Market View
Economics and Strategy

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Monitoring momentum

By Taylor Schleich & Alexandra Ducharme

We're sure you've had your fair share of analysis on Tuesday's Canadian CPI report, including from us and straight from the BoC Governor via a National Post op-ed. The punchline from economic pontificators is clear: inflation is still too high in Canada, as it is in most jurisdictions across the globe. While falling gas prices limited the rise in monthly inflation to just 0.1% and helped push the annual rate down to 7.6%, core measures continued their ascent. But to us, this is *somewhat* of a head fake. We wrote yesterday and last month (in great detail) about the structural issues of CPI common and how it's been an unreliable indicator of underlying price pressures. We won't spend much time rehashing this issue but it's important to stress that revisions to this measure overwhelmingly contributed to the rise in the average of the core measures from 5.0% (initially reported in the June report) to 5.3%. The average of CPI-Median and CPI-Trim—the more reliable measures—was unchanged versus June at 5.2%. But there's more to the story than just the headline annual rate of core inflation. Now, perhaps more than ever, capturing momentum is vitally important given how quickly and aggressively the Bank of Canada is tightening policy. Unfortunately, these core measures are reported solely on an annual basis so assessing month-over-month or 3-month changes is not easily accessible. Fortunately, the methodology is straightforward enough that we're able to construct the underlying indices.

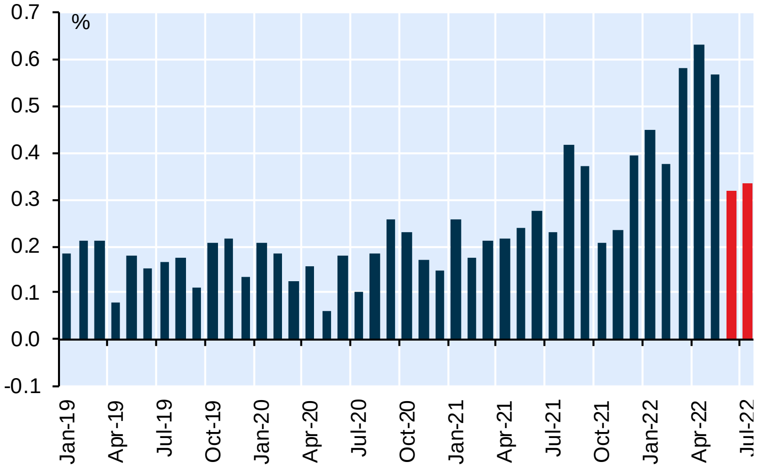
Dissecting the shorter-term dynamics of core inflation, it's apparent that underlying price pressures are decelerating. That's clear for CPI-trim (Chart 1) and that's clear for CPI-median (Chart 2). And compared to the U.S., Canadian core measures appear to be decelerating *faster* (Chart 3), though momentum is easing stateside too. It's true that these rates are still too high to be consistent with on-target inflation, but these developments are encouraging—far more so than you might expect from a cursory look at the average of the 3 core measures on an annual basis. Moreover, the 3-month annualized pace of CPI-Median and CPI-Trim is now tracking below the 6-month rate and in line with (technically *slightly* below) the year-over-year rate (Charts 4-5)—another comforting sign that peak inflation is now behind us.

Certainly, the Bank of Canada's job is not yet done. With the overnight only now at a neutral level, another large (75 basis points?) hike in September, that would bring policy into restrictive territory, is probably appropriate. But this would represent a total of 300 basis points of interest rate increases over a 6-month period—a pace of tightening not observed in close to 30 years. Famously, Friedman noted that monetary policy works with long and variable lags. And the BoC will tell you:

> *"it takes some time (usually between 18 and 24 months) for changes in interest rates to affect every part of the economy. So we set the policy interest rate based on where we expect inflation will likely be in about two years, not where it is today."*

