Economics

THE WEEK AHEAD

July 18-22, 2022

Good policy or good luck

by **Karyne Charbonneau** karyne.charbonneau@cibc.com

Canada is blessed with skillful central bankers but they will also need luck on their side to bring inflation down.

The Bank of Canada's rhetoric has emphasized the role of reducing excess demand to control inflation. But to fight inflationary pressures that are largely global, you need more than good policy. Over the next year, the Bank of Canada projects that inflation will decelerate by 3.3p.p., but a deeper look reveals that a large portion of this dynamic is attributable to factors outside of its control.

About 60% of the deceleration is coming from commodity prices and what they call supply-related disruptions (Chart). Those are the same factors that explain the majority of the Bank's inflation forecast errors over the past year, suggesting they are also the hardest to predict. While we believe that oil prices will not go back to their recent peaks, there is still a lot of uncertainty around their future evolution, which continues to be tied to geopolitical developments. As for supply disruptions, they are largely driven by excess goods demand from American consumers and lockdowns in China. Policies in these countries are therefore key to their resolution.

Then there are the mysterious "other factors". The Bank of Canada argues that parts of this category will respond to interest rate increases because it reflects excess demand not captured by the impact of the output gap. The main "other factor" that may fit the bill is shelter costs. We agree that the cooling of the housing market will help to reduce inflation, but according to the Bank's forecast, the deceleration in shelter inflation accounts for only 0.7p.p. over the next year. That would account for less than half of "other factors".

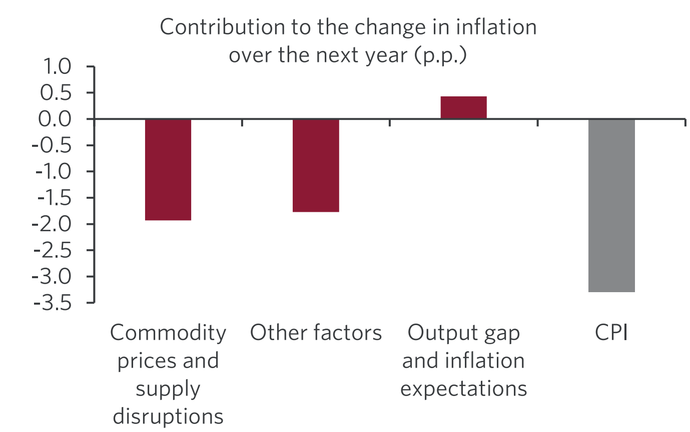
Overall, this suggests that most of the deceleration over the next year is due to drivers over which the Bank of Canada has little control.

Monetary policy does have a strong impact on two drivers in the Bank's forecast: the output gap and inflation expectations. The central bank wants to prevent an escalation in excess demand. It also wants to prevent the recent uptick in inflation expectations from worsening. In fact, this is the first time that the Bank of Canada has acknowledged above-target inflation expectations are playing a role in its outlook.

To this end, in the Bank's forecast, monetary policy is playing a crucial role in preventing the output gap and inflation expectations from exerting further upward pressure on inflation. This is essential to ensuring that inflation does not become entrenched. Good policy is therefore very important, but it is not sufficient to rein in inflation.

If we don't get a little help from our friends abroad and a healthy dose of luck, we will need a recession to bring down inflation. For now, we'll keep our fingers crossed.

Chart: Bank of Canada expects decline in inflation to be driven largely by outside factors



Source: Bank of Canada, CIBC

Week Ahead Calendar And Forecast—Canada

H, M, L = High, Medium or Low Priority
SAAR = Seasonally Adjusted Annual Rate
Consensus Source: Bloomberg

Date	Time	Economic Releases, Auctions and Speakers	Month	Priority	CIBC	Consensus	Prior
Monday, July 18	8:15 AM	HOUSING STARTS SAAR	(Jun)	(M)	240K	-	287.3K
Tuesday, July 19	-	AUCTION: 3-M BILLS $9.2B, 6-M BILLS $3.4B, 1-YR BILLS $3.4B	-	-	-	-	-
Wednesday, July 20	-	AUCTION: 5-YR CANADAS $4B	-	-	-	-	-
Wednesday, July 20	8:30 AM	INDUSTRIAL PROD. PRICES M/M	(Jun)	(M)	-	-	1.7%
Wednesday, July 20	8:30 AM	RAW MATERIALS M/M	(Jun)	(M)	-	-	2.5%
Wednesday, July 20	8:30 AM	CPI M/M	(Jun)	(H)	1.0%	-	1.4%
Wednesday, July 20	8:30 AM	CPI Y/Y	(Jun)	(H)	8.5%	-	7.7%
Wednesday, July 20	8:30 AM	CPI Core- Common Y/Y%	(Jun)	(M)	-	-	3.9%
Wednesday, July 20	8:30 AM	CPI Core- Median Y/Y%	(Jun)	(M)	-	-	4.9%
Wednesday, July 20	8:30 AM	CPI Core- Trim Y/Y%	(Jun)	(M)	-	-	5.4%
Thursday, July 21	-	AUCTION: 3-YR CANADAS $2.5B	-	-	-	-	-
Friday, July 22	8:30 AM	RETAIL TRADE TOTAL M/M	(May)	(H)	1.6%	-	0.9%
Friday, July 22	8:30 AM	RETAIL TRADE EX-AUTO M/M	(May)	(H)	2.3%	-	1.3%

