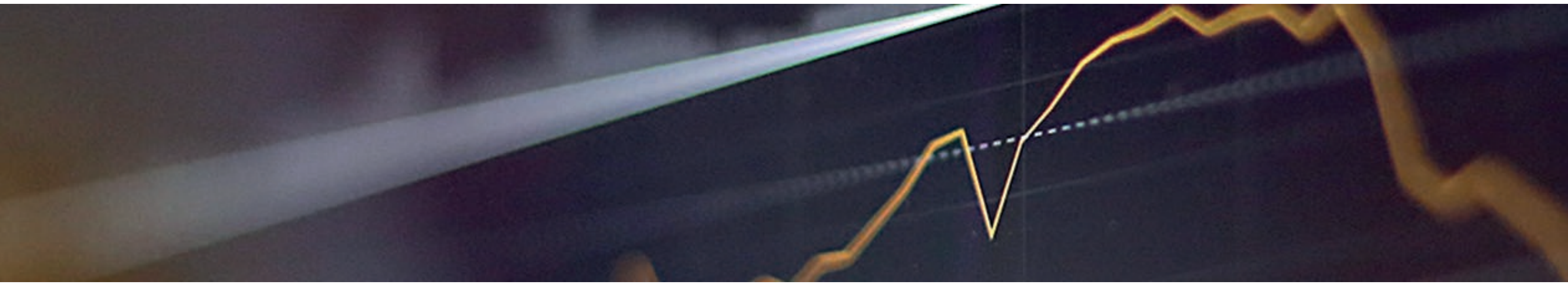


Canadian Market Insights | February 2024

INVESTMENT STRATEGY

Expecting Early Spring Rate Cuts? Curb Your Enthusiasm

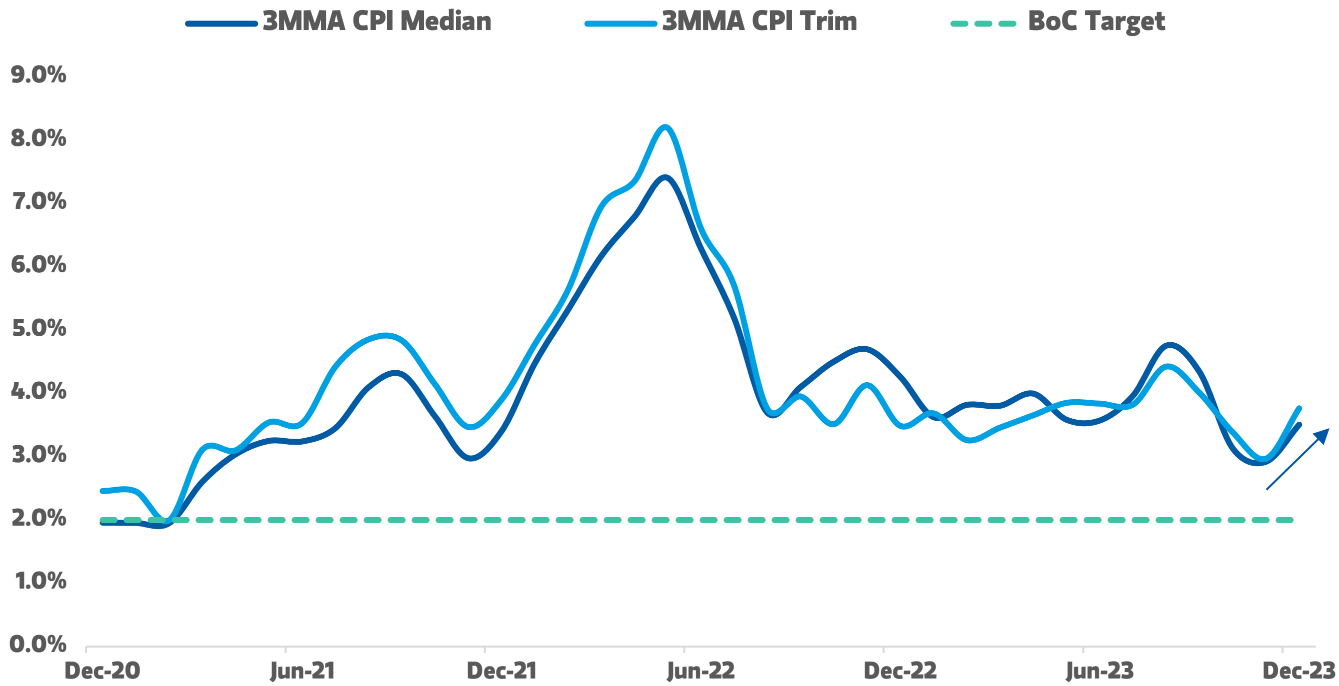
Executive Summary

- We expect Canadian inflation will slowly decline towards the Bank of Canada (BoC)'s 2% inflation target over the next 12 to 18 months.
- Recent inflation data, consumer and business surveys and commentary from the BoC seem to suggest that investors should curb their enthusiasm, however, for early spring policy rate cuts.
- We continue to recommend investors maintain defensive positioning in portfolios, as we anticipate that market volatility will remain high in 2024, as detailed in our report "2024 Canadian Financial Market Outlook: "Dear, Tiff. Are We There Yet?"

Canada's Inflation in December: Not Heading in the Right Direction

On January 16, 2024, Statistics Canada released the December Consumer Price Index report, showing that trend inflation, using a three-month moving average (3MMA) of two different measures of inflation (CPI Median, CPI Trim), moved higher from the previous month (Exhibit 1).

Exhibit 1. Bank of Canada Key Underlying Inflation Measures: Consumer Price Index (CPI), Three-Month Moving Averages (Ann.)



Sources: Statistics Canada, Bank of Canada. Notes: '3MMA' refers to the three-month moving average. 'CPI-Trim' is a measure of core inflation that excludes CPI components whose rates of change in a given month are located in the tails of the distribution of price changes. 'CPI-Median' is a measure of core inflation corresponding to the price change located at the 50th percentile (in terms of the CPI basket weights) of the distribution of price changes in a given month. 'BoC Target' shows the Bank of Canada's target inflation rate: at the 2% midpoint of an inflation-control target range of 1 to 3%. The inflation target is expressed as the year-over-year increase in the headline consumer price index (CPI).

