

Walks like a hawk, talks like a dove.

Bank of Cda raises rates by 25bps (0.75%). The statement's a kid glove.

The alchemists at the BoC have managed to once again take the DNA of a hawk and fold it into the make up of a dove. What mythical creature hath the BoC wrought in the fires of monetary policy? A hawk that coos gently.

While raising rates by 25bps as widely expected by all and sundry (including ourselves), the BoC birthed what ostensibly is a rather dovish post meeting statement. Not that this was entirely unexpected given the recent adoption at the BoC of a *modus operandi* that has taken to hiking rates with a velvet glove.

Monetary policy in Canada, rather than presenting any necessarily clear trajectory is largely meeting by meeting process. That is to say, no one in markets is rewarded for aggressively attempting to price the Bank of Canada and monetary policy. In that, the BoC controls the story with a iron grip, providing little impetus to move or price in either direction.

So what are we left with? Overnight rates have moved from 0.50% to 0.75% while at the same time the BoC's growth forecasts (forecasts that have been consistently chasing the economy higher) get a bit of a hair cut in their current incantation. And while uncertainty abounds and in the words of the Governor, nothing is preordained, the BoC has chosen to close no doors. Including that door leading to further rate hikes.

"Given the considerable uncertainty surrounding the outlook, any further reduction of monetary stimulus would have to be weighed carefully against domestic and global economic developments." This is how the BoC left us at the June 2 meeting following the inaugural rate hike, this is how the BoC leaves us today.

To be certain, there is a fair heft to today's statement, drawing upon the BoC updates to its base case scenario that are set to be released this Thursday. Although overall, the pace of the global economic recovery is seen to be less than what was assumed back in the BoC's April monetary report, but not significantly so. Interesting to note that while BoC has downgraded its expectations for global growth since April, the IMF has upgraded its forecasts for global growth - currently 4.5% for 2010 and 4.25% for 2011, up around a 1/2% from their April report.

And there is certainly a more relaxed view coming across in the Bank's comments as they pertain to events in Europe. Although policy responses to the European sovereign debt crisis are expected to slow the global recovery, they have reduced the event risk to an adverse outcome and increased the prospect of sustainable long term growth. Absent is talk of the European crisis translating into some tightening of financial conditions. A pretty big step in the right direction.

For Canada, the BoC continues to characterize economic activity as largely unfolding as expected although the forecasts have been trimmed after having to chase the economy higher in previous quarters. Chief contributors to growth remain the household and government spending. Business investment has yet to recover which is to say we have yet to see any progress in the necessary roll-over in demand drivers from the consumer and government on over to business. Global uncertainties are pinpointed as the potential hurdle to a recovery in business demand which fits with its findings in its recently released business outlook survey. And while the BoC has rolled back its expectations for when the output gap will close - the forecast now looks for the economy to hit full capacity near to the end of 2011- this follows the Bank having pulled forward their expectations by a quarter in April.

Still, from the standpoint of an event risk scenario, the story really has not really changed all that much. There remains a significant level of uncertainty as it pertains to the unfolding of the global economic recovery and the roll over of demand drivers in Canada from the government and the consumer on over to external demand and business investment. This really has not changed. These challenges have been with us throughout 2010. A balanced and sustainable economic recovery for Canada continues to be a function of replacing the expectation for softening consumer demand and the removal of fiscal stimulus, with growing business and external demand. However, while business demand has yet to pick up, it is still early days. Realistically, Canada has had but two quarters of solid economic growth. Following the wrenching exercise of having to right sizing one's self in face of global financial contagion and economic recession brought on by the events of 2008 and 2009, it is unlikely that businesses are keen to plunge head first into the economic recovery story against the backdrop of a uncertainty. At one point you would worry about the lack of progression with regards to business investment. But realistically, a recovery in business investment is likely a story to be reserved for 2011.

For the here and now, the question remains, does 0.75% fit with the expectations for growth and expectations for inflation. At 0.75%, the overnight rate and the BoC acknowledges this, continues to provide for a considerable amount of monetary stimulus into an economy that is expected to grow by (April's forecasts in parentheses) 3.5%y/y (3.7%) in 2010, 2.9%y/y (3.1%) in 2011 and 2.2%y/y (1.9%) in 2012. Has the story changed significantly enough to warrant a move away from further rate hikes despite the considerable monetary stimulus afforded by an overnight target rate of 0.75%.

To suggest that the economic story has moderated does not necessarily suggest that the need back away from continuing to raise rates. The financial crisis that precipitated the move to emergency rate levels in many developed economies has for Canada, largely dissipated. Rather quite telling is the dramatic turn around in M3 growth. Currently, M3 is growing at a rate of 5.2%y/y (for the month of May), pushed along by month over month growth rates of 1.0% and 1.3% for the previous two months. The trajectory and trend is rather clear.

So too is there a need to alter the pricing signals that policy is transmitting to the consumer and encouraging a continued binge on credit, that threatens to push the consumer into imbalance. Don't blame a consumer that is merely following the pricing signals afforded by the cost of money for indulging in debt and consumption.

We would suggest that there is room for the rate cycle to grow and maintain our forecast for 25bp rate hike at each of the remaining rate meetings for a year end target of 1.50% out of a need to change the pricing signals being delivered to the consumer and rightsize policy in keeping with an economy that is still expected to be operating at capacity in less than 18 months, yet is saddled with a rates policy far from what could be considered anywhere near rate neutrality.

Disclosure appendix

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