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Economics and Strategy

NATIONAL BANK OF CANADA
FINANCIAL MARKETS

February 2025

Forecast Summary

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- These days, economic and financial market forecasts don't have the shelf-life investors are accustomed to. Case in point, following the U.S. Administration's tariff announcement on February 1st, we presented a **forecast update** incorporating the impacts on growth/inflation from what appeared to be an imminent trade war. An 11th hour reprieve/delay invalidated that tariff-related scenario. We nonetheless hold this more dramatic 'alternative scenario' in reserve should the tariff threat legitimately resurface. (March 4th is the latest date circled on the geopolitical calendar, whether you're making a living north or south of the U.S. border.)
- While a begger-thy-neighbour, GDP-destroying, inflation-sparking trade war has seemingly been placed on hold, it does not permit a full reversion to pre-tariff thinking. For Canada, immense policy uncertainty is an unwelcome headwind for an underperforming economy. Investment and spending are apt to be negatively impacted, leading us to mark down 2025 growth prospects. Put differently, Canada looks to be robbed of some of the pick-up that might have otherwise accrued in the wake of aggressive Bank of Canada rate cuts.
- The Bank of Canada favoured an up-tempo approach to policy relief last year, out cutting major advanced economy central banks. The BoC's first decision of the year took the overnight target lower still. Having pushed decisively, the base increasingly matters. At 3%, the target is close(r) to the middle of the neutral band. This implies less urgency. Back-to-back months of robust hiring and unexpected heat in core CPI likewise support graduality. There are nonetheless mixed signals and we see the balance of economic risks tilted to the downside. A continuation of sub-potential growth and the likely return of soft(er) labour market conditions argue for an overnight setting at the low end of the neutral range.
- In short, we still see a case for a 25 bp BoC rate cut on March 12th, acknowledging that much will be learned before then, including on tariffs. In all, 75 bps of cumulative BoC easing (vs. current) would leave overnight at 2.25% by Q3. Beyond tariffs, Canada's own political landscape could be recast, where prospective policy adjustments would need to be controlled for. Various tariff-proofing initiatives, including a renewed push on inter-provincial trade, bear scrutiny. Assuming tariffs are on hold and no further momentum is lost, we envision the BoC holding at 2.25% through the first half of 2026. This near-stimulative level would be appropriate for a time given the slack that remains to be taken up.
- 'Resilience' remains the watchword in the U.S., even if Americans are themselves coming face-to-face with political uncertainty. Ample jobs, firm(ish) growth and mounting inflation expectations forced markets to scale back easing expectations. Absent a near-term weakening in the labour market, there's unlikely to be much urgency in re-starting FOMC rate cuts. Nonetheless, our baseline forecast (incorporating a moderation in growth), envisions 75 bps of cuts this year. We see this easing re-commencing around mid-year with fed funds upper closing 2025 at 3.75%. It follows that the wide divergence in Canada-U.S. policy rates is to be sustained, perhaps accentuated in the near-term. The story could be somewhat different later in the year and into 2026, though relative risks keep an ample premium on Canadian rates through our forecast horizon.
- In a partial replay of 2017, bond market anxiety—expressed via term premia—has subsided to a degree, U.S. Treasury Secretary Bessent placing a deliberate (if unconventional) focus on longer-term Treasury yields. Notwithstanding the promise of deregulation, government efficiencies and eventual energy price relief ('drill, baby, drill'), unsustainable fiscal policy remains a latent risk factor for U.S. bond investors, one that could prove difficult to nullify quickly or easily.

