Economics

ECONOMIC INSIGHTS

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Unhappy in its own way

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As Tolstoy said about families, so it is for economies: happy ones are all alike, but unhappy economies are unhappy in their own way. When central banks raise interest rates to cool growth and inflation, they intend to create some economic pain. That shows up in trouble somewhere, but not necessarily in the same manner as in other countries or prior cycles. We don't replay the 2008 US mortgage and derivatives losses, the Asian financial crisis, or the slower rolling Savings and Loan debacle. It's often something new.

This past week, it looked like duration risk in US banking could be part of the 2023 route to an unhappy economy. In contrast to 2008, it's about mid-sized banks rather than the giants of the sector. An unprecedented pace of rate hikes in a short window, coupled with an aggressive QT program, made for a painful lesson for any institution that mismatched short term funds with longer term assets, one that revealed itself when the loss of deposits forced the sale of those assets at a loss.

This wasn't about loan defaults, although every economic slowdown will increase them. Still, the risks to confidence in the banking system compelled government action, with the past weekend's moves covering depositors at the failed banks, and creating a financing mechanism for other US institutions if they need to replace deposits with alternative funding.

But such borrowing, or other wholesale funding, will still represent a higher cost of funds than the deposits they replace. The result is that whatever fed funds rate would have been needed to cool the economy in the absence of these pressures, as long as these banking uncertainties prevail, the appropriate target rate will be lower than otherwise.

Our prior forecast was below what markets were pricing in, as we were looking for only 25 bps this month, with a final quarter point at the next meeting. But upside surprises in growth and PCE inflation had us on the verge of turning the March hike into a 50 bp move. The banking issues have us sticking with the quarter point hikes for this meeting and next, and a pause thereafter. We're maintaining our call for a stand-pat Bank of Canada until 2024.

Outright rate cuts, as seen during market jitters after the LTCM failure, aren't as likely this time around, since back then, inflation was tame and the Fed wasn't really aiming at a major slowdown. But the Fed ought to decelerate its QT pace until the dust settles, rather than continuing at a pace that could be negatively impacting the banking sector.

Further out the curve, our Canadian yield targets for June, which we essentially reached early this month, now look too high, as they assumed the market would temporarily price-in a larger Fed overshoot. Our revised outlook has yields rising on a less dramatic track towards this summer, but maintains our 2024 levels, with Fed and Bank of Canada rate cuts that year (Tables 3 and 4, page 7).

Talk that the Bank of Canada would hike again, a view we didn't share, has been set aside. The rush into safe assets has pushed the curve to the point where, at least technically, the market is eyeing rate cuts by this summer. But if the cuts priced in were actually delivered, five year mortgage rates, for example, might actually get cheaper. That seems too quick a dose of relief for a economy in which labour markets are deemed to be too tight to get inflation under control, so we'll stick with our call for no cuts until 2024.

None of this has a significant impact on our economic outlook (Tables 1 and 2, page 6), because it's mostly about the interest rate path needed to get the easing in growth and inflation that central banks will still be seeking. The roots of economic unhappiness have some new details, but it still sees a moderate upturn in the unemployment rate as the recipe for getting inflation to 2% next year.

Canadian inflation: After the fall

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Inflation is set for a sharp fall in the coming months, as some of the biggest monthly price increases from last year drop out of the annual calculation. However, that should be well known to investors, and what comes afterwards will have a much larger bearing on future interest rate policy and expectations.

Looking at a number of core inflation measures, we find that underlying price pressures have already eased sharply and by more than the Bank of Canada is currently acknowledging, alleviating the need for any further interest rate hikes. However, food price inflation is turning into a key issue. While policymakers can do little about it at the micro level, groceries play an important role in setting inflation expectations, which could still lead to a wage-price spiral. We also find that food prices play a large role in the BoC's new core inflation measures, which will keep those running above a 3% annualized rate for now and prevent the Bank from trimming rates until early next year.

Just how weak is the core?

