

Canada Watch

Lower inflation in Dec. and the possibility of tariffs make a 25bp cut likely

Key takeaways

- Headline inflation fell to 1.8% yoy in Dec. (vs. 1.9% in Nov.) driven by the GST/HST break. Core fell to 2.5% from 2.6%.
- We now expect the BoC to cut 25bp in Jan. due to falling inflation and the possibility of tariffs. Risks to the upside.
- Rates: Tariffs risk pricing of further cuts. FX: We believe USDCAD can break above 1.45 if the US confirms tariffs of 25%.

Headline fell in December due to the GST/HST tax break...

Consumer Price Index (CPI) inflation came in below expectations in December at 1.8% yoy (E. 1.9%, BofA 1.7%), down from 1.9% a month ago (Exhibit 1); and CPI excl. gasoline fell again to 1.8% yoy (vs. 2.0% in Nov.), despite the 3.5% yoy increase observed in gasoline prices (Exhibit 2). The lower inflation was explained in part by articles eligible for the [GST/HST "tax holiday," effective as of Dec. 14 and until Feb. 15](#), which affects ~10% of the CPI basket (e.g., food purchased in restaurants, alcoholic beverages purchased in stores) (Exhibit 3, Exhibit 4). We estimated that December's print would have been 2.2% yoy without the tax holiday. In monthly terms, inflation was -0.4% mom nsa (E. -0.4%, BofA -0.5%) (we estimated -0.1% without the tax holiday). In seasonally adjusted terms, inflation increased 0.2% mom sa, up from 0.1% a month ago.

... and core fell as well, although it remains above target

The average of the two core measures (trimmed and median) fell to 2.45% yoy, down from 2.60% in November (revised from 2.65%), with the median measure leading at 2.4% yoy (vs. 2.6% a month ago), followed by the trimmed mean at 2.5% yoy (vs. 2.6% a month ago, revised from 2.7%) (Exhibit 5). Core measures are tax-adjusted; thus, their fall signal some underlying easing. Services inflation came in at 3.5% yoy, unchanged vs. November. Shelter slowed down to 4.5% yoy (vs. 4.6% in Nov.), and mortgage interest costs to 11.7% yoy (vs. 13.2% in Nov.), both due to lower interest rates. As the economy recovers, core inflation is unlikely to fall much more, putting upside pressure to inflation.

Our inflation forecasts are virtually unchanged

After incorporating December's print to our inflation forecasts, we continue to see inflation at 2.0% yoy by end-2025 and end-2026 (Exhibit 6, Exhibit 7).

BoC: We now expect a 25bp cut in January

We expect the BoC to cut 25bp at its January 29 meeting (previously on hold). Inflation continued to fall in December, inflation expectations remain anchored (according to BoC's 4Q Business Outlook and Consumer Expectations Surveys), and flash activity indicators show a weak economy in November 2024. Moreover, we believe that President Trump's comments on imposing 25% tariffs to Canada [could nudge the BoC to support the Canadian economy by allowing a weaker CAD](#) (through cuts); thus, letting the CAD to act as buffer. Risks for the January meeting are tilted to the upside, as the BoC could decide to remain on hold. Our terminal rate is 3.0% (conditional on tariffs).

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Glossary

CPI = Consumer Price Index

E. = Bloomberg Consensus estimate

nsa = not-seasonally adjusted

sa = seasonally adjusted

mom = month-over-month

yoy = year-over-year

BoC = Bank of Canada

StatCan = Statistics Canada

GST = Goods and Services Tax

Rates: Tariffs risk pricing of further cuts

CAD rates rose across the curve following the CPI print but remain below yesterday's close, likely due to the pricing in of tariffs. Markets are currently pricing an 84% chance of a cut at next week's meeting, according to BoC OIS. A cut next week would potentially drive the pricing of the respective terminal rates between the US and Canada wider despite already being near record wides. The risk of tariffs could drive further pricing of additional BoC cuts to counter the impact of tariffs on CAD growth. In line with our economist's view, we fade the pricing of BoC cuts. We see the pricing of the BoC and Fed's respective terminals as a proxy for 10y rates and therefore currently see risk skewed towards CAD 10y rate outperformance due to headlines around tariffs, but a hawkish BoC would likely drive CAD rates higher across the curve.

