

## What's The BoC To Do With Higher Canadian CPI, Stable Core?

Canada, CPI, y/y / m/m NSA %, December:

Actual: 2.0 / -0.1

Scotia: 1.6 / -0.5

Consensus: 1.7 / -0.4

Prior: Unrevised from 1.7 / -0.4

Core inflation, y/y %, November:

Average: 1.9 (prior 1.9%)

Common component: 1.9 (prior 1.9%)

Weighted Median: 1.8 (revised to 1.8% from 1.9%)

Trimmed Mean: 1.9 (prior 1.9%)

- Headline inflation surprised higher and core inflation was unchanged but these two observations mask important underlying shifts.** This is a touch more complicated than expected inflation update but I'll walk through the implications toward why I think it reinforces our narrative that markets are significantly underpricing rate hike risks by the BoC over 2019. As charts 1 and 2 depict, headline inflation is on the BoC's 2% target and core inflation is close to it. Inflation averaged 2.0% y/y in Q4 which was what the BoC's January MPR revised down to, but at the margin the greater than expected monthly momentum might indicate higher tracking risk into Q1 than the BoC's 1.7% forecast suggests. Note that excluding gasoline (-8.6% y/y), CPI was up 2.5% y/y
- There is considerable breadth to the gains** but the volatility in the tails of the price distribution is weeded out by the central tendency measures. Chart 3 depicts year-ago price changes by basket component ranked from highest to lowest. Chart 4 shows the role of several important components and how they've swung, like electricity prices following prior cuts and mortgage interest costs following rate hikes.
- On auto prices acting as a dampening influence in this report, I'd be careful toward this component. Pass through of a weak currency probably still lies ahead as chart 5 suggests by lagging out in time the movements in the C\$ and showing the rough correlation with auto prices given the heavy import propensity.
- Among the components that influenced prices higher were air travel +28.1% y/y, vegetables prices 11.2% y/y, fruit +2.4%, fish prices 3.8% y/y, mortgage interest 7.5 y/y, electricity 3.6% (a sizeable swing factor), water 2.8%, communications 5.2%, auto insurance 5.1%, tuition 3.1% y/y, restaurant prices 3.8% and cigarettes prices are up 8.3%.
- To the downside were meat prices +0.6%, dairy +1.5%, bakery +0.9%, rent 1.4%, property taxes 1.4%, natural gas -4.1%, furniture prices -2.1%, clothing 0.5%, autos 0.3%, gasoline -8.6%, bus/subway fares 1.6%, health care 0.2%, recreation prices 1.0%.
- Regarding big movements in some components, StatsCan warns to treat the airfare surge "with caution" given the ongoing influences of the

### CONTACTS

Derek Holt, VP & Head of Capital Markets Economics

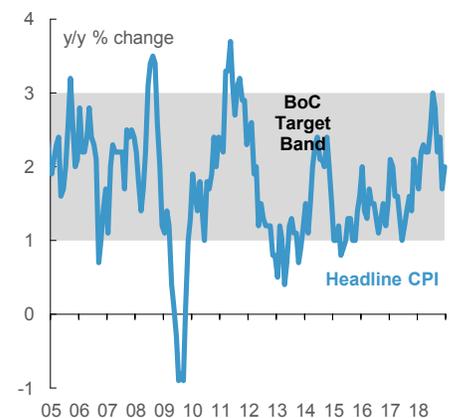
416.863.7707

Scotiabank Economics

derek.holt@scotiabank.com

Chart 1

### Inflation On The BoC's Target



Source: Statistics Canada, Scotiabank Economics.

