TD Bank Financial Group

TD Economics

Special Report

March 17, 2008

CANADA: BOC RESPONSE TO U.S. TURMOIL

Overview

-Having revised our U.S. Federal Reserve rate call in light of persistent negative developments and the anticipated repercussions still to come in that country, we must now turn to the implications for Canada.

-Our revised forecast for the Bank of Canada is now that the overnight rate will fall to just 2.00% over the next three meetings. This means that we continue to call for 50bp cuts at each of the next two decision dates for the BoC (Apr 22 & Jun 10), and that we tack a further 50bp easing on at the opportunity after that (July 15).

Canada-U.S. Elasticity

-At its simplest level, we believe Canada has perhaps a 40% elasticity to the U.S. For instance, if U.S. GDP were to be hit by a theoretical negative shock of 1%, Canada would slow by 0.4%, or thereabouts. The direct trade ties between the two countries are somewhat less than this (about 27% of Canada's GDP is generated by exports to the U.S.), but the close link between credit markets provides an additional impact.

-Given that our revised economic assessment of the U.S. now calls for an additional 125bp of Fed easing (for a floor of 0.75%, versus our previous call of 2.00%), that aforementioned 40% elasticity very roughly suggests that the BoC may wish to ease by an additional 50bp or so. In turn, this pushes our ultimate BoC forecast to a floor of 2.00% from our prior forecast of 2.50%.

Reality Check

-From a historical perspective, this will place the overnight rate at the same floor as it hit in 2001. This does not seem unreasonable, though given that this correction appears more serious than the 2001 one, perhaps there is a slight risk to the downside.

-While tempting to forecast chunkier eases from the BoC given what the Fed will likely be up to, the BoC does tend to be somewhat more cautious and incrementalist than the Fed. Some portion of that incrementalist nature may have been shed with the introduction of a new Governor, but we feel that 50bp increments are still likely large enough for Canada.

Economic Angle

-In Canada, the name of the game remains addressing the trifecta of the U.S. slowdown, the credit crunch, and the deflationary impact of CAD. That last impact could be waning if BoC musings are correct, but the credit crunch is intensifying, as is the U.S. slowdown. With core CPI still quite soft in Canada, there is ample room to ease.

Bond View

-From a bond market perspective, our new view leaves us with a forecast for the Fed that is somewhat more aggressive than our forecast for Canada when contrasted against the market. Although we are more pessimistic than the market for both, the difference is more extreme in the U.S. Thus, this would seem to argue for the U.S. to outperform Canada in bonds, even though Canadian bonds have managed to keep pace and even occasionally outperform over recent weeks. This marks a reversal of our recent view. To be clear, once we enter the second half of 2008 or first half of 2009 we think there is very real scope for Canada to outperform the U.S. in bonds. But that time is not yet here.

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