MACKENZIE Investments

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Bank of Canada: One hike to rule them all

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Following the Bank of Canada's pause in January, we had argued that the Bank might not be done hiking. At that time, global growth was picking up, and we felt the Bank's inflation projections were too optimistic. The Bank justified its January pause three ways: (1) policy was restrictive enough for inflation to ease by itself; (2) the job market had peaked; and (3) residential real estate was at risk of a nonlinear meltdown. Four months later, inflation is stuck around a 4% trend, the job market is as tight as ever and housing has not only stabilized but rebounded. The Bank of Canada had little choice but to resume its monetary tightening. It decided to rip the band-aid off in June with a 25bps hike.

The Bank's decision to pause had a major reflationary impact on the Canadian economy. The Bank didn't intend its January pause to be an absolute one. In its January statement, the Bank advised that "if economic developments evolve broadly in line with the MPR outlook, Governing Council expects to hold the policy rate at its current level [but] is prepared to increase the policy rate further if needed". Markets, consumers and businesses ignored the conditionality in the statement. They merely took away that the Bank was done hiking. In Canadians' minds, the January "pause" trimmed the right tail of the distribution of future rates (Figure 1). Notably, Canadian homebuyers began operating with the assumption that, while variable mortgage rates were high, at least they wouldn't climb any higher.

The decision to resume hikes in June didn't just result in a policy rate 25bps higher, it brought back the right tail of that distribution. Markets, consumers, and businesses can no longer take for granted that rates have reached their peak. This will have a large nonlinear effect on mortgage activity, but also on non-mortgage bank lending.

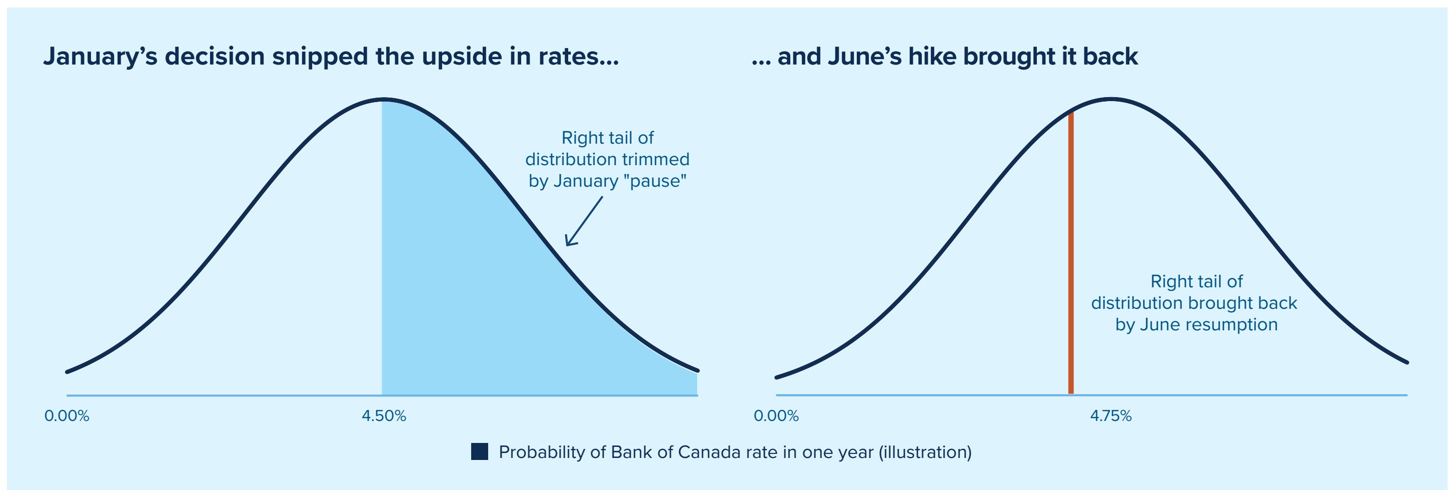
HIGHLIGHTS

The Bank's most recent hike shouldn't be seen as a vanilla 25bps increase. It will have a disproportionately large impact on the Canadian economy.

Canadian consumers and businesses interpreted the Bank's January decision as a permanent pause. The June hike undoes January's effect and brings back rate uncertainty.

For the first time in a long time, we think markets are getting ahead of themselves in terms of rate expectations for the Bank of Canada. We see it as an opportunity to buy short-term Canadian bonds.

