

Bank of Canada Monetary Policy Report.

Risks, rewards, remarks, response

Market and forecaster sentiment alike was largely cemented earlier in the week with the release of the BoC's post meeting statement on Tuesday. The collective catalyst - a ceremonious dropping of the BoC's conditional pledge to hold rates at 0.25% through to the end of Q2/10 - pulled to the fore, a June rate hike scenario. While the Governor will emphasize that nothing is preordained, the impact of the act of removing of the conditional rates pledge was to focus the various elements of Canadian monetary opinion into a fairly narrow beam of expectations.

Following the release of the post meeting statement, a poll of primary dealers conducted by Reuters indicated that 11 of 12, including ourselves, were looking for the BoC to kick off a rate cycle in June with a 25bp rate hike. Market pricing has fully priced in this expectation.

That which is worth repeating - from Tuesday (the emphasis is ours).

From the post meeting statement the bank said that, "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 down side 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."

The release of the broader and deeper MPR, did little to dissuade us from the opinions we already adopted on Tuesday on the back of the post meeting statement. And largely reinforces our opinion that the rate cycle will be conducted in a measured fashion which we would define as rate adjustments in 25bp packets.

Bank of Canada governor Carney was in front of the press at 11:15am ET. For markets, we were of the view that this appearance was being seen as more important than necessarily the release of the MPR itself. It was here where market opinion would be either confirmed or conquered. To be certain, the ink on the MPR dried about the same time as the ink on Tuesday's post meeting statement. Going into today's press conference, if the BoC had judged that there had been any misinterpretation in the marketplace or amongst forecasters with regard to the outlook on policy, it was here where the governor would have the opportunity to re-calibrate those views. Yet there was no real effort to move that sentiment.

The underlying story remained largely as originally viewed through the starkness of the post meeting statement. The economic base case changed (for the better) and so too what it necessary for monetary policy to adapt. Radical change? No. While Bank forecasts are being marked higher, a good slug of the upside to the BoC economic story is a function of cannibalizing future forecasts and carrying that growth forward. So too is the Bank clear to point out that risks remain. That said, it is apparent that the full body of monetary stimulus that rode in on the back of market and financial dislocation followed by global economic recession is no longer appropriate under the current market and economic conditions. And while the risks to inflation over the projection period are determined to be "roughly balanced" this does not preclude the removal of that stimulus which is deemed superfluous under the improved market and economic conditions.

Tactically, the inclusion of a "balance" of risks assessment may move to curb some elements of the market that were edging towards the prospect of a more aggressive policy response. To certain, the recent history of markets has been to aggressively price interpreted changes in monetary policy. Suffice to say, upside surprises in the Bank's underlying economic base case from January support the contention that the BoC need calibrate its monetary policy with an economy and inflation rate that is coming in ahead of plan and an output gap that is expected to close a full quarter earlier than originally expected. In Q1/10, the BoC now estimates that the economy is operating at about 2% below its production capacity which is significantly tighter than the 3.25% it saw in the January MPR.

Heh! Who put fruit juice in the punch!

Upside surprises for Canada yes. Still, the Bank's base case remains cautious. Although few would put a lot of stock long term forecasts, the BoC projections looking at growth out into the second half of 2011 and 2012 speak to the BoC's longer term concerns for aging demographics, dismal productivity rates and the need to rectify global imbalances. At 1.9%, the forecasts for economic growth in H2/11 and 2012 is indicative of an economy that is largely standing still given the BoC forecasts on the ability of the economy to grow capacity judged to be 1.9% in each of those years. From the standpoint of their model, it could really be no other way. An economy operating at full capacity need equate its growth rate with the economy's ability to grow capacity else it raises inflationary concerns. Just as easily the BoC could have adjusted higher its assumptions on the economy's ability to grow capacity. Instead, at 1.9% the view speaks to a moribund economic profile for Canada in the years to come.

Interesting to note, the divergence in growth rates between Canada and the US. The Bank's forecasts for the US in 2011 and 2012 sit at 3.5%/y/y for each, while the Canadian economy is expected to grow by 3.1% and 1.9% respectively. If the forecasts prove correct, draws in some interesting assumptions as they pertain to potential rate differentials and what USD-CAD forecasts may look like in the longer term.

Our supposition has been to take an equally cautious approach to changing our forecasts. While we have increased our expectations for a year end overnight rate target from 1.00 to 1.50% to take into consideration an earlier than expected start to the rate cycle. Year end overnight rate forecast for 2011 is at 2.50%, up from 2.00%. At 2.50% at the end of 2011, this is a rate profile still reflective of a stimulative monetary stance if one could agree with the metric of 1 - 3% real rates as the yardstick for rate neutrality coupled to an inflation target of 2.0% at the BoC.

The Bank's future view on growth (2010 3.7%, 2011 3.1%, and 2012 1.9%) is one that is taking into consideration high consumer debt levels, an aging population, the withdrawal of fiscal support and the view that a housing market, feathered in a bed of cheap interest rates, will see a measurable cooling as both the rates picture changes (mortgage rates are already marching higher) and administrative efforts come to bear. Not the least of which, high levels of household debt, a historically high percentage of which was taken out in variable rate debt product, points to a transmission mechanism between policy changes i.e. higher costs for overnight funding, and consumer behavior, that is arguably operating rather more clearly and direct than may historically have been the case. A factor supporting the case for a more measured approach to policy despite the fact that the base rate from which the BoC is expected to move from is at the zero bound.

At the end of a frenetic policy week for Canada there are a number of issues that have been made clear. One of which is the recognition that a good slug of that monetary stimulus that rode in on the back of financial and market disruption is no longer warranted. On the basis of market and economic recovery, the reversal of those policy initiatives is nearing - most would suggest the June 1 meeting kicks off the path to rate normalization or what counts for normalization in a world in which productivity is running below 1% and trend growth is less than 2%. That said, the mickey in the punch bowl is GDI. Gross

domestic income is forecast by the BoC to grow by 5.6% in 2010, although down to 2.4% in 2012. Still, this would be one area with perhaps the most potential to surprise on the upside given the potential for commodities to go boo!.

Disclosure appendix

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