United States

Quarter	Target	3M	2Y	5Y	10Y	30Y
7-Feb-25	**4.50**	**4.34**	**4.27**	**4.33**	**4.48**	**4.69**
Q1:2025	4.50	4.30	4.25	4.30	4.45	4.65
Q2:2025	4.25	4.05	4.05	4.15	4.35	4.55
Q3:2025	4.00	3.80	3.80	3.95	4.15	4.35
Q4:2025	3.75	3.55	3.55	3.70	4.00	4.20
Q1:2026	3.50	3.30	3.40	3.60	3.90	4.10
Q2:2026	3.50	3.30	3.45	3.65	3.90	4.10
Q3:2026	3.50	3.35	3.50	3.70	3.95	4.15
Q4:2026	3.50	3.35	3.55	3.75	4.00	4.20

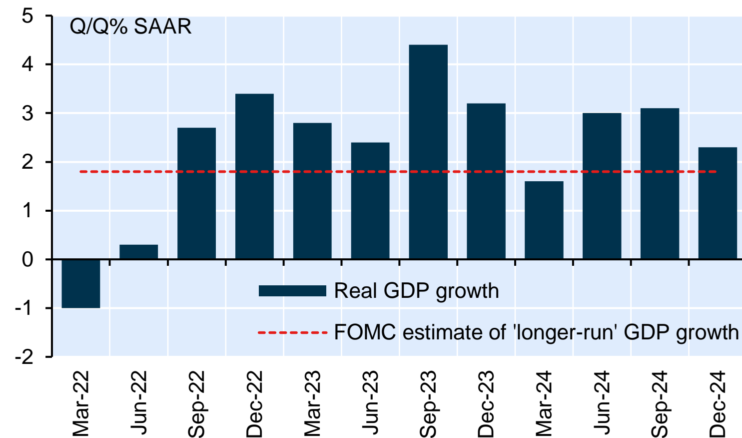
Canada

Quarter	Target	3M	2Y	5Y	10Y	30Y
7-Feb-25	**3.00**	**2.88**	**2.69**	**2.75**	**3.07**	**3.24**
Q1:2025	2.75	2.60	2.55	2.65	3.00	3.15
Q2:2025	2.50	2.35	2.35	2.50	2.85	3.05
Q3:2025	2.25	2.15	2.25	2.45	2.75	2.95
Q4:2025	2.25	2.20	2.20	2.40	2.70	2.90
Q1:2026	2.25	2.25	2.30	2.50	2.75	2.95
Q2:2026	2.25	2.35	2.45	2.60	2.85	3.00
Q3:2026	2.50	2.60	2.60	2.75	2.95	3.05
Q4:2026	2.75	2.70	2.75	2.85	3.00	3.10

FOMC: No reason for easing… for now

President Trump hasn't even been in office for a month but it has already become clear it's going to be a long four years. Tariffs and trade policy have dominated discourse since inauguration (and even before then) and will remain in focus over coming weeks and months (all the while, fiscal policy uncertainty looms large too). Canada and Mexico were able to get a last-minute reprieve from February 4th tariff imposition, but a short 30-day pause means uncertainty will linger. That's not a pro-growth, risk-on backdrop by any means but underlying economic momentum in the U.S. economy should mean this storm can be weathered for now.

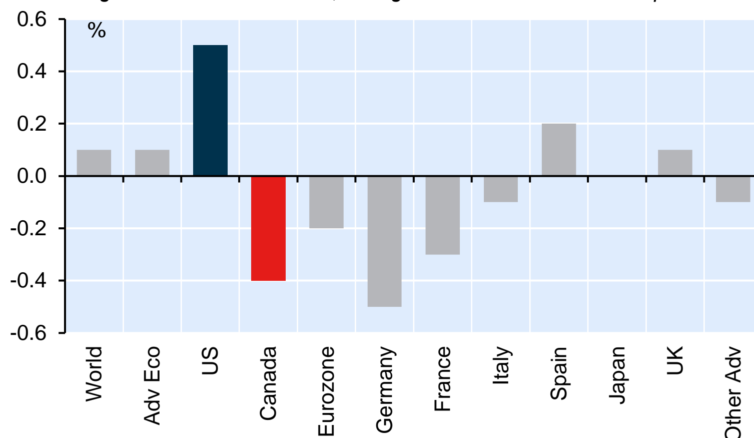
GDP growth slowed in Q4, but still printed above 2%
U.S. real GDP growth, QoQ SAAR



Source: NBC, BBG

The latest read on U.S. GDP growth reinforced the U.S. exceptionalism theme, as output expanded by more than 2% for a third straight quarter and the ninth of the last ten. The U.S. consumer remains well engaged and many forecasters find themselves revising up their growth projections for 2025 given this unrelenting positive momentum.

