Get Used To Rising Inflation In Canada

- **Core inflation met expectations at a sticky 1.7% y/y…**
- **...and just tenths away from 2% as the operational guide**
- **Headline inflation climbed by more than expected**
- **Underlying pressures on inflation are building into 2021**

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Canadian CPI, m/m / y/y %, November:
Actual: 0.1 / 1.0
Scotia: -0.3 / 0.5
Consensus: 0.0 / 0.8
Prior: 0.4 / 0.7

Canadian core CPI, y/y % change, November :
Average: 1.7 (prior 1.7%)
Weighted median: 1.9 (prior (1.9%)
Common component: 1.5 (prior 1.5 revised down from 1.6%)
Trimmed mean: 1.7 (prior 1.7% revised down from 1.8%)

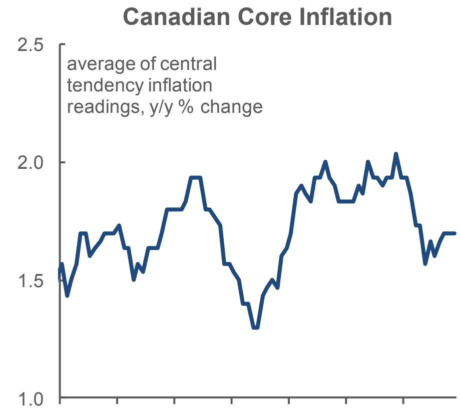
Headline CPI inflation was firmer than expected while core inflation met my guesstimate. There were surprises across several components in a bottom-up approach that best suits trying to guesstimate monthly inflation estimates, but they weren't enough to materially alter the picture for the Bank of Canada—yet. What could impact thinking at the BoC, however, is nascent evidence of rising upside pressure in some key drivers that could reinforce a general output gap framework approach.

Average core inflation was 1.7% y/y in November. The downward revision to the prior month (from 1.8% to 1.7%) was not anticipated. On balance, trend core inflation is riding at a remarkably sticky 1.7% y/y for four consecutive months.

The output gap is forecast to gradually shut over the next 18 months or so using our actual GDP forecast and the mid-point of the BoC's range fore potential growth (chart 2). As that happens, Canada could well see core inflation converge upon target with headline and core trending toward 2%. Or at least that's one way of looking at it, but this output gap framework at least needs to be supplemented by more granular bottom-up perspectives. One reason for doing so is the spotty ability of output gaps as a driver of inflation.

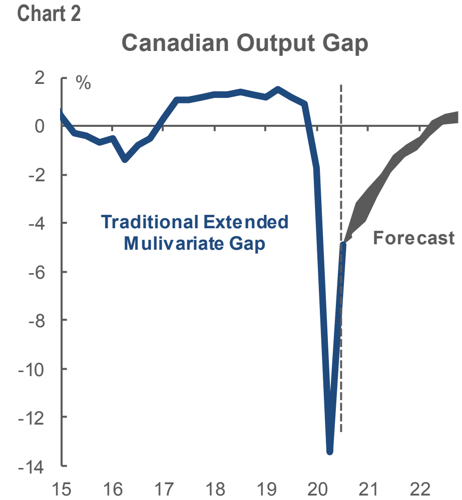
For example, housing costs are a rising driver of inflation. There are multiple ways in which hot housing markets are driving inflation and expected to continue to do so. The way they principally get captured is through owners' replacement cost which is estimated largely on the basis of what happened to the house only component of Statistics Canada's new house price index (chart 3). We don't yet have the NHPI for November but what is inferred from today's CPI report is a further strong rise. In fact, so much so that housing is now starting to eclipse its

Chart 1



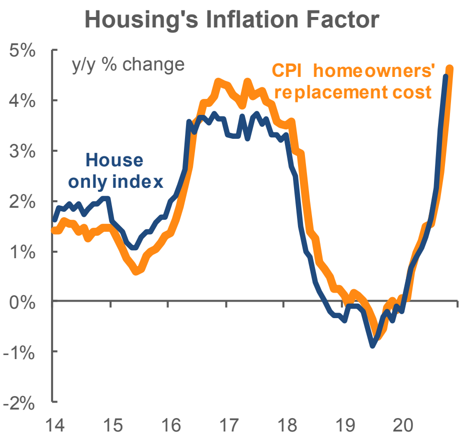
Sources: Scotiabank Economics, Statistics Canada.

