Bank of Canada Preview

Economics and Strategy

NATIONAL BANK OF CANADA FINANCIAL MARKETS

May 30, 2025

A closer call than meets the eye?

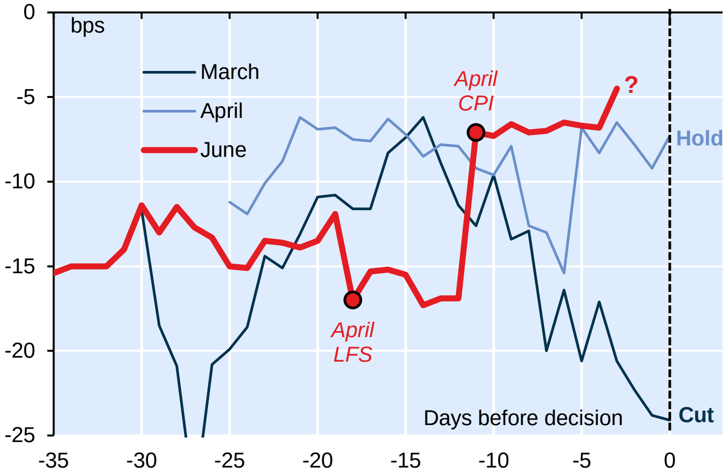
By Taylor Schleich & Ethan Currie

In what has become a regular occurrence, the inter-meeting period has been characterized by significant expectations volatility. This time, a weak jobs report pushed the odds of a June rate cut to roughly 70%, only for hotter-than-expected inflation and GDP data to slash those odds to ~20%. To us, the probability of a cut is *more* likely than the market expects but is it *most* likely? Inspired by the proverbial two-handed economist, we break down the decision across key variables, assessing whether each lean toward a cut or a hold, *based on how we think the Bank is interpreting the data.* We encourage readers to apply their own lens, but our scoring of the key meeting issues sees this one leaning hold, as we detail below. Whichever way the decision goes, we continue to expect further easing this year and see the overnight target ending the year at 2%.

Case to cut	Variable	Case to hold
Headline inflation is below 2% and has been in the control band for 16 straight months. Retaliatory tariffs are narrow and will likely have negligible effects on the CPI. While core inflation is hotter, emerging economic slack points to downward pressure ahead. Moreover, shelter is skewing/misleading headline and core inflation. In contrast to CPI, market rents/house prices are *falling*.	Inflation ✓	Inflation was assisted by a fall in gas prices that are not reflective of underlying price pressures. Excluding taxes, inflation is >2%. Preferred core measures are above 3% on a 3, 6 or 12M basis. Canadian tariffs may add to inflation (even if only marginally) and there could also be supply-side inflation impacts from global trade disruptions. The COVID inflation episode still weighs on GC.
While tariffs increased expectations, gas prices have since fallen sharply and home prices/rents are down too. These highly visible goods tend to drive expectations so we should see moderation ahead. Moreover, expectations are an empirically bad driver of inflation. Meantime, market-based measures are well anchored.	Inflation expectations ✓	Short-term inflation expectations jumped earlier this year. There's been no update since April to the BoC's main measures and it's unclear if these improved given still-acute trade anxiety. During the hiking cycle, the BoC put a lot of stock into expectations, and they did again at the April decision. They're not screaming for a cut.
Job market strength in late-'24/early-'25 has been wiped out as Canada's economy shed jobs over the last 3 months. May is likely to be soft too as election workers 'lose' their job. The jobless rate is back to its cycle high and headed higher by most estimates.	✓ Labour market	Soft employment data from Feb-Apr was a function of trade uncertainty that has moderated since. As tariffs are negotiated down, conditions could stabilize. *Some* wage growth measures are still elevated, complicating the path to further inflation relief.
Growth is expected to slow sharply as Canada potentially enters a technical recession in Q2-Q3. GDP in Q1 was okay but that doesn't reflect emerging slack. See domestic demand, which *contracted*.	GDP ✓	Growth may in fact slow but it hasn't yet, in aggregate. The BoC has said they can't be forward-looking so with overall growth okay and core inflation hot, there's no clear path to a cut in June.
The housing market is paralyzed, sales falling each month since the U.S. election. Nationally, house prices are down YTD and are still below 2022 prices. With supply mounting, it's not clear that reduced uncertainty will be the cure. Moreover, mortgages from the zero-interest rate era of 2020-21 are renewing, squeezing households.	✓ Housing	The BoC largely attributes housing market weakness to trade policy. Thus, marginally lower rates are of little help. As uncertainty resolves, activity should naturally pick up. Even with lower prices, housing affordability is challenged and there may be reluctance to encourage more housing debt to power economic growth.
The tax cut is only worth *up to* $48/month for individuals and in this economic environment, this is more likely to be saved *not spent*. A price of <$6 billion/year is only 0.2% of GDP anyways. Other federal government spending won't be deployed until later.	Fiscal policy ✓	While there's been no budget, the Liberal election platform involves *a lot* of spending and tax cuts going into effect 1-Jul. Provincially, deficits are growing too. With core CPI already hot, marginal fiscal *and* monetary stimulus carries risk. It's better to wait and see.
Despite BoC easing, long-term borrowing costs have *risen* since last summer. Rate cut pass through to fixed mortgage rates is minimal.	Financial conditions ✓	Equity markets have shrugged off trade risks. The TSX is up 9% since the last BoC decision and is back to setting all-time highs.
It's too early to discern the trade fallout but it's impossible for exporters to avoid negative impacts. Even as negotiations progress, US protectionism will remain for the next 3+ years. That's bad news for an economy that's ~20% US exports. Associated uncertainty is keeping households/businesses sidelined and while the BoC can't *fix* this, policy relief can mitigate damage and shore up confidence.	✓ Trade & uncertainty ✓	Trade *uncertainty* hurts but tariffs themselves aren't *so* damaging in aggregate. With USMCA compliance, the average U.S. tariff rate on Canada is ~5%, far from the 'headline' 25%. Globally, trade uncertainty is *much* better than in April as the U.S. moved into negotiation mode, tariff rates coming down. Still, economic, inflation impacts remain unclear which argues for waiting it out a little longer.
The CAD has strengthened materially, an unhelpful move for exporters in an already challenged time. It's doubly painful for western Canadian economies facing lower oil prices too. Despite emphasizing patience earlier, the GC was contemplating a cut in April. Since then, the economy has softened, making the cut case stronger. A neutral policy stance is too restrictive at this juncture. Empirically, the BoC doesn't care about market pricing.	✓ Other factors ✓	The BoC has an agnostic CAD view, so this shouldn't come into play. GC says they can't be forward-looking until there's clarity. Then, they can act decisively which could mean cuts *later*. For now, a pause is *most* consistent with their stance. The Fed and other CBs are staying put, so there's strength in numbers. 225 bps of earlier easing is substantial, still working through the economy. The coming G7 meeting in Alberta may also provide clarity.

