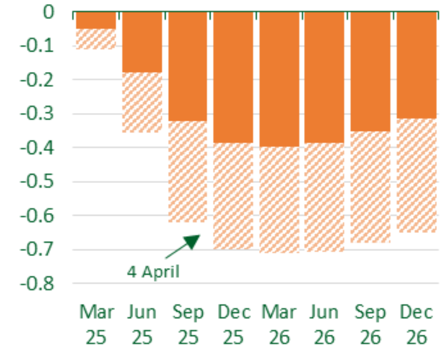
WATT STRATEGIC ECONOMIC ADVISORS

14 APRIL 2025

Musing on the Bank of Canada — April 2025

Expectations for the Bank of Canada for this week have been in flux. Not long ago, it seemed almost a certainty that the BoC would reduce its policy rate by 25bp from 2.75% to 2.50% on 16 April. It is much less certain now.

Bank of Canada CORRA futures
(bp implied futures rate - CORRA)



Source: Macrobond Toronto Stock Exchange

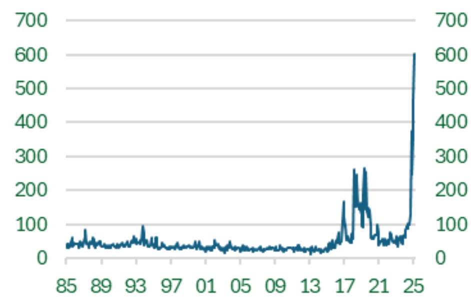
Market pricing

CORRA futures currently place the probability of a rate cut next week at a smidge over 34%. Hence, there is still the solid possibility of a move, but the market has come down on the side of the Bank skipping another meeting and remaining in wait-and-see mode. A week ago, the probability of a cut was much roughly a 50-50 proposition.

More interesting of late has been the repricing of BoC rate cuts toward year end.

The December 2025 3-month CORRA futures contract had been trading around an implied rate of 2.1% in early April. It currently implies a rate of between 2.3% and 2.4%. From a current policy rate of 2.75%, the implication is that market continues to price Bank of Canada rate cuts, but the focus is on two rather than three cuts and that there seems to be less urgency to cut right away. That the Bank of Canada has already lowered the policy rate by 275bp and that that stimulus is still working its way into the economy provides a bit of leeway.

Trade policy uncertainty index: United States
(index)



Source: Macrobnd, Caldara, Iacoviollo, Molligo, Prestipino, and Raffo

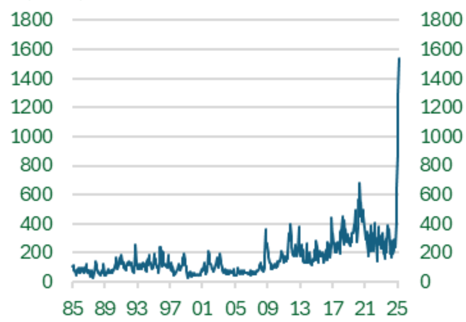
Rate cut on 16 April: Yea or Nay

We think that the Bank will remain on hold once again, though the Governing Council is expected to have a lively debate over whether to leave the policy rate unchanged at 2.75% or cut by 25bp. We would be surprised, but not be shocked by a rate cut, as there are credible arguments on both sides.

A significant factor in favour of a rate cut is the potential magnitude of the impact of US trade policy uncertainty (or irrationality) on the economic outlook — for the US, the global economy, and regarding the potential direct and indirect effects on Canada. Recession risks in Canada and the US have increased materially in recent weeks.

The clearest reflection of the spike in uncertainty comes via the US trade policy uncertainty index which has soared to record levels. Don't worry if you hadn't heard of this index until recently, neither had most analysts. There was some attention paid to this indicator amid the tariff shenanigans during the Trump45 administration, but it is front and centre now. The cross-border effects of US trade policy uncertainty are reflected in the spike in the Canadian economic policy uncertainty index to record levels.

