MONTRÉAL EXCHANGE

February 2023

Hedging for Canadian Disinflation and Recession

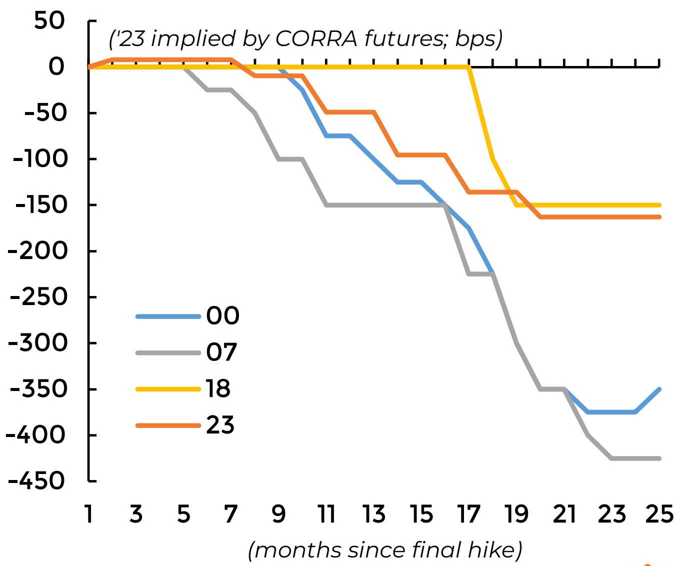
Owning September 2024 CORRA and Canada 10Y Futures

The Bank of Canada (BoC) is likely to cut the policy rate more than currently implied by the Three-Month CORRA Futures (CRA™; Bloomberg: CORU4) curve. As it stands, 163bps of cuts are priced within the next two years. This is over 200bps shy of the cutting cycles that occurred following the 2000 hiking cycle and Global Financial Crisis (GFC). As a result, there is value in owning the September 2024 Three-month CORRA Futures contract.

Further along the Canadian bond curve, there is value in owning the Ten-Year Government of Canada Bond Future (CGB™; Bloomberg: CNA). That is because the Canadian economy is likely to underperform current expectations. Historically speaking, the Canadian 10-year yield has fallen by at least 150bps over the past three cutting cycles (Figure 2). The macro rationale for this view is laid out below.

