

Contributors

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Chart 1

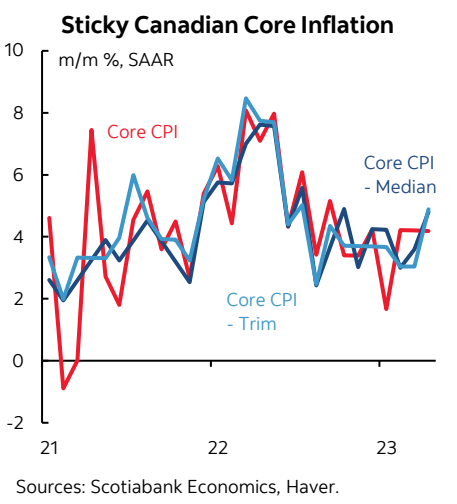
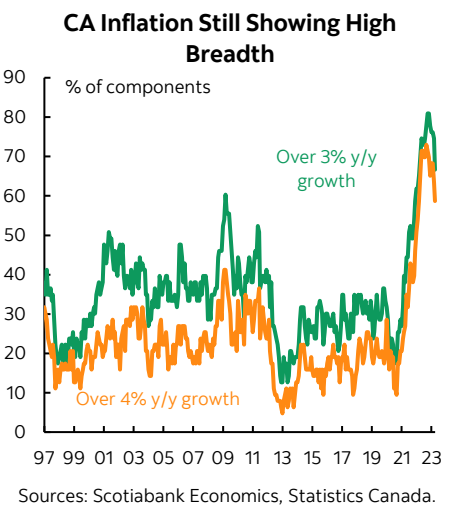


Chart 2



The BoC's Unfinished Business

- **High odds that the BoC hikes again in June with July as a backup option**
- **Core inflation gauges are reaccelerating**
- **No further set up is required**

CDN CPI m/m % / y/y %, April:

Actual: 0.7 / 4.4
 Scotia: 0.5 / 4.2
 Consensus: 0.4 / 4.1
 Prior: 0.5 / 4.3

Canadian inflation surprised higher than expected on the headline and underlying measures and details. The result vaulted the Canadian dollar to the top of the heap versus major crosses to the USD and CAD would have been stronger yet if not for strong US data (retail sales, industrial output) that drove broad USD strength. Canada's rates curve is getting crushed with a double digit increase in yields across most maturities concentrated in a 14bps spiked in the two-year yield on the day. OIS markets bumped up terminal rate pricing post-data and rate cuts have been wiped off the map for the rest of the year's meeting calendar.

So far so good. Guidance to lean against an overvalued front-end has worked but now faces the debate over whether it's mission accomplished for the BoC or if further hikes are required. I think they have more work to do.

CORE INFLATION IS ACCELERATING AGAIN

Headline inflation landed at 0.7% m/m NSA and 0.6% m/m SA which was hotter than my slightly above-consensus estimate. The concern runs much deeper than headline inflation.

At the heart of the matter is the need to look at the figures in the correct way by examining core price pressures in the highest frequency manner possible and by considering the breadth of price pressures. That's not the year-over-year rates.

Enter chart 1. It shows three measures of core inflation at m/m seasonally adjusted and annualized rates. They are all running at a four-handled pace. Traditional core CPI was up by 4.2% m/m SAAR. Weighted median CPI was up by 4.8%. Trimmed mean CPI was up by 4.9%. Even headline all-in CPI was up by 7.2% m/m SAAR.

These measures suggest that inflation continues to run far above the BoC's 2% headline target. Core inflation ebbed from the peak rates early last year, but these preferred measures have been remarkably sticky since then.

...WITH HIGH BREADTH...

Breadth to even the year-over-year rates remains exceptionally high (chart 2). 67% of the CPI basket continues to increase by over 3% y/y. 59% of the basket continues to rise by over 4%. 44% of the basket is still rising by over 5%.

...AND UPWARD REVISIONS...

As if forecasting isn't difficult enough. Revisions destroyed the credibility of the BoC's common component CPI that they no longer even reference. Traditional core CPI was just revised up from 3.4% m/m SAAR in March to 4.2% in March for an eight-tenths upward revision. Trimmed mean and weighted median were left intact. Our shop believes simple traditional core CPI inflation is the superior gauge and therefore core inflation has been hotter than previously understood.

...AS THE INFLECTION POINT HAS ARRIVED

Furthermore, I continue to think that Canadian core inflation is at an inflection point toward persistently higher inflation risk.

