

Bank of Canada business outlook survey.

A little something for everyone.

Both the Q1/10 business outlook survey and the senior loan officer survey were largely as was expected. The headline future sales sentiment index remained strong at 44.0 vs. although somewhat softer than the previous quarter's 49.0 as the initial flush of economic recovery begins to fade. And while inflation expectations drifted higher in the first quarter of 2010, conversely, the index of capacity constraints remained benign.

Off the top, the structural weakness of the BoC business outlook survey, much like that of the PMI indexes, is in the binary nature of the data collection. Participants are asked whether or not sales are higher, lower. In that, the response mechanisms provide no orders of magnitude for the change they reflect, only that there has been either an increase or a decrease in the balance of opinion amongst respondents. As such, it is difficult to translate the survey data into a hard economic numbers save for the inflation expectations component. On that basis there is a pretty wide berth with which one may treat some of the number sets contained within both the business outlook survey and the senior loan officer survey.

From a policy standpoint, there seems to be a something for the hawks, the doves and the carrion that often gets caught in between. The question on most minds will be the level of emphasis the BoC is inclined to place on the various policy sensitive components, particularly those elements that reflect upon capacity utilization and inflation expectations. On the one hand, inflation expectations remain well contained within the BoC's inflation target range of 1-3%. Indeed, fully 94% reported 2-year inflation expectations within this range. However, the picture is far from static and within those responses, the gravitation in inflation expectations is out of the lower reaches of the band on into the upper reaches.

Gasoline?

Part of the story on inflation expectations may be as simple as the higher gasoline prices experienced over the reporting period. Changes in gasoline prices have in the past tended to correlate with changes in inflation expectations. Canadian's after all are fanatics when it comes to coffee, donuts and saving pennies per litre when it comes to petrol. And indeed gasoline prices were higher in the current survey than they were in the previous. That aside, against the backdrop of overall economic recovery and with input prices moving higher (as reflected in the survey) courtesy of a global economic recovery, it is not unreasonable to expect that this drift, this gravitation in inflation expectations could continue to evolve into a rising trend. A worrying potential for the BoC with monetary policy so far removed from any semblance of rate neutrality. Does the BoC believe they have the room to let these types of trends establish themselves before responding? To be certain, the level of sensitivity at the BoC to changes in inflation expectations at this stage is likely a product of the distance the current rate setting is from what conceivably could be considered the level of rate neutrality. Subjectively 1 to 3% real rates has in the past been seen to be the level of rate neutrality in the US and by extension, a not unreasonable assumption/yardstick for Canada as well. In a round about answer, under the auspices of economic recovery and upside economic surprises, the BoC probably sees very little room with which to experiment with trends.

Yet at the same time that inflation expectations are moving higher, albeit still reflecting an extremely benign profile vs the history of the data set, the question of capacity utilization suggest that excess capacity continues to slosh about in the economy. Changes in capacity utilization are barely perceptible. Those firms reporting some level of difficulty is at 30%, up from 29% in Q4/09, off the cycle low of 22% in Q3/09 at the tail end of the recession. At 30%, the level is characterized as indicative of "subdued capacity pressures" with most firms operating below capacity, a situation expected to persist for at least the next 6-

months. Under this framework it is hard to see how inflation expectations will translate into actual price inflation in the absence of corresponding capacity tightness and economic bottlenecks. Alternatively with inflation expectations having moved out of the lower band, are inflation expectations at this point not considered to have normalized and with that, should not policy be normalized?

How the BoC is inclined to spin this report is yet to be seen. Ostensibly, markets will await the BoC monetary policy report set to be released April 22nd, following the BoC's rate decision on April 20th, for the answers to those pressing questions. There is nothing definitive to the business outlook survey, rather, you have a report that largely straddles the policy divide. To be certain, it is clear that the upside surprises associated with the US economy and inflation will need to be addressed in the MPR. Although in the outlook on inflation for Q2/10 a relaxed view on inflation is expected courtesy of a base effect in the CPI that will provide some temporary respite. Assuming no change in month over month prices, inflation will be halved from its current year over year rate in May, June and July. Although this is little comfort to a BoC that is tasked with targeting inflation in the medium term.

Overall, we feel that there is sufficient ammunition in the current report such as to provide the BoC with the room to maintain its conditional pledge to hold rates at 0.25% through to the end of Q2/10. After all, 94% of respondents reflect 2-year inflation expectations between 1-3% in line with the BoC's inflation band and capacity constraints are yet to be recognized. Yet the potential for inflation expectations to continue gravitating higher along with rising input and output prices, the upside surprises in US economic growth, and an inflation rate running ahead of forecast, are together, a recipe for a BoC rate hike in Q3/10 in line with our forecasts.

BoC Senior Loan Officer Survey. Banking on credit.

Credit conditions in the business outlook survey were largely unchanged. Large firms that have access to market capital continue to see improvements while small to mid sized companies continue to see credit conditions as either unchanged or having tightened over the past three months. A response not out of context with the release of today's Q1/10 Senior Loan Officer Survey.

The Q1/10 SLOS suggested that overall lending conditions had eased with the balance of opinion at -18.7, vs. -8.7 in the previous survey. Both the pricing and non pricing elements of lending reflected improvements. In front of today's release, we pointed to the turn around in M3 growth as indicative of a banking sector that is once again beginning to grow lending. So too the continued improvements in market liquidity were seen as contributing factors to what could be viewed as an overall improvement in the environment for credit.

However, although on the surface credit conditions continue to improve, the improvements are far from symmetrical given the divide that exists between large borrowers who have access to market capital and those smaller to mid sized borrowers who are more reliant upon bank capital. For large businesses, credit conditions continue to improve. For small borrowers and commercial lenders, while conditions are characterized as having stabilized (that's the - the good news) this follows several quarters of tightening (the bad news). BoC data on business lending remains depressed having contracted by -0.5% y/y in February. And as we all know, the broader economy is about the small to mid sized business rather than the larger conglomerates.

Disclosure appendix

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