U.S. exceptionalism reflected in IMF outlook revisions
IMF GDP growth outlooks for 2025, change from Oct-24 to Jan-25 report

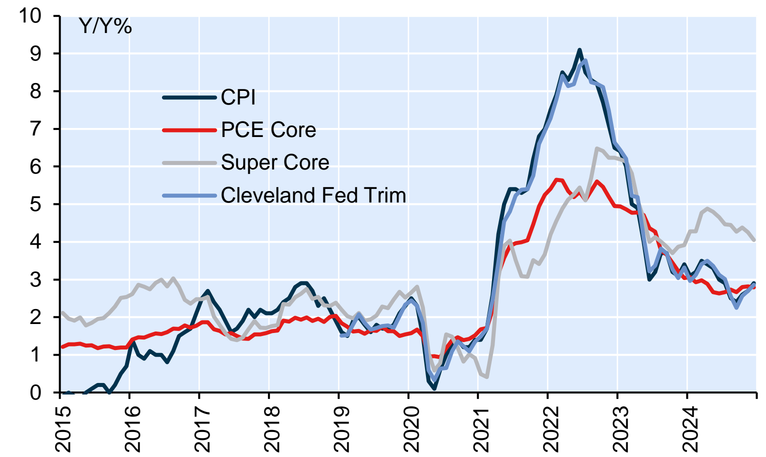


Source: NBC, IMF | Note: 'Adv Eco' refers to advanced economies, as presented by IMF.

We too have nudged up our GDP forecast relative to our prior thinking but not by as much as others, remaining below consensus. As our **U.S. Economic Monitor** outlines, we expect that heightened uncertainty will characterize much of the year, which in turn will dampen the economic mood. That should lead to growth slowing to a below potential clip later this year. This would surely have implications for Fed policy but for now, there's nothing the FOMC can do but wait.

When it comes to the committee's mandate variables (i.e., inflation and employment), there's nothing screaming for further near-term interest rate relief either. The steady inflation progress we saw earlier has sputtered and, no matter which measure you prefer, it's clear that price pressures are *not* consistent with the Fed's mandate. True, December inflation data was *better,* but they'll likely need to see a string of 'good' reports before they'll be comfortable easing again.

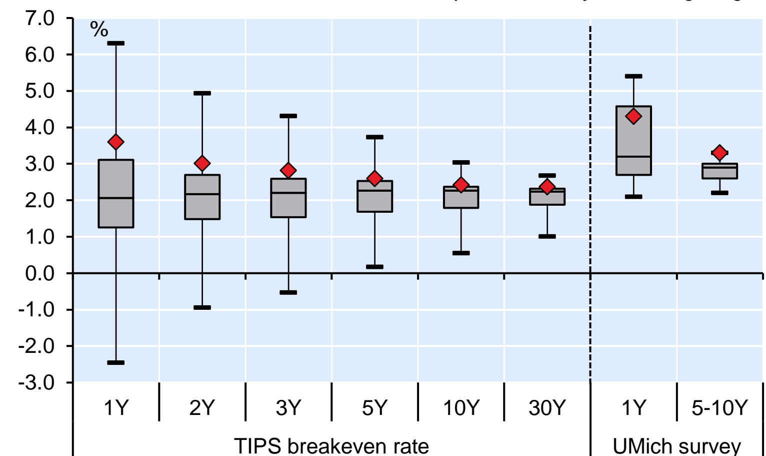
Inflation is still too high, no matter the measure
Select measures of U.S. inflation



Source: NBC, BBG

Inflation expectations bear watching too. These have steadily edged up since the summer, Trump's election and his promised/threatened policies no doubt contributing. This is most acute in consumer expectations, but even market-based measures are on the upper end of the 'comfortable' range. For now, Chair Powell is downplaying consumer surveys and focusing on the better contained breakevens. However, further upward pressure at this point (on any measure) would not be welcomed and could act as a headwind to further cuts. For now, it's another reason to stay sidelined.