- No material progress is being made to open up disinflationary slack in the economy or labour market. Estimates vary depending upon what gets fudged, but the BoC's April MPR estimated that the output gap was still in net excess demand at between 0.25% to 1.25% in 2023Q1. There are long lags after opening up slack for disinflationary forces to occur and that process has not even begun for those who believe output gaps are the bee knees. I don't.
- In my opinion, we can't put much stock in a Philips curve framework that has underestimated out of sample pressures during the pandemic era.
- Housing is on a tear again which is directionally consistent with arguments I've given for why this would happen and why consensus was too bearish toward housing dating back to last year. The problem is that I didn't think it would happen by quite this magnitude and this soon with much of the Spring housing market still ahead of us along with longer-wave influences. For starters, there is practically no inventory on either the new build or resale sides of the market. That's a problem with surging immigration as the country put little thought into where to house all of these new arrivals. A domestic demand story is getting a lift from first time home buyers that are ready to pounce with bigger down payments on cheaper prices. Another stimulus program was introduced on April Fool's Day. Job markets remain very tight. Expected capital gains are driving FOMO behaviour and the renewed risk of extrapolative behaviour that would concern the BoC. I think this combination is bringing the return of rampant speculation in Canada's housing market that pre-adjusted to some of the higher rates on the originations part of the picture through the B20 mortgage stress test. The direct effect on Canadian CPI is likely to turn positive going forward alongside spillover effects.
- Wage pressures remain well in excess of Canada's moribund performance on labour productivity. Collective bargaining is putting upward pressure on wage settlements and setting wage gains above the 2% target for years to come.
- The BoC's measures of inflation expectations continue to indicate pressures well above the 2% inflation target for years to come.
- The broad macro backdrop has a number of supporting arguments that can drive resilience.
- There isn't enough evidence that domestic lending conditions are tightening rapidly or significantly enough to do the BoC's work at the margin. Apparently folks are able to get the requisite mortgages!

Overall, recent data has reinforced the narrative that I have been communicating to clients throughout this year that the Bank of Canada's job is not finished after it quit hiking too early back in January. There is a highly compelling case for returning with a hike at the June meeting and if not then July's odds go up. I would assign high market probability to a June hike with info to this point.

NO SET-UP REQUIRED

I don't believe that the BoC thinks it has to hold anyone's hand in setting up a hike with explicit guidance. After all, it surprised on three out of eight meetings last year!

Furthermore, Governor Macklem could well say that he has provided enough forward guidance in any event. I won't repeat the arguments here, but what they have said to this effect is spelled out [here](#) and in subsequent communications. Perhaps we'll hear from him on Thursday, but he has tended to divorce monetary policy discussions from that day's planned focus on financial stability.