Chart 2



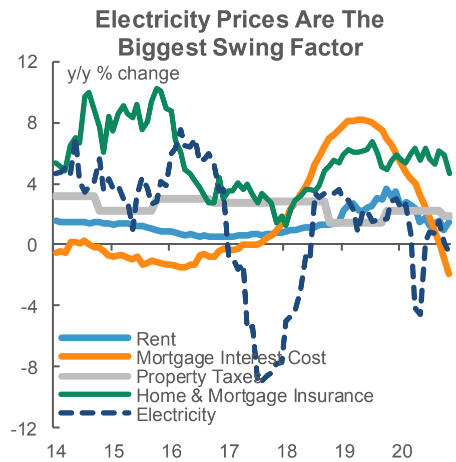
Sources: Scotiabank Economics, Statistics Canada.

Chart 3



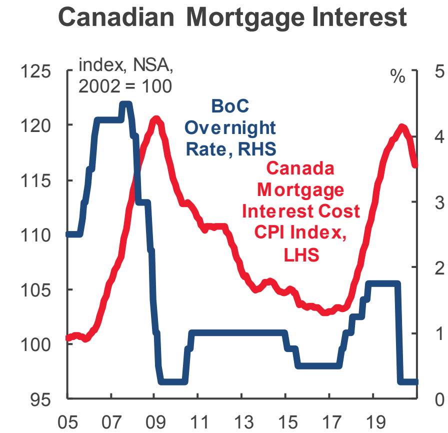
Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

Chart 5



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

role as a driver of inflation during the 2016–18 period in lagged response to the BoC 2015 rate cuts and the Federal government's stimulus around that time.

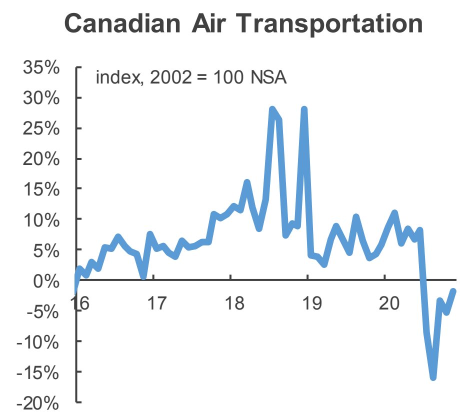
Housing impacts inflation in additional ways through things like home insurance and property taxes. Home insurance premiums continue to post strong gains in part driven by rising house prices (chart 4). Property tax increases also continue to rise at a fairly steady rate in the same chart.

Mortgage interest costs are a waning driver of inflation (chart 5). The BoC strips that out of a decomposition of inflationary pressure anyway as it would be pretty strange to basically react to inflation that is a lagging by-product of prior policy rate changes as shown in the chart. Besides, as 2021 unfolds, mortgage interest costs will start off the year as a continued downward influence upon inflation before that neutralizes in the second half and probably begins to exert upward pressure as market rates pull fixed rate mortgages higher over time.

Air transportation prices are becoming less of a drag on CPI inflation (chart 6). They're still a drag with relatively few folks flying these days, but at a diminishing rate that may very well turn flat in the near-term and possibly marginally higher again when vaccines begin to have a material impact. Longer term what happens to airfare prices depends upon how travel confidence returns, but we're likely at a gradually more inflationary turning point on this component.