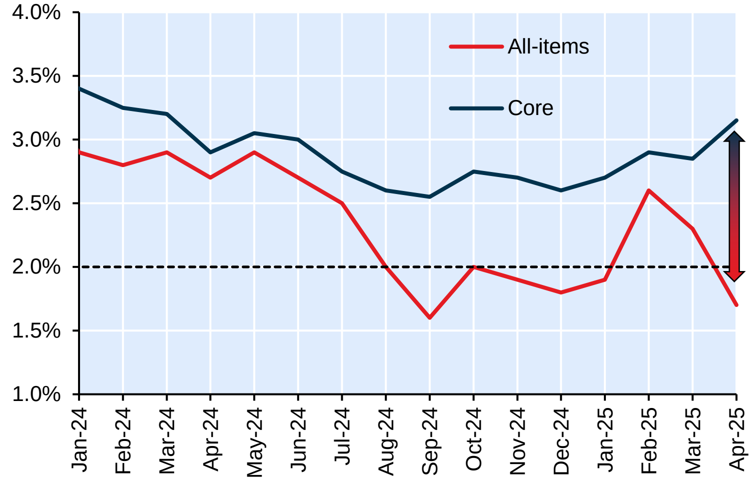
Bottom Line: Hold | Rationale: Ultimately, our call hinges on policymakers' judgement that they can't be forward-looking. If they could be forward-looking (and despite uncertainty, we'd argue they should be), we see it as a clear-cut decision to ease. But if policymakers are, as they imply, able to only react to the data they have in hand, the picture is admittedly mixed. The labour market—which carries a lot of weight—is consistent with further rate relief, but the inflation picture *right now* isn't giving the green light. There are also still key unknowns on trade impacts, inflation expectations and fiscal policy which further obscure the picture. Really though, if the Bank was comfortable holding steady in April when the outlook looked even more troubled, they should be fine waiting eight weeks from here. The next decision in July will bring more data (to gauge tariff impacts), another Business Outlook Survey and greater clarity on the U.S. trade relationship with Canada (and the world). We expect that by the time 30-Jul arrives, inflation anxiety will have moderated as economic slack accumulates and dominates modest tariff-driven inflation. This would tip the scales towards a cut. Further out, our outlook for two quarters of negative growth, an unemployment rate above 7% and on-target inflation is consistent with the overnight target reaching 2% by year-end.