Econonmic policy uncertainty: Canada
(Index)



Source: Macrobnd, Baker, Bloom, and Davis

The instability and volatility in US policymaking was evident last week. Trump47 had imposed 145% tariffs on imports from China. Then he exempted imports of electronic products such as smart phones, iPads, semiconductors and other electronic devices. Then Trump47 said that there were no exemptions and that tariffs on semiconductors and electronics were just moving to a different tariff "bucket," with US Commerce Secretary Howard Lutnick chiming in that tariffs on semiconductors and electronics were coming in a month or two. Basically, no one knows what is going on or what will happen, and that seems to include Trump47.

David G Watt

Founder and Principal
david.g.watt@outlook.com

No matter, the market perceived that Trump47 stood down amid worries about the US Treasury market as the 30-year bond soared toward 5% mid-week, raising questions about the functioning of the market. ***Let's just hope Trump47 declares victory and retreats.***

The most immediate impact of the heightened uncertainty from an economic perspective is the sharp deterioration in business and consumer sentiment in both the US and Canada.

Regarding business confidence domestically, the Bank of Canada's Q1 2025 Business Outlook Survey (BOS) showed that sentiment on current business conditions plunged in March, confirming earlier data from the Canadian Federation of Independent Businesses (CFIB) that the business confidence outlook plunged over 3-month and 12-month horizons. The CFIB also showed the sudden shift in small firms' expected performance over the next 12 months from moderate optimism to abject terror.

From the consumer perspective, sentiment has deteriorated to levels last observed during the pandemic. Given that consumers were generally in a foul mood anyway, the heightened economic uncertainty is an added source of worry.

These developments could tilt the balance toward a rate cut on 16 April to help cushion a vulnerable economy from the shock of US policy volatility, which could thwart the positive impact of past rate cuts.

That said, it is nearly impossible to assign realistic probabilities to economic scenarios arising from uncertainties linked to US trade policy per se, although clearly the uncertainty is having impacts on supply chains and investment decisions. Hence, it seems that additional monetary stimulus will eventually be required, but it is not evident that moving right away is the best course of action. It thus makes sense for the Bank of Canada to remain on the sidelines until there is more clarity.

The evolution of labour market conditions and the risks to the inflation outlook will be key to Bank of Canada deliberations.

Labour market conditions

On the labour market, the risks are tilted to the downside and will remain so as outcomes depend on the mercurial and volatile temperament of Trump47. That said, despite clear reasons to be concerned, the job market news has not been all bad.

Starting with the bad news, a key reason to be worried is that the increase in economic uncertainty comes at a time when the Canadian economy had little positive momentum and as the rate of growth of total labour demand had been close to zero since early 2024. In addition, the Bank of Canada's recent BOS showed that firms' outlook for employment growth has declined to its lowest level in a decade to a reading consistent with periods of heightened recession risk. Hence, the concern that US tariff uncertainty could drag the economy into recession.

Also, according to the BoC's CSCE consumers have become extremely anxious about potentially losing their jobs, potentially even more acutely given tariff related layoffs in the auto sector — Stellantis in Windsor, and CAMI in Ingersoll. Though the layoffs are said to be temporary, they are adding to uncertainty about the outlook for the auto and auto parts industries, and employment.

David G Watt

Founder and Principal
david.g.watt@outlook.com

These developments tilt toward a rate cut.

However, other indicators suggest that the labour market remains in fairly good shape — *at the present time*.

For example, the contributions to the slowdown in total labour demand demonstrate that payroll growth has slowed, but that it has remained positive, while the number of vacancies has declined. This indicates that firms have pulled back on hiring intentions but have not shifted toward reducing payrolls, despite the temporary layoffs in the auto sector.

In fact, this was the "soft landing" scenario outlined by the Bank of Canada in H2 2022, where more of the burden of a weaker job market was anticipated to fall on elevated job vacancies. Meanwhile, there has not been a significant rise in the number of firms anticipating lower future employment levels over the next year. The available evidence therefore suggests that firms are comfortable with current staffing levels. Of course this could change quickly, should activity levels fall. The challenge for policymakers is that while soft data, such as sentiment surveys, have worsened sharply, hard data has been more resilient, and there is no direct read across from soft data to hard data outcomes.