Inflation expectations somewhat elevated in the U.S.
Breakeven inflation rates & U. Mich inflation expectations, 5-year trading range

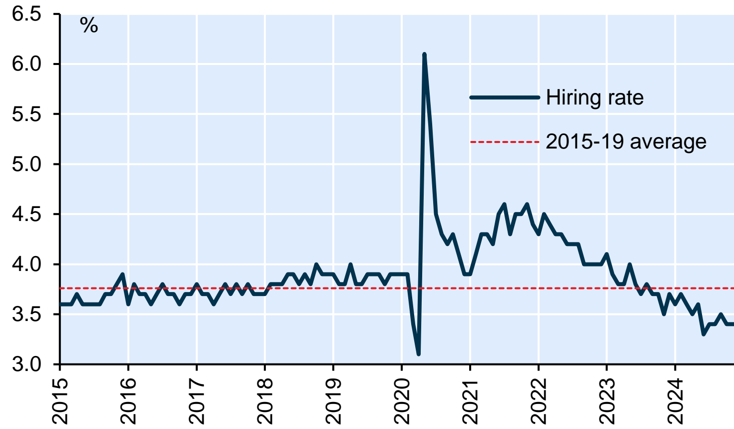


Source: NBC, BBG | Note: Red dot denotes current level. Box shows middle 2 quartiles.

The labour market has the potential to generate a re-think on Fed policy, but data here have been decidedly good of late. Good enough to lead policymakers to declare in January that 'unemployment has stabilized at a low level'. Indeed, the closely-watched unemployment rate *has* been rangebound since the run-up earlier in 2024 and for now, that can support this policymaker pause. However, we continue to argue that risks are skewed to more softening, not less. As Powell

readily conceded, we're in a "low-hiring environment." Layer in White House trade uncertainty/volatility, a desire to cut federal headcounts and an immigration crackdown and we don't see the makings of an overheating labour market.

Despite low jobless rate, U.S. in a low hiring environment
U.S. hiring rate vs. pre-pandemic average



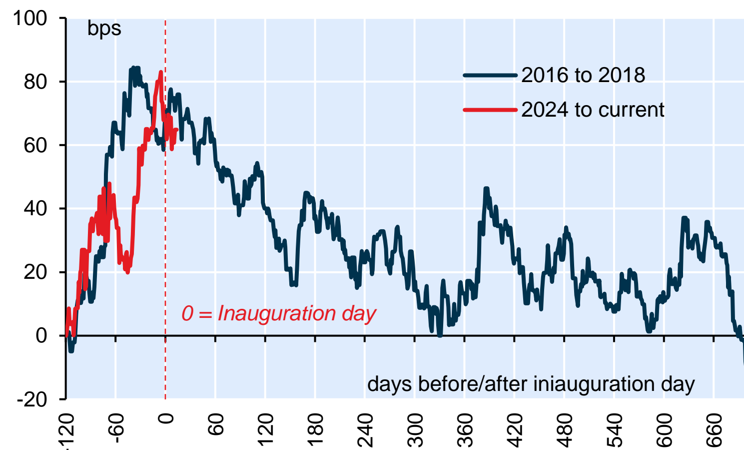
Source: NBC, BBG

More broad-based labour market softening may be a development that plays out in the second half of the year, but it leaves us continuing to take the 'over' on Fed easing in 2025. As it stands, we see the FOMC cutting three times this year which compares to the two cuts signaled by the Fed in December (and the ~36 bps discounted by markets).