It's been an uncertain, volatile inter-meeting period (again)
OIS-implied BoC policy rate change leading up to each decision



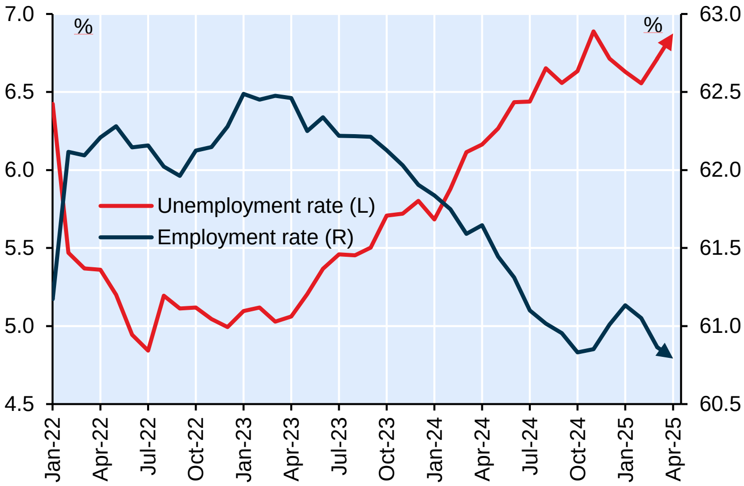
Source: NBC, Bloomberg

Core and headline inflation are giving opposing signals
Annual CPI and core inflation



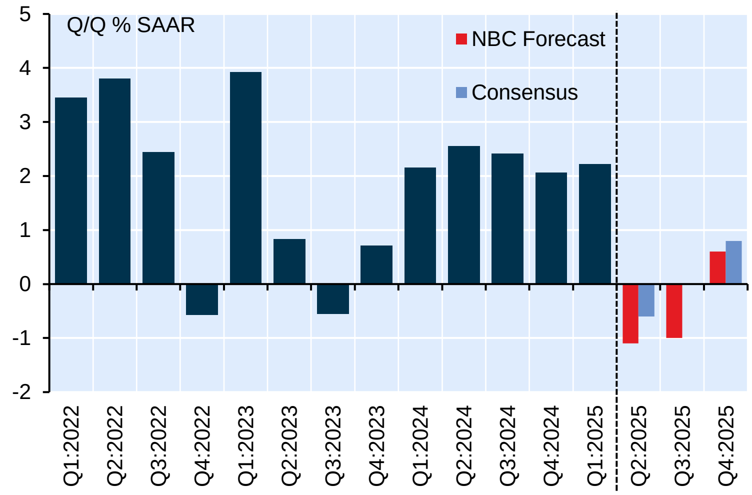
Source: NBC, StatCan | Note: Core refers to the average of CPI-Trim & -Median

After earlier improvement, labour market softening again
Canadian unemployment and employment rate



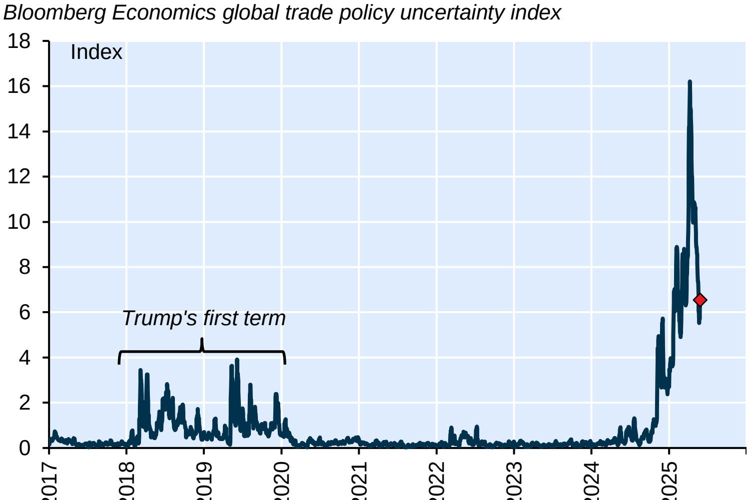
Source: NBC, StatCan

We (and most forecasters) see growth slowing sharply in Q2
Canadian GDP growth with NBC, consensus forecasts for 2025



