TD Economics

Dollars & Sense

The Bank of Canada Takes Out Inflation Insurance

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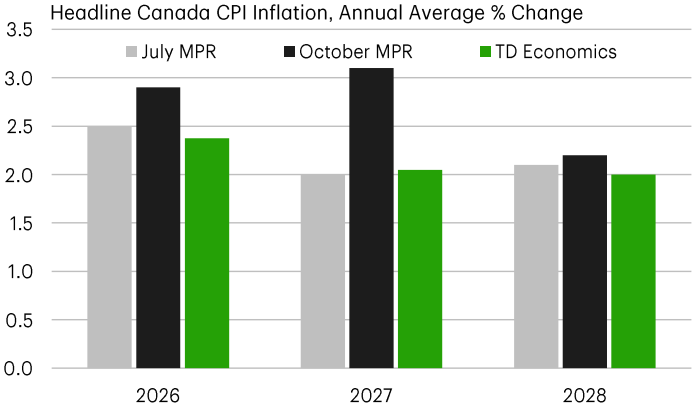
Highlights

- The Bank of Canada raised the policy rate by 25 basis points to 2.50%, after an 11th hour tactic to pull market expectations on side. The Federal Reserve delivered no surprises keeping the Fed funds rate steady.
- A seismic shift in the Bank's inflation outlook drove the decision, with its 2027 forecast revised up to 3.1%.
- The Bank's outlook should compel another 25-basis-point increase, which we pencilled in for January. Economic slack, a soft job market and resistant consumer prices to broad energy pass-through warrant a cautious approach.

In November 1989, an East German official inadvertently accelerated the fall of the Berlin Wall by announcing that crossing into West Germany would take effect "immediately, without delay."

The Bank of Canada's Governor, Tiff Macklem, had a similarly dramatic effect on interest rate expectations at the International Monetary Fund meetings in Bangkok on October 17. After what seemed like a subtle reflection on the pass-through risk of energy costs to broader prices, markets immediately repriced bond yields to that outcome. It wasn't necessarily the words that moved markets, but the timing. It occurred just three business days before the scheduled BoC policy meeting — a well-respected "quiet period" for central bankers unless they want to correct market expectations. And that they did. As soon as markets opened on Monday, the probability of an October interest rate hike jumped from just 36% to more than 80%.

Chart 1: Bank of Canada's Inflation Outlook Shifts Sharply Higher



Source: Bank of Canada, TD Economics.

The Bank of Canada followed through by raising the policy rate by 25 basis points to 2.50%. Building on views expressed over the prior weekend, the press conference reinforced that the decision helps reduce the risk that elevated energy prices "spill over and become general-

ized inflation". We view this as an "insurance" hike in an economy with stable underlying inflation and battling over-capacity. Even though every additional step-up in interest rates will carry a heavier weight on growth, we anticipate one more insurance hike based on the Bank's elevated inflation projection.

In contrast, the Federal Reserve provided no surprises in the run-up to its policy decision. Already at 4.00% and in restrictive territory, it elected to stand pat. Even so, a case exists for further tightening, potentially in December. Inflation has been persistently above target for more than five years, with progress stalling recently amid stronger demand-side pressures and a trio of supply-side shocks (i.e., AI, oil, and tariffs).

Bank of Canada's Seismic Shift in Inflation Outlook

The most striking change in the Bank of Canada's Monetary Policy Report (MPR) was its inflation outlook. CPI inflation is projected to average 3.1% in 2027, up 1.1 percentage points from July's forecast (Chart 1). In the world of economic forecasting, this is a sonic boom. It stands in sharp contrast to our projections (and consensus) in the assessment of persistent inflationary pressures.

The Bank expects inflation to reach 3.5% by year-end and remain at or above 3% through much of 2027, returning close to target only by mid-2028. The principal driver is the expected pass-through of persistently elevated energy costs to a broader range of consumer prices. Higher non-energy import prices and Canadian counter-tariffs add to these pressures, although their contribution to the forecast revision is comparatively modest.

The Bank's new model may be informing this conclusion. Introduced for the October forecast, the model explicitly captures how sector-specific cost shocks propagate through supply chains and ultimately affect consumer prices. While the extent to which the new model contributed to upward revisions remains unclear, its introduction is particularly relevant given the nature of the current shock.

