Market View
Economics and Strategy

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An increasingly contrarian take on the March BoC decision

By Taylor Schleich

Not even three weeks ago, a 25 bp Bank of Canada rate cut by March was fully priced, with some chance of an intermeeting move. Today, that's been whittled down to less than one-in-three odds. The repricing is attributable to a (temporary) tariff reprieve, firmer elements in the January CPI report and surprisingly strong jobs data. Naturally, these developments leave forecasts for a 25 bp cut next month on shakier footing but there are still some compelling reasons to expect a cut.

Let's start with inflation and consider how the BoC was thinking about its key mandate variable just three weeks ago. Per the January MPR:

> *"The Bank judges that underlying inflation is close to 2%. There are no signs that inflationary pressures are broad-based."*

At the time, the tax holiday was in place and its suppression of headline inflation was known as the BoC had the December report in hand on decision day. Yet there were no warnings about upward underlying pressures and the Bank even implied that its 'preferred' inflation indicators (which were/are hotter) were sending a false signal. Instead, the MPR focused on inflation breadth on a 12-month basis. Viewing inflation through this lens, January's report doesn't change much.

On the labour market, it's true the Canadian economy has put together a string of strong jobs reports but that was also true on January 29th and yet the BoC was not convinced:

> *"According to multiple indicators, the job market remained soft… Members agreed they needed to see [job gains outpacing labour force growth] over a longer period to be convinced that the labour market was strengthening".*

Does January's reported 76K net new jobs 'convince' them? We're not so sure, especially since other indicators are not singing a similar tune. Hiring intentions remain below historical averages, the job vacancy rate is at a seven-year low and other employment data (SEPH) is signaling the *opposite* of what the LFS is (though these data are lagged).

To be clear, we don't think recent inflation/jobs data *strengthen* the case to cut but we'd argue they aren't as much of a *barrier* as markets are implying. That's because economic slack remains in Canada, and it may grow further as geopolitical uncertainty weighs. Next week's GDP report then may be the more important data point guiding the decision.

One way to visualize slack is via the output gap which hovers around 1% of GDP. This isn't immaterial. To absorb this, above-potential growth for some time is *needed*. Q4 GDP growth is tracking *around* potential, but activity may slow in 2025 amidst abundant uncertainty. (In theory a policy rate residing in the upper half of the neutral range isn't supportive of much faster growth either). This is already becoming clear in consensus forecasts which have been trimmed in the past month, including by us, our 2025 growth outlook on the more pessimistic side.

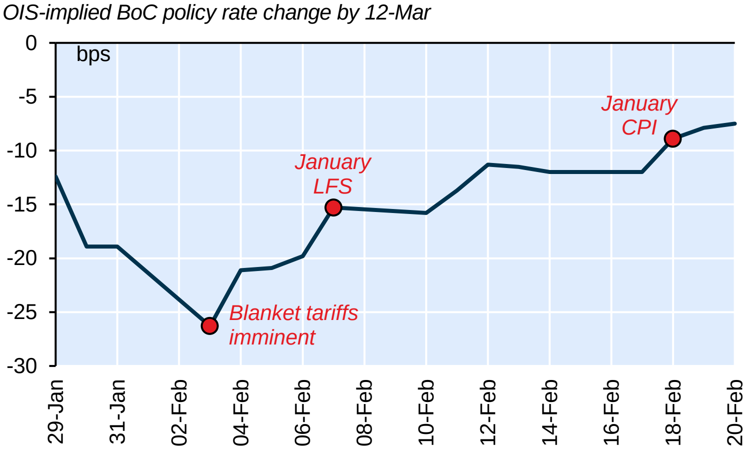
When it comes to tariffs, some may doubt the credibility of Trump's threats and there's no doubt a scenario exists in which the President's rhetoric proves to be more bark than bite. Still, the threats alone are impactful. Just ask Canadian businesses and you'll see behaviour already being altered. The BoC's Q4 BOS noted some firms are holding back investment due to US trade uncertainty. A detailed CFIB survey likewise found many SMEs were already taking action. While the most common response to trade uncertainty was to seek new suppliers, at least a fifth of firms said they were delaying or cancelling expansion plans and/or reducing their workforce (or at least considering it).

The impact on households can't be ignored either. Earlier this week, CREA noted a drop in resale housing activity in January and suggested it reflected "uncertainty over the potential for a trade war with the US".

Simply put, there remains a case for an 'insurance cut', allowing policymakers to cushion the blow of tariff uncertainty and potentially, tariffs themselves. We could get behind that. (Ironically, steel and aluminium tariffs go in effect on decision day. By then, we should have clarity on border-related tariffs, but 1-Apr is another key milestone). At the same time, the BoC doesn't have blinders on. If more evidence surfaces that growth *is* accelerating, labour markets *are* firming and inflation *is* picking up, the Bank's bias/tone will have to change. But for now, the BoC leans dovish, likely to err on the side of accommodation under uncertainty. We're not convinced recent data have completely upended that, especially since uncertainty may snuff out any nascent economic recovery. Perhaps then, implied odds of a March cut should be higher, recent underperformance of the Canada curve overdone.

