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CIBC World Markets Inc. trims forecast for rate hikes and currency strength in Canada as economic growth outlook dampens abroad

TORONTO, Ontario, August 18, 2010 — Continuing weakness in the U.S. economy may force the Bank of Canada to put interest rate hikes on hold after September, notes a new report from CIBC World Markets Inc.

"North America's story is again darkening," says CIBC's Chief Economist Avery Shenfeld in the latest Global Positioning Strategy report. "We were looking for a material second-half slowdown for the U.S. but as it turns out, it's already happened."

Economic growth stateside from April to June is being revised downward, Mr. Shenfeld notes, and key indicators are pointing to growth that will be slower than anticipated by U.S. monetary policy makers.

And still ahead is a "further fiscal belt tightening in 2011 that will have to be softened, and accompanied by quantitative easing, if the U.S. is to stay out of recession in early 2011 and get back to potential growth by the end of that year.

"Forget about any rates hikes from the U.S. Federal Reserve until sometime in 2012 at the earliest."

While Canada is in much better economic shape - it leads the U.S., Eurozone, U.K. and Japan in first-half growth and has a record gap over the U.S. in the share of working age population holding a job - it "cannot move all the way to normalized interest rates while the U.S. Federal Reserve is still on hold," Mr. Shenfeld contends.

For starters, an interest rate differential of 300-400 basis points would take the loonie "substantially stronger" creating additional headwinds for Canadian economic growth, says Mr. Shenfeld.

Furthermore, the "external environment will be one of less-than-normal growth as fiscal tightening bites in Europe and the U.S., and with our own upcoming fiscal tightening also hitting domestic demand, monetary policy might have to be set at stimulative levels to allow the economy to return to potential and remain there. To keep moving at all, you have to step on the gas if your car is trying to roll up a steep incline."

Mr. Shenfeld doubts that the Bank of Canada "has been shocked enough to forestall a rate hike in September" but his forecast that Canadian growth in Q2 and Q3 will fall below the BoC's outlook will likely warrant a rethinking in the October Monetary Policy Report and in the months to follow.

The report also notes that there are limits to how far the Bank of Canada can diverge from the U.S. Federal Reserve without later regretting it. Episodes in recent years in which rate overnight rates were 2 per cent or more above those stateside resulted in sagging or sacrificed growth. These are "lessons learned, we hope," says Mr. Shenfeld.

"Since a hike at every rate setting date through 2011 would take rates substantially higher than 2%, a pause is coming on the road to tightening."

As a result of the dampened external growth outlook, Mr. Shenfeld has trimmed his call for rate hikes. He sees Canadian overnight rates going no higher than 2% next year as the U.S. Federal Reserve stays on hold.

A less hawkish monetary policy combined with a mixed outlook for commodity prices affected by slow global growth will also likely see the Canadian dollar roughly two cents weaker than earlier forecast over the same horizon, adds Mr. Shenfeld.