Clearly, our more cautious economic outlook is consistent with policy rates coming down this year. But for bonds, the expected Fed path is only one part of the equation. The term premium, garnering no shortage of attention of late, is another critical consideration. As Trump election odds grew in the summer up to his inauguration earlier this year, the 10-year term premium was climbing. Attribute that to the President's promises on fiscal and trade policy, and generalized uncertainty.

This is a movie we've seen before though. Back in late 2016 and early 2017, similar uncertainty brought about a similar increase in the term premium as Trump secured election victory and inauguration day approached. Scan the headlines eight years ago and you could easily mistake them for something published in recent weeks: "*Array of uncertain outcomes under Trump prompting selloff*", "*Increased debt issuance assumed to finance spending plans*".

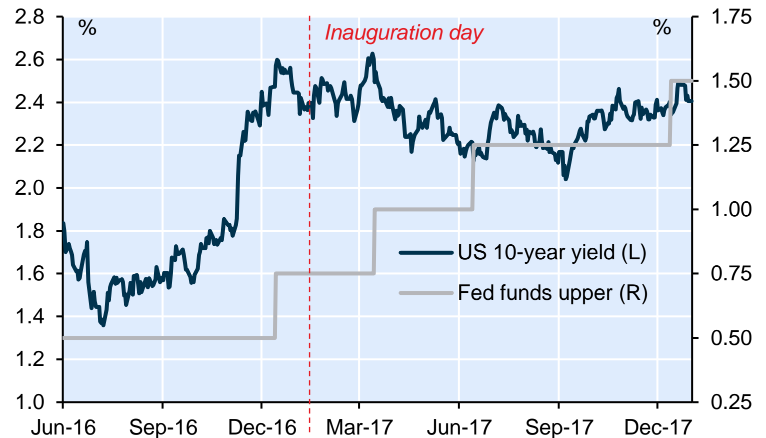
We've seen the Trump term premium effect before
Indexed U.S. 10-year Treasury term premium (Adrian, Crump & Moench)



Source: NBC, BBG | Note: Term premium indexed to 120D prior to Trump inauguration.

So, the pre-inauguration period didn't look that different than today but what did it all amount to after Trump took office? Not much. Ultimately, the term premium steadily moderated after the first few months of 2017 as uncertainty resolved and markets tempered expectations on the President's policy actions. 10-year yields edged down in 2017 too despite the Fed steadily hiking throughout the year. In short, the *fear of Trump* was worse than Trump himself to the bond market.

10-year yields didn't rise in 2017 even with Fed hikes
Fed funds target (upper) and U.S. 10-year yield: 2016-17



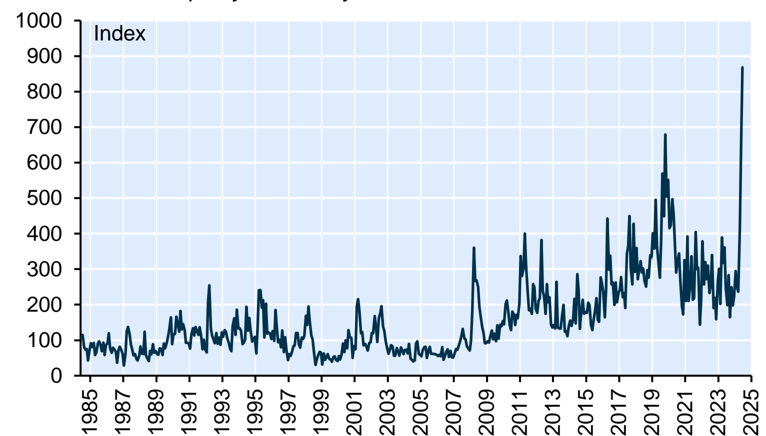
Source: NBC, BBG

Today, Trump has only held office for a handful of weeks but despite a lot of volatility, it's been a similar story for term premiums so far. These have edged down, bringing Treasury yields down with it. That's a trend we expect to continue playing out in 2025, although the compression of term premiums we saw in 2017 may not be as significant this time around. Certainly, the U.S. fiscal situation is worse today than eight years ago.

