canada.com WHERE PERSPECTIVES CONNECT

Friday » September 29 » 2006

Bank will slash rates to curb loonie

CIBC: Cut of as much as 100 basis points predicted

Jacqueline Thorpe
Financial Post

Friday, September 29, 2006

The Bank of Canada will slash interest rates by as much as 100 basis points over the next 12 months to counteract a slowing U.S. economy and past appreciation of the loonie, which could suck another 50,000 manufacturing jobs out of Ontario, an investment bank predicted yesterday.

The U.S. Federal Reserve will chop rates, preventing a housing slump from derailing growth in the world's biggest economy, CIBC World Markets said.

"We expect as many as four 25- basis-point cuts over the next 12 months in an effort not only to restrain the loonie but also revive a sagging central economy," Jeff Rubin, chief economist at CIBC World Markets, said in his 2007 outlook.

By the end of 2007, Canada's overnight rate should have retreated to 3.25%, almost reversing the last year of tightening.

While some Bay Street economists are predicting the Bank of Canada will ease into rate-cutting mode as the year progresses -- yesterday Global Insight predicted two 25-basis-point cuts starting as early as the December announcement -- CIBC is one of the most aggressive.

Its dovish view on rates mainly stems from the fact it sees past appreciation of the loonie continuing to exert a substantial drag, especially on Ontario.

Though it might prove temporary, Canada's recent trade deficit in autos was an ominous sign for the health of Central Canadian manufacturing, Mr. Rubin said.

"The overlay of a US90 cents Canadian dollar and a weakening U.S. consumer is a double hit to Ontario's manufacturing base, which will likely be a graveyard for another 50,000 manufacturing jobs as growth slows to well below 2%," he said.

Overall, CIBC World Markets sees real GDP growing by 2.5% in 2007, down from an estimated 2.9% this year.

While that will be faster than U.S. growth of 2.3% -- the first time since 2002, when the loonie was around US62 cents -- Mr. Rubin believes the United States will manage a soft landing, thanks again to a central bank that will ride to its rescue with rate cuts.

He sees three 25-basis-point cuts next year, taking the Fed funds rate down to 4.50%.

"Instead of a consumer-led recession sparked by imploding property values, we are far more likely to see something akin to the mid-cycle slowdown of 1995 to early 1996, where 75 basis points of Fed cuts ended up buying another half decade of economic growth," Mr. Rubin said.

Many economists are starting to buy into the soft-landing scenario, a view supported by U.S. stock markets.

Yesterday, the Dow Jones industrial average climbed as high as 11,728.46, surpassing by almost six points its Jan. 14, 2000, record. It closed up 29.21, or 0.3%, at 11,718.45.

Gene Huang, chief economist at FedEx Corp., presenting at the Economic Club of Toronto yesterday in a busy day for economic forecasting, said the United States is in the middle of a healthy slowdown.

"The real question currently is the interplay between the cooling housing market and lower, if it's sustained, energy costs. But direction-wise, I think the near-term outlook probably has more upside than one or two months ago," said Mr. Huang.

He said FedEx, which is often seen as a leading indicator of global growth, saw net income rise 40% in the past quarter and has seen a pickup in orders.

"Wholesale is doing well and some of the consumer-driven services are coming back and all this suggests the economy is positioning itself for the upcoming holiday season," Mr. Huang said.

Nariman Behravesh, Global Insight's chief economist, said the United States is likely facing four quarters of below-2% growth, but a recession is unlikely. Global growth will slow, but not dramatically.

However there are risks, including higher oil prices, housing crashes across the world, a slump in the U.S. dollar and a hard landing in China.

"If the U.S. downturn turns out to be worse than we're saying, I'm not sure the rest of the world can offset it," he said. That is because there is no serious consumer-spending growth outside of the United States.

German growth, for example, was 3.6% in the second quarter, but consumer spending dropped 1.6% and even Chinese growth has been driven largely by business investment and exports.

While Canadian growth is expected to slow, CIBC World Markets says rate cuts should give a boost to Toronto stocks, with nearly 40% in interest-sensitive financials, telecoms and utilities.

Mr. Rubin expects the TSX to set a record high north of 13,000 in the next 12 months.