Even on the consumer side, the news is not all bad. For example, even though the BoC's CSCE a spike in concerns about losing a job, the survey also showed that consumers still seemed somewhat optimistic about voluntarily leaving a job and finding another. However, given that full-time employment has declined by 81.7K over the past two months, consumers might be turning more cautious about labour market conditions.

Nonetheless, these developments tilt toward the BoC remaining patient regarding additional rate cuts awaiting more news on the state of the labour market.

Inflation risks

The tariff-related uncertainty is putting upward pressure on inflation and inflation expectations. For example, the share of firms reporting upward pressure on input costs has increased toward pandemic levels. Not helping the situation, firms are also expressing elevated concerns about supply chain disruptions and potential challenges about inventories of inputs to their production processes. Just a few too many reminders of the inflation challenges of the pandemic.

Not surprisingly, firms are also reporting higher levels of expected inflation over the next year. The CFIB survey showed that 60% of firms look for inflation to be above 3% over the next 12 months, up from around 40% just a couple of months ago, and the Bank of Canada's monthly Business Leaders' Pulse (BLP) survey showed an uptick in near-term inflation expectations. Uncomfortably, these developments on inflation expectations have occurred as short-term momentum in core inflation has been turning upward.

After having been under downward pressure for much of the past two years, inflation pressures look to be stabilizing or starting to trend upward once again and are facing off against economic conditions that are placing downward pressure on inflation. In

David G Watt

Founder and Principal
david.g.watt@outlook.com

particular, the slowdown in economic growth has resulted in the economy now being in excess supply and facing fewer capacity constraints.

It is not clear which effect will dominate price trends going forward — upward pressures on inflation from tariffs, trade policy uncertainty and supply chain concerns, or economic slack and uncertainty over the outlook. However, it does seem clear that the process of reducing inflation all the way back to 2% has been interrupted, if only temporarily, and the Bank thus has some concerns about expectations of higher rates of inflation becoming entrenched.

Given that the Bank does not have the tools to deal with tariff and trade-related uncertainty, and that inflation risks are rising once again, it makes sense for the Bank to remain patient and await clarity on the direction of travel for inflation.

As an aside, the situation facing the Bank of Canada is not seen as challenging as that facing the Federal Reserve given that the University of Michigan survey has demonstrated that inflation expectations have spiked at the 1-year and 5-year horizons in the US.

David G Watt

Founder and Principal
david.g.watt@outlook.com

WATT STRATEGIC ECONOMIC ADVISORS

14 APRIL 2025

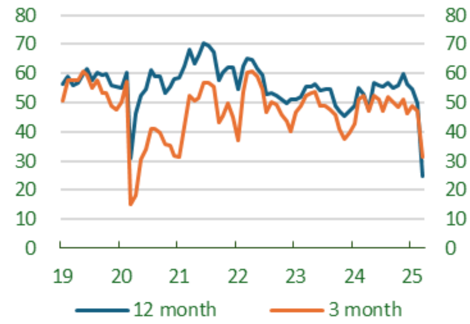
Business sentiment: Balance of opinion

(% firms)

Source: Macrobnd, Bank of Canada

SME sentiment crushed by tariff uncertainty

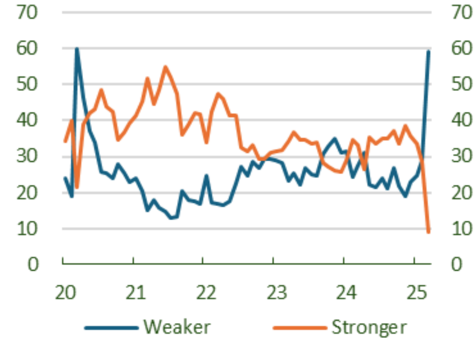
(Index)



Source: Macrobond, CFIB

SMEs expected performance: From somewhat optimistic to abject terror

(% of firms)



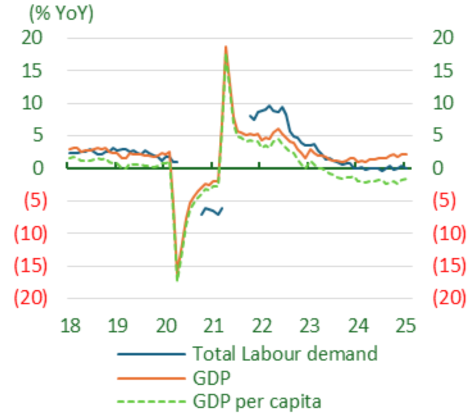
Source: Macrobond, CFIB

Consumer confidence and unemployment

Source: Macrobond, Ipsos, Statistics Canada

Total labour demand and GDP

(% YoY)



