Bank of Canada: More to Come

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The Bank of Canada is like a poker player with a pair of jacks—not sure it has the winning hand, but comfortable throwing in another quarter-point chip at each betting opportunity for now. Having slashed rates to the max during the global economy's Great Recession, the central bankers are, at this point, only certain that Canada no longer needs such extreme stimulus from monetary policy.

The text of the Bank's message to markets, therefore, continues to reflect a note of caution. In particular, it retained its fuzzy language about the future path of rates, saying that subsequent hikes would be "weighed carefully" against the economic backdrop. But just as that language in June did not prevent a rate hike in July, it should not be viewed as a sign that Carney's team will step away from rate hikes just yet. That pair of jacks—an economic growth forecast that sees Canada returning to its non-inflationary potential by the end of 2011—is likely good enough to justify a couple more quarter-point moves in September and October.

But by December, the Bank could have enough evidence to go on hold for several months. The Bank acknowledged the deteriorating global growth context in taking 0.2% off its real GDP growth forecast for 2010 and 2011, taking them to 3.5% and 2.9% respectively. The impact on growth from fiscal tightening in Europe, and uneven private sector demand in the US, are noted as trouble spots abroad. Oddly, the Bank attributes its revision to Canada's forecast to weaker consumption than it previously assumed, and actually raised its expectation for the growth contribution from net exports (and business investment). The change in the net export forecast seems somewhat counterintuitive, unless it captures a downgraded outlook for the C$, and the investment forecast also runs against the Bank's own comment that investment spending is being "held back" by global uncertainties.

The weaker Canadian growth trajectory will delay the attainment of the economy's non-inflationary limits by two quarters in the Bank's view, essentially extending the timeframe for the path of interest rate hikes by six months. Since we have the Canadian economy decelerating more materially (with 2010 at 3.3% and 2011 growth of 2.5%), we expect downside surprises to the Bank of Canada's outlook to see a further softening in their view by year end.

Carney did leave one opportunity to be even more dovish untouched, describing inflation as having run "broadly in line" with his prior forecast, rather than noting that it has, in fact, been a shade below the last MPR projection. Still, the Bank sees 2% inflation as able to coexist with a stimulative stance for monetary policy. We share that view, as a decelerating global economy, and the slack it will leave in Canada's export sector, should be a sufficient braking force on prices.

The bond market, for its part, had already priced in a very dovish track for the Bank of Canada—too dovish in our view in terms of what lies ahead this year. But Investors took heart from the fact that Carney's team stayed away from any pre-commitment to further rate hikes in the language, and the downward revision to growth was slightly more than might have been expected. As a result, while overnight rates are now a quarter-point higher than they were yesterday, anything past December BAs actually moved towards lower yields after the announcement.

So today's rate hike and soft-pedaled language combined to be a rate CUT for those borrowing at fixed rates. We don't expect that reaction to last. Further rate hikes in September and October will now come as a surprise to markets, pushing yields across the curve to higher levels, and giving a dose of support to the Canadian dollar.

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