Fed/BoC Policy Divergence May Extend Despite CAD Strength

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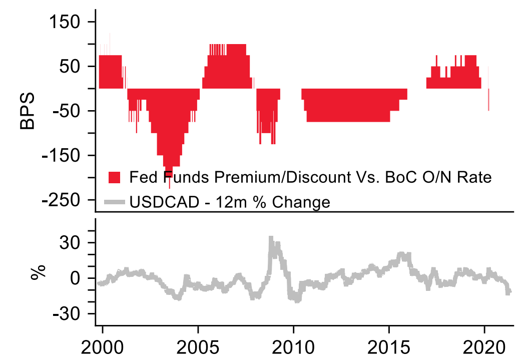
The Bank of Canada's (BoC) slightly more hawkish policy stance announced last week—reducing asset purchases and projecting that inflation will be sustainably on target in H2-2022, paving the way for rate hikes then—stands in starker contrast to the Fed following the FOMC's decision to stand pat yesterday and give very little away in terms of when it might consider dialing back its own asset purchases. Markets are assuming that economic developments, trillions in fiscal stimulus and with some 235mn vaccine doses now administered in the US that the Fed may take the step of indicating asset purchases are under consideration in June but it is still likely to be some time—no sooner than late this year or early in 2022—before the Fed actually trims bond buys. In the meantime, it is possible, if not likely, that the BoC dials back its QE programme further still.

Fed-BoC Policy Rate Differential



Source: Macrobond, Scotiabank FICC Strategy

It is not unusual for the Fed and BoC to diverge somewhat on the matter of monetary policy, although the long run trend in key policy rates is generally similar, which is not too surprising, given how closely aligned the US and Canadian economies are. It is much less common, in fact, for policy settings to hold at similar levels for extended periods of time—at least over the past 20 years or so. Central bankers do what is right for their own economy's circumstances, regardless of what even close neighbours are doing. The BoC has shown a fair degree of independence in recent years relative to the Fed—precisely because domestic conditions warranted a different policy approach; short term rates were higher in Canada by a significant margin in the early 2000s (partly to support the very weak CAD at the time) and the BoC started to lift interest rates well ahead of the Fed in 2010 as the worst of the financial crisis passed—it also lowered rates independently in 2015 amid the sharp decline in energy prices.

In 2010, Governor Carney—whose deputy at the time was current Governor Macklem—made the point that policy makers would adjust settings to domestic circumstances but there were "limits to the divergence that there can be between Canada and the US". In effect, this means that tighter BoC policy would not diverge too far from the Fed if, for example, the US economy weakened as there would be economic spillovers into Canada. Equally, a too aggressive policy in Canada would drive the CAD higher and crimp economic growth at home, forcing a reversal. Practically, that balancing act has meant the benchmark policy spread between the Fed and the BoC has rarely moved beyond +/- 100bps in recent years. It should be noted also that even in the 2010/11 period, when the BoC was running a persistently tighter monetary policy than the Fed, USDCAD tended to appreciate.

USDCAD has reached our 2021 year-end target (1.23) and we have recently upgraded our BoC call (to factor in two 25bps hikes in H2 2022); we had signaled the risk of a downside "overshoot" in USDCAD towards the 1.20 zone but instead of a temporary dip to that level, we may have to factor in the risk of the CAD trading stronger for longer. We do not think CAD gains are an impediment to further BoC policy tightening at this point. The CAD is not obviously misaligned. In fact, it still looks modestly undervalued relative to fundamentals, in our opinion and while the CAD's near 20% rally from last March's low is impressive, a better marker is perhaps the CAD's average level in the year prior to the pandemic outbreak; from that point, CAD gains are a more measured 6%. Nor can policy makers object to "speculative" forces driving the CAD beyond justifiable levels; CFTC data suggest bullish bets on the CAD are relatively weakly populated right now (net longs of 13k contracts currently compared with a net CAD long of 76k contracts the last time the USDCAD neared 1.20 in 2017).