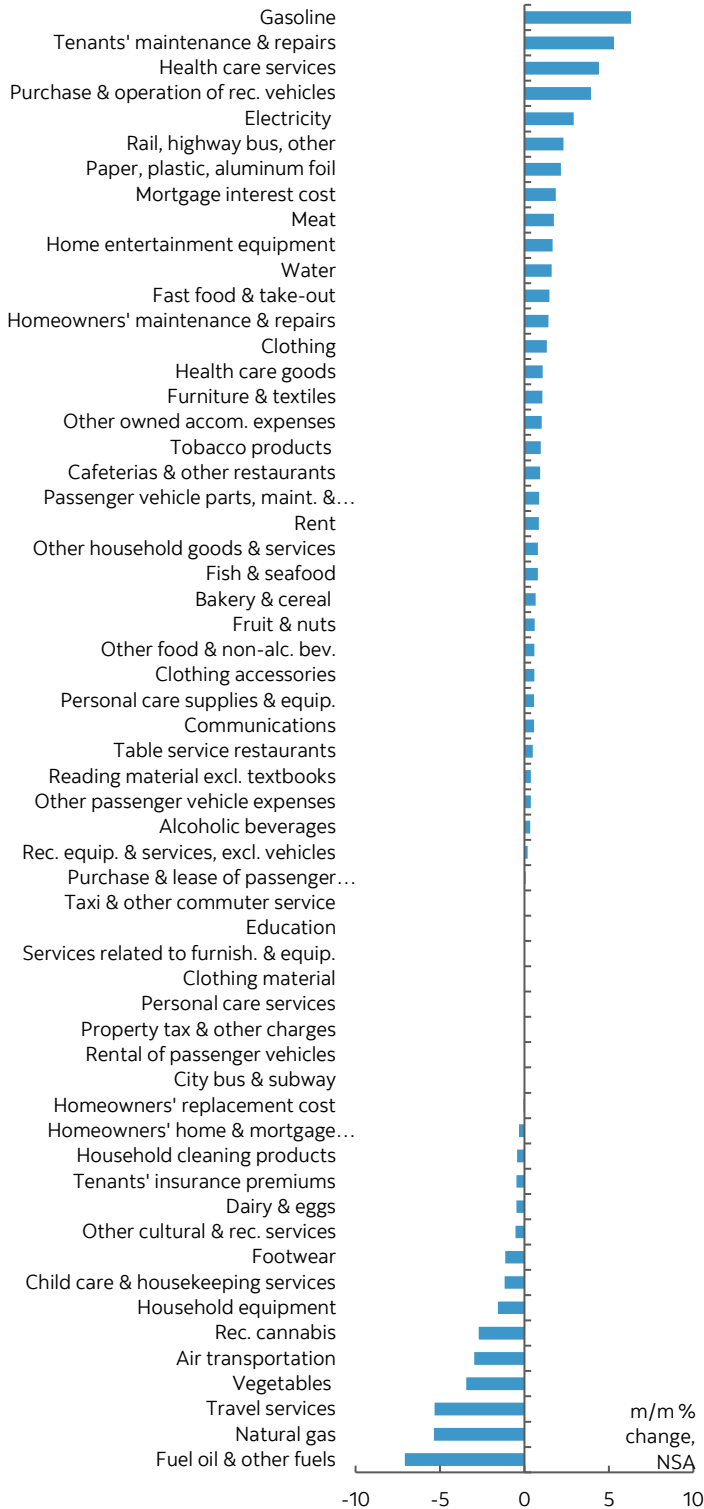
DEBT CEILING BASE CASE

Obviously if the US defaults on its obligations then all of our forecasts go straight back to the drawing board in a dire scenario, but I don't find that to be a reasonable base case. Our base case assumption is that the US debt ceiling eventually gets resolved after some market turbulence. It may be settled by the June 7th BoC decision or kicked down the road. We are assuming there will be no default and that market turbulence will be transitory. Therefore, absent material default risk, Canadian monetary