FIGURE 1. JUNE'S HIKE UNDOES JANUARY'S EXPECTATIONS-DRIVEN MOMENTUM



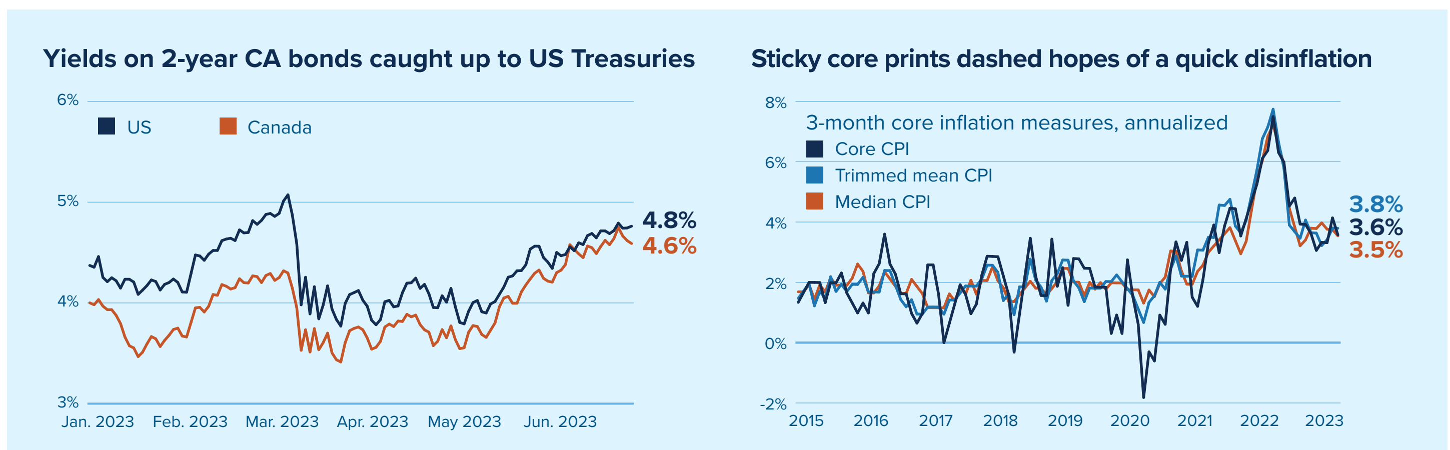
Source: Charts by the Multi-Asset Strategies Team, illustrative purposes only.

Canadian short-term bonds had a rough couple months as investors progressively realized that the economy was still overheating. The combination of a hot inflation print on May 16, a strong Q1 GDP print on May 31 and, of course, the Bank of Canada's June 7 rate hike sent short-term Canadian yields surging. Yields on two-year Canadian government bonds caught up to those on 2-year US Treasuries, a sharp contrast to the 0.75% spread we saw a few months ago (Figure 2).

Many analysts interpreted the lack of forward guidance in June's Bank of Canada statement as an indication that it would keep raising rates. It is, rather, an indication that the Bank got burned on its "pause" framework in January and is eschewing forward guidance altogether. A hike in July is likely, but not guaranteed.

It's been a long time since we've liked bonds — of any kind — but 2-year Canadian bonds now offer an attractive risk-return trade-off. For the first time in years, market expectations of Bank of Canada hikes might be overdone. The yield curve is extremely inverted, by far the most of any advanced country, with a spread 1.3% between the yields of 2- and 10-year Canadian government bonds. Plus, in our view Canada faces a much higher risk of recession than the US. We recently initiated a long 2-year Canadian government bonds position in the Mackenzie Global Macro Fund for those reasons.

FIGURE 2. SHORTING CANADIAN BONDS WAS ONE OF THE WINNING TRADES OF Q2



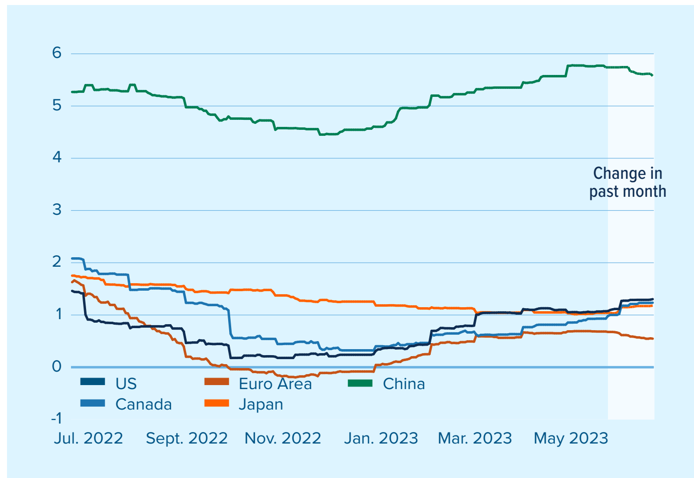
Source: Bloomberg as of June 27, 2023.