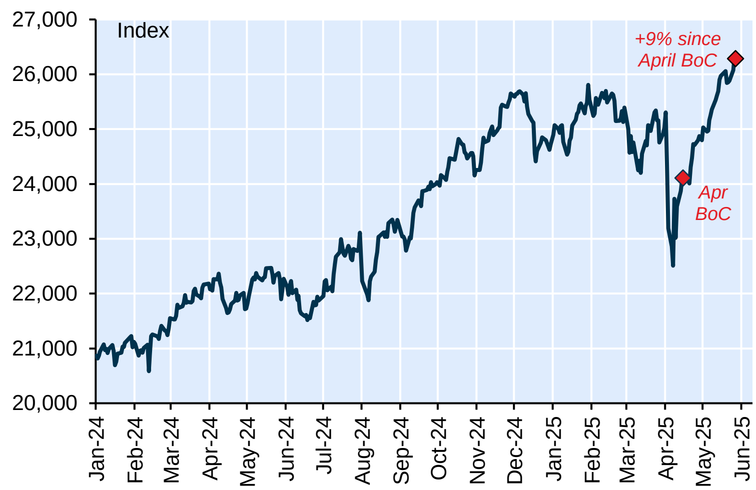
Source: NBC, StatCan, Bloomberg

While still elevated, uncertainty has come down
Bloomberg Economics global trade policy uncertainty index



Source: NBC, Bloomberg

Equity markets have shrugged off earlier trade worries
S&P TSX Index



Source: NBC, Bloomberg

Latest policy statement: April 16, 2025

Bank of Canada reduces policy rate by 25 basis points to 2.75%

The Bank of Canada today maintained its target for the overnight rate at 2.75%, with the Bank Rate at 3% and the deposit rate at 2.70%.

The major shift in direction of US trade policy and the unpredictability of tariffs have increased uncertainty, diminished prospects for economic growth, and raised inflation expectations. Pervasive uncertainty makes it unusually challenging to project GDP growth and inflation in Canada and globally. Instead, the April Monetary Policy Report (MPR) presents two scenarios that explore different paths for US trade policy. In the first scenario, uncertainty is high but tariffs are limited in scope. Canadian growth weakens temporarily and inflation remains around the 2% target. In the second scenario, a protracted trade war causes Canada's economy to fall into recession this year and inflation rises temporarily above 3% next year. Many other trade policy scenarios are possible. There is also an unusual degree of uncertainty about the economic outcomes within any scenario, since the magnitude and speed of the shift in US trade policy are unprecedented.

Global economic growth was solid in late 2024 and inflation has been easing towards central bank targets. However, tariffs and uncertainty have weakened the outlook. In the United States, the economy is showing signs of slowing amid rising policy uncertainty and rapidly deteriorating sentiment, while inflation expectations have risen. In the euro area, growth has been modest in early 2025, with continued weakness in the manufacturing sector. China's economy was strong at the end of 2024 but more recent data shows it slowing modestly.

Financial markets have been roiled by serial tariff announcements, postponements and continued threats of escalation. This extreme market volatility is adding to uncertainty. Oil prices have declined substantially since January, mainly reflecting weaker prospects for global growth. Canada's exchange rate has recently appreciated as a result of broad US dollar weakness.

In Canada, the economy is slowing as tariff announcements and uncertainty pull down consumer and business confidence. Consumption, residential investment and business spending all look to have weakened in the first quarter. Trade tensions are also disrupting recovery in the labour market. Employment declined in March and businesses are reporting plans to slow their hiring. Wage growth continues to show signs of moderation.

Inflation was 2.3% in March, lower than in February but still higher than 1.8% at the time of the January MPR. The higher inflation in the last couple of months reflects some rebound in goods price inflation and the end of the temporary suspension of the GST/HST. Starting in April, CPI inflation will be pulled down for one year by the removal of the consumer carbon tax. Lower global oil prices will also dampen inflation in the near term. However, we expect tariffs and supply chain disruptions to push up some prices. How much upward pressure this puts on inflation will depend on the evolution of tariffs and how quickly businesses pass on higher costs to consumers. Short-term inflation expectations have moved up, as businesses and consumers anticipate higher costs from trade conflict and supply disruptions. Longer term inflation expectations are little changed.

Governing Council will continue to assess the timing and strength of both the downward pressures on inflation from a weaker economy and the upward pressures on inflation from higher costs. Our focus will be on ensuring that Canadians continue to have confidence in price stability through this period of global upheaval. This means we will support economic growth while ensuring that inflation remains well controlled.

Governing Council will proceed carefully, with particular attention to the risks and uncertainties facing the Canadian economy. These include: the extent to which higher tariffs reduce demand for Canadian exports; how much this spills over into business investment, employment and household spending; how much and how quickly cost increases are passed on to consumer prices; and how inflation expectations evolve.

Monetary policy cannot resolve trade uncertainty or offset the impacts of a trade war. What it can and must do is maintain price stability for Canadians.

Information note

The next scheduled date for announcing the overnight rate target is June 4, 2025. The Bank will publish its next MPR on July 30, 2025.

Source: Bank of Canada

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