policy should be crafted with domestic conditions in mind and while considering idiosyncratic drivers unique to the country—while being prepared to adjust to a possible tail event if needed. US politics will remain dysfunctional for a long while yet and cannot hold up BoC policy.

For further details please see the accompanying table showing the breakdown of the CPI basket along with micro charts and z-score measures of deviations from historical tendencies.

Chart 3

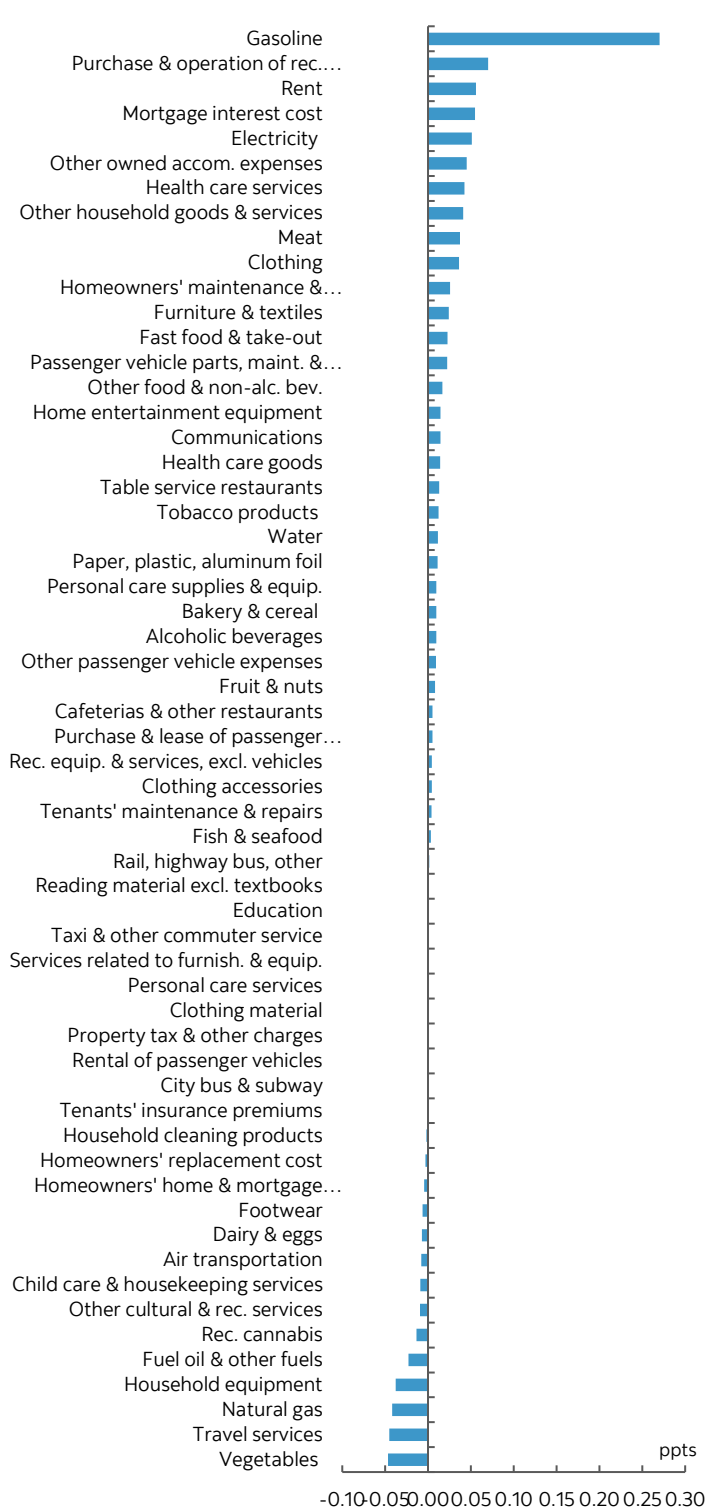
April Detailed Category Monthly Change in Canadian CPI