Notably, the Bank's assessment also contrasts with the more gradual inflation response anticipated in the U.S. The Federal Reserve must consider a stronger demand environment pressing on a more capacity constrained economy. Here too there's limited evidence of spillover from higher energy prices into broader consumer inflation, in part because American companies cite concerns over customer retention. That makes the Bank of Canada's relatively aggressive pass-through assumptions noteworthy, especially given the excess capacity within the economy.

Bank of Canada's Strong Emphasis on Business Expectations

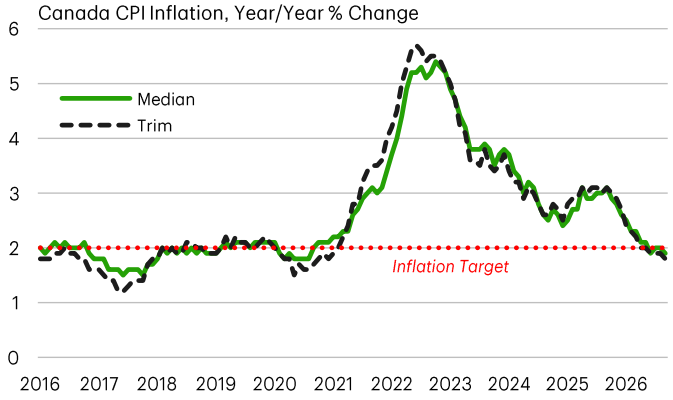
This weight on businesses' expectations of future cost pass-through is likely the biggest driver in forecast differences on inflation between the Bank's assessment and ours. Its latest Business Outlook Survey (BOS) indicates that one-quarter of firms have already passed higher costs on to customers, while nearly half intend to do so.

We do not dismiss this risk. As noted in an earlier client note, the longer energy prices remain elevated, the greater the likelihood that businesses capitulate in recovering their higher costs. But intentions do not always materialize when firms continue to report that competitive pressures constrain their pricing power. The Bank's consumer survey also revealed weakening spending intentions in the third quarter, particularly among households anticipating higher inflation. Unlike in 2022, when exceptionally strong demand collided with widespread supply constraints, demand pressures today are more subdued. At least in Canada, that is.

Little Evidence of Broad-based Pass-Through so Far

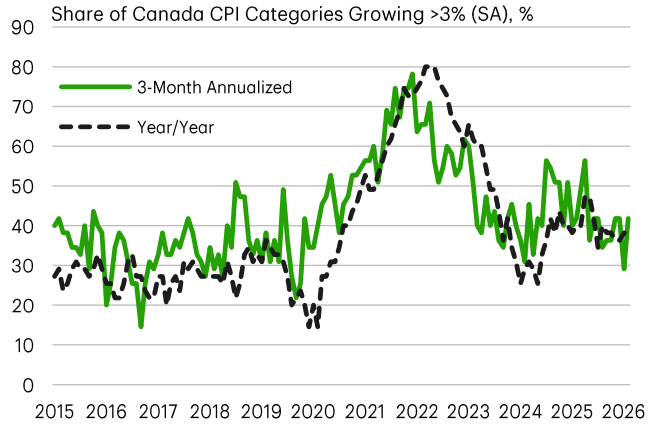
Seven months into the energy shock, there is still limited signs that higher costs are spreading across the consumption basket, either in Canada or the U.S. Indeed, the Bank's own analysis finds that just five CPI components account for the increase in inflation since February. Excluding gasoline, inflation is running close to the Bank's 2% target, while its preferred core mea-

Chart 2: Canada's Underlying Inflation Measures Return to 2%



Source: Statistics Canada, TD Economics. Last Observation: September 2026.

Chart 3: Canadian Inflation Breadth Remains Contained



Source: Statistics Canada, TD Economics. Last Observation: September 2026.

sures remain tame (Chart 2). The share of CPI categories recording price increases above 3% has also been stable (Chart 3). Our forecast allows for some additional pass-through from higher energy costs, with core inflation rising toward 2.4% over the coming months. The disagreement is therefore not about whether higher costs will reach consumers, but about the extent and persistence of that pass-through.

Diminishing Economic Slack

This brings us to the next consideration – level of economic slack. The Bank has adopted a more constructive growth outlook, supported by resilient consumer spending and stronger business investment. Most forecasters, including us, have this too in the forecast, but the Bank builds in greater momentum. Even so, the economy expands by 2.0% in 2027, up from 1.8% in their July estimate. This is not a robust performance, but sufficient to absorb the remaining excess capacity in the economy. The Bank anticipates the stronger tailwind to capital spending will come from oil and gas investment and the federal government's Productivity Mega Deduction. Doing so allows these supports to outweigh some of the restraint that will come from higher borrowing costs and trade uncertainty.