Source: Macrobond, Statistics Canada

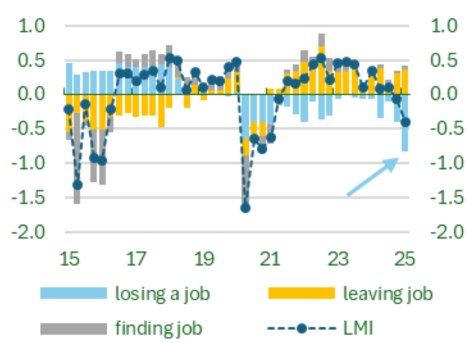
Future employment levels

(% firms)

Source: Macrobond, Bank of Canada

Consumers more worried about losing job

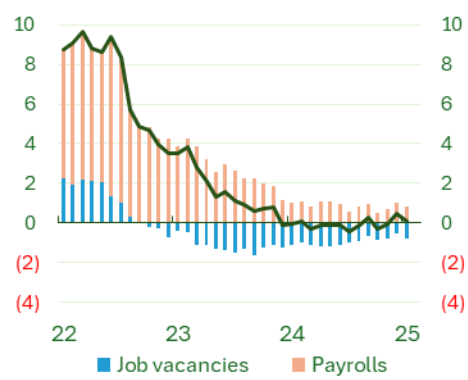
(contributions to labour market index)



Source: Macrobnd, Bank of Canada

Total labour demand

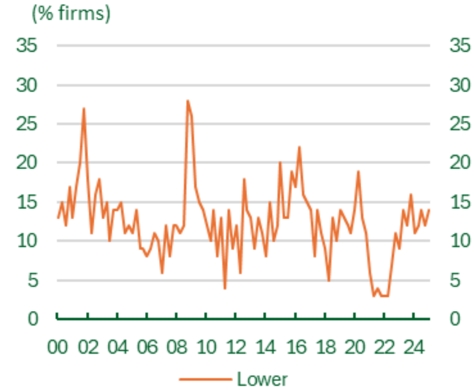
(ppt contribution to YoY % change)



Source: Macrobond, Statistics Canada

Future employment levels

(% firms)



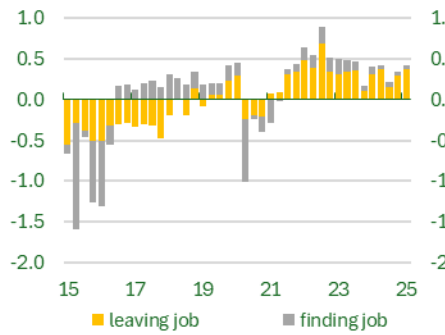
Source: Macrobond, Bank of Canada

David G Watt

Founder and Principal
david.g.watt@outlook.com

Worried about losing job, but not bearish on labour market

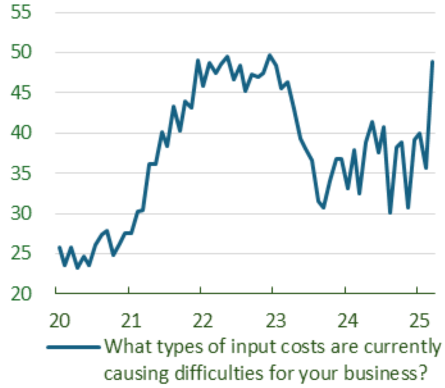
(contributions to labour market index)



Source: Macrobnd, Bank of Canada

Product input costs arise anew

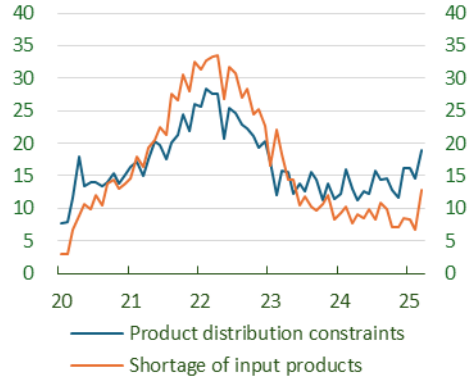
(% of firms)