Chart 2

### Canadian Core Inflation



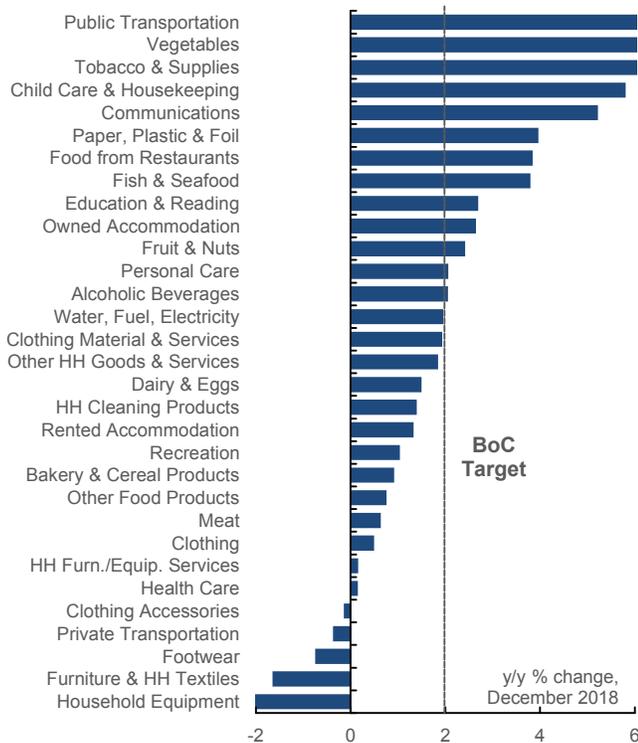
Sources: Scotiabank Economics, Statistics Canada.

methodological change in March 2018. StatsCan warns of further methodological shifts in the next inflation report when it changes the methodology for rent that carries a 6.1% weight in the basket. Also note that higher telephone services prices (+6.1% y/y) are being pinned on base effects back to the end of promotions in December 2017.

- In all, while it's very early for the overall 2019 narrative, at the margin the fact that headline inflation remains on target, core inflation is close, breadth is significant, some components could rise ahead (autos) while others are unsustainable (airfare on methodological changes) reinforce a bias that markets have gone too far in pricing out rate hikes in 2019. The BoC will likely remain on hold until we get through a transitory shock effect from Alberta's production cuts plus the effects of higher than previously estimated slack, but from Q2-onward there is the risk of a return to hiking when the air clears. Clearly the BoC—like other central banks—also has a cautious eye toward Brexit, US-China negotiations, US shutdown and debt ceiling risks and broader US politics. By March, those risks should be much better informed.

Chart 3

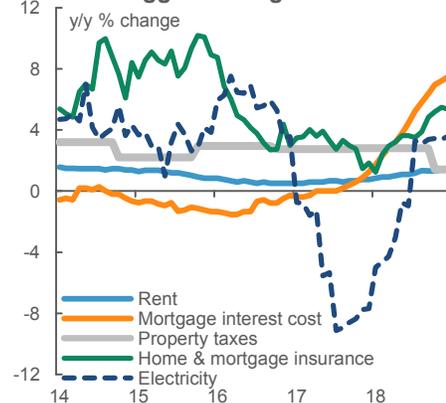
**What Canadian Prices Are Rising?**



Source: Scotiabank Economics, Statistics Canada.

Chart 4

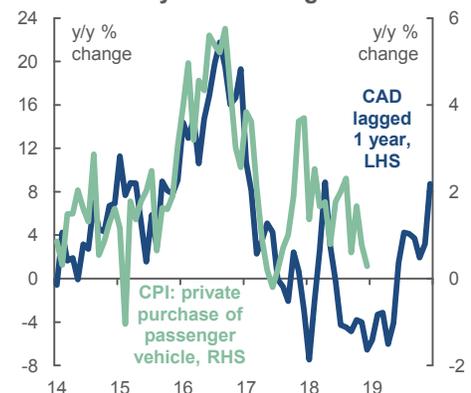
**Electricity Prices Are The Biggest Swing Factor**



Sources: Scotiabank Economics, Statistics Canada.

Chart 5

**Auto Price Inflation Bottoming on Currency Pass-through Effects**



Sources: Scotiabank Economics, Statistics Canada, Bank of Canada.

This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a “call to action” or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

**This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.**

<sup>TM</sup> Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with “Global Banking and Markets”, is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia’s regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.