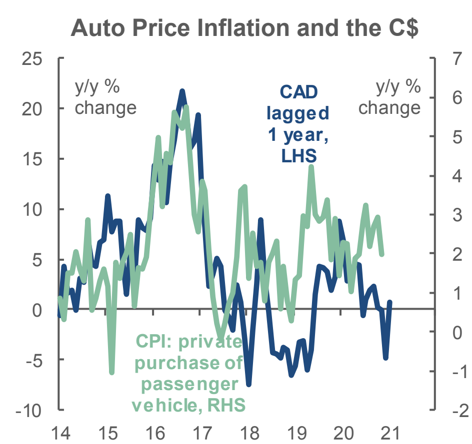
Auto price inflation remains more resilient than suggested by way of exchange rate movements (chart 7). Normally, if the C$ depreciates to the USD then with about a one year lag it results in pass-through to higher retail auto prices. By corollary, as the C$ has appreciated since March, it might be expected to put downward pressure on retail auto prices. The strong connection in prior years has weakened in more recent years. Other drivers such as strong demand and changing products with new technologies might be part of the explanation for auto price inflation. It's also feasible that automakers and their hedging activities are looking through this year's volatile exchanges rates in setting prices; if so, then the fact that USDCAD has changed only marginally since about a year ago might explain why there is little connection to auto prices now.

Chart 6



Sources: Scotiabank Economics, Statistics Canada.

Chart 7



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

Food prices took a marginal step backward in November (-0.2% m/m SA) but that was not unexpected after a large 0.8% m/m rise the prior month. In year-ago terms, food is up 1.9%. Chart 8 breaks down the weighted contributions of different food prices to the overall food price basket. Sugar is cheap, vegetables not so much, as clearly kids are driving these decisions. I'll check toothpaste prices and dental fees later. Anyway….ongoing supply shocks to various fruits and vegetables plus poultry and pork prices are driving overall food price inflation.

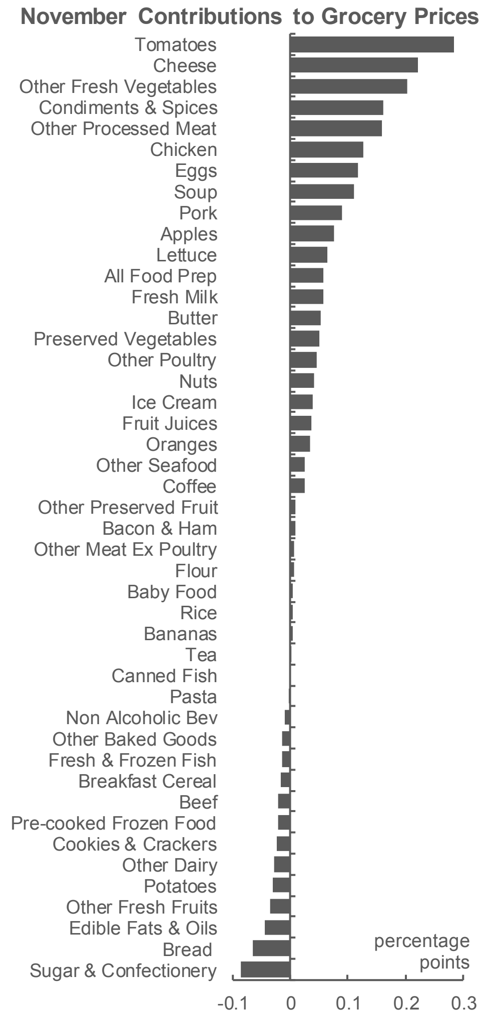
Electricity prices only carry a 2.2% weight in CPI, but the fact that earlier price cuts have shaken out and price inflation has moved back to zero has added about a tenth to headline inflation compared to earlier this year (chart 4 again). Electricity is likely to keep adding to the year-ago inflation rate in early 2021. Recall Ontario's move to take away off- and on-peak pricing on March 24th when they shifted back to a 10.1 cents per kWh flat rate and then raised that to 12.8 cents on June 1st before bringing back on- and off-peak pricing on November 1st. Carbon taxes will carry a longer fuse given the recently announced massive hike in levies.

