Bank of Canada leaves rates unchanged (0.25%)...

But throws open the door on a June rate hike prompting a change in forecast.

On the back of today's statement we are pulling forward our expectations for a 25bps rate hike from September into the June 1 meeting. June is now expected to kick off a cycle of measured rate hikes that will deliver a steady diet of 25bp increases at each of the remaining BoC rate meetings in 2010. We are now expecting a 2010 year end rate target of 1.50% (up from the original forecast of 1.00%) and 2.50% in 2011 up from 2.00%.

At 2.50% our year end rate forecast for a 2011 is hardly restrictive. Indeed, conventional measurement would suggest that it would be considered moderately stimulative (on the basis of rate neutrality lurking somewhere in the area of 1-3% real rates and an inflation target at the BoC of 2%).

The Bank of Canada left rates unchanged at 0.25% as expected at today's scheduled rate announcement. However, significant changes in the Bank's outlook and sentiment have prompted us to rework our own expectations for what the BoC may be inclined to deliver in terms of rate policy. Of particular note was the dropping from the text of its conditional pledge to hold rates at 0.25% through to the end of Q2/10. So too did the BoC decline to indicate a bias. In March, the BoC had indicated a neutral bias. Despite the absence of a specific telegraphing of bias, the overall tone and texture of the post meeting statement strongly suggests an upside bias to the risks associated with inflation.

In keeping with their dropping of the conditional pledge, the BoC wound up its PRA's (purchase and resale agreements). A not unexpected happenstance in keeping with its eventual move toward a rate hike.

In life there is very little that is certain. However the dropping of the BoC rate pledge in such close proximity to the natural expiry of that pledge, suggests to us a clear signal of the BoC's intent to raise rates at the June meeting. Aside from the economics behind the BoC story, tactically, the pledge to hold rates at 0.25% was in and of itself a reflection of the BoC's effort to adopt a higher degree of transparency during a time of crisis. So too can the dropping of the pledge be viewed in the context of transparency in signalling the Bank's its intent to come off the sidelines.

From the bank
"In response to the sharp, synchronous global recession, the Bank lowered its target rate rapidly over the course of 2008 and early 2009 to its lowest possible level. With its conditional commitment introduced in April 2009, the Bank also provided exceptional guidance on the likely path of its target rate. This unconventional policy provided considerable additional stimulus during a period of very weak economic conditions and major downside risks to the global and Canadian economies. With recent improvements in the economic outlook, the need for such extraordinary policy is now passing, and it is appropriate to begin to lessen the degree of monetary stimulus. The extent and timing will depend on the outlook for economic activity and inflation, and will be consistent with achieving the 2 per cent inflation target."

Is the BoC compelled to raise rates in June? By no means. Rate hikes remain conditional upon economic activity and inflation.

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The extent, timing, orders of magnitude, and rates of change will depend on the outlook for economic activity and inflation. To this end, what we know is that the Canadian economy has been tracking ahead of plan, besting BoC forecasts as laid out in the January MPR. Of key import and a large part of the economic story behind our change in rate forecast was the move by the BoC to drag forward by a quarter its expectations as to when they expect the output gap to close. Their forecasts now look for the output gap to close by Q2/2011, moved forward from Q3/2011 which in turn will invariably affect their views on inflation. Going into today's rate meeting we had taken considerable comfort from the fact that while GDP had been tracking well ahead of expectations, so too had productivity been rather robust. To no avail. In keeping with the BoC move to compress their time lines associated with the output gap, we have responded by pulling forward our own expectations for the onset of rate hikes.

Still, there is some attempt on behalf of the BoC to aviod green lighting both rates and FX markets. To wit, the Bank's growth forecasts point to a recovery that rather than radically altering the overall growth profile, has instead been more in keeping with a redistribution/cannibalizing growth that has already been accounted for. Atleast that accounts for half the story.

For 2010 the BoC is now forecasting GDP at 3.7% up from the previous forecast at 2.9%. Half of the topside associated with 2010 is coming on the back of a reduction in growth expectations for 2011 which have been trimmed from 3.5% to 3.1%. 2012 is no bag of toys either. BoC forecasts are looking for the economy to grow by a paltry 1.9% in 2012. A rate that is likely at best just managing to keep pace with the economy's ability to grow capacity. Although a full airing of the BoC forecasts will come on Thursday and with it we may see that their expectations for the economy's ability to grow capacity also changing.

On this basis, it suggests to us that the year-end 2011 forecast for overnight rates need not necessarily take on overly aggressive profile. So too do we believe that the BoC forecasts for 2012, aneamic as they are, are also taking into consideration what we believe to be a fairly direct impact between changes in monetary policy and the associated knock on into consumer behavior.

What keeps us up at nights? Consumer leverage. Total household debt to disposable income is at historically high levels (143%). Conspicuous consumption in Canada of all places. High debt levels and comparably low savings rates suggest that there is little room in the household budget with which to absorb higher financing costs. One of the characteristics of the Canadian binge on debt was the consumer interest in variable rate products.

Taken together, these factors point to a fairly direct transmission of changes in BoC rate policy into a desired consumer effect in terms of a consumer willingness and ability to spend. This transmission of policy and effect is expected to contain less of a lag than perhaps has been considered to be the case in the past. In turn the degree to which the BoC may need to adjust policy in keeping with the need to change behavior may be less than has been the case in the past. High debt levels and an abundance of variable rate debt products suggest the BoC need conduct policy with a light touch rather than a necessarily heavy hand despite overnight rates at the zero bound.

Disclosure appendix

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2 All market data included in this report are dated as at close 20 April 2010, unless otherwise indicated in the report.

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