Policymakers know full well that the current inflationary trend is weaker than year-over-year prints suggest, with the Bank of Canada recently placing greater weight on the three-month seasonally adjusted annualized rates of its preferred core measures, CPI-trim and CPI-median. While much lower than their 2022 peaks, at roughly 3.5% for each, the three-month annualized rates of inflation on these measures are still above the target band.

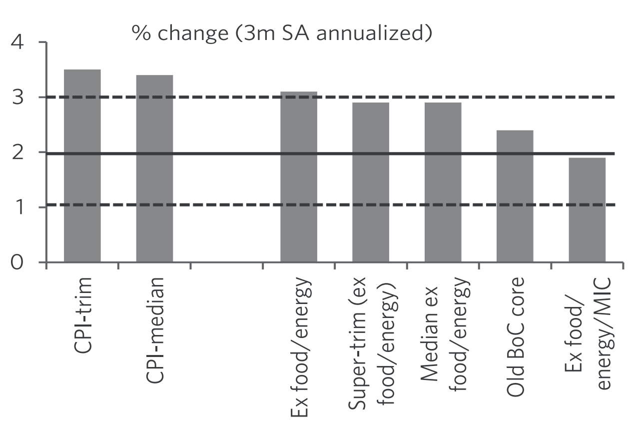
However, when we look at other measures of core inflation, including the old BoC core indicators and replicating trim and median to exclude food and energy, most are already within the target band (Chart 1). That raises some important questions including whether the Bank of Canada's new core measures are accurately reflecting current inflationary pressures, and whether these measures will also fall back within the target range ahead.

When unusual trends in Canadian inflation are observed, the usual suspect is the way housing costs are included, and in particular the use of mortgage interest payments. While the Bank of Canada is raising interest rates to slow the economy down, the use of mortgage costs in CPI means that it's very actions are directly affecting one component of the basket. The speed of interest rate hikes means that the mortgage interest component is adding significantly to overall inflation at the moment, but would be something that policymakers look through when setting interest rates. After all, a largely mechanical increase in mortgage costs does not give information on underlying price pressures in the economy.

The impact of mortgage interest costs on current inflationary pressures is easy to see. Excluding food and energy, the three-month seasonally adjusted annualized rate of inflation is currently 3.1%. Exclude mortgage interest costs as well, and that rate drops to a mere 1.9%. The more than 1% contribution is easily the highest on record (Chart 2), and is the difference between inflationary pressures that are still slightly above the upper bound (3%) or almost bang in line with the 2% target. With mortgages still resetting at higher interest rates, the mortgage interest component will remain a positive contributor to inflation even if the Bank doesn't hike interest rates again.

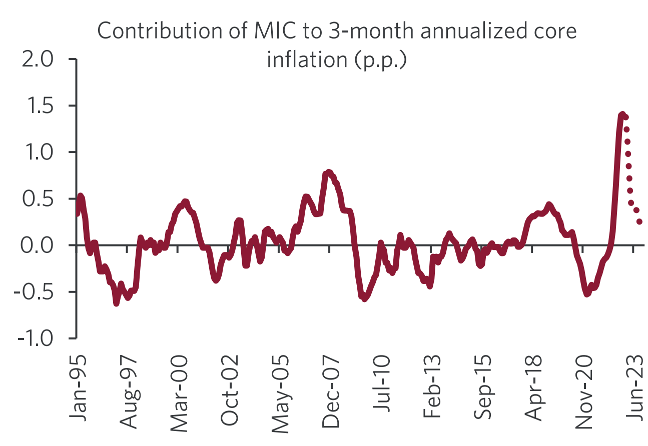
Mortgage interest costs were one of the eight components excluded from the Bank of Canada's old CPI-X measure of

Chart 1: Recent trends in alternate measures of core inflation already within target range



