A stronger than expected core inflation reading including upward revisions counts for more than export figures. The latter set of numbers is replete with distortions in what was largely expected to be the low point for exports in Q1 on the back of Alberta's production cuts and a soft patch in the global, US and Canadian economies. If our rebound forecast transpires as we believe it will, then a higher starting point for the Bank of Canada's key inflation metrics further prices out rate cut bets and declares 'game back on' for timing the next hike. Scotia Economics remains the only one of the large domestic banks to continue to forecast a rate hike later this year and the incremental information may lean toward sooner rather than later.

CONTACTS

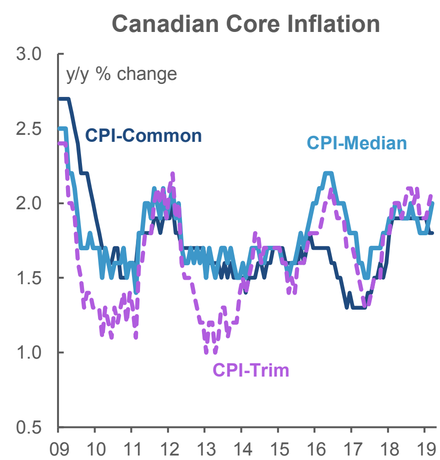
Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

Canadian Core CPI Hawkishly On Target

Canada, CPI, y/y / m/m NSA %, March :
Actual: 1.9 / 0.7
Scotia: 1.9 / 0.7
Consensus: 1.9 / 0.7
Prior: Unrevised from 1.5 / 0.7

Core inflation, y/y %, March:
Average: 2.0 (prior revised to 1.9 from 1.8)
Weighted Median: 2.0 (revised to 1.9 from 1.8)
Common component: 1.8 (prior 1.8)
Trimmed Mean: 2.1 (prior revised to 2.0 from 1.9)

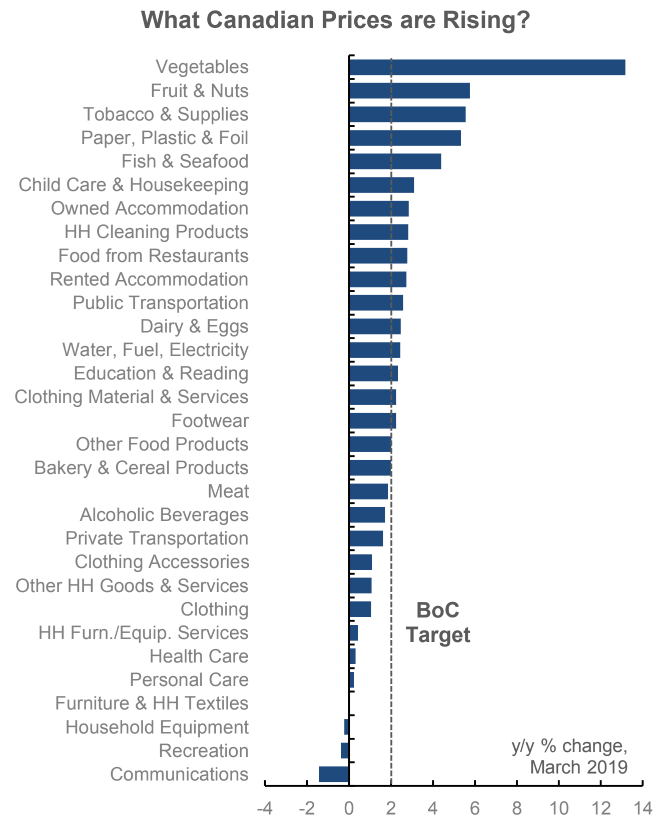
Sources: Scotiabank Economics, Statistics Canada.



Sources: Scotiabank Economics, Statistics Canada.

- Core inflation came in materially stronger than anticipated as headline inflation climbed in line with expectations. The former matters more than the latter to the Bank of Canada. If one were left with no greater impression than the fact that headline inflation rose due to things like gasoline prices, base effects and typical seasonality then the BoC would shrug its shoulders. But with the average of the three core inflation readings rising to 1.97% y/y and revised up to 1.9% the prior month, core inflation is proving stickier than expected.
- At a minimum, this sparks more covering at the front end as rate cut bets are getting further unwound. It makes the debate on timing the BoC's next hike more interesting as markets and consensus may have given up on that narrative too prematurely. We still think the BoC is not done with its hike cycle and our current view is a hike by year-end. There are two tail risks to this, but the incremental information this morning may tilt the risk to earlier. We still need to see progress toward de-escalation of geopolitical risks (Brexit, US-China, US-Europe, US debt ceiling etc) and that merits continued caution. We also still need to see rebound evidence confirm expectations into Q2-onward. But sticky inflation with core on target and slightly higher of late (first chart below) skews the rate hike risks potentially nearer term. Breadth to the core rise was quite strong not only in the form of the three individual 'core' readings (second chart) but also in terms of the underlying breadth across individual components that I'll return to in a moment.

