ECONOMIC VIEWPOINT

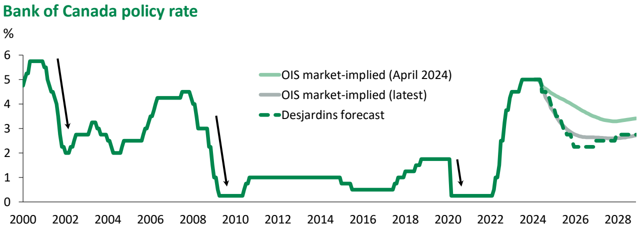
Bank of Canada:

To Neutral and (a Bit) Beyond

By Royce Mendes, Managing Director and Head of Macro Strategy

What was once labeled an overly dovish forecast has now largely become consensus. The market-implied path currently sees the Bank of Canada's policy rate falling to 3.15% by the middle of next year, slightly below our long-held forecast that the central bank would need to significantly cut rates ahead of the mortgage renewal wall (graph 1). This move has come faster than we predicted, with 2-year yields reaching our third-quarter target two months early. That said, we still believe there's more room to run, and the next few months will be critical to seeing the market fully incorporate our forecast for the Bank of Canada to cut rates below its neutral rate estimate.

Graph 1
Market-Implied Pricing Has Converged to Our Long-Standing View on Rate Cuts
Bank of Canada policy rate



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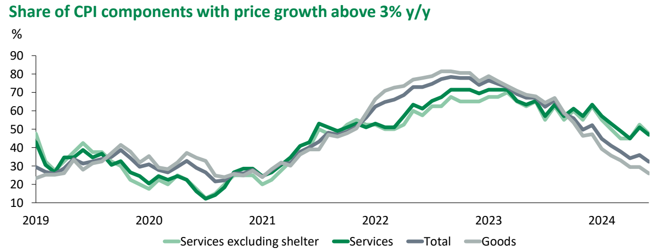
Now that policymakers seemingly agree with our view that the battle against inflation has largely been won, Canadian central bankers are no longer preoccupied with driving price pressures lower. The Bank of Canada dropped any and all reference to the suite of inflation indicators previously cited as guiding rate decisions. Instead, officials are now focused on balancing two opposing forces: weakness in the economy and the lingering inflation in specific sectors such as shelter and other services (graph 2). Also absent was any guidance about rate cuts being gradual, which opens the door for consistent moves at upcoming fixed announcement dates.

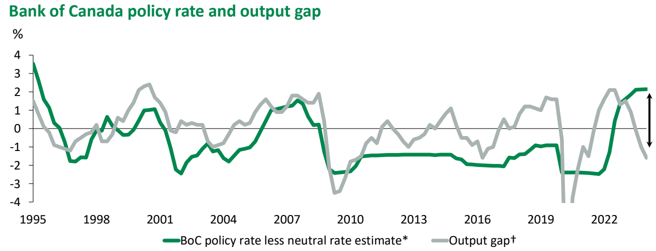
Graph 2
The Share of CPI Components with Inflation above 3% Is Still Elevated for Services
Share of CPI components with price growth above 3% y/y



Bank of Canada and Statistics Canada

Given the amount of economic slack already evident, central bankers will likely need to take rates below neutral (graph 3). This comes as no surprise to anyone who's followed our extensive work on mortgage renewals. There's no silver bullet that can erase upcoming mortgage payment shocks, but rate cuts can work to make the situation more manageable for

Graph 3
Monetary Policy Was Very Restrictive in Q1 When Compared to the Degree of Economic Slack
Bank of Canada policy rate and output gap

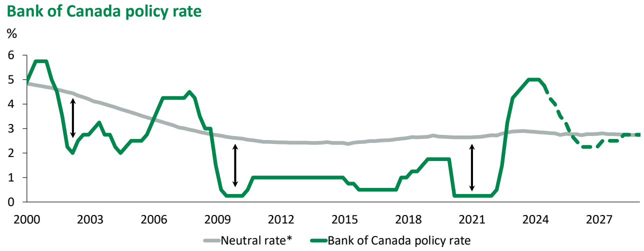


*Desjardins estimate of Canadian neutral rate; †Extended multivariate filter
Low of -11.6% reached in Q2 2020
Bank of Canada and Desjardins Capital Markets

most households. As a result, we believe the decline in rates and steepening of the yield curve have further to go.