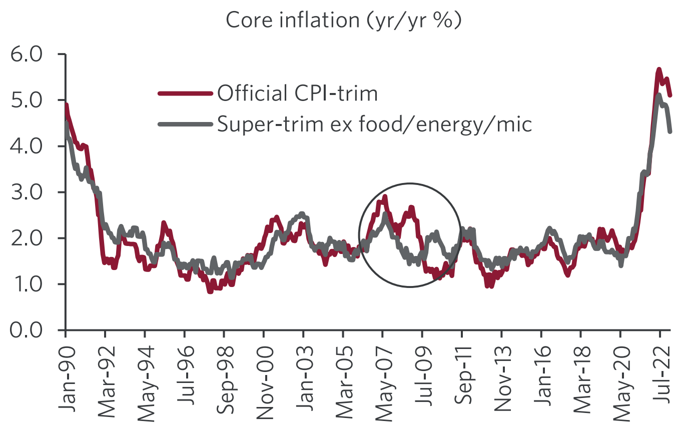
Source: Statistics Canada, Bank of Canada, CIBC

Chart 2: Mortgage interest costs having a large impact on inflation currently



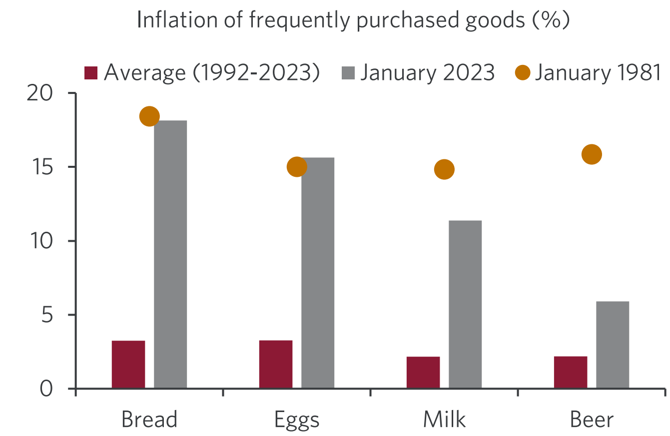
Source: Statistics Canada, CIBC

Chart 3: CPI-trim can sometimes vary if food/energy excluded



Source: Statistics Canada, Bank of Canada, CIBC

Chart 4: Inflation for food essentials still very high



Source: Statistics Canada, CIBC

inflation, and a key reason why the three-month annualized trend on that measure has already fallen to 2.4%.

Food for thought

That said, mortgage interest costs cannot be blamed for continued above-target readings on the Bank of Canada's CPI-trim and CPI-median measures of inflation. After all, the recent surge means that monthly changes in mortgage interest costs easily fall within the 20% that is trimmed out of the former, and have been well above the median and therefore little impact on the latter either.

Instead, we find that CPI-trim and CPI-median are being influenced at the moment by food prices. Typically, food, alongside energy, is something that is excluded from core measures of inflation because, particularly for less-processed foods, price changes are very volatile and tend to be globally rather than domestically driven. However, food and energy are not excluded from the BoC's new core measures of inflation.

Historically, the inclusion of food and energy in the trim and median measures of inflation has made little difference to the end result (Chart 3). In other words, even during periods of energy or food price volatility these measure of inflation have typically remained effective in picking up the underlying trend.

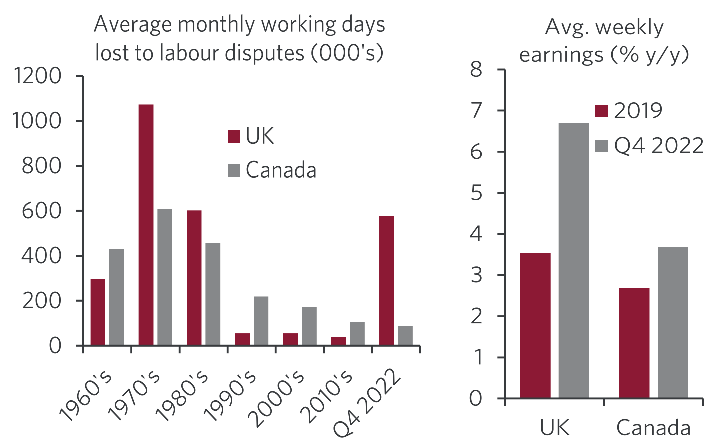
However, there was one important period when that was not the case. In 2007 and 2008, as the financial crisis was evolving, CPI-trim was accelerating and generally trending above 2%. At the same time, though, our super-trim measure (excluding food/energy and MIC) was running below target and would have been a much better gauge of the weakening global and domestic backdrop.