Had enough? Righto, me too with the Fed ahead, but more of this decomposition of idiosyncratic component drivers of inflation is going to be done into 2021. Pictures will be left to do the rest of the talking for today. Charts 9–10 show the unweighted break downs of the month-ago change in CPI by components and the year-ago percentage change. Charts 11–12 do the same thing for weighted contributions by component to give a sense of relative importance.

Finally, charts 13–14 break down what goes into the trimmed mean CPI first by showing what got excluded in the latest month in the upper and lower 20% tails that wipes out 40% of the basket, and then by showing weighted contributions to trimmed mean CPI in terms of what was actually included.

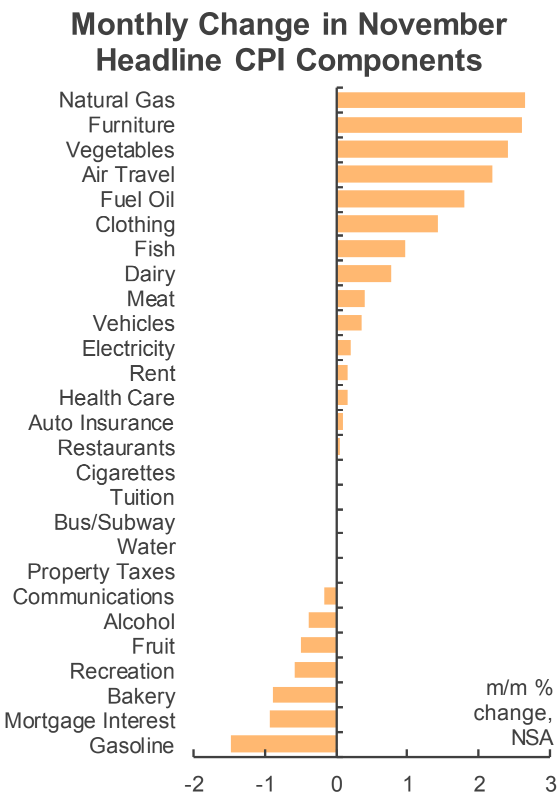
The punchline to all of this is that promising that the policy rate will be on hold for years to come may well be tested much sooner than recent BoC guidance indicates, though I suspect that if it's because the economy is doing better sooner than anticipated they'd likely be quite fine with that.

Chart 8



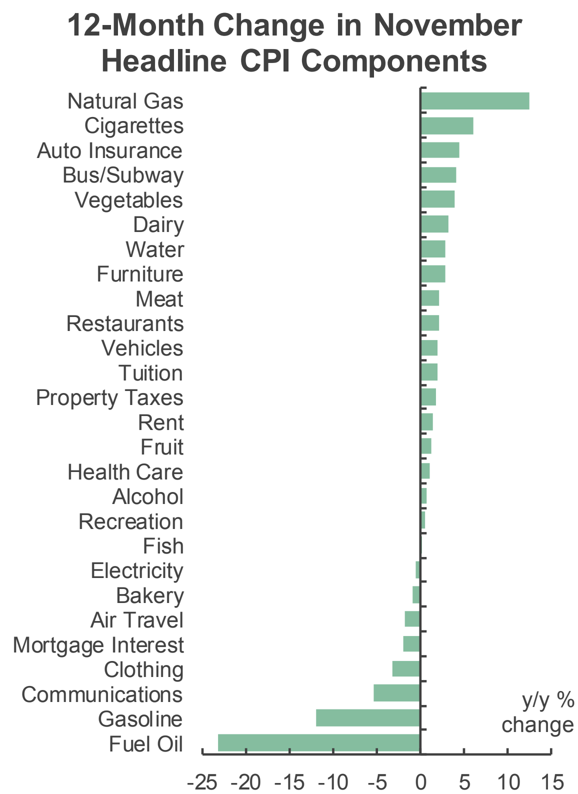
Sources: Scotiabank Economics, Statistics Canada.

