Why You Should Look Through Canadian CPI

- Canadian inflation was considerably stronger than expected...
- ...but the breadth of the rise was weak...
- ...as recreation/reading/education drove almost all of the rise...
- ...as ‘Spring fever’ drove prices for travel and outdoor toys higher...
- ...such that an idiosyncratic and likely transitory driver should be faded…
- ...in favour of forward-looking risks to the BoC policy outlook

Canada, CPI (m/m % NSA ; y/y % NSA), May:

Actual: 0.4 / 2.4
Scotia: 0.1 / 2.0
Consensus: 0.1 / 2.1
Prior: Unrevised from 0.4 / 2.0

Canada, Core Inflation, y/y %, May:

Average: 2.1 (prior 1.9)
Weighted Median: 2.1 (prior 1.9)
Common Component: 1.8 (prior 1.8)
Trimmed Mean: 2.3 (prior 2.0)

- Core inflation hit its highest since February 2012 so kiss goodbye to any talk of easing by the Bank of Canada, right? Not so fast. There are three major reasons for being more guarded against the immediate market reaction that sparked a CAD rally and spike in short-term yields.

- The average of the three central tendency price measures climbed to 2.07% y/y, so 2.1% rounded up and two-tenths higher than the prior month’s reading. See the accompanying chart for a depiction. That’s stronger than our bottom up and model-based perspectives anticipated. That puts core still in line with the 2% inflation target. When the BoC references risks to its inflation target, it is likely to continue to describe inflation as being on target.

- One reason to be careful here is that against StatsCan’s guidance in their write-up that there was strong breadth to the drivers of higher inflation, only one oddball volatile category accounted for almost all of the surge in weighted terms across the major categories.

- In weighted terms, the recreation/reading/education category was responsible for two-thirds of the 0.3% m/m SA CPI headline rise and three-quarters of the 0.4% m/m NSA CPI headline rise. This category has a 10.25% weight in CPI. It was up by 2.4% m/m NSA and 1.6% m/m SA in May.

- In month-ago SA terms, there are only two months since 1992 when the rec/reading/education category was slightly stronger. For purposes of calculating what the month-ago CPI change did to the year-ago rates, however, we need to use the month-ago seasonally unadjusted change in this category. That’s shown in the second accompanying chart. May 2019 was historically right off the charts with precious few precedents behind this big jump in...
recreation/reading/education prices. Given the notorious volatility of this component, the overall report has to be labelled as transitory and idiosyncratic in terms of the drivers.

- It’s not the least clear that this effect would get weeded out of the central tendency ‘core’ measures. The central tendency measures weed out from the tails the y/l changes and the rec/reading/education category performed similarly this month to last month in year-ago terms even though it was off the charts in month-ago terms. The trimmed mean CPI measure, for instance, lops off the top and bottom 20% of changes to the year-ago rate and would have kept in the basket the rec/reading/education category.

- However, if you remove three quarters of the m/m NSA rise in headline inflation that was due to rec/reading/ed/n, then headline CPI would have been 2.1% y/l, not 2.4% and hence on consensus expectations.

- What drove the recreation/reading/education category higher? StatsCan flagged traveller accommodation (+15.5% m/m), travel tours (+5.5%), recreational equipment index (+2.3%), sporting and exercise equipment index (+2.0%), and purchase of recreational vehicles and outboard motors (+1.9%). In short, Spring fever drove demand for travel and outdoor toys in more powerful ways than is typically the case. This suggests the category could well drop out as an inflation driver and fairly soon at that.

- Another way of looking at breadth is to break down all 55 categories and look at their weighted contributions. This is done in the accompanying table (thanks Nikita!). The eight categories listed at the bottom accounting for 0.2 of the 0.3 m/m seasonally adjusted price gain in May. By corollary, the other 47 of 55 categories only contributed 0.1% cumulatively. Again, there was narrow breadth.

- A second reason for fading this report reflects caution toward telecomm service pricing and what it may do to the June CPI report a month from now and subsequent reports. The nation’s carriers have embarked upon a major discount price war. CPI captures price changes after controlling for service quality changes and the more attractive pricing also entails higher data limits. Lower prices and better quality/service combine to both be disinflationary. This effect may be among the bigger influences to the downside in subsequent inflation readings and it could well combine with a full-on reversal of the recreation/reading/education category.

- Nevertheless, backward looking inflation doesn’t necessarily carry the day in terms of future policy risks and lessons from the past counsel continued caution which is the third reason for looking through this report.

- Recall some history here. Back in 2008H2 when the world was falling apart, headline inflation was running at 3.5% in Canada and the average of the three core measures was still riding at 2.7% y/y in December 2008. The BoC reversed course despite all of that and did so starting in late 2007. This isn’t 2008. But there are major risks overhanging the outlook for the world economy, trade policy, and commodities. The BoC was hiking in 2007 partly because of inflation before it woke up.

- Also consider that the BoC’s commodity price index ex-energy is still at its weakest since the start of the year. The terms of trade have still
deteriorated. A Q2 growth rebound faces still significant uncertainty about the durability into 2019H2. There are still limits including through the C$ to the extent to which the BoC can ignore potential Fed easing. And the core CPI up-tick could well be transitory.

- In terms of further detail, on a month-ago seasonally unadjusted basis that reflects consensus polling, CPI was up by 0.4% or four times consensus. That’s the fourth solid month in a row. Breadth was high. Food prices were up by 0.5% m/m, transportation was up by 0.7% led by a 1.1% rise in gas prices, recreation/reading/education prices were up by 2.4% and other categories were up by 0.1–0.2%.

- On a month-ago seasonally adjusted basis, prices were up by 0.3% again. Here too, breadth was notable. Food was up 0.3% m/m, transportation prices were up 0.8% including gas effects, recreation/reading/education prices were up by 1.6% and other categories were up by 0.1% for the most part.

- Components that influenced prices higher on a year over year basis were vegetables +14.4%, air travel +8.8%, mortgage interest +8.2%, auto insurance +8.1%, vehicles +4.2%, dairy +3.1%, tuition +3.1%, meat +2.9%, restaurants +2.5%, electricity +2.3%, fruits +2.2%, and rent 2.1%. See the accompanying chart.

- Downside pressure on inflation on a year over year basis came from gasoline -3.7%, communications -0.9%, furniture -0.5%, health care +1.1%, clothing 1.2%, alcohol +1.4%, and property taxes +1.4%.