Global macro update

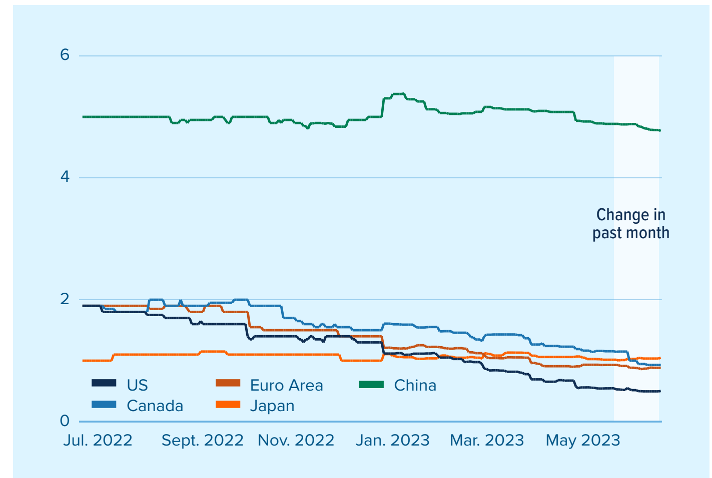
Growth and inflation forecasts for China slumped in June, as evidence of the weakening recovery keeps mounting. While China has returned to positive growth after a disastrous 2022, stimulus is waning. As we anticipated back in April, the Chinese yuan has depreciated sharply in recent months. The government refrained from pushing back against the depreciation in the hopes that a weaker yuan would help stimulate the economy. But China's economy is unbalanced, with structurally depressed household consumption that can't be boosted by a weaker yuan. With the yuan-dollar exchange rate approaching last year's zero-COVID bottom, the government will have to find a different way to boost growth. We've trimmed our tactical yuan position towards zero.

Eurozone inflation consensus forecasts have stabilized at a high level. Relative to the US, where strong demand is, by now, the main source of inflation, Europe's inflation stems mostly from supply issues. As such, it should revert more quickly towards target and the European Central Bank's rate hikes should prove to be temporary. While we have outright short positions in global sovereign bonds, we prefer German bunds to US Treasuries.

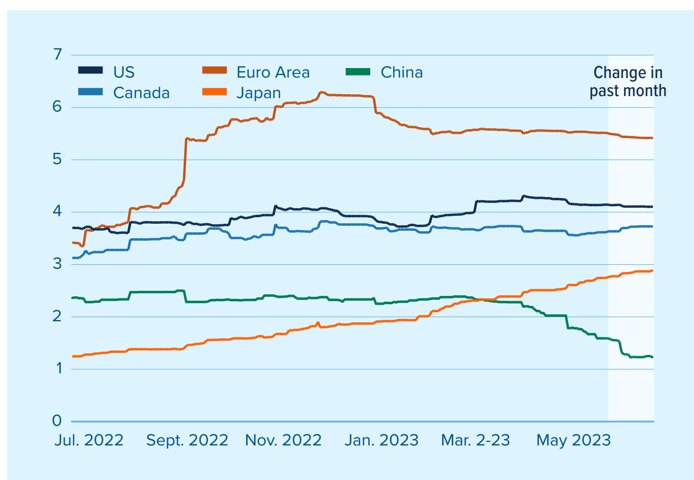
2023 REAL GDP GROWTH FORECAST (%, CONSENSUS)



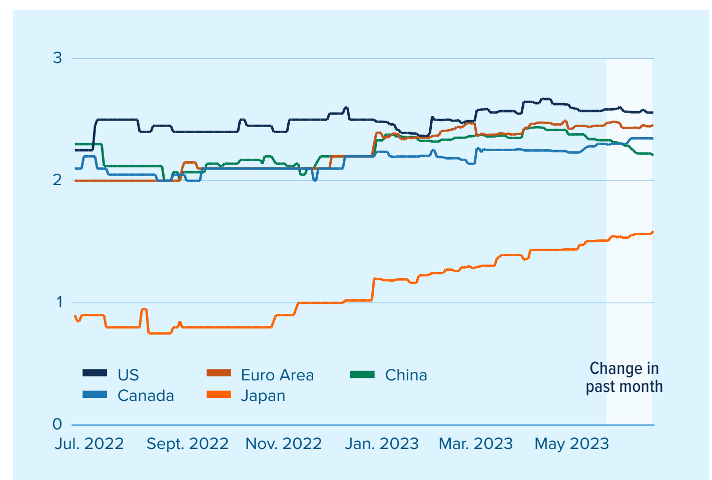
2024 REAL GDP GROWTH FORECAST (%, CONSENSUS)



