CAD & Rates Rightly Shrug Off Canadian CPI

- Headline inflation unexpectedly stay flat and lower than consensus…
- ...primarily due to three one-offs…
- ...while average core inflation edged a tick higher…
- ...and has remained in a 2.0–2.1% range over the past 5 months.
- Canada deserves a Fed-style debate on symmetry & expectations
- External and domestic risks…
- ...don't guarantee staying on the inflation target

Canada, CPI m/m % / CPI y/y %, NSA, September:
Actual: -0.4 / 1.9
Scotia: -0.1 / 2.2
Consensus: -0.2 / 2.1
Prior: Unrevised from -0.1 / 1.9

Canada, Core Inflation y/y %, September:
Average: 2.1
Common Component: 1.9 (prior 1.8)
Trimmed Mean: 2.1 (prior 2.0 revised from 2.1)
Weighted Median: 2.2 (prior 2.1)

Headline inflation came in materially weaker than expected and core inflation was slightly stronger in September. Neither should matter. One reason is that the factors that drove weaker headline inflation are probably all transitory. Another reason is that the average core inflation measure including a small revision effect ticked up by a small 0.1%, but remains in the oscillating 2.0–2.1% y/y range of the past five months. Further, this average core inflation measure conflicts with the core measures that prior BoC regimes would have used and leaves intact the symmetry and expectations arguments that I gave in the morning note.

The average of the three central tendency measures of inflation moved from 1.97% y/y to 2.07% y/y in September. Rounded, it's a rise from 2.0% to 2.1%.

The Canada two year yield initially dropped by about 2bps but has since reversed this while CAD slightly depreciated. Bigger considerations dominate movements in global markets.

So why did CDN CPI come in weaker than expected and average core tick very slightly higher? Core measures exclude the big movements in several categories that were real outliers this time but the picture would be different using the old core measures. Chart 1 shows weighted contributions to CPI in year-ago terms and chart 2 shows weighted contributions to CPI in month-ago terms in order to help quickly hone in on the major drivers.

1. Internet and cellphone price wars: Internet access fees fell 7.9% y/y and telephone services prices fell 2% y/y. In month-ago terms, seasonally unadjusted internet service fees stabilized (+0.2% m/m) but telephone services continued to decline (-2.1% m/m). This reflects the price wars that started in Canada earlier this

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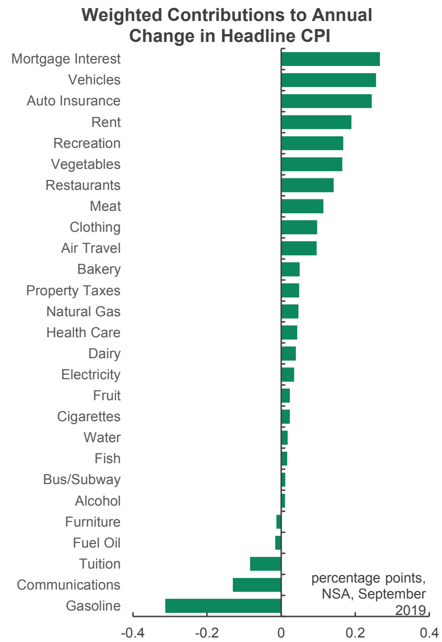
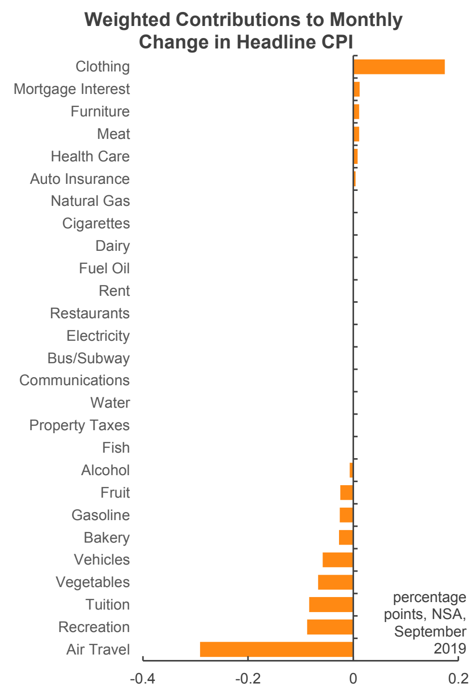


Source: Scotiabank Economics, Statistics Canada.



Source: Scotiabank Economics, Statistics Canada.

summer and they are likely transitory effects. In weighted terms, both categories combined to drive the communications category to knock 0.1% off year-ago headline inflation.

2. Tuition: Ontario's tuition fee cuts last month drove the single biggest decline in tuition expense on record. That knocked about another 0.1% off year-ago headline inflation all else equal. Tuition prices get reset each year in September and so this too is a transitory effect on headline CPI.

3. Gas: the decline was materially bigger than tracking for regular unleaded prices. That's partly because of the change from summer-blend gasoline to cheaper winter blend. Gasoline knocked about 0.3% off headline inflation. The switch to winter blend is mostly a one-off effect that is perhaps alien to residents in more southerly climates.

Basically the core measures are designed to weed out such abrupt swings in the tails and pretend they didn't happen. Trimmed mean CPI, for instance, kicks the top and bottom fifth of the basket out. The BoC argues these are superior measures of underlying price pressures over time. **If, instead, we go back to the BoC's old pre-Poloz core measures then we get a different picture that a prior regime and Governor might have viewed a bit differently.** CPI ex food and energy is decelerating to 2.1% y/y (2.2% prior, 2.4% peak in May) and CPI ex-eight was stable at 1.9% y/y after previously falling from 2.1% back in May. That contrasts with the average of the newish core measures that has oscillated between 2.0–2.1% over the past five months.

The BoC is likely to take some comfort in the fact that core inflation continues to ride around the 2% target. This confidence might be exaggerated, however, for several reasons many of which were outlined in my morning note (here). The BoC has missed its 2% target using the average of the core measures about 90% of the time over the past eight years of monthly year-ago figures. Instead of referencing a return to home defined as equilibrium in terms of spare capacity and inflation, the BoC should perhaps be more concerned about persistently failing to hit its target over the years and forward looking risks defined both in terms of external risk factors and domestic risks that question the durability of staying on target absent easing. These risks will be materially informed over coming weeks and months. Further, market and business expectations are in the lower half of the 1–3% target range and hence indicating risk of unmoored expectations.