Sources: Scotiabank Economics, Statistics Canada.

Chart 4

April Detailed Category Contributions to Monthly Change in Canadian CPI



Sources: Scotiabank Economics, Statistics Canada.

Chart 5

April Detailed Category 12-Month Change in Canadian CPI

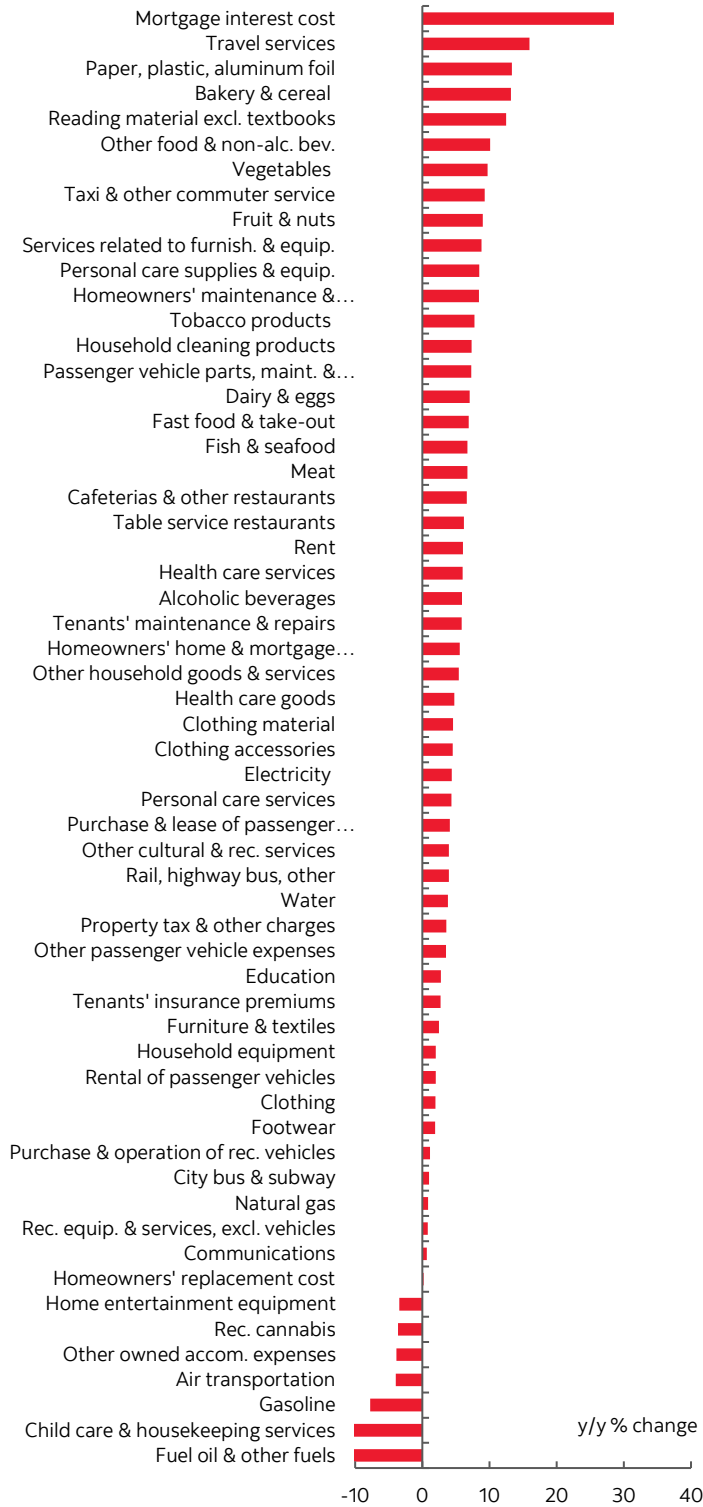
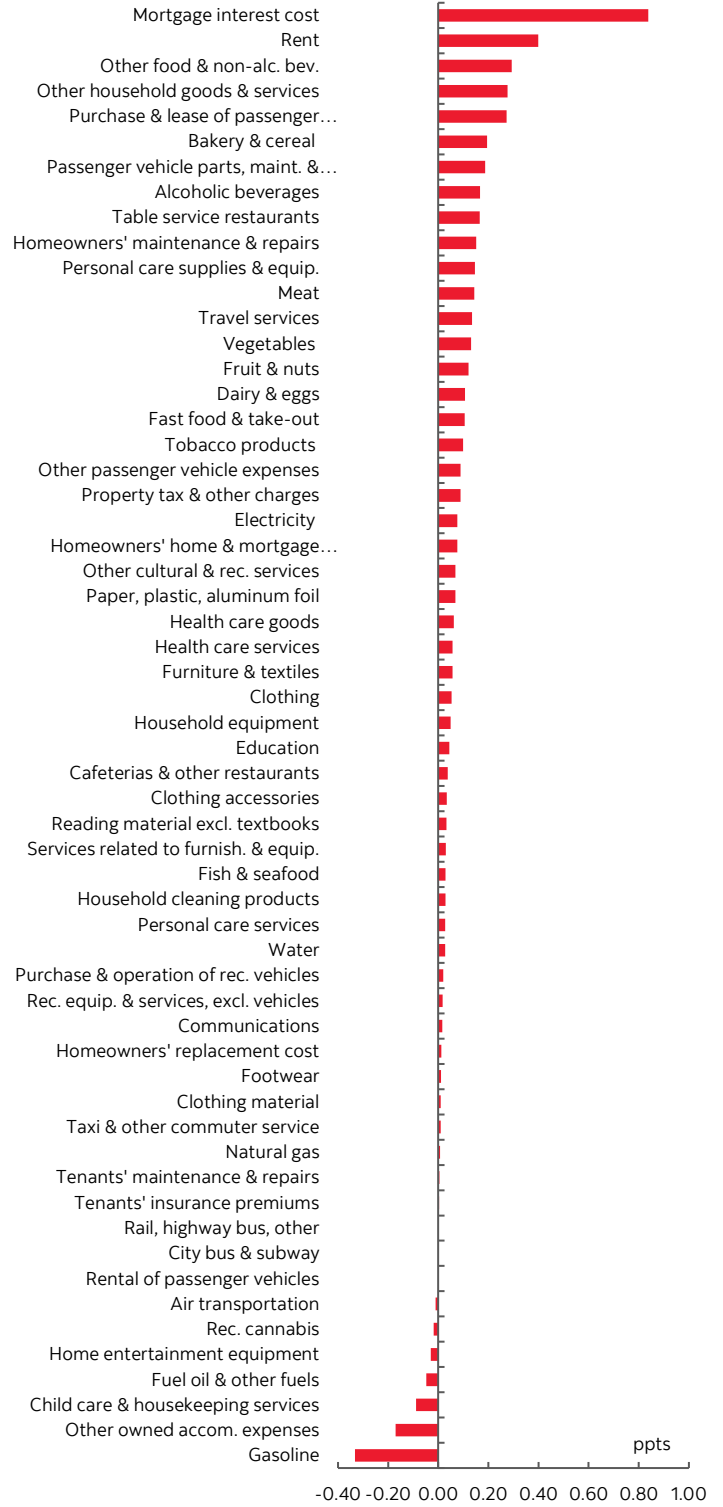


Chart 6

April Detailed Category Contributions to 12-Month Change in Canadian CPI



Sources: Scotiabank Economics, Statistics Canada.