BoC: Uncertainty weighs heavy

In the 11th hour, Prime Minister Justin Trudeau was able to earn Canada a 30-day reprieve on the 25% blanket tariffs (with a small carve-out for energy) that were set to come into effect on February 4th. All it took was re-announcing previously-budgeted measures, pledging to name a 'fentanyl czar' and a few other relatively low-cost measures. For now, Canadian households, businesses and investors can take a collective deep breathe, but the removal of an immediate threat does not mean the complete removal of uncertainty. We could see this same volatility play out again next month.

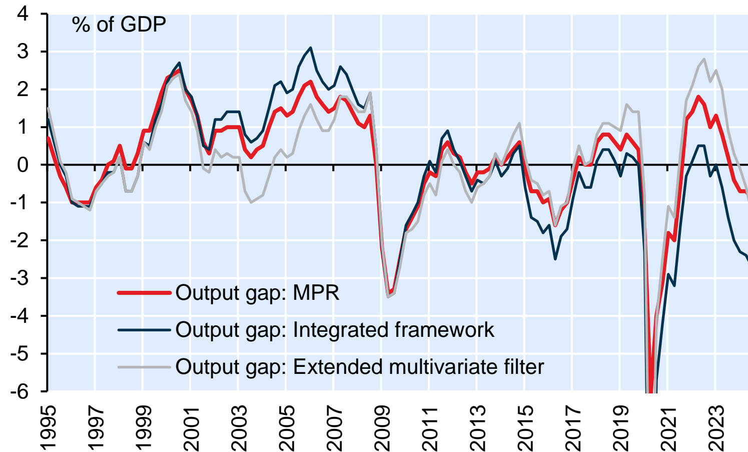
Tariffs deferred but uncertainty remains
Canada economic policy uncertainty index



Source: NBC, BBG

It's clear this uncertainty is weighing on the Bank of Canada, who held its first 2025 rate decision just days before tariffs were to go into effect. One could argue that a cut was justified based only on accumulated economic slack, and we'd generally agree. Still, the Governor admitted that the looming tariff threat contributed to the decision to ease as uncertainty was "clouding the economic outlook". Those clouds haven't fully parted, which may become a headwind to hiring, investment and overall economic activity going forward. With the policy rate still in the upper half of the Bank's estimated neutral range, it argues for following January's cut with another in March.

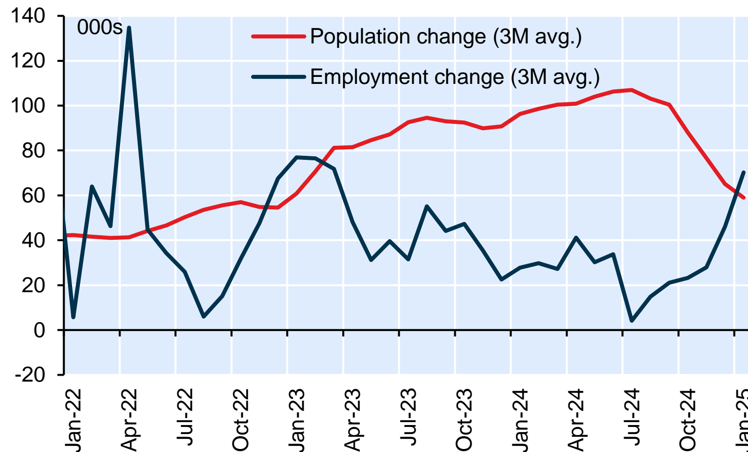
Economic slack argues for further rate relief
Bank of Canada output gap estimates (actual GDP less potential GDP)



Source: NBC, BoC | Note: Last observation = Q3:2024

What's particularly unfortunate about this trade policy panic is that it comes at a time when Canada's economy seemed to be firming. Hiring was picking up, lower rates were leading to more housing activity and business sentiment was rebounding. Conditions were far from perfect in Canada but it appeared that the period of below-potential activity was mostly behind us. That assessment has changed over recent weeks, and we expect more sluggish economic performance this year as uncertainty weighs.

