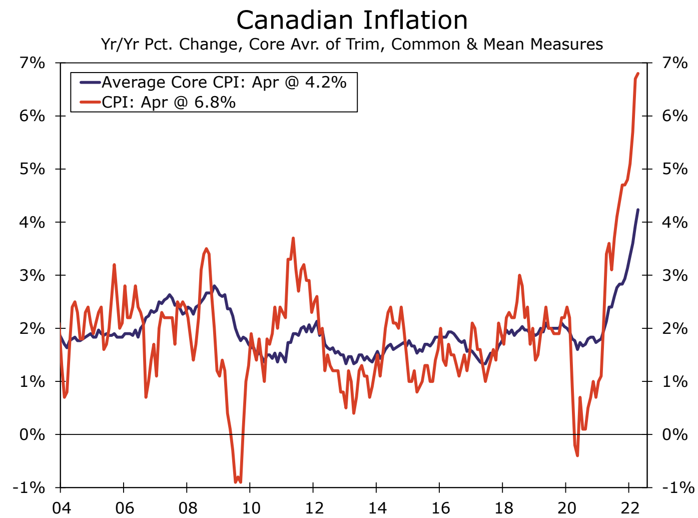
- we now anticipate 50 bps rate increases at the July, September and October announcements. As inflation potentially peaks and begins to slow, we expect the Bank of Canada to revert bank to a 25 bps rate increase in December. That cumulative 175 bps of rate increase over the rest of this year would see the Bank of Canada's policy rate end 2022 at 3.25%.

- we continue to see moderate further tightening in the first half of 2023, with 50 bps of rate hikes during that period taking the policy rate to a peak of 3.75%. Given reasonably sturdy growth trends and elevated inflation trends, we expect policy interest rates to peak modestly above a "neutral" level.

The solid Canadian growth outlook and aggressive central bank tightening means the outlook remains, in our view, for a resilient Canadian dollar. Indeed, given recent gains the Canadian dollar is already approaching our medium-term USD/CAD exchange rate target of CAD1.2500. We clearly see the risks as tilted towards further Canadian dollar gains over time, perhaps to the lower end of a CAD1.2000-1.2500 range. We will provide more precise guidance on our Canadian dollar outlook at our next full forecast update, scheduled for publication in late June.



Source: Bloomberg Finance L.P. and Wells Fargo Economics



Source: Bloomberg Finance L.P. and Wells Fargo Economics

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