The U.S. is coming at it from a different starting point. The economy is already operating from a position of excess demand, increasing the risk that higher energy prices will bleed through to core inflation. Yet, Fed officials are taking a more cautious approach to policy tightening. Unlike in Canada, most economists would argue that the fed funds rate is already in restrictive territory. This makes each incremental increase more meaningful. And with financial conditions already tightening, the FOMC is content to let the market do some of the heavy-lifting over the near-term. However, this still requires delivering to market expectations, which is priced 85% for another hike in December.

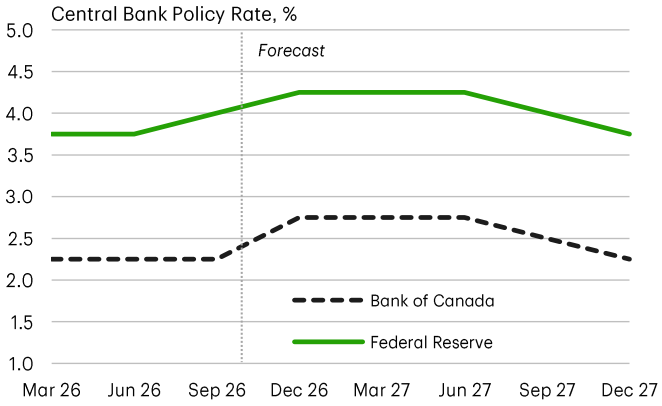
In Canada, Trade Costs Have Worsened

In August, the U.S. administration dialed up tariffs on Canada and then shifted the mix of tariffed products again last week. Trade policy uncertainty and costs have risen, but the Bank's more constructive outlook suggests less weight on this downside risk. While it still expects growth to slow sharply in the fourth quarter amid tariffs and heightened trade uncertainty, these concerns take a back seat to the improving medium-term outlook. There is an implicit view that business models are adjusting as more time passes. And government programs need to be taken on board within the outlook, such as the recently announced $8.7 billion in federal and Ontario support measures. At the same time, those measures underscore the scale of the challenges facing affected industries.

What's Next: Less Room for Patience, More Scope for Hikes

Taken together, the Bank's revised projections (particularly on inflation) are the smoking gun to higher

Chart 4: One More Hike Expected from Fed and BoC, with Insurance Hikes Reversed in 2027



Source: Bank of Canada, Federal Reserve Board, TD Economics.

interest rates, rather than the incoming data alone. If inflation remains above 3% through much of 2027 while excess capacity steadily diminishes, the case for additional monetary restraint becomes difficult to dismiss. Indeed, the MPR and the Governor's opening statement suggest that another increase is possible. However, the Governor struck a cautious tone during the press conference, emphasizing that further tightening would depend on incoming evidence and that policymakers would proceed carefully.

We expect the Bank to wait until January before delivering another 25-basis-point increase, bringing the policy rate to 2.75% (Chart4). Given inflation has yet to respond meaningfully to energy cost pressures, time is our friend to allow an assessment of incoming data and policy developments. By the January meeting, policymakers will have three additional CPI reports, further labour market data, another Business Outlook Survey and the third-quarter GDP report. Early indicators of fourth-quarter spending and investment will also help assess the degree of economic resilience.

South of the border, we expect the Fed to deliver another 25-basis point hike in December, bringing the upper bound of its policy rate to 4.25%. With both central banks taking out additional insurance against inflation. Any reversal in energy prices opens the door for these hikes to be reversed in late 2027.