FIGURE 1

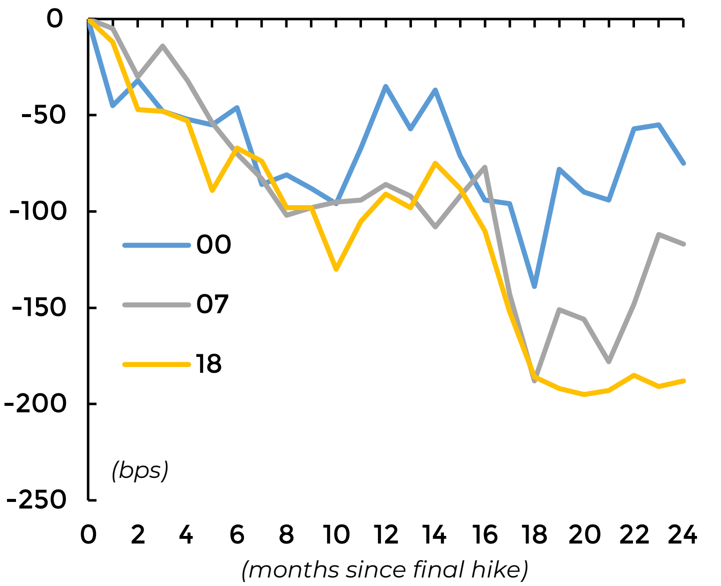
Canadian Cuts Mispriced



Source: Macro Hive, TMX, BoC

FIGURE 2

Canadian 10Y Could Trade at Least 150bps Lower



Source: Macro Hive, Macrobond

Macro Rationale

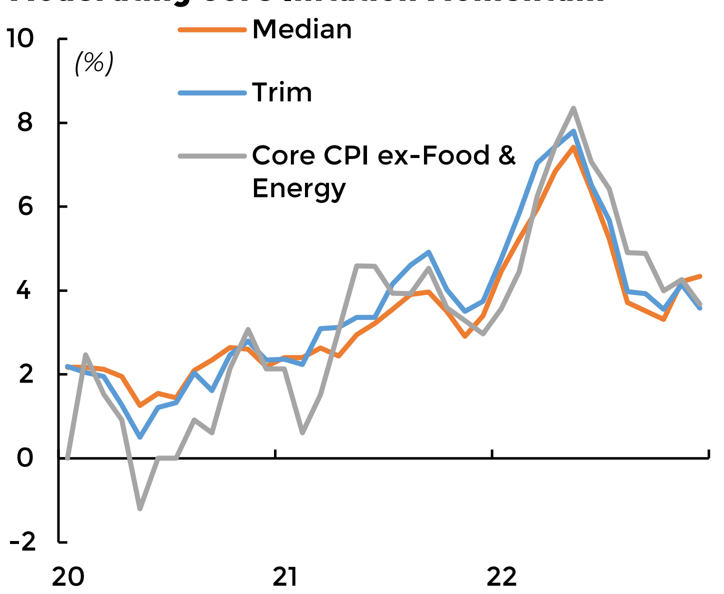
The Inflation Trend

On Canadian inflation, we find that services inflation momentum is quickly moderating (Figure 3). Monthly readings averaged +0.24% MoM through Q4, down from +0.43% MoM in Q3 and +0.69% in Q2. Meanwhile, core inflation momentum is slowing, suggesting the peak in core inflation is forthcoming despite inflation expectations proving hard to budge (Figure 4).

Admittedly, wage growth has yet to decline. But this could prove less inflationary if productivity rises. Currently, it is well below trend (Figures 5 and 6).