Chart 9



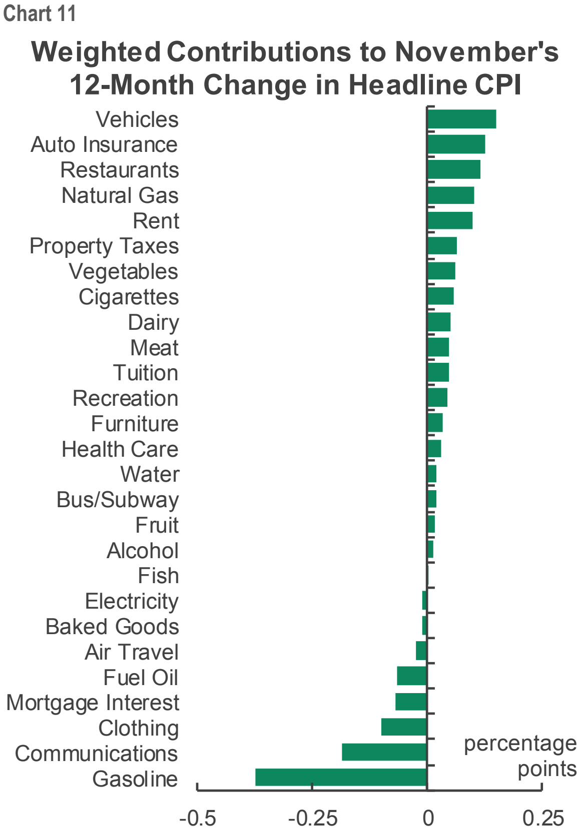
Sources: Scotiabank Economics, Statistics Canada.

Chart 10



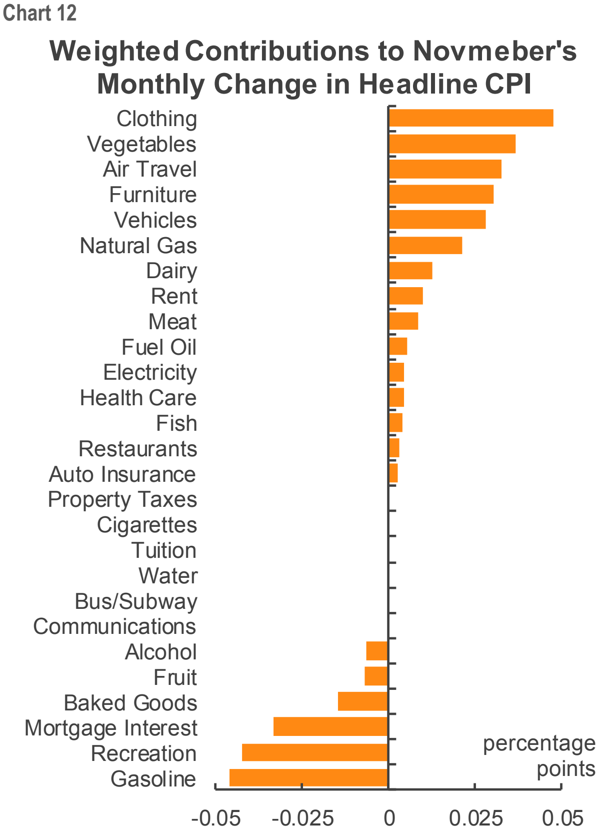
Sources: Scotiabank Economics, Statistics Canada.