Chart 1: March rate cut odds pared to roughly one-in-three

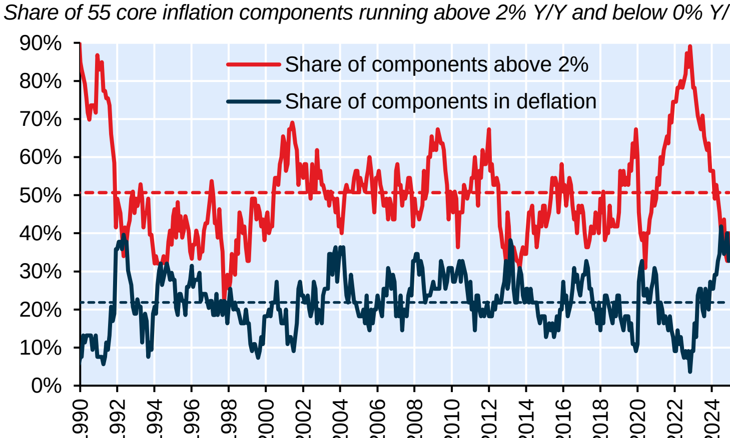
OIS-implied BoC policy rate change by 12-Mar



Source: NBC, BBG

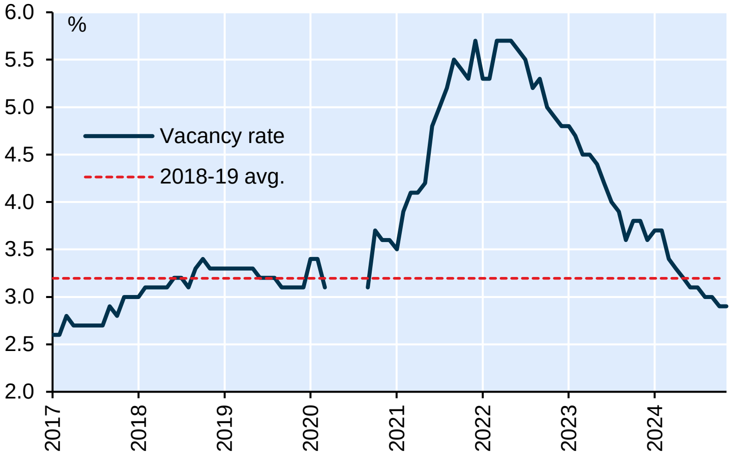
Chart 2: Despite core pressures, inflation *breadth* contained

Share of 55 core inflation components running above 2% Y/Y and below 0% Y/Y



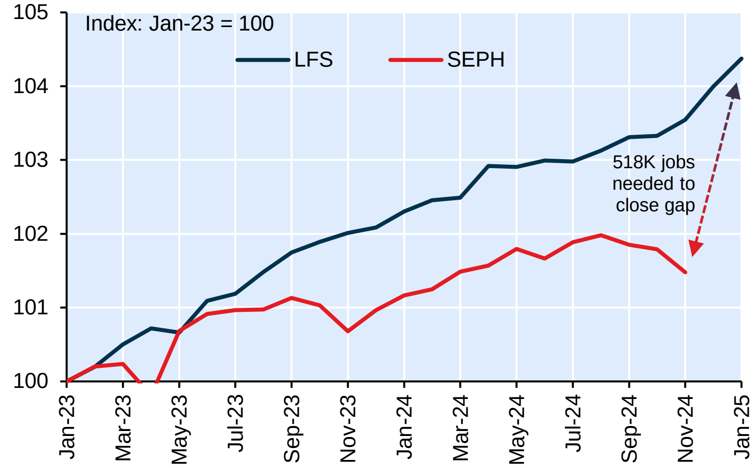
Source: NBC, StatCan | Note: Dotted lines refer to historical average (since 1990)

Chart 3: Despite LFS strength, labour demand appears soft…
Canada job vacancy rate



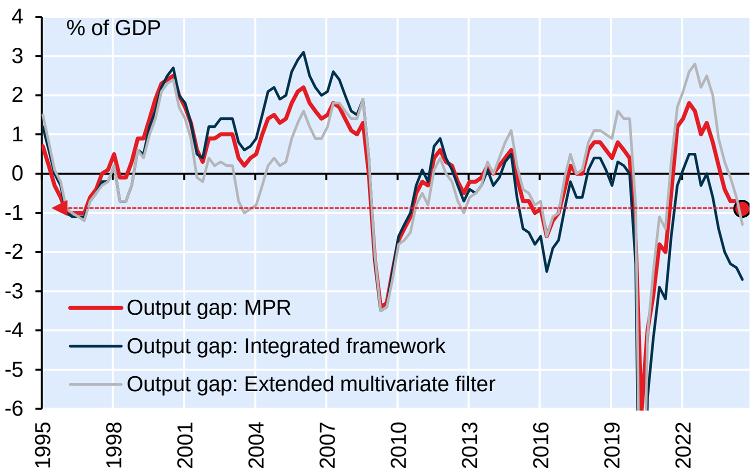
Source: NBC, StatCan

Chart 4: …which is more consistent with weaker SEPH data
Canadian employment relative to Jan-23: SEPH vs. LFS