Interest Rate Outlook

Interest Rates	Spot Rate Oct-28	2026 Q1	2026 Q2	2026 Q3	2026 Q4F	2027 Q1F	2027 Q2F	2027 Q3F	2027 Q4F	2028 Q1F	2028 Q2F	2028 Q3F	2028 Q4F
CANADA													
Overnight Target Rate	2.50	2.25	2.25	2.25	2.50	2.75	2.75	2.50	2.25	2.25	2.25	2.25	2.25
3-mth T-Bill Rate	2.55	2.31	2.26	2.39	2.63	2.75	2.63	2.38	2.25	2.25	2.25	2.25	2.25
2-yr Govt. Bond Yield	3.41	2.82	2.74	3.37	3.25	2.85	2.60	2.60	2.60	2.60	2.60	2.60	2.60
5-yr Govt. Bond Yield	3.62	3.09	3.01	3.69	3.50	3.35	3.30	3.15	3.05	3.00	3.00	2.95	2.95
10-yr Govt. Bond Yield	3.87	3.46	3.38	3.99	3.80	3.55	3.40	3.35	3.30	3.30	3.30	3.30	3.30
30-yr Govt. Bond Yield	4.16	3.89	3.78	4.29	4.10	3.85	3.70	3.65	3.60	3.60	3.60	3.60	3.60
10-yr-2-yr Govt Spread	0.46	0.64	0.64	0.62	0.55	0.70	0.80	0.75	0.70	0.70	0.70	0.70	0.70
U.S.													
Fed Funds Target Rate	4.00	3.75	3.75	4.00	4.25	4.25	4.25	4.00	3.75	3.75	3.75	3.75	3.75
3-mth T-Bill Rate	4.00	3.61	3.74	4.03	4.15	4.15	4.05	3.80	3.65	3.65	3.65	3.65	3.55
2-yr Govt. Bond Yield	4.71	3.79	4.14	4.88	4.75	4.35	3.90	3.80	3.65	3.60	3.55	3.50	3.40
5-yr Govt. Bond Yield	4.86	3.92	4.19	5.09	4.90	4.75	4.55	4.20	3.95	3.90	3.90	3.85	3.85
10-yr Govt. Bond Yield	5.04	4.30	4.44	5.29	5.10	4.95	4.75	4.45	4.35	4.25	4.25	4.25	4.20
30-yr Govt. Bond Yield	5.37	4.88	4.91	5.64	5.50	5.35	5.15	4.85	4.75	4.65	4.65	4.65	4.60
10-yr-2-yr Govt Spread	0.33	0.51	0.30	0.41	0.35	0.60	0.85	0.65	0.70	0.65	0.70	0.75	0.80
CANADA - U.S SPREADS													
Can - U.S. T-Bill Spread	-1.45	-1.30	-1.48	-1.64	-1.52	-1.40	-1.42	-1.42	-1.40	-1.40	-1.40	-1.40	-1.30
Can - U.S. 10-Year Bond Spread	-1.17	-0.84	-1.06	-1.30	-1.30	-1.40	-1.35	-1.10	-1.05	-0.95	-0.95	-0.95	-0.90

Note: 'F' = Forecast by TD Economics, October 2026; Forecasts are End-of-Period.
Source: Bloomberg, Bank of Canada, U.S. Federal Reserve, TD Economics.