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May 16, 2023

Apr 2023					Weighted Contributions (ppts)*			5-Year Pre-Pandemic			10-Year Pre-Pandemic			
CA INFLATION COMPONENT BREAKDOWN	y/y % change	10-year trend	Pandemic trend (Jan 2019–Present)	m/m % change, NSA	m/m % change, SA**	Weights (%)	y/y	m/m	2015–2019 avg. y/y	Std. Dev.	Z-Score	2011–2019 avg. y/y	Std. Dev.	Z-Score
Food	8.3			0.4	0.5	15.94	1.33	0.06	2.1	1.7	3.6	2.2	1.5	4.2
Food, stores	9.1			0.2		11.14	1.02	0.02	1.7	2.4	3.0	2.0	2.0	3.5
Meat	6.7			1.7	0.7	2.14	0.14	0.04	2.5	3.6	1.2	3.4	3.6	0.9
Fish & seafood	6.7			0.8	0.8	0.44	0.03	0.00	2.9	1.4	2.7	2.8	2.5	1.6
Dairy products & eggs	7.0			-0.5	-0.4	1.52	0.11	-0.01	0.2	1.5	4.5	0.6	1.5	4.3
Bakery & cereal products	13.2			0.7	0.9	1.48	0.20	0.01	0.5	2.1	6.1	1.2	2.3	5.1
Fruit, fruit prep. & nuts	9.0			0.6	1.0	1.34	0.12	0.01	1.8	4.4	1.6	2.0	3.5	2.0
Vegetables & vegetable prep.	9.7			-3.4	-1.1	1.35	0.13	-0.05	4.9	6.4	0.7	3.6	5.8	1.1
Other food & non-alcoholic beverages	10.1			0.6	0.6	2.91	0.29	0.02	1.0	1.5	5.9	1.3	1.7	5.1
Food, restaurants	6.4			0.8		4.80	0.31	0.04	3.0	0.7	5.2	2.6	0.7	5.3
Table service restaurants	6.2			0.5		2.68	0.17	0.01	2.9	0.6	6.0	2.6	0.6	5.6
Fast food & take-out	6.9			1.5		1.54	0.11	0.02	3.2	1.2	3.0	2.6	1.2	3.7
Cafeterias & other restaurants	6.6			0.9		0.58	0.04	0.01	3.0	0.6	5.8	2.6	0.7	5.6
Shelter	4.9			0.6	0.6	29.80	1.47	0.18	1.8	0.6	5.3	1.7	0.8	4.1
Rented accommodation	6.1			0.9	0.9	6.77	0.41	0.06	1.3	0.8	5.9	1.3	0.6	8.1
Rent	6.1			0.9		6.57	0.40	0.06	1.3	0.8	5.8	1.3	0.6	7.9
Tenants' insurance premiums	2.7			-0.5		0.11	0.00	0.00	1.1	1.6	1.0	0.3	1.6	1.5
Tenants' maintenance & repairs	5.9			5.3		0.08	0.00	0.00	2.2	1.0	3.5	2.6	2.2	1.5
Owned accommodation	5.1			0.6		19.46	1.00	0.12	2.3	0.4	6.6	1.7	0.8	4.1
Mortgage interest cost	28.5			1.9	1.9	2.94	0.84	0.05	2.1	3.6	7.3	-0.1	3.6	8.0
Homeowners' replacement cost	0.2			0.0	-0.1	6.44	0.01	0.00	1.9	1.7	-1.0	2.1	1.5	-1.3
Property tax & other charges	3.6			0.0	0.1	2.47	0.09	0.00	2.4	0.6	2.1	2.8	0.7	1.2
Homeowners' home & mortgage insurance	5.5			-0.3	-0.3	1.37	0.08	0.00	5.2	2.3	0.1	4.5	2.6	0.4
Homeowners' maintenance & repairs	8.4			1.4	1.4	1.81	0.15	0.03	2.0	1.1	5.7	2.0	1.4	4.4
Other owned accommodation expenses	-3.8			1.0	0.0	4.43	-0.17	0.05	2.0	1.2	-4.8	2.4	2.0	-3.2
Water, fuel, & elec.	1.8			-0.1		3.57	0.06	0.00	0.8	2.1	0.5	2.5	3.4	-0.2
Electricity	4.4			2.9	2.9	1.75	0.08	0.05	1.2	4.4	0.7	2.5	3.8	0.5
Water	3.8			1.6	0.7	0.72	0.03	0.01	3.7	0.9	0.1	4.9	1.4	-0.8
Natural gas	0.9			-5.4	-9.3	0.78	0.01	-0.04	-1.3	9.0	0.2	0.4	10.6	0.0
Fuel oil & other fuels	-14.8			-7.1	-8.0	0.32	-0.05	-0.02	-0.1	15.5	-0.9	5.1	14.2	-1.4
Household operations, furniture & equipment	3.0			0.3	0.2	14.50	0.44	0.04	1.2	1.0	1.7	1.4	0.9	1.8
Household ops.	3.2			0.6		9.30	0.30	0.06	1.3	1.1	1.7	2.1	1.3	0.9
Communications	0.7			0.6	0.6	2.54	0.02	0.01	0.0	2.8	0.2	1.5	2.9	-0.3
Child care & housekeeping services	-11.6			-1.2	-0.4	0.76	-0.09	-0.01	3.4	1.4	-10.9	3.3	1.3	-11.2
Household cleaning products	7.3			-0.4	-0.4	0.40	0.03	0.00	1.3	1.9	3.2	0.8	1.9	3.3
Paper, plastic, aluminum foil	13.3			2.2	2.3	0.52	0.07	0.01	2.2	2.2	5.0	2.0	2.0	5.7
Other household goods & services	5.4			0.8	0.3	5.11	0.28	0.04	1.8	0.5	7.6	2.4	1.1	2.8
Household furnishings & equip.	2.6			-0.3		5.20	0.14	-0.02	0.8	1.7	1.0	0.1	1.6	1.6
Furniture & textiles	2.5			1.1		2.28	0.06	0.02	0.4	2.1	1.0	-0.3	2.1	1.3
Household equipment	2.0			-1.6	-1.9	2.42	0.05	-0.04	0.9	1.7	0.7	0.0	1.8	1.1
Services related to furnishings & equipment	8.8			0.0	0.5	0.35	0.03	0.00	2.4	1.8	3.5	2.7	2.9	2.1
Clothing & footwear	2.5			0.7	-0.2	4.3	0.11	0.03	0.6	1.2	1.6	0.3	1.4	1.6
Clothing	1.9			1.3	0.3	2.73	0.05	0.04	0.5	1.6	0.9	-0.3	2.1	1.0
Footwear	1.9			-1.1	-1.0	0.57	0.01	-0.01	0.4	1.2	1.4	0.1	1.4	1.3
Clothing accessories	4.5			0.6		0.75	0.03	0.00	1.0	1.8	2.0	2.3	2.6	0.9
Clothing material	4.6			0.0		0.23	0.01	0.00	2.2	0.7	3.5	2.7	1.2	1.7