2023 INFLATION FORECAST (%, CONSENSUS)



2024 INFLATION FORECAST (%, CONSENSUS)



Source: Consensus Economics as of June 30, 2023.

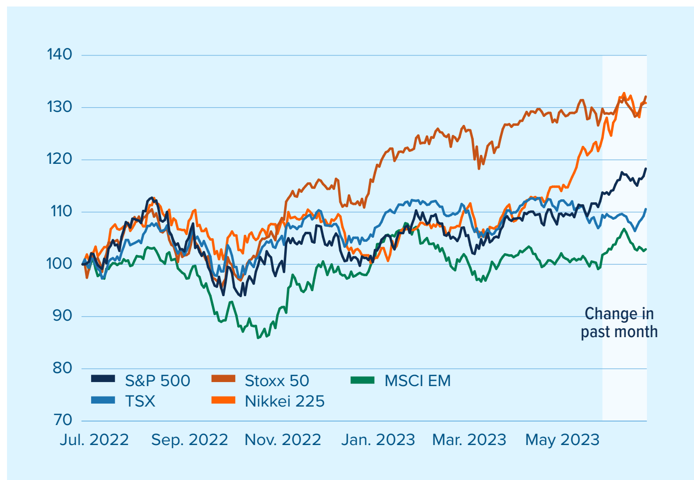
Capital markets update

Equities kept climbing in June, with the Nasdaq closing Q2 with its best first-half performance in history. Canadian stocks fared worse than US and international stocks in June, as oil prices dipped. Japanese stocks sustained their winning streak in June, driven by AI hype and a depreciation of the yen.

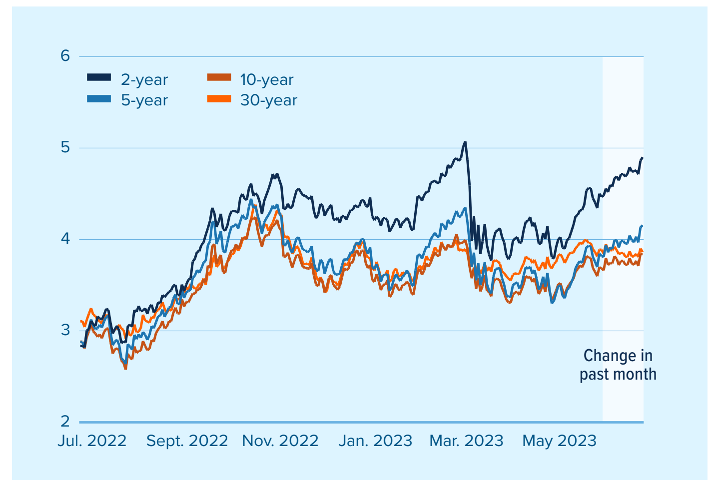
The **Treasury curve** inverted further in June, with the spread between 2- and 10-year bonds exceeding 1% for the first time since Silicon Valley Bank's failure in early March. Markets expect the Fed to hike once more, bringing the Fed's lending rate to 5.5%. We agree.

The **Canadian dollar** appreciated sharply against the US dollar in June, following bond yields higher as strong economic data and a Bank of Canada rate hike surprised markets. While the Canadian dollar remains cheap vs. the US dollar, we underweight it against most other G10 currencies.