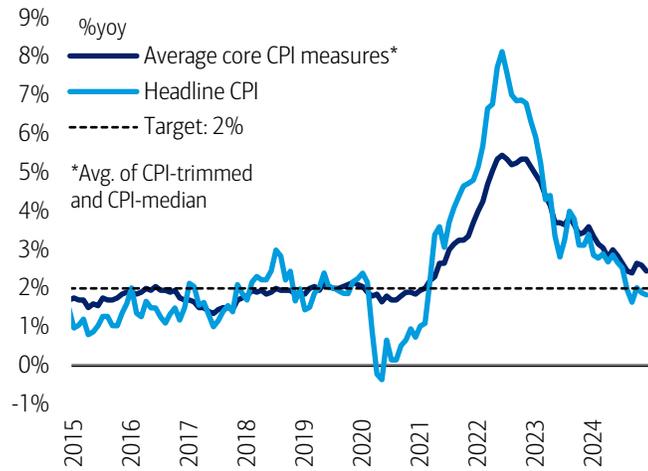
FX: It's all about US tariffs

USDCAD saw little change after the CPI release. Market has largely priced-in a BoC rate cut for next week and investors are well-aware of the temporary holiday tax break lowering inflation. Driven by US headlines, USDCAD saw volatile two-way price action yesterday, but remains below 1.45. We believe the pair can break above this resistance level if the US confirms full implementation of the 25% tariff in the coming days. Once the pair starts trading in a new 1.45-1.50 range, further upside would likely depend on the Canadian government and the BoC's response. Should the BoC choose to cut policy rates further toward the low-end of the 2.25-3.25 neutral range, widening US-CA rate differential could further push USDCAD toward a 1.50-handle.



Exhibit 1: Headline and core inflation (%yoy)

Both headline and core fell in Dec., with headline driven by the tax holiday

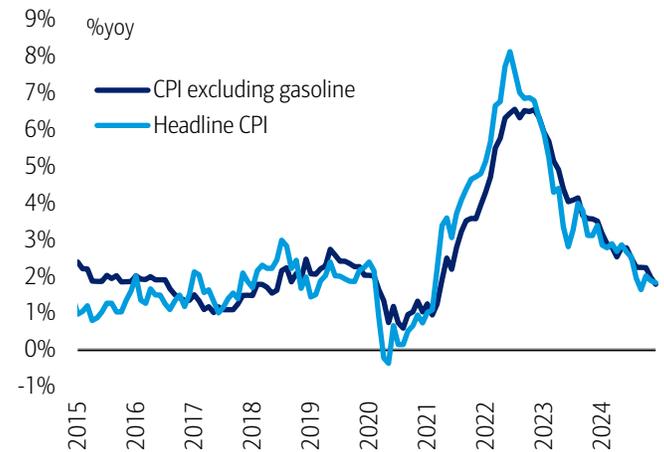


Source: BofA Global Research, Stat Canada, Haver

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Exhibit 2: Inflation excluding gasoline (%yoy)

CPI excluding gasoline fell as well, but was also helped by the tax break



Source: BofA Global Research, Stat Canada, Haver

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Exhibit 3: CPI heatmap: % mom nsa