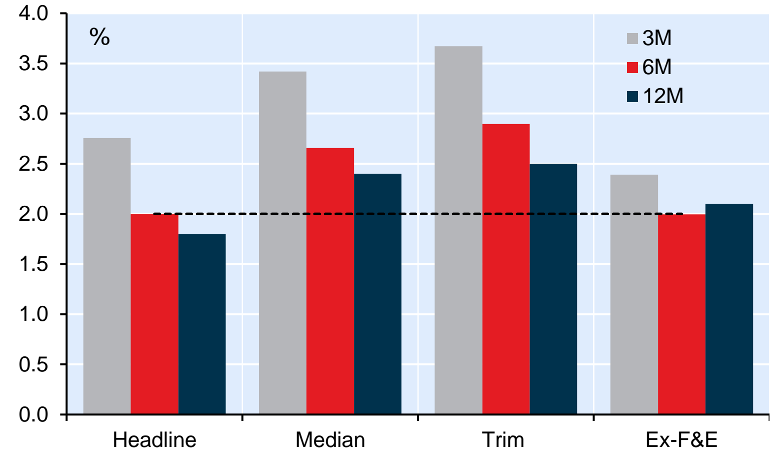
The labour market was improving after a couple rough years
Change in Canadian working age population and employment



Source: NBC, BoC

Just as the economy was improving there were also some signs that inflation was perking back up, even if only modestly. While headline year-on-year inflation came in at or below 2% for a fifth straight month in December, the more sensitive/volatile 3-month measures of price pressures were all running *above* 2%. This was even more significant in the Bank's preferred core inflation indicators. Although, in what we'd interpret as a dovish signal, Senior Deputy Governor Rogers tried to downplay CPI-trim, citing calculation 'particularities' which made it a poor gauge of underlying inflation. To them, underlying pressures *are* running at 2%. Long-time Bank of Canada watchers will appreciate this isn't the first time the BoC has changed its focus on inflation (recall most recently the **CPI-common fiasco** in 2022). Importantly, it means the BoC doesn't view inflation as a hurdle to further cuts, at least right now.

There were signs of modest inflation momentum
Select measures of Canadian inflation: Last 3, 6, 12 months

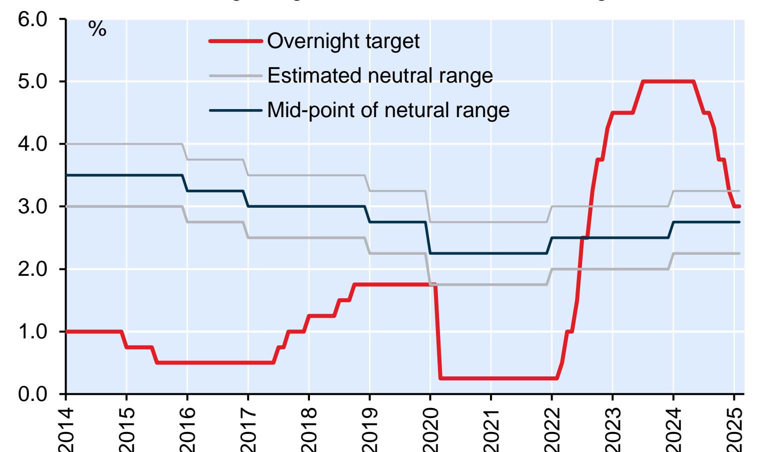


Source: NBC, StatCan | Note: 3- and 6-month inflation rates are annualized

So for Canada, it's bit of a mixed bag. Economic slack remains but was seemingly starting to be absorbed. The labour market is weak but in the early stages of recovery. Inflation is on target but there are some modest signs of pressure. And then there's a chance the nascent recovery is blown up anyways if tariffs were to be imposed in March. It's a frustrating time to be a forecaster and means we need multiple forecasts on hand.