However, since we're not ready to pencil in a recession just yet, the extent of the moves will be limited by the policy rate falling just 50 basis points (bps) below our neutral rate estimate (graph 4). During past recessions, the policy rate has tended to fall 250 to 300 bps below neutral. Because we still see a path for the Bank of Canada to achieve a soft landing, we don't view such a dramatic decline in rates as necessary.

Graph 4
Desjardins's Bank of Canada Forecast Sees the Policy Rate Falling below the Neutral Rate Estimate



*Desjardins estimate of Canadian neutral rate
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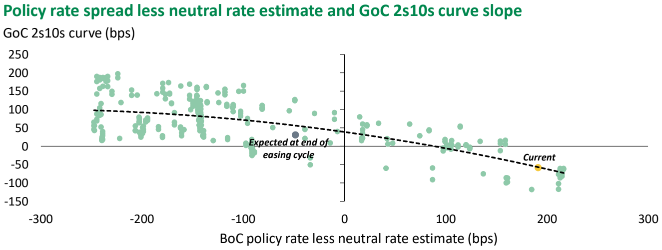
The extent to which the central bank cuts rates relative to the neutral rate estimate has important implications for the shape of the yield curve (graph 5). The neutral rate provides an anchor for longer-term interest rates. So moving too far below means curve steepening will be limited relative to past cutting cycles (graph 6).

Graph 5
If the BoC Cuts 50 bps below Neutral, the Yield Curve Should Steepen



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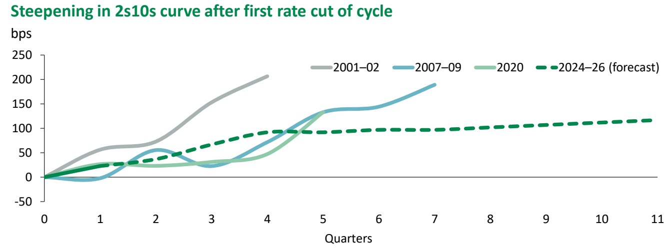
Graph 6
Curve Steepening Should Be Less Pronounced This Cycle



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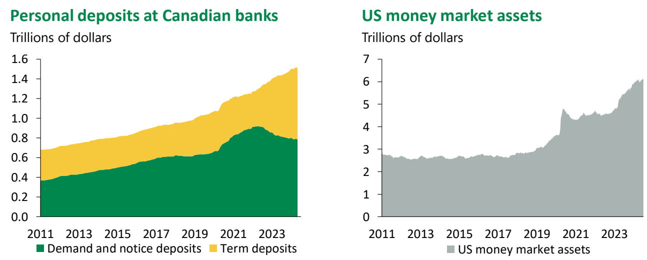
Also containing the steepening trend globally will be cash flowing from term deposits and money market funds into the longer end (graph 7). Central bank rate cuts will work to make the yields on short-term debt instruments less attractive both in absolute terms and relative to securities with longer tenors. As cash migrates further out the yield curve, term premiums should remain contained.

Graph 7
Cash-Like Instruments Need to Find a New Home



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All that being said, the magnitude of this easing cycle could be greater than we currently envisage if a domestic or global recession hits. Should a downturn take hold and begin to snowball, central bankers will need to cut rates more forcefully than what's accounted for in our base case forecast. That would lead to lower rates across the curve and also a steeper curve as the policy rate falls further below neutral. For now, we believe central bankers are on the right track and can narrowly avoid a recession, meaning our base case forecast remains the most likely outcome with a recession just a downside risk.