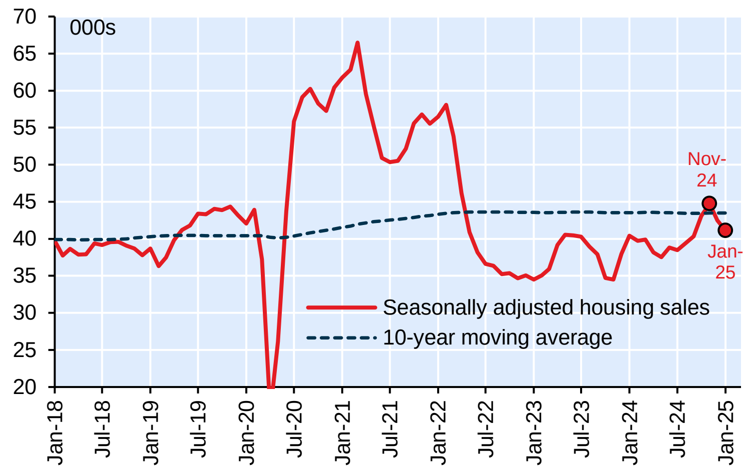
Source: NBC, StatCan | Note: Latest LFS data = Jan-25, latest SEPH data = Nov-24

Chart 5: There's still material economic slack to absorb
Bank of Canada estimates of Canadian output gap (actual GDP – potential GDP)



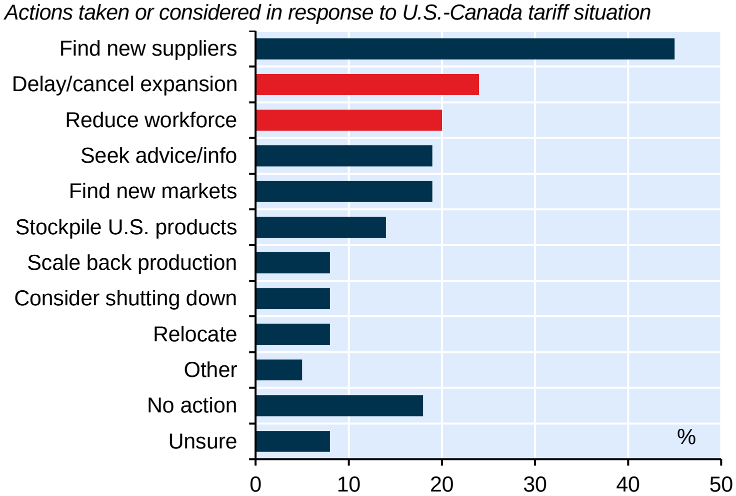
Source: NBC, BoC | Note: Latest estimate is for Q3:2024.

Chart 6: Uncertainty impact even evident in housing market
Seasonally adjusted housing sales vs. 10-year moving average



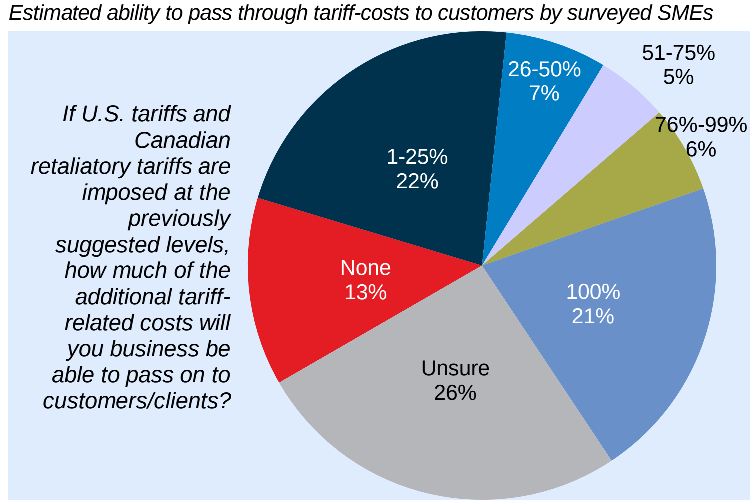
Source: NBC, CREA

Chart 7: Businesses already taking or considering action
Actions taken or considered in response to U.S.-Canada tariff situation



Source: CFIB | Note: Specific question is: "Which of the following actions is your business taking or considering to deal with the U.S.-Canada tariff situation?"

Chart 8: Just ~1/4 of firms can fully pass through tariff costs
Estimated ability to pass through tariff-costs to customers by surveyed SMEs



Source: CFIB

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