The gap opening up currently between CPI-trim and our super-trim measure is being driven by similar dynamics. In other words, until food price inflation starts to moderate, the BoC's core measures of inflation are likely to remain above the Bank's target range, and potentially provide a misleading signal regarding inflationary pressure being generated by the Canadian economy itself.

This is not to say that policymakers can ignore food price inflation altogether, however. Staple food items such as bread and milk are some of the most important price pressures in terms of shaping consumers' inflation expectations. These key areas are currently seeing inflation rates close to the peaks witnessed in the early 1980's — the last time longer-term inflation expectations became unanchored (Chart 4).

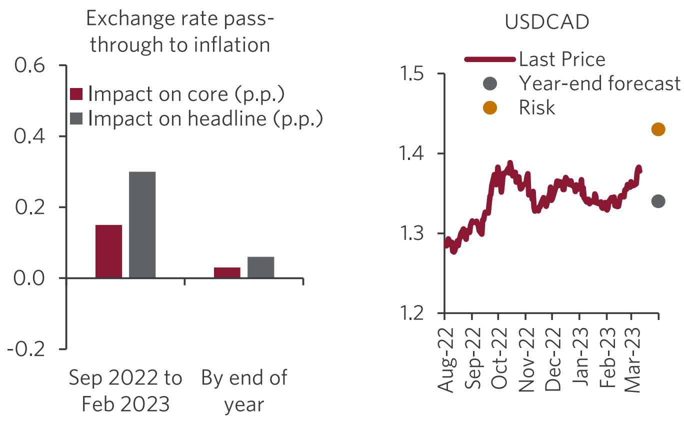
We only have to look to the UK to see how problematic unhinged inflation expectations and wage demands can be. Even though UK real GDP has failed to even reattain end-of-2019 levels, food and energy-led inflationary pressures have resulted in a surge in strike activity and elevated wage demands (Chart 5). While there isn't much evidence of such behaviour yet in Canada, and the Bank stated in it's last Monetary Policy

Chart 5: The UK is an example of elevated inflation expectations impacting wage demands



Source: ONS, Statistics Canada, CIBC

Chart 6: Inflation from FX depreciation has peaked (L), unless USDCAD reaches 1.43 (R)



Source: Bank of Canada, Bloomberg, CIBC

Report that the probability of a wage-price spiral has diminished, policymakers can't completely sound the all clear on that front with food price inflation remaining elevated.

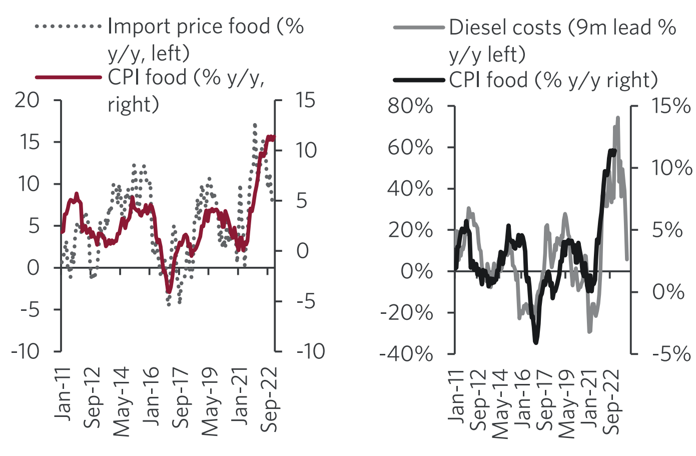
Some relief to come

The good news is that, by the second half of this year, there should be some relief at the grocery stores. We should have already seen the biggest hit from last year's exchange rate depreciation on food prices and other items (Chart 6, left).