Foreign Exchange Outlook

Currency	Exchange Rate	Spot Price Oct-28	2026 Q1	2026 Q2	2026 Q3	2026 Q4F	2027 Q1F	2027 Q2F	2027 Q3F	2027 Q4F	2028 Q1F	2028 Q2F	2028 Q3F	2028 Q4F
Exchange Rate to U.S. Dollar														
Chinese Yuan	CNY per USD	6.67	6.90	6.79	6.70	6.65	6.60	6.55	6.50	6.45	6.40	6.80	6.80	6.80
Japanese Yen	JPY per USD	158	159	163	157	157	157	157	156	155	155	154	153	153
Euro	USD per EUR	1.12	1.15	1.14	1.14	1.13	1.13	1.14	1.15	1.16	1.17	1.18	1.18	1.19
U.K. Pound	USD per GBP	1.33	1.32	1.33	1.33	1.34	1.34	1.34	1.35	1.36	1.36	1.37	1.37	1.38
Canadian Dollar	CAD per USD	1.40	1.40	1.42	1.42	1.41	1.40	1.40	1.39	1.37	1.36	1.36	1.35	1.35
Australian Dollar	USD per AUD	0.71	0.69	0.69	0.70	0.69	0.69	0.70	0.70	0.71	0.72	0.72	0.72	0.73
NZ Dollar	USD per NZD	0.56	0.57	0.57	0.56	0.56	0.56	0.56	0.57	0.58	0.58	0.58	0.59	0.59
Exchange Rate to Euro														
U.S. Dollar	USD per EUR	1.12	1.15	1.14	1.14	1.13	1.13	1.14	1.15	1.16	1.17	1.18	1.18	1.19
Japanese Yen	JPY per EUR	176	183	186	178	177	176	178	179	180	181	181	181	181
U.K. Pound	GBP per EUR	0.84	0.87	0.86	0.86	0.84	0.84	0.85	0.85	0.86	0.86	0.86	0.86	0.86
Canadian Dollar	CAD per EUR	1.56	1.61	1.62	1.61	1.58	1.58	1.58	1.59	1.59	1.59	1.59	1.59	1.59
Australian Dollar	AUD per EUR	1.58	1.68	1.65	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63
NZ Dollar	NZD per EUR	1.98	2.02	2.01	2.01	2.01	2.01	2.01	2.01	2.01	2.01	2.01	2.01	2.01
Exchange Rate to Japanese Yen														
U.S. Dollar	JPY per USD	158	159	163	157	157	157	157	156	155	155	154	153	153
Euro	JPY per EUR	176	183	186	178	177	176	178	179	180	181	181	181	181
U.K. Pound	JPY per GBP	210	210	216	209	210	209	210	211	211	211	210	210	210
Canadian Dollar	JPY per CAD	112.8	114.0	114.5	110.7	111.7	112.0	112.3	112.3	113.5	113.8	113.8	113.6	113.5
Australian Dollar	JPY per AUD	111.4	109.0	112.4	109.3	108.2	108.1	109.0	109.5	110.5	111.0	111.0	110.9	110.9
NZ Dollar	JPY per NZD	88.9	90.8	92.3	88.7	87.8	87.7	88.4	88.8	89.6	90.0	90.1	90.0	89.9
Exchange Rate to Canadian Dollar														
U.S. Dollar	USD per CAD	0.71	0.72	0.70	0.70	0.71	0.71	0.72	0.72	0.73	0.74	0.74	0.74	0.74
Japanese Yen	JPY per CAD	112.8	114.0	114.5	110.7	111.7	112.0	112.3	112.3	113.5	113.8	113.8	113.6	113.5
Euro	CAD per EUR	1.56	1.61	1.62	1.61	1.58	1.58	1.58	1.59	1.59	1.59	1.59	1.59	1.59
U.K. Pound	CAD per GBP	1.87	1.84	1.88	1.89	1.88	1.87	1.87	1.88	1.86	1.85	1.85	1.85	1.85
Australian Dollar	AUD per CAD	1.01	1.04	1.02	1.01	1.03	1.04	1.03	1.03	1.03	1.03	1.02	1.02	1.02
NZ Dollar	NZD per CAD	1.27	1.25	1.24	1.25	1.27	1.28	1.27	1.26	1.27	1.26	1.26	1.26	1.26

Note: 'F' = Forecast by TD Economics, October 2026; Forecasts are End-of-Period.
Source: Bloomberg, TD Economics.

Commodity Price Outlook															
Commodity	Price Oct-28	52-Week High	52-Week Low	2026				2027				2028			
				Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Crude Oil (WTI, $US/bbl)	103	113	55	73	93	86	94	85	79	76	75	75	76	76	77
Natural Gas ($US/MMBtu)	2.76	33.80	2.44	4.71	2.95	2.85	3.15	3.35	3.25	3.15	3.15	3.17	3.18	3.20	3.21
Gold ($US/troy oz.)	4055	5417	3930	4865	4512	4265	4200	4450	4650	4650	4550	4573	4596	4619	4642
Silver (US$/troy oz.)	53.78	116.70	46.85	83.71	73.29	62.80	61.50	66.00	68.00	68.00	66.00	66.33	66.66	66.99	67.33
Copper (cents/lb)	666	672	482	582	603	640	625	615	600	610	610	613	616	619	622
Nickel (US$/lb)	7.09	8.91	6.47	7.87	8.21	7.51	7.15	7.50	7.75	7.95	7.95	7.99	8.03	8.07	8.11
Aluminum (Cents/lb)	140	170	126	145	162	146	142	137	136	134	134	135	135	136	137
Wheat ($US/bu)	7.61	8.66	6.42	5.50	6.08	6.47	6.75	6.85	6.90	6.95	7.00	7.04	7.07	7.11	7.14
Note: 'F' = Forecast by TD Economics, October 2026; Forecasts are Period Averages.															
Source: Bloomberg, TD Economics.															

Global Stock Markets					
Major Market Indexes	Price Oct-28	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	7,731	-0.2	12.9	7,819	6,344
S&P/TSX Composite	36,202	1.1	14.2	36,958	29,778
DAX	25,704	1.2	5.0	26,570	22,301
FTSE 100	10,695	-0.0	7.7	10,911	9,507
Nikkei	63,954	-3.6	27.0	72,366	48,538
MSCI AC World Index*	1,130	-1.6	11.3	1,161	961
*Weighted equity index that includes both developed and emerging markets.					
Source: Bloomberg, TD Economics.					

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