FIGURE 3

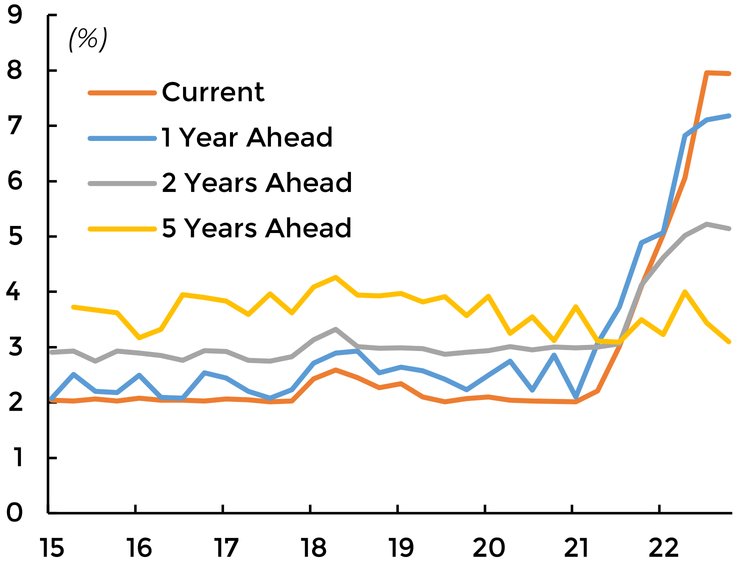
Moderating Core Inflation Momentum



Source: Macro Hive, StatCan

FIGURE 4

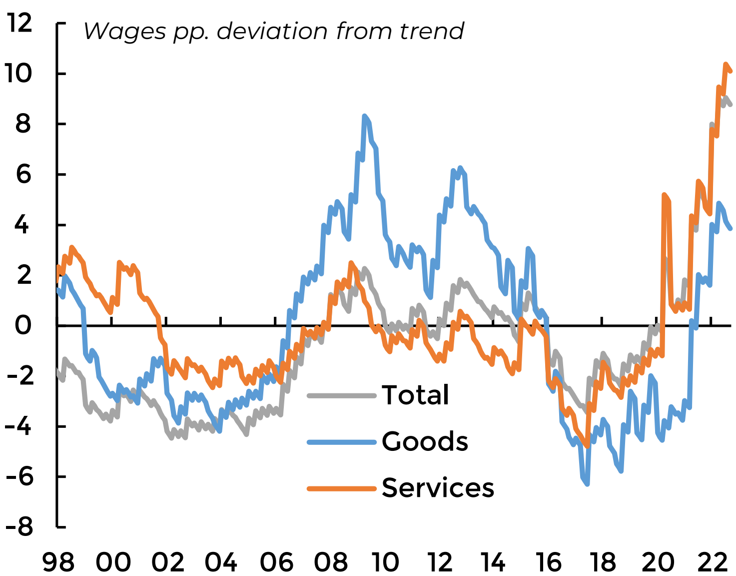
Inflation Yet to Budge



Source: Macro Hive, Bank of Canada

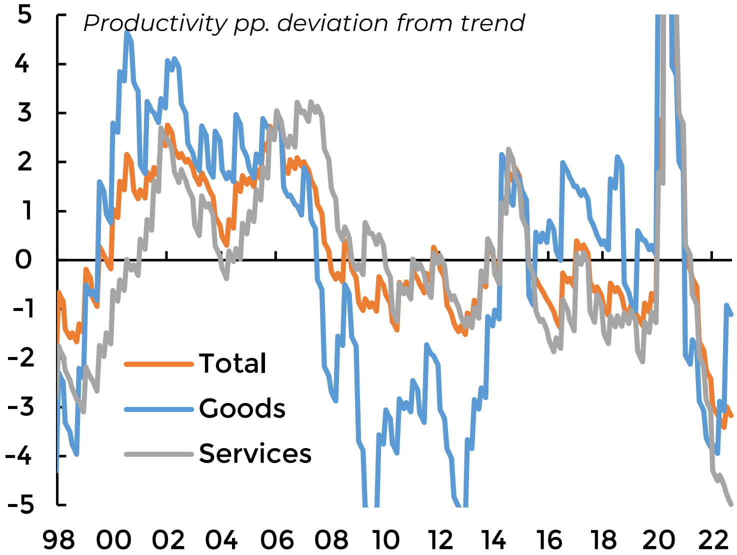
FIGURE 5

Wages Yet to Subside



Source: Macro Hive, StatCan

FIGURE 6
Services Productivity Proving Lax

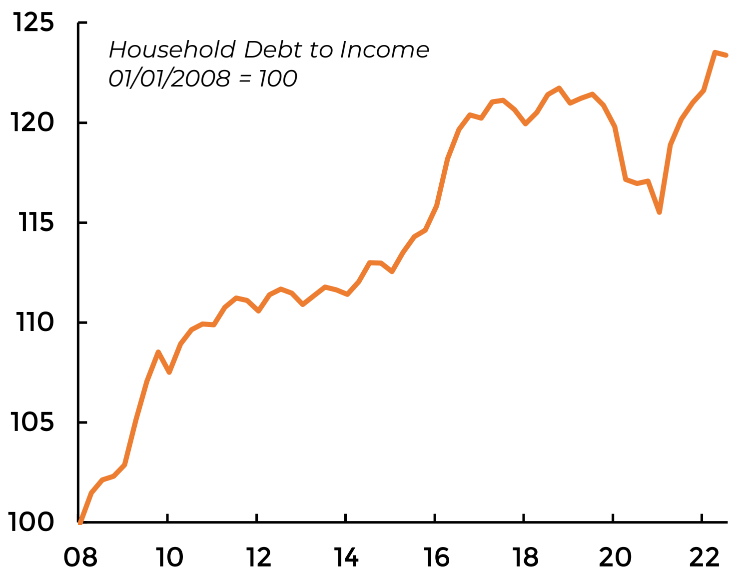


Source: Macro Hive, StatCan

Recession risks

On growth risks, Canada faces a leverage issue. Canadian households have added more debt to their balance sheet than income since the GFC (Figure 7). Specifically, they have concentrated on mortgage loans, helping to inflate Canadian house prices (Figures 8 and 9). Meanwhile, US households have improved the health of their household balance sheets. As a result, Canadian households are nearly twice as levered as they were in the GFC, and in comparison to American households now. This adds to potential recession risks later in 2023.

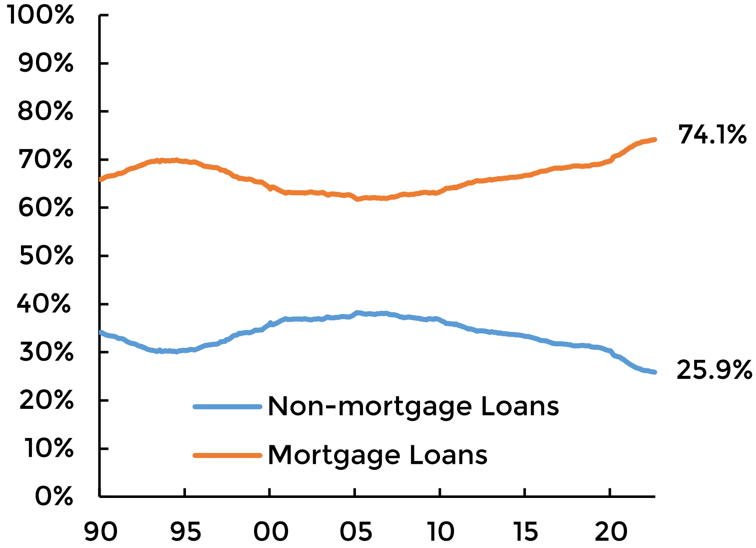
FIGURE 7
Canadian Households Highly Levered vs GFC



