

Rate Hikes? Probably Not Until June

■ **James Barrineau**
 Senior Economist—Global Economic Research

With the Bank of Canada’s commitment to “stay the course” on interest rates through June, the future path of the Canadian dollar—and, in turn, the pace of Canada’s economic recovery—will now mostly depend on the timing of the US Federal Reserve’s rate hikes.

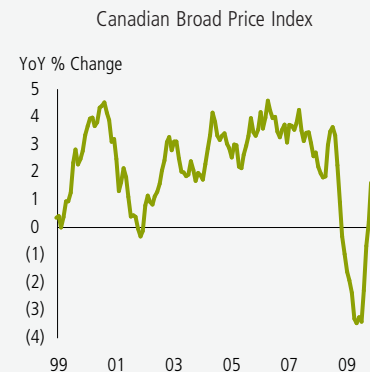
By our reading, the Bank of Canada’s policy statement this week effectively confirmed that its first interest-rate hike will be in June, a detail that the financial markets seem to have already priced in. In our view, waiting until then poses a risk that inflation may rise more quickly than currently forecast. In any event, with the central bank’s commitment to keep rates unchanged through June, the future path of the Canadian dollar—an important component of future GDP growth—will now hinge largely on whether the US Federal Reserve moves earlier to raise rates.

In this month’s statement, the Bank of Canada maintained its long-held position that rates would remain unchanged until late in the second quarter, which would coincide with the June meeting. While acknowledging that inflation is slightly higher than expected, as we discussed in our commentary last week, the central bank also believes that there is enough slack in the economy to keep prices in check.

Nonetheless, we detected some wavering on the outlook. In its October statement, the Bank of Canada seemed generally downbeat on economic prospects, noting that the strong Canadian dollar was “more than fully offsetting” other favorable factors. Based on that forecast, policymakers pushed up by one quarter when they expected inflation to reach their 2% target, to the third quarter of 2011. In its December statement, however, the central bank sounded more upbeat on economic growth, reflecting signs of stronger-than-expected domestic demand. This week, policymakers returned to a more cautious view, again portraying the Canadian dollar as a “significant drag.” With only one other meeting scheduled before the June gathering, we think that the chances of a rate hike earlier in the year are slim.

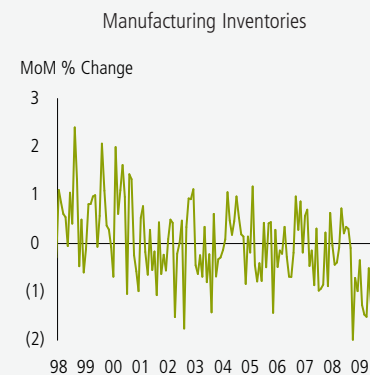
We see significant risks in this policy stance. Though inflationary trends are not likely to manifest themselves until midyear, they may be worrisome enough by then to force the central bank to be more aggressive than it would be if it had

Display 1
Broad Canadian Prices Are Rising Sharply



Source: Bank of Canada and AllianceBernstein

Display 2
Inventories Continue to Fall



Source: Haver Analytics and Statistics Canada

started earlier. Our proprietary broad price index, which incorporates house, equity and producer prices, is rising rapidly (**Display 1, previous page**). If global liquidity remains elevated, Canadian broad prices could quickly rise to levels matching the averages of the decade preceding the recession.

December consumer prices, reported this week, were weaker than expected, rising 1.3%. Because most of that gain came from gas prices, which soared 25% on a year-over-year basis, many analysts concluded that there is no inflation threat. But as we pointed out in previous commentaries, recent increases in prices for early-stage production goods and raw materials are reason for concern. Moreover, the December figure reflected some likely one-time anomalies: for example, in December, prices for household furnishings suffered the worst month-over-month drop in 10 years, while clothing prices fell more than 1%—only the fifth time they have declined that much since 2004.

As for economic growth, recent trends in housing suggest that the Canadian consumer is benefiting significantly from the accommodative monetary policy. This strength is being offset by continuing weakness in the manufacturing sector, a factor that may have inspired the Bank of Canada to once again focus on the dampening effects of the strong Canadian

dollar. In November, manufacturing sales fell 0.8% from the previous month, but this had followed month-over-month gains of more than 1% in each of the two previous months. New orders rose more than 1% in November, for the third month out of the past four. Inventories continued to tumble, marking the 10th consecutive month of declines (**Display 2, previous page**).

In sum, it appears that the Bank of Canada has stepped back from a more optimistic outlook for the economy, even while acknowledging some inflation risk. Under these circumstances, it may view sitting on its hands for two more meetings as the best course. It may also view a “stay the course” stance as a good way to encourage some weakening of the Canadian dollar. In our view, prospects for the Canadian dollar will be far more dependent on general investor sentiment about the US dollar. If the US Federal Reserve decides to hold off on raising rates even longer than its Canadian counterpart, the odds for a weaker Canadian dollar are quite small, in our view. How this currency dynamic plays out will have an important influence on the pace and strength of Canada’s nascent recovery.

This document reflects the views of AllianceBernstein and sources believed by AllianceBernstein L.P. to be reliable as of the dates cited. No representation or warranty is made concerning the accuracy of cited data. Nor is there any guarantee that any projection, forecast or opinion will be realized. The views expressed may change at any time. References to stocks, securities or investments should not be considered recommendations to buy or sell. The value of investments, and the income from them, can fall as well as rise and you may not get back the original amount invested. Past performance is not a guide to future performance. The value of overseas securities will be subject to exchange-rate fluctuations. Under no circumstances should this information be construed as investment advice. Nor should it be construed as sales or marketing material for any financial instrument, product or service sponsored or provided by AllianceBernstein or its affiliates or agents.

Note to Canadian Readers:

AllianceBernstein provides its investment management services in Canada through its affiliates, Sanford C. Bernstein & Co., LLC, and AllianceBernstein Canada, Inc.

Note to UK Readers:

UK readers should note that this document has been issued by AllianceBernstein Limited, which is authorised and regulated in the UK by the Financial Services Authority. The registered office of the firm is: Devonshire House, One Mayfair Place, London W1J 8AJ.

Note to Taiwan Readers:

This information is provided by AllianceBernstein funds Taiwan Master Agent, AllianceBernstein Taiwan Limited. SFB operating license No.: (97) FSC SICE no. 049. Address: 57F-1, 7 Xin Yi Road, Sec. 5, Taipei 110, Taiwan R.O.C. Telephone: 02-8758-3888. AllianceBernstein Taiwan Limited is a separate entity and an independently operated business.

Note to Singapore Readers:

This document has been issued by AllianceBernstein (Singapore) Ltd. (Company Registration No. 199703364C.) The Company is a holder of a Capital Markets Services Licence issued by the Monetary Authority of Singapore to conduct regulated activity in fund management.

Note to Hong Kong Readers:

This contributor is not licensed by the Hong Kong SFC and does not intend to provide investment advice in Hong Kong. For Financial Representatives General Information only and shall not be regarded as provision of investment advice.