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BoC butts heads with bond markets

OTTAWA -- The Bank of Canada may have signaled its intent last month to gradually hike interest rates but bond markets have other thoughts.

The rally in bonds, powered by concerns of a weaker U.S. economy, has driven yields downward. This has allowed banks, which get their funding in the bond markets, to lower consumer borrowing costs. That was evident this week when the country's chartered banks lowered mortgage rates.

The question is which is the dog and which is the tail? Will the Bank of Canada follow the bond market's cue and hold off on raising rates at its September policy announcement amid signs of a slowing global economy? Or has the bond market gone overboard with the idea that a dramatic slowdown is imminent?

"Clearly the bond markets think the Bank of Canada is already on hold or will be after one more hike until economic conditions improve," said Andrew Pyle, a wealth advisor and markets commentator at ScotiaMcLeod.

In a report issued Wednesday, Avery Shenfeld, chief economist at CIBC World Markets, predicted the central bank will likely pause after one more 25-basis-point hike next month to 1%.

Mr. Shenfeld says Bank of Canada governor Mark Carney has seen "enough evidence" of a slowdown in the offing.

"Any pause is going to require a period in which growth either runs below 2% or would be at risk of doing so if rates were pushed higher," Mr. Shenfeld said, adding he doesn't expect the central bank to push up rates past the 2% level next year.

To date, the bond rally has largely offset the 50-basis-point increase in the Bank of Canada's benchmark policy rate since June 1. Since that date, yields on two-year Government of Canada notes have dropped roughly 44 basis points to 1.4%, while five-year yields have dropped 43 basis points and 10-year yields 34 points.

This is probably not what the central bank expected when it launched its rate-hiking campaign in an effort to normalize interest rates and tighten credit conditions. The goal, of course, is to keep inflation close to its preferred 2% target.

“If the central bank retains a tightening bias, then it doesn’t welcome the decline in long-term rates, which nullifies the tightening at the short end,” said Sal Guatieri, senior economist at BMO Capital Markets.

Others, however, contend the Bank of Canada will take the yield drop in stride because it reflects genuine concerns over the global recovery.

“The bank is very open minded about its plan to raise rates,” said Mark Chandler, head of fixed-income and currency strategy at RBC Capital Markets. “Nothing is carved in stone. It is likely looking at the rally in bonds and drop in government yields as probably a welcome buffer to the risks of a slowdown in U.S. growth.”

In its most recent economic outlook, released last month, the Bank of Canada said its forecast on consumer prices incorporated “gradual” increases in interest rates. Yet the central bank added that “considerable uncertainty” in the global economic outlook would force it to “carefully” weigh future rate decisions. With that in mind, it also pushed back the date at which it believed the Canadian economy would return to full capacity — now expected by the end of 2011 as opposed to the second quarter.

Besides the bond market, other measures suggest the central bank’s tightening efforts have worked. Sébastien Lavoie, an economist at Laurentian Bank Securities, said effective household and business interest rates — a weighted average of various financing costs compiled by the Bank of Canada — are higher today than they were back in March, when they hit their troughs for the year.

Still, “the external environment will make upcoming rate decisions more tricky,” Mr. Lavoie said. “Certainly, lifting from 0.75% to 1% is not going to be a policy error, but going up to 1.5% [by year-end] appears unlikely.”