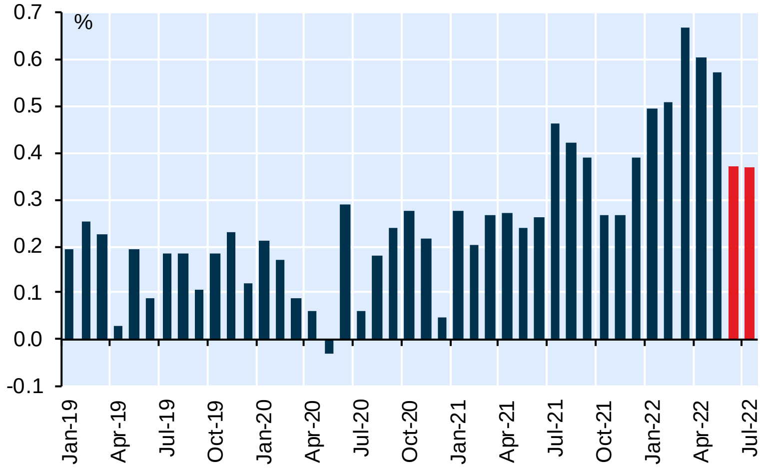
In other words, still-elevated inflation today doesn't reflect poor efficacy of monetary policy, there just hasn't been time enough time afforded for it to catch up. In 18-24 months, will a sustained 3.25% policy rate be sufficient to bring inflation back to target? That's what past experiences have shown (Chart 6) and have involved far less aggressive tightening (both in pace and magnitude). With a structurally lower neutral rate than in bygone decades, we believe an overnight target with a three-handle is enough to do the job. And while current inflation might not fully reflect that yet, elsewhere, it's becoming increasingly clear that tightening is having a significant effect. Housing markets are grinding to a stand-still as prices now edge lower (we'd note that raising the overnight target to 3.50%+ would risk triggering resets on a non-trivial segment of variable rate mortgages). Job growth has been non-existent in recent months. GDP, which is likely to have expanded by 4-5% in Q2, is expected to fall well below potential as soon as the third quarter (and stay there). All of this has come before the full extent of earlier rate hikes have been felt (let alone another 75 bps still in the pipeline). All of this to say, it's time to return to forward-looking policy making. Rip off the band-aid in September and bring the overnight target 'slightly above the neutral range'. From there, just wait and let the economy and inflation catch up. While central banks collectively left monetary policy too loose for too long, we now fear a policy mistake could be made in the opposite direction. However, it might not be too late to prevent that.

Chart 1: CPI-Median has decelerated considerably…
Month-over-month change in CPI-Median (in-house replication)



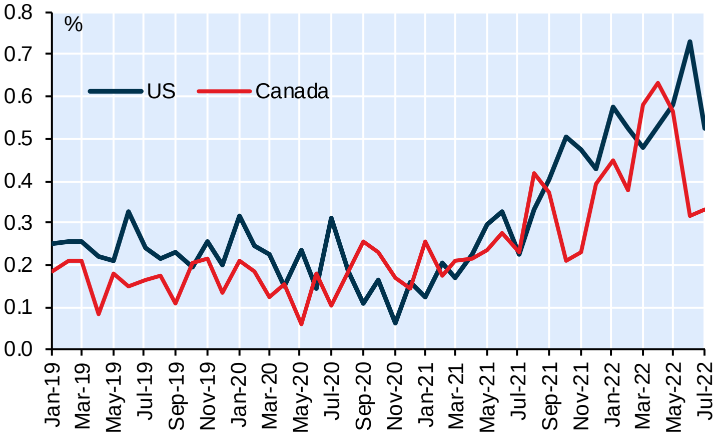
Source: NBF, StatCan

Chart 2: …with a similar move in CPI-Trim
Month-over-month change in CPI-Trim (in-house replication)