The tax holiday helped to bring inflation down, particularly in food prices

Component	Dec-24	Nov-24	Oct-24	Sep-24	Aug-24	Jul-24	Jun-24	May-24	Apr-24	Mar-24	Feb-24	Jan-24	Dec-23
Headline	-0.4%	0.0%	0.4%	-0.4%	-0.2%	0.4%	-0.1%	0.6%	0.5%	0.6%	0.3%	0.0%	-0.3%
Food	-1.8%	0.5%	0.1%	0.0%	-0.1%	0.3%	0.5%	0.9%	-0.2%	-0.2%	0.0%	0.7%	0.3%
Shelter	0.3%	0.3%	0.7%	0.1%	0.4%	0.2%	0.3%	0.4%	0.5%	0.4%	0.4%	0.3%	0.4%
Household Operations/Furnishings/Equipment	-1.1%	-0.9%	0.2%	-0.2%	-0.4%	0.5%	0.0%	0.1%	0.5%	-0.3%	-0.2%	0.8%	-0.9%
Clothing and Footwear	-3.0%	-0.8%	2.4%	0.9%	-0.6%	-0.6%	-1.9%	0.0%	0.8%	2.8%	-1.1%	-3.2%	-2.2%
Transportation	1.8%	0.3%	0.4%	-2.4%	-1.4%	1.3%	-0.2%	0.1%	1.6%	1.5%	0.7%	-1.2%	0.6%
Health and Personal Care	-0.2%	-0.2%	0.0%	0.5%	0.2%	1.0%	-0.3%	0.8%	1.1%	-0.1%	0.5%	0.7%	-0.5%
Recreation, Education and Reading	-0.7%	-0.5%	0.0%	-0.4%	-0.9%	1.2%	-1.5%	2.3%	-0.7%	2.0%	1.6%	-0.6%	-3.4%
Alcoholic Beverages and Tobacco Products	-2.4%	0.2%	0.1%	-0.1%	0.8%	-0.1%	0.1%	0.3%	0.5%	0.5%	-0.1%	1.1%	-0.5%

Source: BofA Global Research, Stat Canada, Haver

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Exhibit 4: CPI heatmap: % yoy

Shelter inflation, currently one of the most important upside pressures on the CPI, continues to come down, albeit slowly

Component	Dec-24	Nov-24	Oct-24	Sep-24	Aug-24	Jul-24	Jun-24	May-24	Apr-24	Mar-24	Feb-24	Jan-24	Dec-23
Headline	1.8%	1.9%	2.0%	1.6%	2.0%	2.5%	2.7%	2.9%	2.7%	2.9%	2.8%	2.9%	3.4%
Food	0.6%	2.8%	3.0%	2.8%	2.7%	2.7%	2.8%	2.4%	2.3%	3.0%	3.3%	3.9%	5.0%
Shelter	4.5%	4.6%	4.8%	5.0%	5.3%	5.7%	6.2%	6.4%	6.4%	6.5%	6.5%	6.2%	6.0%
Household Operations/Furnishings/Equipment	-0.8%	-0.7%	-0.1%	-0.2%	-0.8%	-0.1%	-0.9%	-1.5%	-2.1%	-2.3%	-1.7%	-0.5%	-1.7%
Clothing and Footwear	-4.5%	-3.8%	-2.3%	-4.4%	-4.4%	-2.7%	-3.1%	-3.0%	-2.6%	-2.7%	-4.2%	-1.3%	0.9%
Transportation	2.3%	1.1%	0.2%	-1.5%	-0.1%	2.0%	2.0%	3.5%	3.1%	3.0%	2.2%	1.2%	3.2%
Health and Personal Care	3.1%	2.8%	3.1%	3.1%	2.6%	2.9%	3.0%	3.6%	3.0%	3.2%	3.8%	3.7%	3.7%
Recreation, Education and Reading	1.8%	-0.9%	-0.9%	0.0%	-0.2%	-0.2%	0.6%	1.3%	1.0%	1.9%	1.1%	0.3%	1.7%
Alcoholic Beverages and Tobacco Products	0.7%	2.7%	3.0%	3.0%	3.1%	2.7%	3.1%	3.2%	3.4%	3.2%	3.6%	4.2%	4.3%
Average core CPI measures	2.5%	2.6%	2.7%	2.4%	2.5%	2.7%	2.9%	3.0%	2.8%	3.1%	3.2%	3.4%	3.6%
Core Trimmed Mean	2.5%	2.6%	2.6%	2.4%	2.4%	2.7%	2.8%	3.0%	2.8%	3.1%	3.1%	3.3%	3.6%