Chart 11



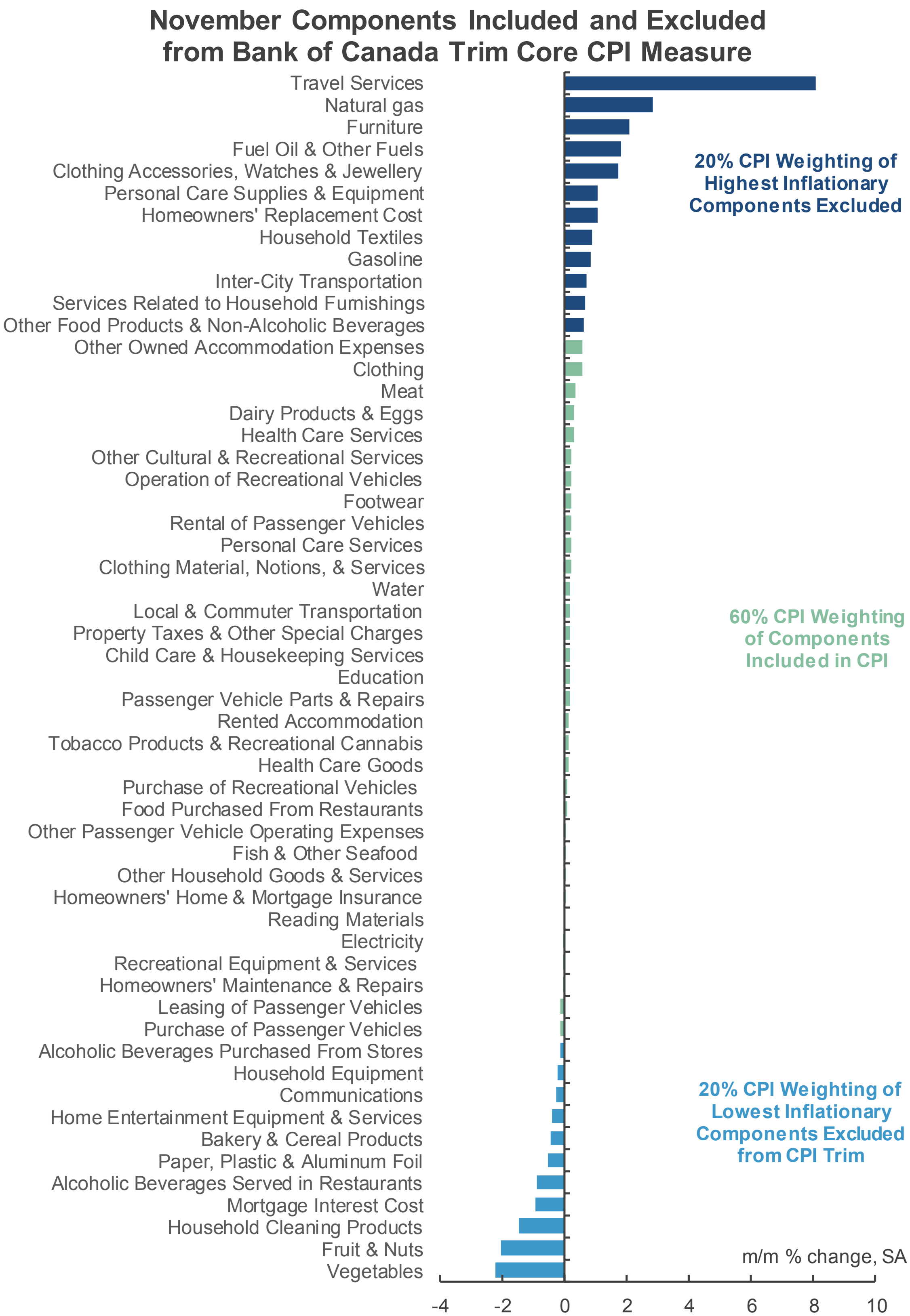
Source: Scotiabank Economics, Statistics Canada.

