December 7, 2022

BoC's hawkish(ish) 50 bp hike could be its last

- BoC hikes by 50 bps to 4.25%, bringing cumulative tightening to 400 bps this year
- Slightly hawkish surprise: consensus was split between 25 and 50 bps
- Soft tightening bias opens the door to a January pause

The BoC lifted its overnight rate by 50 bps to 4.25%, a stronger increase than the 25 bps we expected. Consensus was almost evenly split between a 25 and 50 bp hike though market pricing was leaning toward the former, so yields have increased and the Canadian dollar is a touch stronger in the wake of the decision. The policy statement wasn't as hawkish as the decision itself—in fact the BoC's updated forward guidance features a softer tightening bias than we expected. Rather than suggesting the "the policy interest rate will need to rise further," today's guidance is that "Governing Council will be considering whether the policy interest rate needs to rise further." That clearly opens the door to a pause as soon as the next meeting in January, and in our view frames that decision as between 0 and 25 bps.

There's plenty of data in the next seven weeks that will influence that January decision—two CPI reports, another month's GDP and jobs data, and the bank's quarterly BOS and CSCE surveys. We think today's larger-than-expected hike was due in part to strong labour market data since the October meeting. Indeed, the statement noted "Canada's labour market remains tight, with unemployment near historic lows." One jobs report isn't likely to change that story, but a soft December LFS would help build the case for a pause. And since the labour market is generally a lagging indicator, another muted increase in monthly GDP could also help push the BoC to the sidelines. The bank reiterated its view that growth will essentially stall in the coming quarters.

Today's statement made note of recent slowing in three-month measures of core inflation—a trend we've keyed in on, in addition to evidence suggesting inflationary pressure is becoming less broadly based. Two more months of CPI moving in that direction would likely be enough to keep the BoC on hold—we'd say those reports are likely to be the most influential for January's decision. But with ongoing emphasis on inflation expectations, relevant measures in the upcoming BOS and CSCE will also have to cooperate. Interestingly, the BoC made no mention of firming wage growth in recent Labour Force Surveys, perhaps because the separate payrolls survey calls that trend into question.

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The BoC is also likely to be watching changes in financial conditions over the next seven weeks. 5-year GoC bond yields were down 75 bps in the month leading to today's decision—an easing in financial conditions that may have caused some discomfort and motivated today's 50 bp hike. A further decline in yields could prompt push-back from the BoC, either through another hike in January or emphasis that rates will have to remain high for an extended period. We expect a challenging consumer backdrop and ongoing pullback in housing will see Canada's economy slip into recession in the first half of 2023. But with inflation remaining elevated, the BoC isn't likely to react as quickly to that slowdown as it has in recent cycles.