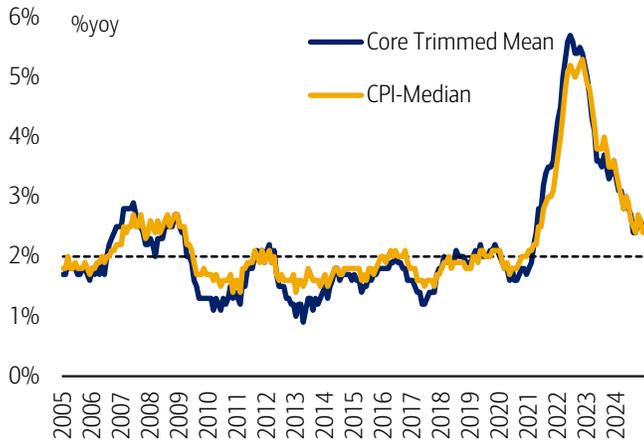
Source: BofA Global Research, Stat Canada, Haver

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Exhibit 5: Core inflation measures

The average of the two core measures is now below 2.5% yoy



Source: BofA Global Research, Stat Canada, Haver

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Exhibit 6: Inflation forecasts

We expect inflation close to the 2.0% target in 2025 and 2026



Source: BofA Global Research estimates, Stat Canada, Haver

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Exhibit 7: Monthly CPI forecasts (nsa)

We expect inflation at 2.0% yoy by end-2025 and end-2026

	Level	mom (%)	yoy (%)
2024: Dec	161.2	-0.4	1.8
2025: Jan	160.9	-0.2	1.7
2025: Feb	162.0	0.7	2.0
2025: Mar	163.5	0.9	2.3
2025: Apr	164.0	0.3	2.1
2025: May	164.9	0.6	2.1
2025: Jun	165.2	0.2	2.4
2025: Jul	165.6	0.2	2.1
2025: Aug	165.5	0.0	2.3
2025: Sep	165.0	-0.3	2.4
2025: Oct	165.2	0.1	2.1
2025: Nov	165.0	-0.1	2.0
2025: Dec	164.5	-0.3	2.0
2026: Jan	164.8	0.2	2.4
2026: Feb	165.6	0.5	2.2
2026: Mar	166.5	0.5	1.8
2026: Apr	167.1	0.4	1.9
2026: May	168.0	0.5	1.9
2026: Jun	168.5	0.3	2.0
2026: Jul	169.0	0.3	2.1
2026: Aug	169.2	0.1	2.3
2026: Sep	168.8	-0.3	2.3
2026: Oct	168.7	-0.1	2.1
2026: Nov	168.5	-0.1	2.1
2026: Dec	167.8	-0.4	2.0

Source: BofA Global Research estimates, Stat Canada, Haver

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Exhibit 8: BoC monetary policy path

We now expect a 25bp cut on January 29, to leave the terminal rate at 3.00%

Date	New path		Old path	
	Rate (%)	Change (bp)	Rate (%)	Change (bp)
Dec-24	3.25		3.25	
Jan-25	3.00	-25	3.25	
Feb-25	3.00		3.25	
Mar-25	3.00		3.25	
Apr-25	3.00		3.25	
May-25	3.00		3.25	
Jun-25	3.00		3.25	
Jul-25	3.00		3.25	
Aug-25	3.00		3.25	
Sep-25	3.00		3.25	
Oct-25	3.00		3.25	
Nov-25	3.00		3.25	
Dec-25	3.00		3.25	
Jan-26	3.00		3.25	
Feb-26	3.00		3.25	
Mar-26	3.00		3.25	
Apr-26	3.00		3.25	
May-26	3.00		3.25	
Jun-26	3.00		3.25	
Jul-26	3.00		3.25	
Aug-26	3.00		3.25	
Sep-26	3.00		3.25	
Oct-26	3.00		3.25	
Nov-26	3.00		3.25	
Dec-26	3.00		3.25	

Source: BofA Global Research, Bloomberg

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