Canada's headline CPI for December increased 3.4% year-over-year, up from 3.1% in November. The key drivers of December's faster inflation were gasoline prices, airfares, fuel oil, passenger vehicles and rents. Rents continued to climb in December, increasing 7.7% year-over-year, versus 7.4% in November. Higher mortgage rates continue to serve as a barrier for prospective homebuyers, supporting rental demand and contributing to a significant portion of the CPI.

As shown in Exhibit 1, the BoC's preferred measures of underlying inflation remain elevated, above its 2% inflation target. The three-month annualized pace increased 3.8% (3.0% prior) for CPI-Trim and 3.5% (2.9% prior) for CPI-Median, while the average three-month annualized pace for the two measures bucked its recent downward trend, rising to 3.6% (2.9% prior).

While one month does not necessarily establish a trend, the December inflation data came at a precarious time, as investors had increased expectations for early spring rate cuts from the BoC. We believe the latest inflation data and other recent economic data suggest that there is likely insufficient evidence that would assure the BoC inflation will sustainably return to its inflation goal. Even if the economy were to slow as we forecast, investors should be prepared for a bumpy ride that will keep the BoC on hold until at least July.

Further Economic Data Does Not Suggest Early Rate Cuts from the BoC

In addition to the December's inflation report, we summarize more recent economic data below, which may suggest expectations for early spring rate cuts are overly ambitious.

BoC Interest Rate Announcement and Monetary Policy Report: January 24

Canadian policy rate was unchanged at the latest BoC interest rate announcement which took place on January 24, 2024. While the BoC did not make any changes to its policy rate at this meeting, there were some important takeaways from the press conference and from the quarterly Monetary Policy Report published on the same day.