To us, all reasonably likely scenarios involve lower rates, but the uncertainty lies in determining *how much* lower rates will go. To us, the immediate removal of all tariff threats (a very low likelihood) might only involve one more cut from the central bank. Meanwhile, our baseline scenario, assuming ongoing uncertainty and potentially some targeted tariff action, is consistent with the Bank of Canada easing to the lower end of their estimated neutral range. After a year of borderline accommodative policy, we'd look for the central bank to gradually move back towards their estimate of neutrality (i.e., 2.75%).

Overnight target close to, but perhaps not quite at neutral
Bank of Canada overnight target versus estimated neutral range

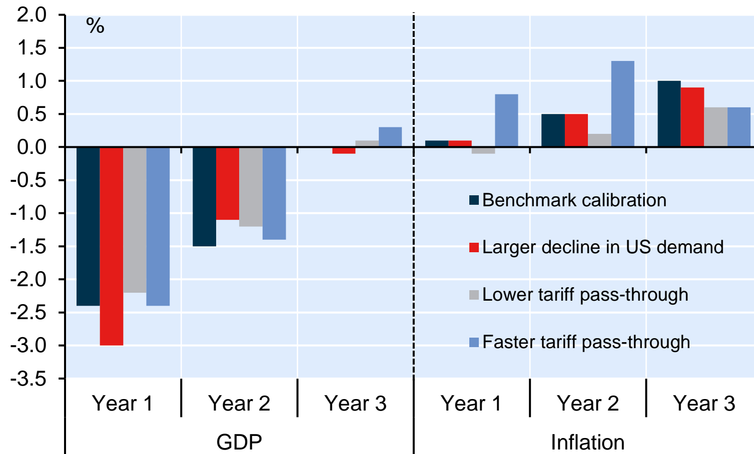


Source: NBC, BoC | Note: Official 2025 neutral estimate will be published in April

Then there's the full-fledged tariff war scenario, which for a moment this month seemed imminent. That, as the Bank of Canada's analysis showed, would be consistent with a large hit to GDP likely pushing the economy into recession. Inflation too would rise as Canada retaliates with tariffs of their own. But while some of our counterparts have suggested the Bank would need to *hike* in response to a tariff-led inflation increase, we believe the Bank would look through the shorter-term CPI spike and instead focus on the damage to GDP that would ensue. True, the BoC might not be comfortable cutting as low as they otherwise might in response to such a growth shock, but we would still expect them to move into unambiguously stimulative territory (say, around 1.5%).

GDP damage would outweigh inflation spike in trade war

Impact on real GDP growth & inflation vs. no-tariff scenario, annual avg



Source: NBC, BoC January 2025 MPR

What does this imply for the bond market? Once again, we see most paths leading to lower yields and a steeper curve. Key risks to that view are of course a more resilient economy (as the reaction to January's jobs report showed) but fiscal policy is on our radar too. Reports last month that the federal government would respond to U.S. tariffs with 'pandemic style' supports is not likely to be well-received by bond investors. Even though Canada's fiscal fundamentals are in much better shape than key peers, marginal spending measured in tens of billions (alongside a presumed revenue hit) could see the long-end of the curve get hit. We've certainly seen this play out in other jurisdictions in recent years (most notably, the U.K.). Investor sentiment can be fickle and difficult to predict, but this is a risk worth flagging in a downside economic scenario.

With the Fed sidelined in the near-term and better insulated from trade policy fallout, we continue to look for Canadian rates to outperform in the coming months. A protracted trade war would provide even more support for GoCs but even in a 'friendlier' geopolitical environment, we'd favour Canada in the near-term. However, in the baseline scenario, we feel that we're *close* to limits of yield divergence. Around the middle of the year, as the Fed gets back to cutting, it should be U.S. treasuries that perform best, helping to narrow what are now historically wide rate gaps.

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