- CAD appreciated by one-third of a cent to the USD following the data and the Canada two year yield jumped by about 3bps to underperform a flat US front-end before this reaction was reduced somewhat. The reduced response probably had more to do with external developments as the US front-end became richer.
- By province, the hottest inflation was in western Canada with BC at 2.6% y/y, Alberta at (2.3%) and Manitoba (2.3%) hot on its heels. Each of Ontario, Quebec and Saskatchewan sit at 1.8% y/y with others trailing.
- On a month-ago seasonally adjusted basis, CPI was up 0.3% m/m. That was driven by transportation (+1.2%) including higher gasoline prices. Food prices were up 0.3% along with shelter costs. Health and personal care prices advanced 0.2% while recreation/education/reading was flat.
- On a seasonally unadjusted basis, prices were up 0.7% m/m in line with expectations. Gas prices were up 11.6% m/m and that drove transportation up 2%. Clothing and footwear prices were up 1.7% which is consistent with new Spring/Summer lines coming in. Excluding food and energy, CPI was up 0.3% m/m.
- In year-ago terms, there is substantial breadth to the inflation figures as the third chart demonstrates. A large portion of the CPI basket is either on or above target with several categories not far behind. It would therefore be a mistake to dismiss inflation as reflecting idiosyncratic distortions.



Source: Scotiabank Economics, Statistics Canada.

- Relative to BoC expectations, headline CPI was a touch softer in Q1 at 1.6% y/y versus the January MPR reading of 1.7% y/y. Then again, it may be stronger than the BoC had anticipated in two other respects. One is that the BoC turned more neutral after the January meeting and so it may have been concerned that there was greater downside risk to its January CPI forecast. For another, the BoC does not publish a forecast for core CPI and I wouldn't be the least surprised to have seen Governor Poloz's eyebrow rise when he was told the core inflation figures that surprised everyone.

Fade Canada's Trade Figures

Canada, International Merchandise Trade balance (CAD billions), February:

Actual: -2.9

Scotia: -4.0

Consensus: -3.25

Prior: -3.09 (revised from -4.25)

- While the trade figures are weaker than the impression left by the improved overall trade deficit including positive revisions, I would suggest fading the overall report for three main reasons.
- For one thing, the energy sector data was simply made up. As StatsCan notes, the large 5.3% decline in crude oil export volumes is unreliable. To quote StatsCan: "Given the late reporting of crude oil transactions, statistics on these exports must be estimated in the current month's release, and can be subject to large revisions during times of high volatility in energy prices." As Alberta scaled back its production cuts twice already, I find it debatable whether they fell that much again in February and the upward revisions to the prior month's made up figures was perhaps a case in point.
- For another, the large 6.6% m/m drop in exports of metal and non-metallic mineral products was "largely due to lower exports of refined gold to the United Kingdom, which had increased significantly in January." This is an anomaly and a banking sector transaction and not something that reflects underlying fundamental drivers of export activity.

- Removing these two sectors—one made-up, the other an anomaly—still leaves export volumes weak at about -2% m/m but that's about half of the reported decline. Nevertheless, it's a caution against going too far with the Q1 nowcast GDP growth tracking estimates on the back of the trade figures that are subject to revision as actual energy trade data gets factored in and that reinforces expectations the economy hit a soft patch before an expected rebound.
- Overall breadth in export volumes was weak as every single category fell.
- At present, export volumes are tracking about a 10% q/q annualized decline in Q1 with revisions and March pending. A big part of this has been the decline in energy export volumes that fell by about two-and-a-half times the total decline in export volumes subject to the same ginormous caveats. As production cuts get scaled back and eliminated over 2019 with further policy risk to be monitored in the wake of Alberta's election results, this contribution to export volumes could snap back the other direction over the duration of the year. This is the third reason to filter the trade figures in that better days may be ahead and that would be consistent with BoC communications that anticipate a trade rebound of sorts.
- On the flip side, import volumes are tracking a rise of 7.5% q/q in seasonally adjusted and annualized terms during Q1 after a drop of 2.4% in Q1. That reflects underlying strength in the domestic economy but also several huge distortions in categories like ores and planes. Transportation equipment imports are tracking up 293% q/q as one example. Metal ores imports are tracking 52% higher as another. Underlying this activity is nevertheless an 18% rise in motor vehicle and parts imports during Q1 so far, plus gains in consumer goods ex-autos, chemicals, forestry products and metal products excluding ores.