June 15, 2022

Forceful BoC surprises with 100 bp hike

- Today's 100 bp hike topped widespread expectations for a 75 bp increase
- BoC front-loading the path to higher rates amid excess demand, high inflation and rising inflation expectations
- "Interest rates will need to rise further"; we see 3.25% policy rate by October

The BoC was widely expected to accelerate the pace of its tightening cycle but today's 100 bp hike was larger than the 75 bp increase analysts predicted. Such a move wasn't out of the question, though, with our interest rate strategists putting ~25% odds on a 100 bp hike. Economists (including ourselves) aren't likely to argue with the merits of today's decision. Data flow over the past month including another upside surprise on inflation, a worrying increase in inflation expectations, a further decline in the already record-low unemployment rate, and accelerating wage growth all suggest monetary policy needs to get away from stimulative territory as soon as possible. Indeed, those were the factors the BoC said motivated its decision to "front-load" the path to higher interest rates. At 2.50% the overnight rate is now in the middle of the 2-3% neutral range that is assumed to neither stimulate nor meaningfully slow the economy. Tougher medicine will be needed to get inflation under control and we look for the policy rate to rise to a restrictive 3.25% by October. The BoC's limited guidance seems to align with that view, saying a front-loaded tightening cycle argues for getting the policy rate "quickly to the top end or slightly above the neutral range."

The BoC revised its GDP growth forecasts significantly lower, trimming ¾ ppts from its 2022 projection and 1 ½ ppts from 2023. It attributed the downward revisions to higher inflation, tighter financial conditions, ongoing supply chain disruptions and weaker foreign demand (global GDP growth seen slowing to 2% next year with the US at 1.1%). Even with those revisions the BoC's 2023 GDP forecast is a full percentage point above our own recently updated projection. The BoC thinks the easing of temporary supply disruptions (assumed to be worth 2.5% of GDP currently) will support growth over the next two years, allowing for decent GDP gains while still absorbing excess demand (currently thought to be around 1% of GDP). That allows inflation to ease from 8% in the near-term to 3% by the end of next year and 2% in 2024. But the BoC admitted the path to such a soft landing has narrowed. Indeed, we think the BoC's forecasts are optimistic, with growth likely needing to slow more materially next year if domestic inflationary pressure is to be brought under control in any reasonable timeframe. In our view, a soft landing will be difficult to achieve and our forecast now assumes a mild recession next year.

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