First, the BoC seems to have shifted its focus from the required policy rate to bring inflation down, to a focus on how long its policy rate needs to persist. This does not signal imminent rate cuts, in our view. Second, the BoC reiterated progress on bringing inflation closer to target as previously communicated, but that inflationary pressures remain persistent, especially with respect to housing. And third, the BoC did not rule out the possibility of further rate hikes if higher inflation proved to be persistent.

The next BoC interest rate announcement is set for March 6, 2024. We continue to expect the first interest rate cut by the BoC by mid-2024.

Bank of Canada Business Outlook Survey: Fourth Quarter of 2023 (link)

This quarterly publication by the BoC, released on January 15, suggests that corporate pricing behaviour continues to normalize, and fewer businesses indicated they intend to raise prices more than usual. Also, the survey noted that, while inflation expectations have been slowly trending down, about one-third of Canadian firms think it will take longer than four years for inflation to return to 2%. We believe the survey results support a continued hold for the BoC's policy rates, as the lagged and variable impact of tightening financial conditions has only started to impact business planning.

Canadian Survey of Consumer Expectations: Fourth Quarter of 2023 (link)

This quarterly BoC survey took place between November 1 and 17, 2023, with follow-up interviews taking place between December 1 to 8, 2023. Overall, consumer expectations for inflation have barely changed, mostly as rents remain high. According to the BoC, Canadians are adjusting their behaviour in response to high inflation. Consumers expect fewer wage increases going forward, which the BoC may interpret as a headwind for future wage growth. Consumer have been reducing consumption in the face of high interest rates and persistent rent inflation. Commentary from Canadian banks in their latest quarterly earnings calls in November/December 2023 corroborated this change in consumer behaviour.

Determinants of Bank of Canada Policy Rate

To begin the process of lowering Canadian interest rates, we believe that the BoC will want to see core inflation on a sustained path back to its 2% inflation target. That doesn't mean that the BoC needs to see a sustained period of 2% inflation, but rather a 'downward momentum' toward its target. The BoC also considers three other factors in determining the policy rate. These include monitoring trends and levels of inflation expectations, corporate pricing behaviour and wage growth, which the BoC reviews holistically when considering policy changes. It's important to remember that, in setting its policy rate, the BoC will likely consider changes in all four of these indicators, and not just one.

Portfolio Positioning: Expecting lower inflation, while also preparing for alternative outcomes

Under our base-case scenario, we see disinflationary trends picking up during the second half of 2024 and into 2025. The lagged and variable impact of monetary policy tightening since 2022 is starting to have an impact, so investors need to be patient and remain defensively positioned. Our tactical asset allocation recommendations remain unchanged from our 2024 Canadian Market Outlook (link).

The upside risks to inflation remain higher inflation expectations, persistent wage growth and rising home prices.

The longer inflation remains at the forefront of business and consumer expectations, the more difficult it may be for the BoC to reign it in. Even if we do see inflation decline as expected by our base case scenario, it may take more time for expectations to ease; potentially putting pressure on future wage growth. Persistently high inflation may result in interest rates remaining higher for longer. In turn, higher home prices would increase inflation by raising shelter costs, according to the BoC.

If interest rates persist for higher than expected, this may have negative consequences for Canadian consumers and potentially earnings growth for Canadian banks, supporting our market-weight recommendation in Canadian Equities. Our tactical overweight recommendation for Canadian Fixed Income is partly based on a 'higher-for-longer' regime that creates opportunities to own better risk-adjusted returns in current coupons, with the potential for capital gains if rates fade in 2024, as is forecasted.

Alternatively, the downside risk to disinflation could be a result of a slowing in the economy, either through continued tightening of policy given record-high household debt, and/or global recession to bring down growth. In such a scenario, investors would want to maintain defensive portfolio positioning with a market-weight in Canadian equities and an overweight within Canadian fixed income.

Please reach out to your Morgan Stanley Wealth Management Canada Financial Advisor with any questions.

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Index Definitions

S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.

S&P/TSX Composite Index: The S&P/Toronto Stock Exchange Composite Index is a capitalization-weighted index designed to measure market activity of stocks listed on the TSX. The index was developed with a base level of 1000 as of 1975.

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