

# In a wicked world...

Virtue smiles on those that work smarter not harder.

**Bank of Canada Governor Carney in a colorfully titled address "The Virtue of Productivity in a Wicked World", drew some interest with his reference to the BoC's conditional pledge to hold rates at 0.25% and its April 22nd Monetary Policy Report.**

**It could easily be an innocuous reference to that which is already in the public record. The BoC rate pledge is conditional on the inflation outlook and the MPR platform is the document through which the BoC updates its economic base case and inflation outlook.**

Fair enough. But for markets charged with pricing money in the here and now, these are far from innocuous times.

While the bulk of the Governor's delivery concentrated on the rather dismal productivity profile for Canada over the last decade. To be certain, with the onset of the new millenium came no new productivity paradigms for Canada. And as all of a certain age are aware, in 2011 the first of the baby boomers begin to retire, ushering in the snake like spiral towards a growing dependency ratio for Canada. And under the auspices of a growing dependency ratio, there is the very real need to work smarter rather than harder. Indeed, there may be no room to work harder given the view that hours worked are going to be on the decline as tee off times get booked. On that basis, leading a first world economic existence is going to require of Canada that its productivity rates need rise. So too if Canada wants to maintain its place in the global economy it needs to consistent keep that economic engine tuned up, which requires investment.

It is an important point. Productivity is the creation of real wealth. Alas, for markets the focus on the Governor's comments likely fell clear of the economic, and largely landed on the BoC reference to the conditional pledge and the April MPR.

The times they are a chang'in.

Just how fast those times are a chang'in is the big question that markets are contending with. What is known? Well, the BoC pledge to hold rates at 0.25% through to the end of Q2/10 is conditional upon the BoC's inflation outlook. On that the BoC has been clear. An outlook that is going to be updated in the April 22nd release of the BoC MPR. That the good Governor felt inclined to reiterate the conditionality of the pledge - an event that on its own is out of context with the BoC's modus operandi - but rather its inclusion along with the telegraphing of the April 22nd update, against the backdrop of better than expected economics in past weeks and a core inflation rate that is firmer than expected (in both cases the adjective "slightly" is used) tends to suggest that the picture, the outlook, may be changing.

Caveat lector.

Lets be clear, at this stage of the recovery, there is an acute awareness of any changes in central bank language and the risk to read well beyond the intent with particular regard to the aggressiveness with which the Bank may be prepared to prosecute policy. Indeed, Governor Carney makes very mention of that, quoted by Reuters in the press conference as saying "we have to use different words to keep your attention. Look, nothing has changed about the conditional commitment."

Yet that market tendency to aggressively price the BoC will look at that combination of today's comments in the context of another potential step down the path towards policy normalization may be taken in April with the release of the MPR and its

update to the inflation outlook. As it stands, we are expecting that the BoC will allow the conditional pledge to expire at the end of Q2/10 and not begin hiking rates until the third quarter.

Now of course, the weight that we attach to the April 22nd MPR will be higher. But of course as we inextricably draw towards the natural expiry of the Bank's conditional rate pledge, most would begin paying that much more attention to the language and potential changes in the disposition of the BoC.

At this time, despite the attention that the comments as they pertain to the April 22nd up date and the conditional pledge may be drumming up, there is little to hang our respective hats on beyond drawing a few more circles of ink around the April 22nd date. For markets, the inclination, is going to be to pull forward rather than push back the probability of a rate hike out of the BoC given the better than expected economic and inflation performance. Still, the overall market response has been largely muted in keeping with the limits of the information provided. Information which really amounts to an affirmation of the conditionality of the pledge and a reference out of the Bank to look towards the April 22nd MPR for an update on the inflation profile.

At the end of the day, it's their outlook, it's their story. And they are the ones that are going to control that story. Beyond that, we are left with conjecture aimed at filling in the gaps. Today's text, while causing us a moment to pause, given the number of caveates that exist, the number of balls that continue to hang in the air, we continue to hold to our forecast (September rate hike telegraphed in July).

Up for consideration - the case for an early rate hike.

Something that does draw our attention is the resurgence in M3 growth. M1 as expected, experienced robust levels of growth in keeping with monetary efforts to maintain liquidity that has occurred over the last 16 months. However, this was not reciprocated in the M3 numbers which experienced a bone crunching crash in the rate of expansion as the banking sector clammed up.

M3 plunged from an 11.3%/y/y rate of growth in October 2008 rate down to a meager 0.7%/y/y rate of growth a little more than a year later. As the calendar rolled from 2009 into 2010, so too did the worm appear to turn. In January 2010, M3 began to once again grow, expanding by 1.5%/y/y. In the latest release, February M3 was seen to have accelerated at 3.1%/y/y. Month over month growth rates for M3 are tracking higher than the pre crisis 12 month average.

The implications? It tends to suggest that the banking system is opening itself up to lending again. Which is to say that all that liquidity that has been injected into the financial system, rather than gathering dust, is now beginning to make it into the economy through the various lending conduits. And perhaps more than some slight upside on core CPI, it may be M3 growth that may be causing the BoC some angst with regards to their inflationary outlook.

For now, the markets have been doing the bulk of the Bank's heavy lifting. 2-year bond yields are up about 40bps. To be certain, the April MPR will be looked at it in terms of whether or not the BoC will be inclined to join market participants and pick up some of that burden. If a material change in the inflation outlook is telegraphed in the April MPR, the market inclination will be to put the pin into a June rate hike, coinciding with the expiration of the Bank's conditional pledge.

# Disclosure appendix

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**HSBC Securities (Canada) Inc.**  
70 York Street, 8th Floor  
Toronto, Ontario M5J 1S9, Canada  
Telephone +1 416 868 7523  
Fax +1 416 364 2543  
Website: [www.research.hsbc.com](http://www.research.hsbc.com)

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