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Transportation	1.3			1.5	1.1	16.9	0.22	0.25	1.7	3.1	-0.1	2.3	3.0	-0.3
Private trans.	1.4			1.7		16.1	0.23	0.28	1.3	3.2	0.0	2.2	3.2	-0.2
Purchase, lease, rental of passenger vehicles	4.1			0.0		6.71	0.27	0.00	2.3	1.5	1.2	1.9	1.6	1.3
<u>Purchase & lease of passenger vehicles</u>	<u>4.1</u>			<u>0.1</u>		<u>6.65</u>	<u>0.27</u>	<u>0.01</u>	<u>2.3</u>	<u>1.5</u>	<u>1.2</u>	<u>1.9</u>	<u>1.6</u>	<u>1.3</u>
<u>Rental of passenger vehicles</u>	<u>2.0</u>			<u>0.0</u>	<u>2.7</u>	<u>0.06</u>	<u>0.00</u>	<u>0.00</u>	<u>1.4</u>	<u>5.2</u>	<u>0.1</u>	<u>1.2</u>	<u>4.1</u>	<u>0.2</u>
Operation of passenger vehicles	-0.6			2.9		9.37	-0.05	0.27	0.7	5.7	-0.2	2.4	5.4	-0.5
<u>Gasoline</u>	<u>-7.7</u>			<u>6.3</u>	<u>2.7</u>	<u>4.28</u>	<u>-0.33</u>	<u>0.27</u>	<u>-0.6</u>	<u>13.5</u>	<u>-0.5</u>	<u>3.0</u>	<u>12.2</u>	<u>-0.9</u>
<u>Passenger vehicle parts, maintenance & repairs</u>	<u>7.3</u>			<u>0.9</u>	<u>0.5</u>	<u>2.56</u>	<u>0.19</u>	<u>0.02</u>	<u>1.9</u>	<u>0.3</u>	<u>15.6</u>	<u>1.6</u>	<u>0.8</u>	<u>7.3</u>
<u>Other passenger vehicle expenses</u>	<u>3.5</u>			<u>0.4</u>	<u>0.4</u>	<u>2.53</u>	<u>0.09</u>	<u>0.01</u>	<u>2.4</u>	<u>2.2</u>	<u>0.5</u>	<u>2.6</u>	<u>2.0</u>	<u>0.5</u>
Public trans.	0.6			-1.1		0.82	0.00	-0.01	4.8	3.9	-1.1	3.4	3.7	-0.8
Local & commuter transportation	4.3			0.0	0.2	0.28	0.01	0.00	1.5	0.5	5.7	2.2	1.2	1.8
<u>City bus & subway</u>	<u>1.0</u>			<u>0.0</u>		<u>0.17</u>	<u>0.00</u>	<u>0.00</u>	<u>2.1</u>	<u>0.7</u>	<u>-1.5</u>	<u>2.8</u>	<u>1.4</u>	<u>-1.2</u>
<u>Taxi & other commuter service</u>	<u>9.3</u>			<u>0.0</u>		<u>0.11</u>	<u>0.01</u>	<u>0.00</u>	<u>0.1</u>	<u>0.8</u>	<u>11.3</u>	<u>0.9</u>	<u>1.2</u>	<u>6.9</u>
Inter-city transportation	-2.4			-2.0	-1.9	0.37	-0.01	-0.01	6.2	5.7	-1.5	3.9	5.8	-1.1
<u>Air transportation</u>	<u>-3.9</u>			<u>-3.0</u>		<u>0.26</u>	<u>-0.01</u>	<u>-0.01</u>	<u>6.5</u>	<u>6.2</u>	<u>-1.7</u>	<u>4.0</u>	<u>6.4</u>	<u>-1.2</u>
<u>Rail, highway bus, other</u>	<u>4.0</u>			<u>2.3</u>		<u>0.07</u>	<u>0.00</u>	<u>0.00</u>	<u>2.7</u>	<u>1.8</u>	<u>0.7</u>	<u>2.0</u>	<u>4.2</u>	<u>0.5</u>
