Economics

THE WEEK AHEAD

January 30-February 3, 2023

The case of contradicting conditions

by **Avery Shenfeld** avery.shenfeld@cibc.com

Which economic indicators will the Bank of Canada be looking at to decide whether to hike again? The short answer is "all of them". But financial market participants will inevitably have to come up with a more nuanced answer if they want to understand Governor Macklem's playbook, because it's almost inevitable that economic data will send conflicting signals about growth and inflation in the coming months. Barring the unlikely cases of a deep economic crash or an outright boom, that's what we always see.

So if the "conditions" contradict, which signals will be the ones likely to hold sway over Canadian monetary policy? Those who think "inflation targeting" implies an obsession with every tick in the CPI don't really understand the Bank's process.

Given the lags between interest rates and economic growth, and some lags between slack in the economy and inflation, it rightly is more focused on where inflation will be a year out than what it might be doing in any one month. The Bank has tightened in the past when inflation was below 2% but slack was rapidly disappearing, and as we just saw, it has been willing to pause on rate hikes when CPI was above target but economic conditions looked likely to cool prices ahead.

In the past, that meant that the Bank's assessment of the "output gap" and its direction was the best predictor of monetary policy. That measure rises whenever real GDP growth exceeded its estimate of potential growth, and ebbs when real GDP gains fall short of the mark. You could look up the starting point for the output gap, and the Bank's last estimate of potential, and by keeping an eye on real GDP trends, get a good sense of its thinking on rates.

But since October 2021, when the Bank sharply revised that method to take into account a large pandemic-related haircut to the economy's ability to supply goods and services, the output gap has become a much fuzzier concept, at least if you only looked at real GDP to assess it. Canada's real output never re-attained its pre-pandemic trend line due various global and domestic factors impeding output per worker, including parts bottlenecks and hours worked lost due to illness. Those supply factors, rather than above trend demand, generated the inflation upsurge.

We could see real GDP surprise to the upside if some of the supply barriers improve and thereby enhance productivity, and that wouldn't entail greater pressure on prices. The Bank would at some point reduce its estimate of supply headwinds, but you would only see that well after the GDP data came out. So real GDP could be a poor guide as a predictor of monetary policy.

Instead, it's apparent that rather than look at economic output, the Bank is focused on tightness in one key input: labour. That market is mentioned first in the last MPR as the indicator that the economy is in excess demand. But even in the labour market, the various data points can sometimes issue contradictory signals.

We've argued, for example, that some of the current wage inflation is a lagging response to the earlier upsurge in the CPI, rather a leading indicator of inflation ahead. As well, the unemployment rate is biased lower because we need more workers to offset the greater number of hours lost due to illness. As in the US, Canadian wage rates first escalated at unemployment rates not far from levels that were not inflationary in the past, owing to higher-than-normal numbers of job vacancies.

The bottom line is that a combination of the unemployment rate, the number of unfilled jobs, and total hours worked will likely be the best predictor of whether the BoC can maintain its conditional pause. For our part, we're looking for enough signs of slack in these measures to keep that pause in place, but not a rapid enough turn of events to allow an easing in rates until 2024.

