RJL PCS: MARKET PERSPECTIVES

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Market Perspectives: BoC pauses rate cuts, to hold at 2.75%, proceeding cautiously due to "pervasive uncertainty"

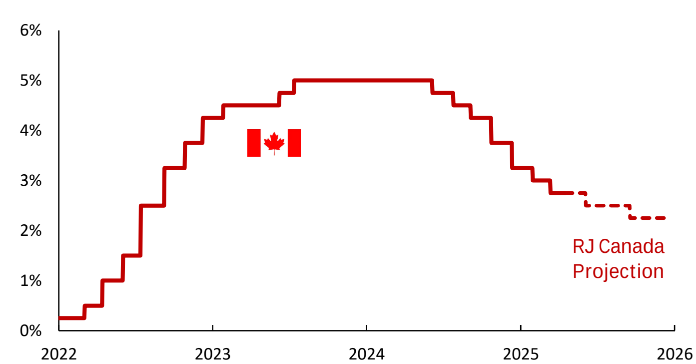
On April 16, the Bank of Canada (BoC) held its policy rate steady at 2.75%, marking the first pause after seven successive rate cuts, totaling 2.25%, since June 2024 (Chart 1). The BoC's decision was largely anticipated by the market, as the uncertainty surrounding the U.S.-imposed tariffs on Canada has temporarily eased. Canada turned out as one of the relative winners, excluded from the reciprocal tariffs announced on April 2. Most goods exported to the U.S. can still be tax-free if they are USMCA-compliant, although certain industries, such as auto, steel, and aluminum, still face significant challenges from sector-specific tariffs.

Canada's economy was strengthening coming out of 2024, at 2.6% in 4Q24, but likely slowed in 1Q25 to an estimated 1.8%, despite a boost in exports (+7.5% in 1Q25) as American firms advanced orders to get goods across the border in advance of tariffs. Entering 2Q25, the economy is likely to be weaker, as tariff uncertainty constrains business and household spending, and the boost from the pull-forward of exports unwinds. Given that we still see pressure on the Canadian economy, and expect still more tariff announcements to cause additional uncertainty, we continue to expect two more rate cuts through the end of 2025.

Some recent optimism on tariff pauses, reversals, and negotiations, and a still good economic situation, have left enough leeway for the BoC to wait out more information as the situation develops. Some easing on the headline inflation looks positive, although core measures leave CPI-trim and CPI-median measures near the upper end of the comfort range, and so it seems reasonable for the BoC to pause its easing for now. This pause also maintains the policy rate spread between the U.S. and Canada, providing additional support to the CAD/USD exchange rate, which is currently at 0.72 compared to the year-to-date low of 0.69.

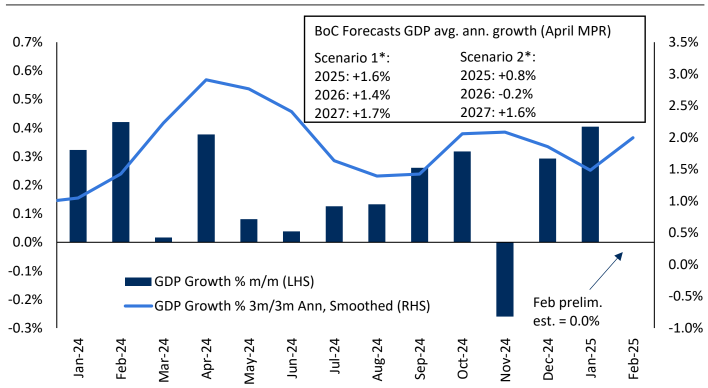
In its January Monetary Policy Report (MPR), the BoC forecasted GDP growth of 1.8% in both 2025 and 2026. In the April MPR, the BoC has elected to instead provide a range of scenarios from (1) GDP growth stalling temporarily in 2Q25, then averaging around 1.6% through the end of 2027, and (2) Canada entering into recession with GDP contraction averaging about -1.2% for four quarters, then recovering through the remainder of 2026 and into 1.8% growth in 2027. A lot rests on the path of U.S. trade policy, and ensuing U.S. GDP growth.

Chart 1 - Rate Easing Cycle to Continue Despite April 16 Pause



Source: FactSet, Raymond James Ltd.; Data as of April 16, 2025.

Chart 2 - High Uncertainty in Future GDP Growth



Source: Statistics Canada, Bank of Canada, Raymond James Ltd.; Data as of January 31, 2025. *Assumptions for both scenarios are in "The possible paths forward for the Canadian economy" section.