Health & personal care	6.4			1.4	0.5	4.62	0.3	0.06	1.4	0.4	12.4	1.3	0.9	6.0
Health care	5.3			2.5		2.26	0.1	0.06	1.3	0.6	6.9	1.1	0.8	5.2
Health care goods	4.8			1.1	1.1	1.31	0.1	0.01	0.5	0.7	6.0	-0.1	1.1	4.4
Health care services	6.0			4.4	1.2	0.96	0.1	0.04	2.5	0.6	6.3	2.9	0.8	3.9
Personal Care	7.4			0.5		2.36	0.2	0.01	1.5	0.5	10.9	1.5	1.2	5.0
Personal care supplies & equipment	8.5			0.6	0.1	1.72	0.1	0.01	0.4	0.9	8.6	0.5	1.6	4.9
Personal care services	4.4			0.0	0.4	0.64	0.0	0.00	2.9	0.7	2.0	2.7	1.4	1.1
Recreation, education & reading	3.1			0.2	0.5	9.29	0.3	0.02	1.7	0.8	1.9	1.3	0.9	2.2
Recreation	2.9			0.27		7.43	0.22	0.02	1.4	1.0	1.5	0.6	1.2	1.8
Recreational equipment & services, excl. vehicles	0.8			0.2	0.3	2.18	0.0	0.00	-0.8	1.6	1.1	-2.2	2.0	1.5
Purchase & operation of recreational vehicles	1.2			3.9	2.3	1.78	0.0	0.07	2.6	1.8	-0.8	1.9	2.0	-0.4
Home entertainment equipment	-3.4			1.7	1.8	0.88	0.0	0.01	-3.8	2.0	0.2	-4.9	2.2	0.7
Travel services	15.9			-5.3	0.4	0.85	0.1	-0.05	0.8	2.9	5.1	0.4	2.8	5.5
Other cultural & rec. services	4.0			-0.5	-0.5	1.75	0.1	-0.01	3.5	1.1	0.4	3.4	1.4	0.4
Educ. & reading	4.1			0.06		1.86	0.08	0.00	2.5	1.4	1.1	3.0	1.1	1.0
Education	2.8			0.0	0.1	1.60	0.0	0.00	2.4	1.4	0.3	3.0	1.2	-0.2
Reading material excl. textbooks	12.5			0.4	0.3	0.26	0.0	0.00	3.8	2.8	3.1	3.2	2.9	3.2
Alcoholic beverages, tobacco & rec. cannabis	5.3			0.2	0.2	4.63	0.2	0.01	3.2	1.2	1.9	2.7	1.3	2.0
Alcoholic beverages	5.9			0.35		2.83	0.17	0.01	1.7	0.5	8.0	1.4	0.7	6.1
Alc. beverages served in licensed establishments	4.6			0.0	0.3	0.67	0.0	0.00	1.8	0.6	4.5	2.0	0.7	3.7
Alc. beverages purchased from stores	6.4			0.5	0.6	2.16	0.1	0.01	1.7	0.7	7.1	1.1	1.1	4.9
Tobacco products	7.8			0.98		1.28	0.10	0.01	5.6	2.1	1.0	4.8	2.8	1.0
Cigarettes	7.6			1.1		1.16	0.1	0.01	5.6	2.1	1.0	4.8	2.8	1.0
Other tobacco products & supplies	9.0			-0.2		0.11	0.0	0.00	5.6	2.0	1.7	4.9	2.6	1.6
Rec. cannabis	-3.6			-2.70		0.50	-0.02	-0.01						

*Number may not add due to rounding

** Only available for components that are tracked on a seasonally adjusted basis.

Sources: Scotiabank Economics, Statistics Canada.

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