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, January 30	-	-	-	-	-	-	-
Tuesday, January 31	-	AUCTION: 3-M BILLS $10.4B, 6-M BILLS $3.8B, 1-YR BILLS $3.8B	-	-	-	-	-
Tuesday, January 31	8:30 AM	GDP M/M	(Nov)	(H)	0.1%	-	0.1%
Wednesday, February 1	-	-	-	-	-	-	-
Thursday, February 2	-	AUCTION: 10-YR CANADAS $4B	-	-	-	-	-
Thursday, February 2	8:30 AM	BUILDING PERMITS M/M	(Dec)	(M)	-	-	14.1%
Friday, February 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, January 30	-	-	-	-	-	-	-
Tuesday, January 31	8:30 AM	EMPLOYMENT COST INDEX	(4Q)	(M)	-	1.1%	1.2%
Tuesday, January 31	9:00 AM	HOUSE PRICE INDEX M/M	(Nov)	(M)	-	-0.5%	0.0%
Tuesday, January 31	9:00 AM	S&P CORELOGIC CS Y/Y	(Nov)	(H)	-	6.80%	8.64%
Tuesday, January 31	9:45 AM	CHICAGO PMI	(Jan)	(M)	-	45.3	44.9
Tuesday, January 31	10:00 AM	CONF.BOARD CONSUMER CONFIDENCE	(Jan)	(H)	108.0	108.2	108.3
Wednesday, February 1	7:00 AM	MBA-APPLICATIONS	(Jan 27)	(L)	-	-	7.0%
Wednesday, February 1	8:15 AM	ADP EMPLOYMENT CHANGE	(Jan)	(M)	-	170K	235K
Wednesday, February 1	10:00 AM	ISM - MANUFACTURING	(Jan)	(H)	47.9	48.0	48.4
Wednesday, February 1	10:00 AM	CONSTRUCTION SPENDING M/M	(Dec)	(M)	-	0.0%	0.2%
Wednesday, February 1	10:00 AM	JOLTS Job Openings	(Dec)	-	-	-	10458K
Wednesday, February 1	2:00 PM	FOMC RATE DECISION (UPPER BOUND)	(Feb 1)	(H)	4.75%	4.75%	4.50%
Wednesday, February 1	2:00 PM	FOMC RATE DECISION (LOWER BOUND)	(Feb 1)	(H)	4.50%	4.50%	4.25%
Wednesday, February 1	-	NEW VEHICLE SALES	(Jan)	(M)	-	14.10M	13.31M
Wednesday, February 1	2:30 PM	Speaker: Jerome H Powell (Chairman) (Voter)	-	-	-	-	-
Thursday, February 2	8:30 AM	INITIAL CLAIMS	(Jan 28)	(M)	-	-	-
Thursday, February 2	8:30 AM	CONTINUING CLAIMS	(Jan 21)	(L)	-	-	-
Thursday, February 2	8:30 AM	NON-FARM PRODUCTIVITY	(4Q P)	(M)	2.4%	2.5%	0.8%
Thursday, February 2	10:00 AM	FACTORY ORDERS M/M	(Dec)	(M)	2.3%	2.2%	-1.8%
Friday, February 3	8:30 AM	NON-FARM PAYROLLS	(Jan)	(H)	170K	190K	223K
Friday, February 3	8:30 AM	UNEMPLOYMENT RATE	(Jan)	(H)	3.6%	3.6%	3.5%
Friday, February 3	8:30 AM	AVERAGE HOURLY EARNINGS ALL EMPLOYEES M/M	(Jan)	(H)	0.3%	0.3%	0.3%
Friday, February 3	8:30 AM	AVERAGE WEEKLY HOURS ALL EMPLOYEES	(Jan)	(H)	-	34.4%	34.3
Friday, February 3	8:30 AM	MANUFACTURING PAYROLLS	(Jan)	(H)	-	-	8K
Friday, February 3	10:00 AM	ISM - SERVICES	(Jan)	(M)	50.0	50.3	49.2

Week Ahead's market call

by Avery Shenfeld

In the **US**, a jam-packed week for economic data will climax in Friday's payrolls data, where our call is a bit below expectations, but still somewhat above the pace needed to materially open up slack in the labour market. We're seeing lots of layoff announcements these days, but many of them represent job losses that won't actually show up for a few months, and there are still some sectors eager to fill vacant positions, a reason why jobless claims continue to hug low levels. Still, progress on lowering job vacancies could end up being as important as a rise in the unemployment rate in quelling wage inflation, so nearly equal attention should be paid to Wednesday's JOLTS data, which could well point to a resumption of the downtrend in vacancies. We're also on the low side of consensus for the manufacturing PMI, based on what regional indexes have shown. None of these trends will stand in the way of a well-telegraphed quarter point hike from the Fed this coming week, and we still see one more such move ahead, in part as a necessary counterweight to the easing in monetary conditions that financial markets have generated in pushing term yields lower. To combat that trend, look for the Fed's messaging to lean strongly away from the notion that it will have room to cut rates in the back half of this year.

In **Canada**, the monthly GDP data for November and advance estimate for December are likely to show some modest growth, presaging a roughly 1½% annualized pace for the more important Q4 real GDP data. That's better than the Bank of Canada anticipated back in October, but no barnburner by historical standards, and we still face much of the lagged impact of the prior year's rate hikes. That suggests that Q1 GDP's growth rate is likely to be even softer, although we're not anticipating a nose dive.

