Economic Commentary

June 22, 2004

Fed Likely to Start Tightening on June 30th, Bank of Canada to Follow by Late Summer

The odds of a June tightening have increased markedly since the May 4 FOMC meeting. The May policy announcement included a neutral bias and noted that "policy accommodation can be removed at a pace that is to be "measured" rather than the "patience" that was indicated in the March meeting. While the May policy stance left room for a move later in the summer, the strong back to back gains in payrolls and core inflation together with the extraordinary low 1% policy rate starting point leaves me and the market siding with a 25 bp tightening at the June 29-30 FOMC meeting.

The anxious markets have been clamoring for a shift in policy direction. The June US treasury bill rate stands at 1.25% right now, fully pricing a 100% probability for a 25 bp June tightening. While the Fed may choose to hold back tightening until the August 10th meeting, it runs the risk of disappointing the markets and inadvertently boosting inflation expectations further, which is something the Fed wants to avoid. The market is beginning to fear a strong rise in inflation with the core rate now running at an annualized 3.3% over the last three months. The Fed now seems to need to quell the chance of a resurgence in inflation expectations more than it needs to nurse the economy to a sustained rate of growth. A move toward tightening rates sooner than later seems to be the best bet for the Fed.

In our last Economic Commentary I had expected the Fed to hold to a more gradual and transparent turn in policy with the May neutral bias turning to a tightening bias in June before opening the door for an August rate tightening. However, given firm market expectations and a surprisingly strong turn in payroll growth and core inflation the more transparent signal of higher rates ahead seems of less importance than a move itself.

Although the Fed might choose to initiate the long-awaited tightening at this June's FOMC meeting, it is my view that it will do it at a more moderate pace than the one it pursued back in 1994. I do not expect any 50bp moves in any single meeting and I suspect that it might choose to skip tightening between meetings as well, so us to make the shift to a more neutral stance more "measured" and less disrupting to financial markets and the real sector of the economy. I expect another 25bp hike in either one of the August 10th or September 21st meetings with a breather in either the September or November

10th meeting. The up-coming November presidential elections also call for a moderate approach in rate tightening.

Turning to the Canadian economic scene, Canada's economy has been surprising us on the upside. Following growth of 2.4% in the first quarter, Canada's growth in the second quarter has accelerated to a pace above 3.0%, the rate considered by the Bank of Canada to be Canada's rate of sustainable growth in potential GDP and is now expected to stay above that level for the balance of the year. At the same time employment and exports have resumed the strong pace of growth seen in 2002, the year before all the freak events and the 20% hike in the value of the Canadian dollar sent our economy to a tail spin. This morning's CPI report showed that although headline inflation jumped to 2.5% on a year-over-year basis, fuelled by a 13.6% hike in gasoline prices last month (up 30.3% from last year), the key core rate of inflation that is watched the most by the central bank, which leaves out the eight most volatile components of the basket, actually dipped to 1.5% from 1.8% in April. With the economy now growing above its potential, the output gap begins to close and the central bank will have to begin removing the policy stimulus of lower rates.

Given that the Fed is now poised to move on rates at the June 30th FOMC meeting the odds of an earlier rate tightening have increased. I now expect that the next rate hike in Canada will come at the September 8th meeting as opposed to the October 19th meeting that I forecast at my June 8th Economic Commentary.

The impact on the Canadian dollar over the near term is in my view is a draw. While the tightening south of the border will reduce interest rate differentials with Canada in the near term those differentials should start widening again once the Bank of Canada starts tightening in September. On the other hand, US dollar weakness will remain a chronic headache for the US since little improvement in the twin trade and budget deficits is expected in the medium term. With the US elections out of the way by late November, I see the odds of a downward adjustment in the value of the US dollar –and therefore an upward move in the value of the Canadian dollar- as exceeding the chances of an appreciation. Thus following a high degree of volatility in the path of the Canadian dollar trading around current levels, I continue to remain bullish on the course of the Canadian dollar starting in early 2005.

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