While there's a risk that the Canadian dollar could depreciate further, USDCAD would need to rise to 1.43 by year-end if the inflationary impact of the currency is to remain as large as it has been in recent months (Chart 6, right).

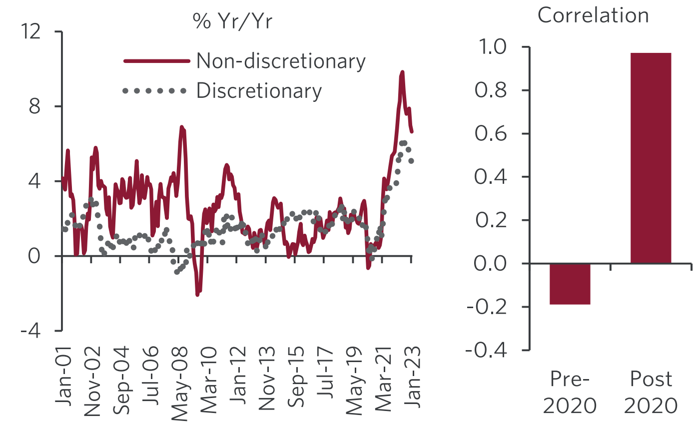
Moreover, we should finally see greater pass-through from softening global food prices to those at grocery store shelves. Indeed, the inflation rate in imported food costs has already eased quite sharply, but that has yet to translate into prices

Chart 7: Imported food inflation has eased (L), but consumer prices haven't yet followed due to transportation costs (R)



Source: Statistics Canada, CIBC

Chart 8: Discretionary and non-discretionary inflation are normally negatively correlated, but not post-pandemic



Source: Statistics Canada, CIBC

consumers are paying (Chart 7, left). While lack of competition is often blamed, other operating costs are also playing a role, including transportation. Diesel prices rose more sharply, and stayed elevated for longer, than the pump prices typically paid by households. However, a decline in diesel prices more recently should be good news for food costs in the second half of the year (Chart 7, right).

A return to normalcy

We are also seeing some changes to spending behaviour within the food space that could have implications for demand and inflation within more discretionary items. Typically, there is a negative correlation between inflation for non-discretionary items such as food and fuel, and discretionary items such as dining out and travel. That makes sense, because when households are forced to spend more on essentials, they often have to make cutbacks to spending in other areas.

There has been nothing typical about the post-pandemic world, though. Inflation soared for both discretionary and non-discretionary items last year, as pent-up demand and excess savings made households temporarily less price conscious (Chart 8). However, we are starting to see signs that consumer behaviour is returning to normalcy, which could have disinflationary consequences.

Monthly GDP showed activity for bars and restaurants falling to a seven-month low in November. Industry data suggested a tick-up in December was driven largely by fast-food chains rather than full-service restaurants. Meanwhile, Statistics Canada stated within its latest retail sales report that some households were shifting from traditional grocery stores to favour lower cost bulk distributors. These are all signs of a change in behaviour amid pressure on household finances from inflation and rising interest rates which could signal a reduced ability for companies to pass on cost increases in such rapid price hikes.

After the fall

The return to normalcy of household spending behaviour, combined with a lower track for food price inflation in the second half of the year, should mean that even the Bank of Canada's preferred core measures of inflation ease close to 2% by early 2024. That will open the door to interest rate cuts in Q1 next year.

However, unless concerns regarding the US economy escalate, or the unemployment rate rises in such a way that reduces the prospect of a wage-price spiral, we are not likely to see the Bank cutting interest rates this year. Inflation relief may be a 2023 story when looking at true underlying trends, but rate relief may have to wait until 2024.