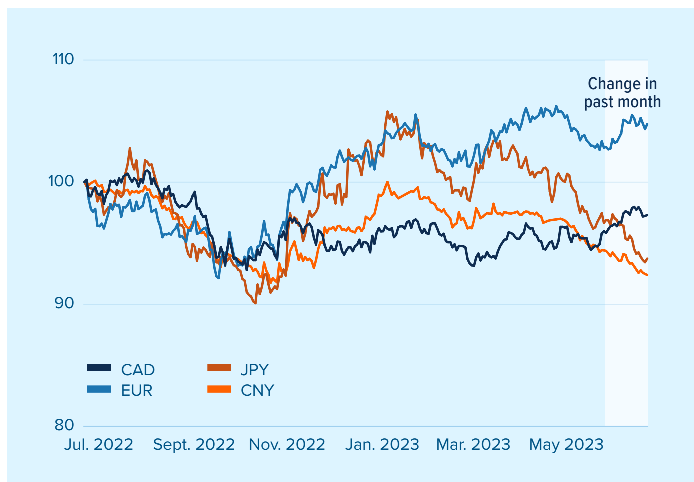
EQUITY INDICES (ONE YEAR AGO=100)



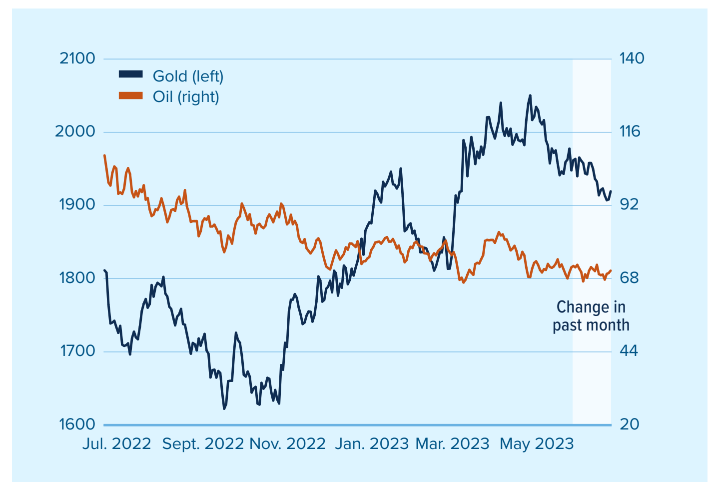
US TREASURY YIELDS (%)



CURRENCIES (RELATIVE TO USD, ONE YEAR AGO=100)



COMMODITY PRICES (USD)



Source: Bloomberg as of June 30, 2023. Total return equity indices are in local currencies, except MSCI EM, which is denominated in US dollars.

What we'll be watching in July

July 12: **Bank of Canada rate decision**

- As covered at the top of this report, the June rate hike will have a disproportionately large impact on the Canadian economy. As such, the Bank could easily keep rates unchanged in July — without promising a pause — and wait for June's hike to ripple through the economy.
- A July hike is currently a 50-50 proposition in our view. In May, Canada experienced job losses for the first time in almost a year. Combined with the slight easing of inflationary pressures seen in the most recent CPI numbers, that weakening in the job market could be enough to make the Bank hold steady at its July meeting.

July 26: **Federal Reserve rate decision**

- Just two months ago, markets were betting on the Fed's policy rate to end the year at around 4%. Now, they expect the Fed's rate to stay above 5.25% for the rest of the year. Talk about a reversal.
- We expect the Fed to hike in July. Inflation has been showing signs of softening recently, but after two years of above-target inflation, Fed officials will want to accelerate the return to 2%. The economic data has been solid, housing is bouncing, the recession chatter has waned somewhat and the banking crisis has clearly stabilized. Therefore, the Fed won't hesitate to keep tightening the screws on the economy.

July 28: **Bank of Japan rate decision**

- The Bank of Japan will eventually have to normalize policy and begin unwinding its cap on 10-year yields. Growth is picking up, inflation expectations are approaching 0 and global interest rates are stabilizing at a "higher-for-longer" level.

Emerging theme

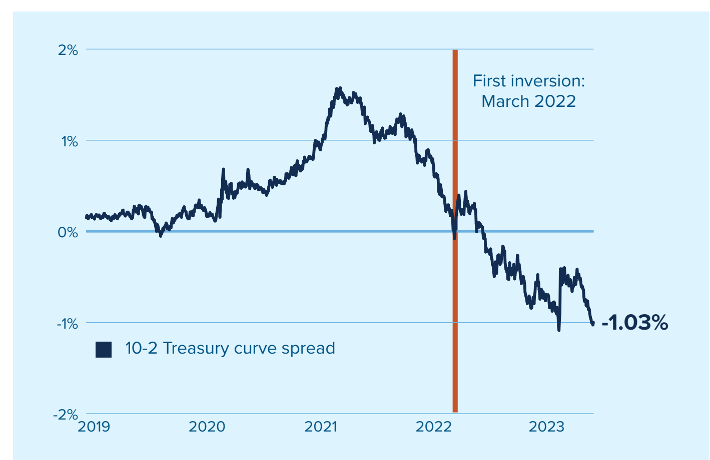
Since early 2022, we received continuous pushback on our view that a US recession was unlikely and that investors' expectations of a recession were exaggerated. One of the signs recessionistas were pointing at? The inverted Treasury curve in the US, a famous leading indicator of economic downturns.