Week Ahead Calendar And Forecast—United States

H, M, L = High, Medium or Low Priority
SAAR = Seasonally Adjusted Annual Rate
Consensus Source: Bloomberg

Date	Time	Economic Releases, Auctions and Speakers	Month	Priority	CIBC	Consensus	Prior
Monday, July 18	10:00 AM	NAHB HOUSING INDEX	(Jul)	(L)	-	66	67
Monday, July 18	10:00 AM	NET CAPITAL INFLOWS (TICS)	(May)	(L)	-	-	$87.7B
Tuesday, July 19	8:30 AM	HOUSING STARTS SAAR	(Jun)	(M)	1610K	1595K	1549K
Tuesday, July 19	8:30 AM	BUILDING PERMITS SAAR	(Jun)	(H)	1650K	1680K	1695K
Wednesday, July 20	-	20-YR AUCTION: $14B	-	-	-	-	-
Wednesday, July 20	7:00 AM	MBA-APPLICATIONS	(Jul 15)	(L)	-	-	-1.7%
Wednesday, July 20	10:00 AM	EXISTING HOME SALES SAAR	(Jun)	(M)	-	5.40M	5.41M
Wednesday, July 20	10:00 AM	EXISTING HOME SALES M/M	(Jun)	(M)	-	-0.2%	-3.4%
Thursday, July 21	-	AUCTION: 10-YR TIPS $17B	-	-	-	-	-
Thursday, July 21	8:30 AM	INITIAL CLAIMS	(Jul 16)	(M)	-	240K	244K
Thursday, July 21	8:30 AM	CONTINUING CLAIMS	(Jul 9)	(L)	-	1345K	1331K
Thursday, July 21	8:30 AM	PHILADELPHIA FED	(Jul)	(M)	-	-0.5	-3.3
Thursday, July 21	8:30 AM	LEADING INDICATORS M/M	(Jun)	(M)	-	-0.5%	-0.4%
Friday, July 22	9:45 AM	S&P GLOBAL US SERVICES PMI	(Jul P)	(L)	-	52.7	52.7
Friday, July 22	9:45 AM	S&P GLOBAL US COMPOSITE PMI	(Jul P)	(L)	-	-	52.3
Friday, July 22	9:45 AM	S&P GLOBAL US MANUFACTURING PMI	(Jul P)	(L)	-	51.5	52.7

Week Ahead's market call

by Katherine Judge and Karyne Charbonneau

In the **US**, it's a quiet week with a slim data calendar and the Fed entering its blackout period ahead of the FOMC. While we expect to see a pickup in housing starts in June, the second quarter overall will have seen a slowdown in the pace of building, as higher interest rates limited demand. That will leave geopolitical developments and equity earnings reports as the main market drivers.

In **Canada**, a busy data calendar will immediately start to test the Bank of Canada's revised inflation forecast with the release of June CPI on Wednesday. We expect inflation to have peaked in June at 8.5% on higher gasoline prices. The recent pull-back in oil prices signals that there should be some relief on that front starting in July. Meanwhile, housing starts on Monday and retail sales on Friday will give us further indication of how households are responding to higher interest rates and even higher inflation. We expect the pace of homebuilding to cool and retail sales to show decent growth, though the latter should be almost entirely due to higher prices.