Source: Macro Hive, StatCan

FIGURE 8

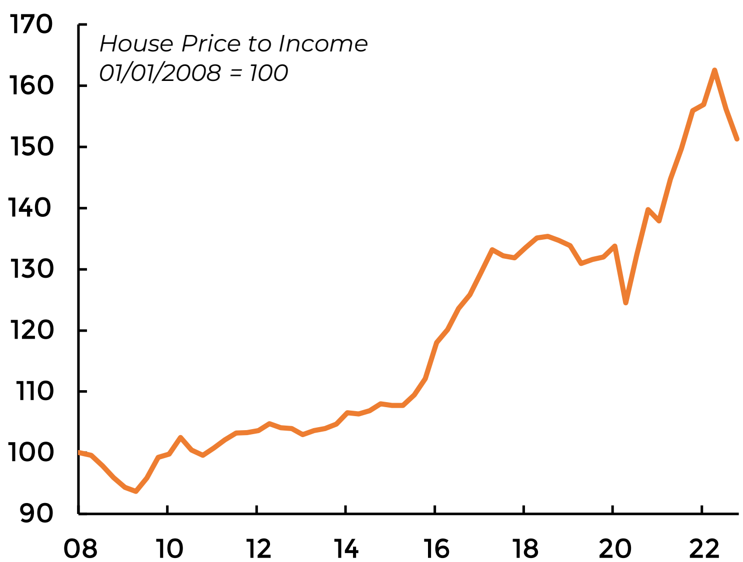
Canadians' Increase Household Purchases



Source: Macro Hive, StatCan

FIGURE 9

Leverage Inflated House Prices



Source: Macro Hive, OECD

What next for BoC and Canadian yields?

Given the inflation backdrop and recessions risks, the most recent BoC hike by 25bps to 4.50% at its January 25 meeting could be the last in this hiking cycle. In total, the BoC has hiked by a historical pace of 425bps during this hiking cycle, which started in March 2022. The next BoC meeting could see the central bank's rhetoric shift to a conditional pause, spurred by the suggestion that 'core inflation has peaked'.

For the BoC to hike again, Governor Tiff Macklem would need to see an 'accumulation' of evidence suggesting that economic data momentum is turning positive. But their base case is services disinflation, moderating wage growth with a pickup in services productivity, and easing labour market tightness.

Another reason for not expecting the BoC to hike again is that they typically end their hiking cycle 75bps below peak Federal Reserve (Fed) policy rates. Assuming market expectations for the Fed are correct at 5%, this would imply that the BoC has already hiked more than history would suggest (Figure 10).

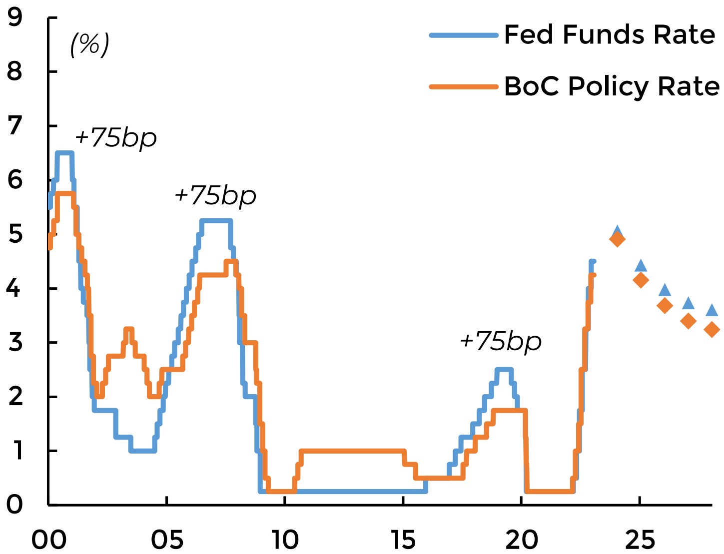
If our view of peak BoC and weakening growth is correct, investors could hedge by going long:

a) September 2024 Three-Month CORRA Futures (CRA; Bloomberg: CORU4).

b) Ten-Year Government of Canada Bond Futures (CGB; Bloomberg: CNA).

FIGURE 10

Relatively Hawkish Hiking Cycle



Source: Macro Hive, Macrobond

Bilal Hafeez is the Founder and CEO of Macro Hive – a leading independent research firm. Prior to MacroHive, Bilal was Global Head of International Fixed Income Strategy at Nomura between 2016 and 2019. Before that, Bilal held various senior roles at Deutsche Bank between 2002 and 2015, including Head of Multi-Asset Research, Advisor to the CEO, Head of Asia Research in Singapore and Global Head of Foreign Exchange Research. Bilal started his career at J.P. Morgan in 1998. During his sell-side career, Bilal was rated #1 market strategist by Euromoney and Institutional Investor for most years between 2004 and 2013. He also pioneered FX investment and smart beta benchmarks. Academically, Bilal was an Honorary Visiting Professor of Finance at Cass Business School. He studied Economics at St John's College, Cambridge.

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