Table 1: Canadian economic update

Variable	22Q3A	22Q4A	23Q1F	23Q2F	23Q3F	23Q4F	2022A	2023F	2024F
Real GDP growth (AR)	2.3	0.0	1.8	0.1	-0.7	0.8	3.4	0.9	1.2
Real final domestic demand (AR)	-0.8	1.0	1.2	-0.1	-0.5	1.0	2.7	0.5	1.4
Household consumption (AR)	-0.4	2.0	1.3	-0.4	-1.2	0.3	4.8	1.0	0.8
All items CPI inflation (Y/Y)	7.2	6.7	5.2	2.9	2.7	2.5	6.8	3.3	2.1
Unemployment rate (%)	5.1	5.1	5.1	5.4	5.7	5.9	5.3	5.5	5.6

Table 2: US Economic update

Variable	22Q3A	22Q4A	23Q1F	23Q2F	23Q3F	23Q4F	2022A	2023F	2024F
Real GDP growth (AR)	3.2	2.7	1.8	-0.4	0.3	-0.2	2.1	1.3	1.0
Real final sales (AR)	4.5	1.2	2.4	-0.1	1.0	-0.4	1.3	1.5	1.0
All items CPI inflation (Y/Y)	8.3	7.1	5.9	4.0	3.2	2.9	8.0	4.0	2.5
Core CPI inflation (Y/Y)	6.3	6.0	5.6	4.9	3.8	2.8	6.2	4.2	2.2
Unemployment rate (%)	3.6	3.6	3.5	3.8	4.2	4.3	3.6	4.0	4.1

Table 3: Canadian interest rates (end of period)

Variable	2023 14-Mar	2023 Jun	2023 Sep	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec
Overnight target rate	4.50	4.50	4.50	4.50	4.00	3.50	3.25	3.00
98-Day Treasury Bills	4.43	4.35	4.25	4.00	3.50	3.25	2.90	2.60
2-Year Government Bond	3.78	4.15	3.90	3.50	3.10	2.75	2.40	2.30
10-Year Government Bond	2.86	3.30	3.25	3.10	2.90	2.80	2.65	2.50
30-Year Government Bond	2.87	3.25	3.15	3.15	3.00	2.90	2.85	2.75
Canada - US T-Bill Spread	-0.37	-0.75	-0.85	-0.95	-1.00	-0.65	-0.70	-0.70
Canada - US 10-Year Bond Spread	-0.79	-0.70	-0.55	-0.60	-0.60	-0.60	-0.70	-0.50
Canada yield curve (10-year — 2-year)	-0.92	-0.85	-0.65	-0.40	-0.20	0.05	0.25	0.20

Table 4: US Interest rates (end of period)

Variable	2023 14-Mar	2023 Jun	2023 Sep	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec
Federal funds rate	4.625	5.125	5.125	5.125	4.625	4.125	3.875	3.625
91-Day Treasury Bills	4.80	5.10	5.10	4.95	4.50	3.90	3.60	3.30
2-Year Government Note	4.33	4.65	4.40	4.00	3.90	3.40	3.20	2.80
10-Year Government Note	3.65	4.00	3.80	3.70	3.50	3.40	3.35	3.00
30-Year Government Bond	3.74	4.00	3.95	3.90	3.80	3.75	3.70	3.60
US Yield curve (10-year — 2-year)	-0.68	-0.65	-0.60	-0.30	-0.40	0.00	0.15	0.20

Table 5: Foreign exchange rates

Exchange rate	2023 14-Mar	2023 Jun	2023 Sep	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec
CAD-USD	0.73	0.74	0.75	0.75	0.76	0.77	0.78	0.78
USD-CAD	1.37	1.35	1.34	1.33	1.32	1.30	1.29	1.28
USD-JPY	134	128	123	121	120	118	116	115
EUR-USD	1.07	1.10	1.11	1.13	1.14	1.15	1.15	1.16
GBP-USD	1.21	1.24	1.24	1.26	1.27	1.28	1.28	1.30
AUD-USD	0.67	0.69	0.70	0.71	0.72	0.74	0.75	0.76
USD-CNY	6.87	6.85	6.81	6.79	6.75	6.73	6.71	6.69
USD-BRL	5.25	5.05	5.20	5.40	5.20	5.20	5.40	5.00
USD-MXN	18.7	20.0	20.5	19.8	20.0	20.5	21.5	21.0

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