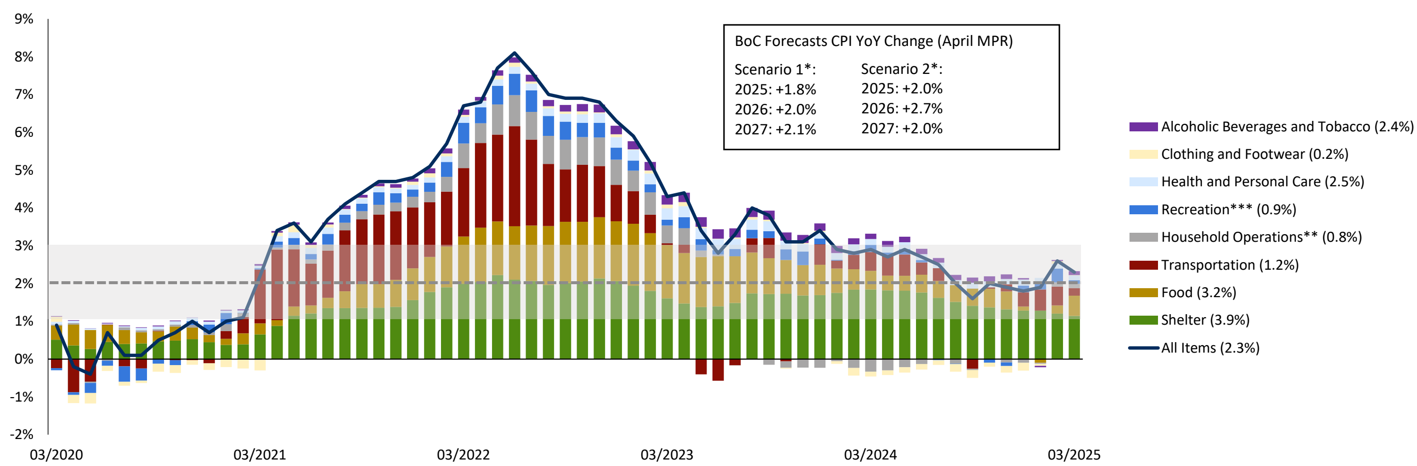
Inflation rate in Canada drops to 2.3%

After the unexpected surge in headline inflation to 2.6% in February, March's headline inflation dropped to 2.3%. February's surge to 2.6% was mainly due to the price increases in travel tours to the U.S., which we already expected to subside in March as Canadians significantly pulled back on trips to the U.S., with land crossings into the U.S. from Canada down 32% y/y in March, while air travel dropped 14%. Lower gasoline prices in March also helped bring the inflation rate down. Excluding gasoline the inflation rate would have been 2.5%.

The Consumer Price Index (CPI) rate in March shows that the move towards the BoC's 2% target is still on track, and staying within the 1-3% comfort zone (Chart 3), giving the BoC more leeway to ease its policy rate to stimulate growth in the economy. That optimism needs to be slightly tempered by the fact that the less volatile core measures that the BoC prefers to focus on remained towards the upper bound of the comfort range, with CPI-trim at 2.8%, down slightly from 2.9% in February, and with CPI-median holding steady at 2.9%.

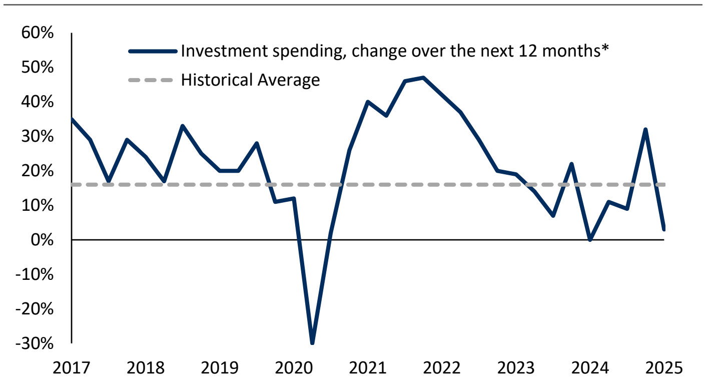
The latest business sentiment survey shows that firms' expectations for changes in average prices have jumped from +2.6% at the beginning of the year to +3.7% in March, mainly due to the concerns around U.S. tariffs and Canada's retaliatory tariffs. However, we do not expect the inflation of most CPI components (with vehicles potentially being an exception) to remain elevated for long before the index resumes its normalizing path, given that (1) consumer sentiment and wage growth expectations have declined, and (2) the slower pace of rate easing will help stabilize inflation. Additionally, the removal of consumer-facing carbon taxes is expected to lower the level of the consumer price index by 0.7% from April 2025 to March 2026. In the April MPR, the BoC has revised its 2025 headline inflation projection downward from its 2.3% forecast in the January MPR. Under scenario 1, it expects inflation to temporarily drop to the 1.5% level through the remainder of 2025 and into 2026 before stabilizing back just above 2% through 2027. In scenario 2, CPI averages around 2% until early 2026 before rising above 3% in 2026 as prices react to tariffs, and then normalize to the 2% level in 2027.

