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International Commentary — October 27, 2021

Bank of Canada Delivers a Hawkish Double-Dose

Summary

- Today's Bank of Canada (BoC) monetary policy announcement was much more hawkish than expected. The BoC ended its quantitative easing program with immediate effect, and also signaled that policy interest rates could start rising earlier than previously expected.
- Given the central bank's signals, we also expect an earlier lift-off for Bank of Canada rate hikes than previously. **We now forecast an initial 25 bps rate increase in April 2022, followed by another 25 bps in July 2022 and again in October 2022.**
- Our forecast for monetary tightening is more gradual than what is currently priced in by market participants. Still, given the overall backdrop, including steady growth, a steady series of rate hikes, and elevated commodity prices, we remain comfortable with our forecast of moderate Canadian dollar appreciation over time. We forecast a USD/CAD exchange rate of CAD1.1800 by early 2023.

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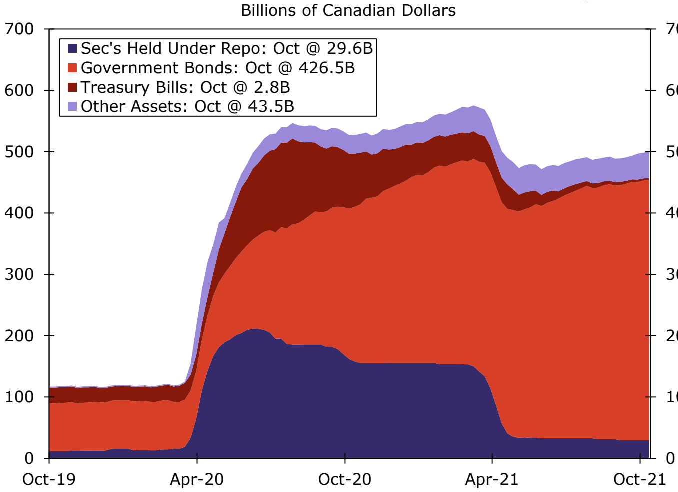
Bank of Canada Ends Quantitative Easing, Readies for Rate Hikes

Today's Bank of Canada (BoC) monetary policy announcement was much more hawkish than expected. The central bank held its overnight rate at 0.25% as expected, although that was where the calm ended and the excitement began. In what was at least a partial surprise to market participants, **the BoC ended its quantitative easing program, saying it would move to a reinvestment phase in early November and that it plans to keep its bond holdings broadly steady.** The BoC had previously been purchasing Canadian government bonds at a pace of approximately C$2 billion per week. In another surprise, the central bank also hinted that it could raise interest rates earlier than previously expected. That clue came from the central bank's assessment of when it believes the spare capacity in the economy will be absorbed, or when the negative output gap will be eliminated. **The BoC's updated economic projections now anticipates that negative output gap being eliminated as early as Q2-2022,** compared to its previous projections which saw the output gap being eliminated in the second half of next year. Financial markets reacted strongly to the BoC announcement, with the Canadian dollar the strongest G10 currency versus the greenback today, and Canadian two-year government bond yields up 19 bps to 1.06%.

Selected Bank of Canada Asset Holdings

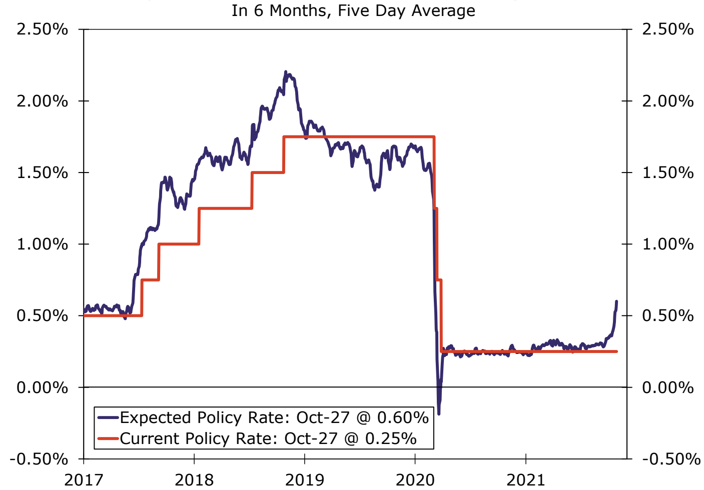
Billions of Canadian Dollars



Source: Bloomberg LP and Wells Fargo Securities

Expected Bank of Canada Policy Rate

In 6 Months, Five Day Average



Source: Bloomberg LP and Wells Fargo Securities

Supply Disruptions in Focus Once Again

The supply disruptions that have been so evident in other countries around the world were also a factor in today's Bank of Canada monetary policy announcement. The central bank's assessment that the output gap could close earlier than previously anticipated comes even as it lowered its outlook for GDP growth. The BoC now sees GDP growth of 5.1% for 2021 (compared to 6.0% previously), while it also lowered its GDP growth forecast for 2022 to 4.3% (from 4.6% previously). With respect to inflation, the BoC forecasts a CPI increase of 3.4% for both 2021 and 2022, before slowing to 2.3% in 2023. A key reason for the earlier elimination of the negative output gap even as growth forecasts were lowered is the central bank's assessment that supply disruptions are weighing on the economy's productive capacity. The BoC cited obstacles such as semiconductor shortages and transportation challenges that have caused prices to rise and in some cases, activity to fall. The central bank expects these supply disruptions to peak in Q4 of this year, before gradually dissipating over 2022.

We expect relatively steady growth in the coming quarters which, in the context of the economy's slower speed limit, we now believe will likely **encourage earlier and fastening monetary tightening from the Bank of Canada. We expect an initial 25 bp rate hike at the April 2022 meeting, followed by another 25 bp hike in July 2022 and a further 25 bp hike in October of next year.** With these moves, we forecast the Bank of Canada's policy interest rate to end 2022 at 1.00%—a slower pace of tightening than currently priced in by market participants. Nonetheless, we believe the overall backdrop, including steady growth, a steady series of rate hikes, and elevated commodity prices, remains relatively constructive for the Canadian dollar. As a result, we remain comfortable with our forecast of moderate Canadian dollar appreciation over time, targeting a USD/CAD exchange rate of CAD1.1800 by early 2023.

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