Chart 12



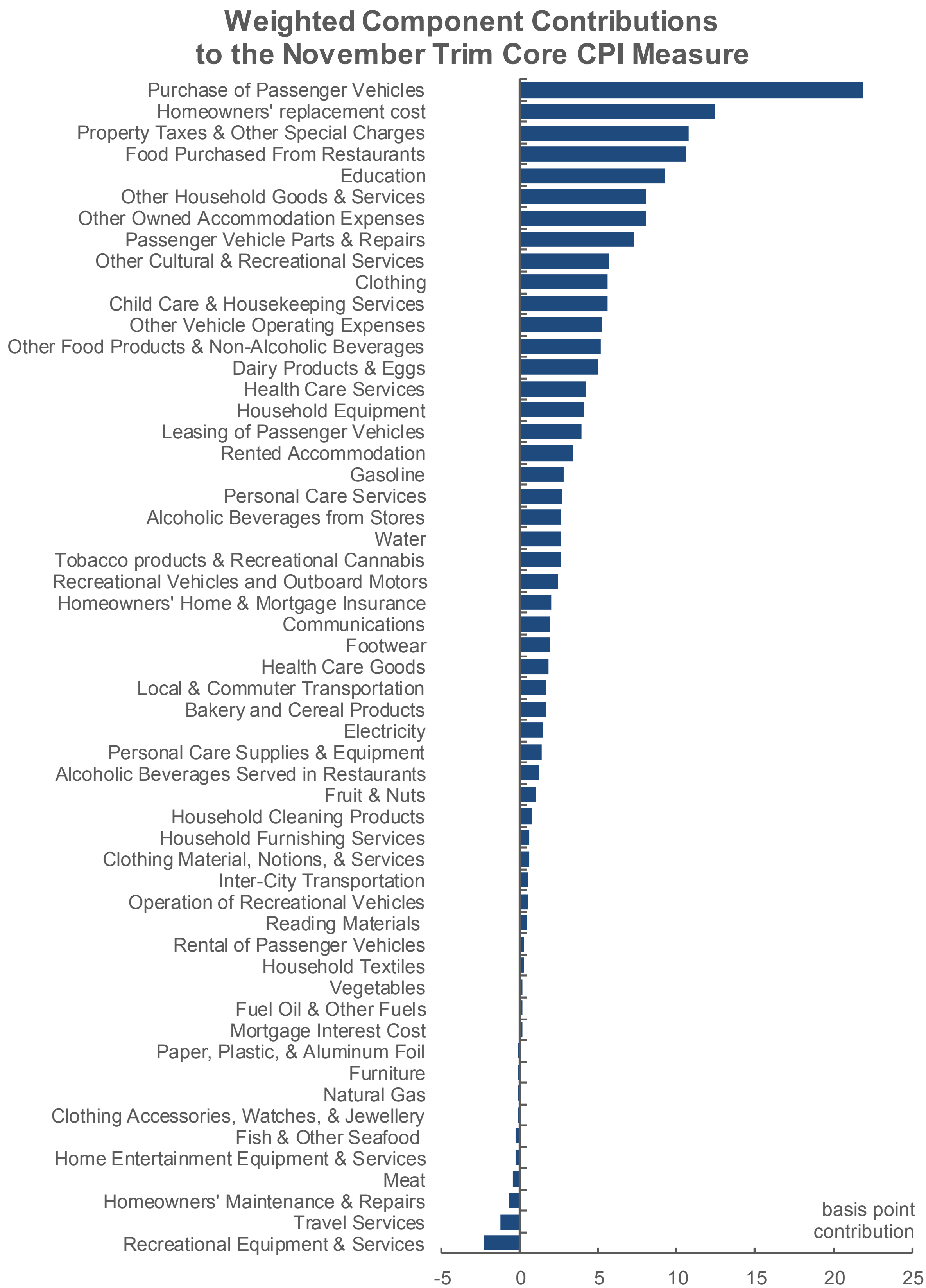
Source: Scotiabank Economics, Statistics Canada.

Chart 13



Sources: Scotiabank Economics, Statistics Canada.

Chart 14



Sources: Scotiabank Economics, Statistics Canada.