Chart 3 - Major Components' Contributions to Canada CPI (Stacked Bars) and Latest Monthly CPI (Bracket Beside the Legend)



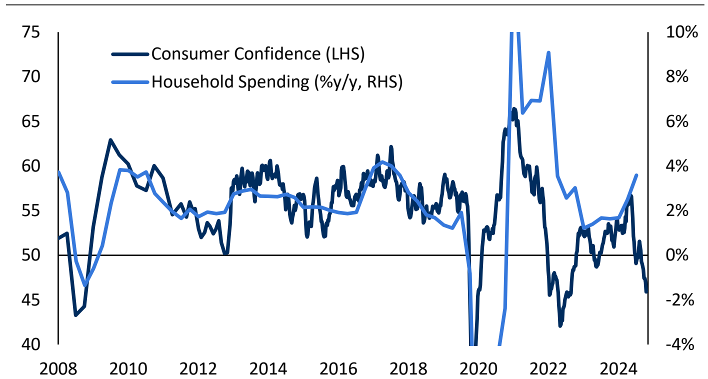
Source: Statistics Canada, Raymond James Ltd.; Data as of March 31, 2025. *Assumptions for both scenarios are in "The possible paths forward for the Canadian economy" section; **Household operations, furnishing and equipment; ***Recreation, education and reading.

Chart 4 - Businesses Are Holding off on Investments



Source: Business Outlook Survey Q1'25 - Bank of Canada. *Balance of Opinion Between Firms' Investment Spending Intentions.

Chart 5 - Weakening Consumer Confidence



Source: Statistics Canada, Bloomberg Economics, Raymond James Ltd.; Data as of April 11, 2025.

Both business and consumer sentiment have been weakening

Some soft data that points us towards continuing rate cuts this year is deteriorating business and consumer sentiment. In the 1Q25 Business Outlook Survey, we saw the sudden and unpredictable U.S. trade policy shifts creating uncertainty across the Canadian business community. Firms are preparing for slower sales growth, and are delaying decisions related to investing and hiring (Chart 4), while also anticipating input costs to rise. 32% of firms are now planning for a recession, up from 15% in the last two quarters. Positive business sentiment (3-month average) about business conditions, declined to just 8% in March, from 16% in February, and a recent high of 22% in October 2024. This month broke through the previous low of 9% in December 2023.

A similar trend is also evident in consumer confidence, which has historically been a good leading indicator of real household spending. Since the end of January, consumer confidence has slumped, reflecting concerns about the economy's strength, job security, and personal financial situations amid the implementation and threats of tariffs (Chart 5).

The possible paths forward for the Canadian economy

So far, GDP growth in 1Q25 looks to be about 1.8% annualized, although some of that growth can be attributed to U.S. companies accelerating imports to get ahead of tariffs. As such, we should expect 2Q25 growth to be much weaker. Following that, the BoC has laid out two possible scenarios for the Canadian economy, with a multitude of possible outcomes in between.

Scenario 1: New tariffs are negotiated away, but the volatile environment keeps businesses and households cautious, and after GDP growth stalling in 2Q25, we see modest growth through the remainder of the year. Inflation drops below the 2% target level through 2025 and 2026.

Scenario 2: A long-lasting global trade war has severe economic consequences, with Canada's GDP contracting in 2Q25, with a recession ensuing, lasting for approximately one year. Growth gradually returns in 2026 and remains soft through 2027 under tariff pressure. Inflation rises above 3% by mid-2026 with tariffs and counter-tariffs pushing up supply chain costs and prices.

Our expectation would be somewhere in between, as we have seen the U.S. administration's commitment to tariffs as a long-term plan, but with multiple shifts to ease burdens on various U.S. industries (such as exclusions for USMCA-compliant goods). Given Canada's significant role in many U.S. supply chains, we tend to see more opportunities for Canada as a whole to be less affected than many other nations, despite what will certainly be some significantly negative impacts on industries such as steel & aluminum, and the automotive sector. The potential for an advanced USMCA renegotiation also provides the potential for a more stable trading relationship a year from now.

Looking ahead, we maintain our projection that the BoC will continue to lower the policy rate throughout the remainder of the year, albeit at a slower pace, ending the year at 2.25%. Besides the external macro and geopolitical impacts, let's not overlook the domestic challenges, such as slower population growth, ongoing issues with residential/business investment, and weak productivity growth, which would bring additional downward pressure on the policy rate. These topics are likely to return to the main stage in the second half of the year once the tariff situation in Canada stabilizes.

The final word

Uncertainty is the final word. Investors should be prepared for a wide range of outcomes and work with their financial advisors to ensure that their return objectives and choice of assets to achieve those goals are appropriately aligned with their risk tolerance.

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