Week Ahead's key Canadian number: Consumer price index—June

(Wednesday, 8:30 am)

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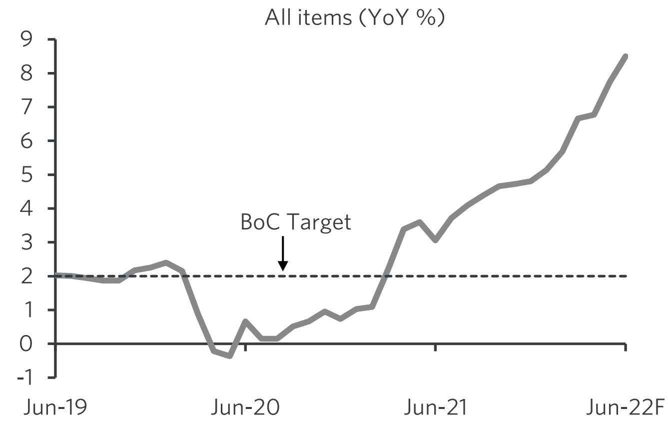
Variable (%)	CIBC	Mkt	Prior
CPI NSA (m/m)	1.0	-	1.4
CPI (y/y)	8.5	-	7.7

Chart: Canadian consumer price index



Source: Statistics Canada, Haver Analytics, CIBC

CPI inflation should have peaked in June at 8.5% year-over-year. While recent pull backs in the prices of oil and some agricultural commodities should provide relief in the future, it will not be apparent in the June CPI data. There was a further increase in gasoline prices in the month relative to May, and with the long lag between changes in agricultural prices and food prices in stores, we are still living through the impact of past increases. But recent developments mean that we should start to see some relief in the months ahead.

Outside of food and energy, we expect CPI inflation to have grown slower on the month and to be roughly stable at an annual rate. Prices linked to the housing market, though still increasing, are not exerting as much upward pressure on CPI as they were just a few months ago.

Forecast implications — The ongoing slowdown in the housing market should act to cool inflation in coming months and into next year, while recent declines in commodity prices should start to provide some relief, as early as July in the case of gasoline prices. With the rapid increase in mortgage rates however, expect mortgage interest costs to prop up inflation in the months ahead. Overall, while we see June as the peak, inflation should stay close to 8% through the summer months.

Other Canadian releases: Retail trade—May, June adv.

(Friday, 8:30 am)

High price pressures in May could result in a healthy advance of 1.6% for headline retail sales in the month, though that will look much less impressive in volume terms. Auto sales, which are typically strong in May, look to have disappointed with a decline. Excluding autos, sales could be up 2.3%, mostly due to the strength in gasoline prices. The advance estimate for June could be for another acceleration due to price pressures and a rebound in auto sales. However, we expect volumes to be weak, as Canadians increasingly turn to service consumption to enjoy their summer, and high inflation and interest rate hikes limit spending.

Housing starts—June

(Monday, 8:30 am)

Housing starts typically take longer to react to interest rate increases than the resale market, but we still expect to start to see a deceleration. Residential permit applications have slowed somewhat in recent months and the resilience in the starts headline number in the past couple of months came from the more volatile multiples segment, while singles retreated. We therefore expect housing starts to have slowed to 240k in June, but to remain above the pre-pandemic pace of homebuilding.

Week Ahead's key US number: Housing starts—June

(Tuesday, 8:30 am)

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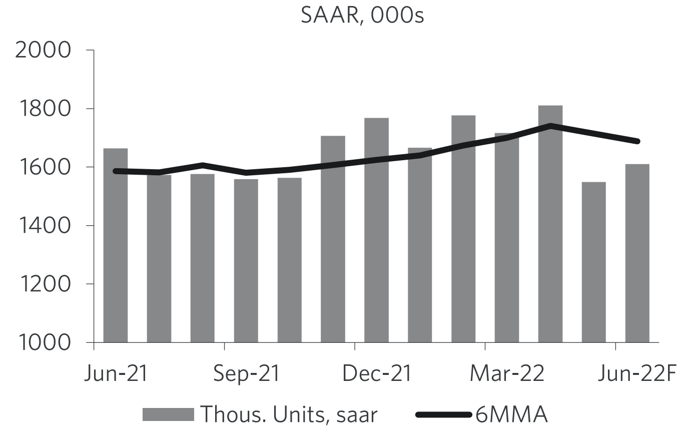
Variable	CIBC	Mkt	Prior
Housing starts	1610K	1595K	1549K
Building permits	1650K	1680K	1695K

Chart: US housing starts



Source: Census Bureau, Haver Analytics, CIBC

Homebuilder confidence continued to fall in June alongside higher mortgage rates. However, the gap between permit issuance and homebuilding in May suggests that June could have still seen an acceleration in housing starts, to a 1610K pace. That would still leave the pace of building lower over the second quarter, consistent with a drop in residential investment as home sales also declined as higher mortgage rates squeezed consumers. Building permit issuance likely pulled back to 1650K on the broad slowdown in demand.

Forecast implications — While the pace of housing starts should average slower over the second half of the year as higher mortgage rates squeeze demand, building will have a floor under it, given undersupply in the pre-Covid market, and we therefore expect the pace of starts to remain above pre-Covid levels into 2023.

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