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BoC ends QE, advances rate hike timing

- BoC switching to reinvestment phase of QE
- Economic slack to be absorbed around mid-2022
- Guidance puts April rate hike on the table

Strong inflation data and growing concerns about the persistence of price pressures intensified focus on today's Bank of Canada meeting. The central bank responded with a more hawkish message than we anticipated, bringing forward the expected timing of economic slack being absorbed (now in the middle quarters of 2022 compared with the second half of 2022 in July and September's statements) and clearly opening the door to a rate hike in April. The other key policy decision—ending QE by moving into the "reinvestment phase" of that program—was as expected and appropriate given progress in the economic recovery, but nonetheless likely added to the market's hawkish interpretation.

Our call has been for two rate hikes in the second half of 2022 (July and October) though risks were already tilting toward earlier liftoff. An April start to tightening looks increasingly likely as long as we see continued progress in the economic and labour market recovery over the next six months. Today's messaging doesn't go quite as far as the 100 bps of tightening by the end of next year markets were pricing in ahead of the meeting, though the move higher in bond yields and the Canadian dollar shows investors see some validation of that view. We'll release an updated interest rate forecast later next week.

The shift in timing for the economy reaching full capacity was despite the BoC downgrading its GDP growth forecasts for this year (5.1% vs. 6.0% in July) and next (4.3% vs. 4.6% in July). Those forecasts are now closely aligned with our projections. To square that with an earlier output gap closure, the bank narrowed its assessment of current slack and lowered its potential growth projections. While we agree that there is significant uncertainty surrounding the current degree of slack and pace of potential growth, the BoC massaging its forecasts is this way only adds to the perception that today's hawkish shift is more about inflation concerns than the growth outlook.

In that regard, inflation saw the most notable revisions in today's updated projections. CPI has surprised to the upside in recent months, and combined with firmer oil prices and more persistent price pressures (including supply bottlenecks) than previously expected, the bank revised its 2022 headline inflation forecast a full percentage point higher to 3.4%, matching its revised 2021 forecast. Such an extended period of above target inflation likely has the bank worried that higher inflation will become embedded in expectations and today's statement noted it is closely watching inflation expectations and labour cost growth. We've seen an increase in near-term inflation expectations but medium- term expectations remain fairly well anchored, and despite tight labour market conditions there are few signs that wage growth is accelerating sharply at this point. As long as that remains the case, we think the bank will raise rates gradually in 2022 and 2023.

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