Source: Macrobond, CFIB

Supply chain issues in play again

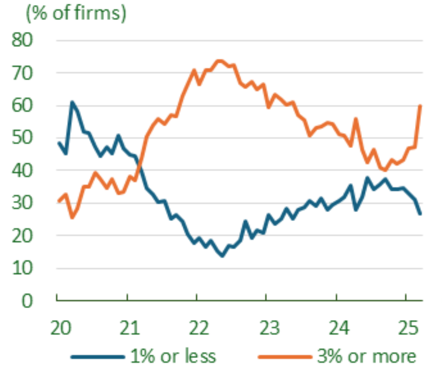
(% of firms)



Source: Macrobond, CFIB

How much prices are expected to change over next 12 months

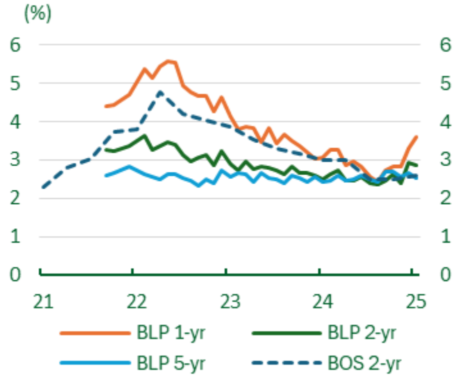
(% of firms)



Source: Macrobond, CFIB

Inflation expectations: BOS and Business Leaders' Pulse (BLP)

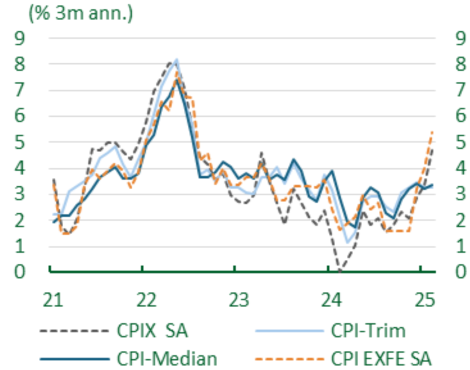
(%)



Source: Macrobnd, Bank of Canada

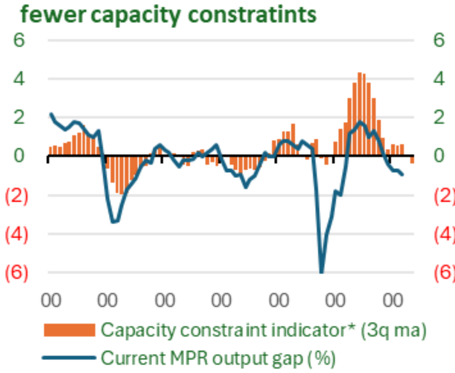
Short-term momentum in core inflation measures

(% 3m ann.)



Source: Macrobond, Statistics Canada, Bank of Canada

Economy in excess supply: Firms face fewer capacity constratints

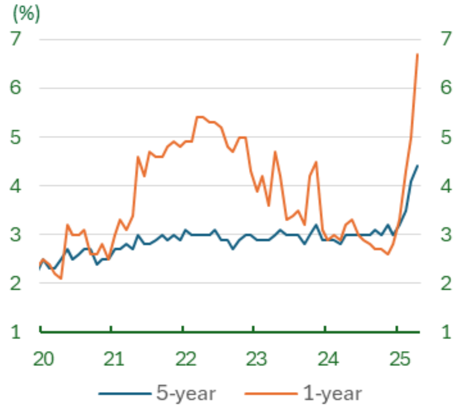


** Business Outlook Survey: At least some capacity constraints, standardized*

Source: Macrobond, Bank of Canada

US expected change in inflation rate

(%)



Source: Macrobond, University of Michigan

David G Watt

Founder and Principal
david.g.watt@outlook.com