Week Ahead's key Canadian number: Gross domestic product—November

(Tuesday, 8:30 am)

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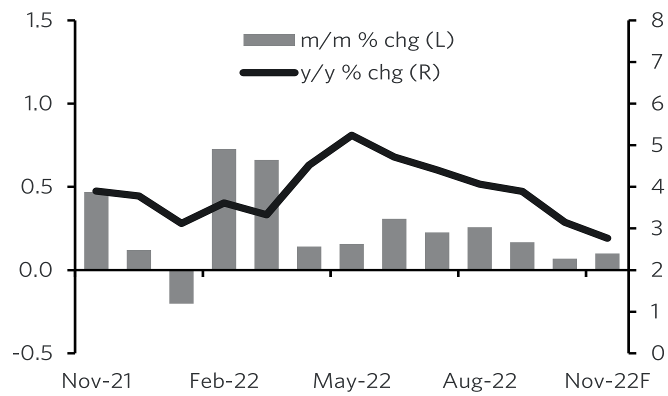
Variable	CIBC	Mkt	Prior
GDP m/m (Nov)	0.1%	-	0.1%

Chart: Canadian GDP at basic prices



Source: Statistics Canada, Haver Analytics, CIBC

It has been slow going for the Canadian economy in recent months, although muted growth is still better than the stall or decline in activity that some had anticipated. Economic activity appears to have advanced by 0.1% in November, and some surprising resilience from the Canadian consumer in terms of a gain in retail sales suggests that the advance forecast for December will also show a modest advance. That should leave the quarter as a whole posting a 1½% growth rate in next week's advance estimate.

Forecast implications — The Canadian economy slowed as 2022 progressed, but maybe not by as much as would typically be expected given the rapidly rising interest rate environment. However, it could be that pent-up demand and elevated savings during the pandemic has meant that the lags between interest rate hikes and a slowing of the economy are longer than normal, and we still expect a bumpy ride for the economy in 2023.

Week Ahead's key US number: Employment situation—January

(Friday, 8:30 am)

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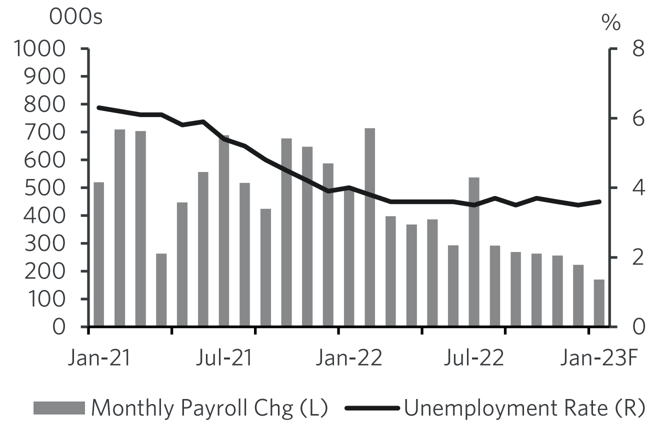
Variable	CIBC	Mkt	Prior
Employment (m/m)	170K	190K	223K
Unemployment rate	3.6%	3.6%	3.5%
Avg hourly earnings (m/m)	0.3%	0.3%	0.3%

Chart: US payroll employment



Source: BLS, Haver Analytics, CIBC

Both initial and continuing jobless claims fell over the January employment survey reference period, a sign that the US labor market remained tight at the start of the year, despite further reports of layoffs in the tech and media sectors. Services consumption stalled in December, in line with the deterioration in business conditions that was suggested by the ISM services index drop. And when combined with signs of a retrenchment in goods-producing sectors, as suggested by foundering exports, a drop in new orders of capital goods, and elevated inventories, total hiring likely slowed to a 170K pace in January.

That's still a healthy pace of job growth, and the recent softening in the prime-age labor force participation rate leaves room for solid hiring without putting more upwards pressure on wages. Assuming an increase in participation, the unemployment rate could have increased to 3.6%, while the outsized gain in the hiring on the household survey that was seen in December isn't likely to have been repeated in January.

With the release of this data, the BLS will also publish it's annual benchmark revision to the establishment employment series. The preliminary release showed that employment in March 2022 was 462K higher than originally reported, and that number will be applied to the series for the previous year.

Forecast implications — A resilient labor market will leave the Fed on track for two 25bp hikes in Q1, and policymakers will be looking for sustained evidence of a slowdown in hiring and wage growth to pause for the rest of the year thereafter.

Market impact — We're roughly in line with the consensus expectation, suggesting limited market reaction.

Other US Releases: ISM Manufacturing—January

(Wednesday, 10:00 am)

Moves in regional PMIs suggest that the ISM's manufacturing index could have fallen further into contractionary territory in January, at 47.9, as new orders likely remained subdued due to demand concerns, and that likely also weighed on the production index. That's also consistent with elevated inventories and the deterioration seen in capital goods orders and capacity utilization in the industrial sector lately.

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