

# David Dodge's Swan Song

The Bank of Canada cut its policy rate 25 bps to 4%, a move that was widely expected a day or two ago. However, the recent carnage in equities and the Fed's surprise 75 bp rate cut this morning pumped expectations of a 50 pointer. The Bank's reason for a rate cut in the first place... *"Financial market conditions have deteriorated since October, leading to a tightening of credit conditions in industrial countries. Given this, and a deeper, more prolonged decline in the U.S. residential housing sector, the 2008 outlook for the U.S. economy is now significantly weaker",* which *"will lead to additional downward pressure on export growth"*. It also helped that *"both core and total CPI inflation have been lower than projected"*. However, the reason for only a 25 bp move... *"Domestic demand in Canada is projected to remain strong. This strength is supported by continued income growth associated with the increase in commodity prices since October, which has led to further gains in our terms of trade."* Indeed, November retail sales out this morning doubled expectations (+0.7%, +1.7% ex-autos), consistent with still-strong consumer spending.

Importantly, **the Bank signalled that more rate cuts are coming...** *"Further monetary stimulus is likely to be required in the near term to keep aggregate supply and demand in balance and to return inflation to target over the medium term."* The Bank now expects total and core CPI inflation to slip below 1.5% y/y by mid-year and return to 2% only by the end of 2009, as the economy moves into an excess supply position in 2008Q2. The economy is projected to move back into balance in early 2010, after stronger growth during 2009. These forecasts will be fleshed out in Thursday's Monetary Policy Report Update.

Barring another move during the next nine days (in these volatile times, you can't completely rule these things out), this marks the last rate action by outgoing governor David Dodge. It's noteworthy that core inflation is currently running at 1.6% y/y, a tenth below the rate at the start of his term in February 2001. Unfortunately, he hands the monetary keys to new governor Mark Carney amid much economic and financial market uncertainty... **Dodge's "swan song" may become Carney's "trial by fire"**.

**Bottom Line:** Canadian rates are headed lower. With the fed funds target rate on a fast train to 2% (consistent with past Fed policy responses to recession), the Bank of Canada will likely cut its policy rate to 3%. Indeed, given that economic and financial market conditions will probably continue to deteriorate between now and the next policy announcement on March 4, you can't rule out an eventual 50 pointer.

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