It is true that curve inversion has forecasted every modern recession. But it says nothing about the *timing* of the impending recession. In this cycle, the curve inverted for the first time in March 2022. Fifteen months later, the US economy is still humming along.

For investors, the 2022 curve inversion is a cautionary tale in macro investing. First, even the best signal should only be seen as one tiny piece of the puzzle. Second, using market signals — bond yields in this case — to forecast market returns is not a particularly distinctive edge for a macro investor.

The 2-10 yield spread is back below 1%, approaching the lows of March 2023, before the failure of Silicon Valley Bank. We still think a US recession is unlikely and remain short bonds overall in Mackenzie Global Macro Fund.

INVERSION SIGNAL, A CAUTIONARY TALE



Source: Bloomberg, as of June 27, 2023.

Multi-Asset Strategies Team

Tactical investment views

	Underweight	Neutral	Overweight
Asset allocation			
Stocks		●	
Sovereign bonds	●		
Relative equity			
US stocks	●		
Currencies			
USD/CAD	●		
EUR/CAD			●
GBP/CAD		●	
JPY/CAD			●

Source: Mackenzie Investments. Note: The views expressed in this piece apply to products that are actively managed by the Multi-Asset Strategies Team.

Positioning highlights

Neutral equity: Our overarching macro view is that of a "delayed landing" for the rest of 2023: resilient growth (no recession in the US), sticky inflation and higher-for-longer rates. Momentum of growth in the US is strong, with employment, investment and industrial production all showing resiliency over the past few months. China's recovery has been disappointing but will generate enough momentum for the global economy to avoid a recession. A "no landing" scenario is both good and bad for stocks: financial conditions will tighten, putting pressure on valuations, but (nominal) company fundamentals should remain solid. We have a slight preference for international stocks in the equity mix. US stocks are more expensive after the recent AI-driven rally, and international stocks should benefit from solid nominal economic growth.

Underweight bonds: Inflation in the US will be sticky and will stay well-above target for the rest of 2023. We expect the Fed to hike once more to 5.5%, and to keep rates above neutral for the foreseeable future. As yields climbed over the past two months, rendering fixed income more attractive, we increased our overall bond exposure. In the Mackenzie Global Macro Fund, we mostly did it through a long position in two-year Canadian government bonds. But we remain underweight bonds in general.

Commodity-exporting EM currencies: Commodity-exporting EMs are well situated to outperform in this macro environment. Their budgetary and external balances have improved due to high global nominal growth and high commodity prices. Their central banks started raising rates much earlier than the rest of the world. As a result they have generally reached the end of their tightening cycle, reducing the risk of overtightening into a recession. But the level of rates remains high, offering positive carry over most other currencies. On the other hand, we have a negative view on the currencies of Asian EM countries. Their external positions have severely deteriorated, and their interest rates are relatively low.

Capital market returns in June

		Return
Major Asset Classes	Global Equity	5.69%
	Global Bonds	0.12%
Regional Equity (local)	S&P 500	6.61%
	TSX	3.57%
	Nikkei	7.61%
	FTSE 100	1.40%
	EuroStoxx 50	4.34%
	MSCI EM	3.80%
Styles	US Small Cap - Large Cap	1.51%
	US Value - Growth	-0.33%
Sovereigns	USA 10-year Treasury Future	-1.92%
	CAN 10-year Gov't Bond Future	-0.92%
	GBR 10-year Gilt Future	-1.54%
	DEU 10-year Bund Future	-1.16%
	JPN 10-year JGB Future	0.49%
Fixed Income	US High Yield Bonds	1.63%
	US Investment Grade Bonds	0.68%
	US Leveraged Loans	2.69%
	CA Provincial Bonds	0.29%
	CA Corporate Bonds	0.21%
	CA Inflation-Linked Bonds	0.25%
Alt	Gold	-2.21%
	Oil	3.47%
	Global REIT	3.88%
	Global Infrastructure	2.58%
FX Spot	CAD/USD	2.50%
	GBP/USD	2.11%
	EUR/USD	2.06%
	JPY/USD	-3.46%

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Market data from Bloomberg as of June 30, 2023. Index returns are for the period: 2023-06-01 to 2023-06-30. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite 60 (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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