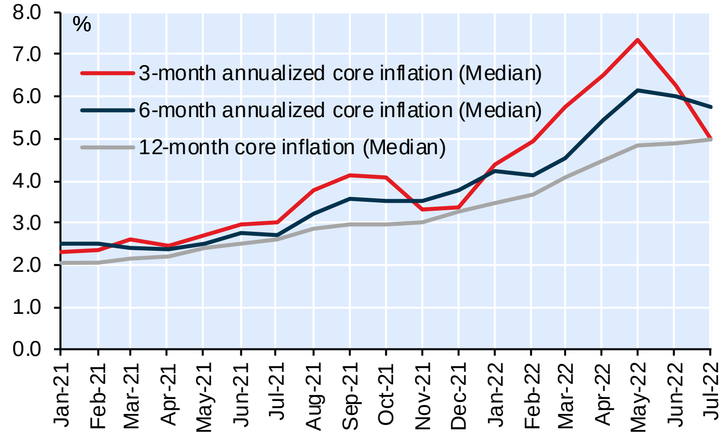
Source: NBF, StatCan

Chart 3: Core deceleration more encouraging in Canada
M/M change in CPI-Median: Canada vs. U.S.



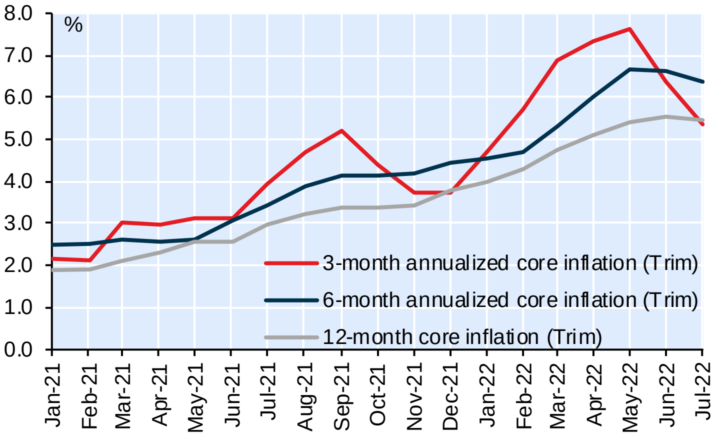
Source: NBF, StatCan | Note: CPI-median based on in-house replication of index

Chart 4: 3M annualized core inflation is losing steam…
3M, 6M and Y/Y CPI-Median inflation since 2021



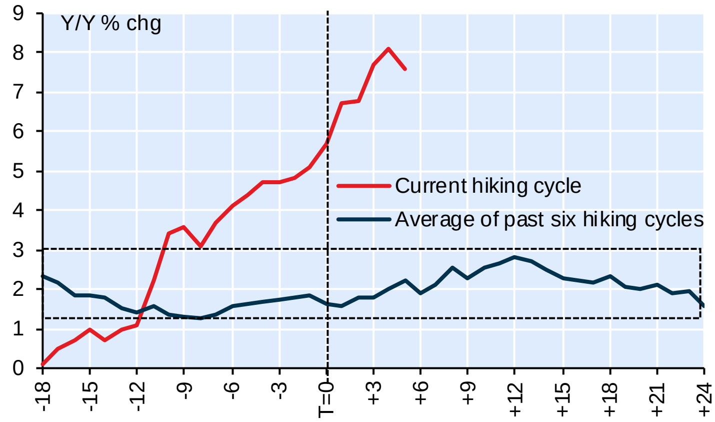
Source: NBF, StatCan | Note: CPI-median based on in-house replication of index

Chart 5: … in both CPI-Median and CPI-Trim
3M, 6M and Y/Y CPI-Trim inflation since 2021



Source: NBF, StatCan | Note: CPI-trim based on in-house replication of index

Chart 6: Rate hike effect on inflation takes time to manifest
Average trajectory for all-items inflation before/after hiking cycle begins



Source: NBF, StatCan

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