Stronger Than Expected Canadian CPI

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

Canada, CPI, y/y %, June:
Actual: 2.5
Scotia: 2.5
Consensus: 2.3
Prior: Unrevised from 2.2

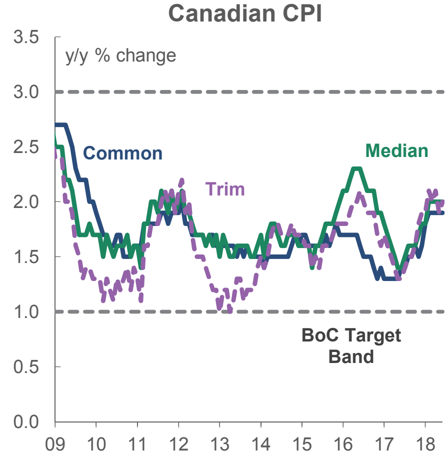
Core inflation, y/y %, June:
Average: 2.0 (prior 1.9%)
Common component: 1.9 (prior 1.9%)
Weighted Median: 2.0 (prior revised up to 2.0% from 1.9%)
Trimmed Mean: 2.0 (prior 1.9%)

- **Inflation surprised to the upside of consensus and market expectations but was in line with my bottom-up estimate this month and is broadly consistent with our smoothed trend modelling.** The C$ has appreciated by a full penny on the back of CPI and retail sales (see below). Canada's 2 year yield jumped by almost 4bps. The underlying details reinforce the headline pressure as the average of the core inflation measures also ticked up and is back at the 2% inflation target and so this is not just a gasoline report. Core inflation is hanging in at the 2% target having registered such a reading in four of the past five months. As growth rebounds and puts further pressure upon capacity, inflation readings are likely to move higher yet.
- Recall that the BoC hiked on July 11th despite the downside surprise in the last report. This upside surprise that fully reverses that earlier reading a) provides legitimacy to its hike, and b) points to September and October and straight up the full OIS curve as being seriously underpriced in terms of rate hike expectations based upon what we know to date. Coupled with the retail report, the broad underlying narrative of firming price pressures and the reversal of transitory prior weakness in consumption should have markets thinking more aggressively about hike risks. At present, September is negligibly priced and a little over half of a ¼ point hike is priced for October. Over the full year ahead, the OIS curve is pricing just one hike and two years out it is pricing less than two. **The full OIS curve is pricing BoC rate risks too lightly across all tenors in my opinion.**
- Inflation averaged a tick higher than the BoC's July MPR had forecast for Q2. The BoC expected 2.2% y/y and the actual reading is 2.3%. That's a marginal upside surprise, but a constructive one to the rate hike dialogue.
- Every province is registering year-ago inflation rates at 2% (Quebec) or north of 2% (everywhere else) and so there is strong regional breadth. On average, inflation is at its fastest in the western half of the country with Alberta up 2.8%, BC up 2.7%, Manitoba and Saskatchewan both up 2.7% and Ontario up 2.4%. The Atlantic provinces are a little softer but still north of 2% with PEI getting the winner-winner-chicken-dinner award for the country's highest inflation rate at 2.9% inflation.
- In month-ago terms, both seasonally adjusted and unadjusted prices were up by 0.1% m/m. In seasonally adjusted terms, prices were up for food (+0.6%), clothing and footwear (+0.5%), alcohol/tobacco (+0.5%) and health and

Average 'Core' Inflation

Sources: Scotiabank Economics, Statistics Canada.

Canadian CPI



Sources: Scotiabank Economics, Statistics Canada.

personal care (+0.2%). Other categories were up by less or down in the case of recreation/education/reading (-0.6%) and household operations, furnishings and equipment (-0.3%).

- In year-ago terms, gasoline prices are a major contributor (+24.6% y/y). At a 3.4% weight in the CPI basket, that single-handedly contributes 0.8% to headline inflation. Nevertheless, don't make the mistake of simply subtracting this to get a much more muted pace of headline inflation down to around 1.7% y/y. For one thing, the average of the core measures is firmer than that at 2%.

Canadian Retail Sales Smash Expectations

nominal sales, m/m%, headline / ex-autos, May:

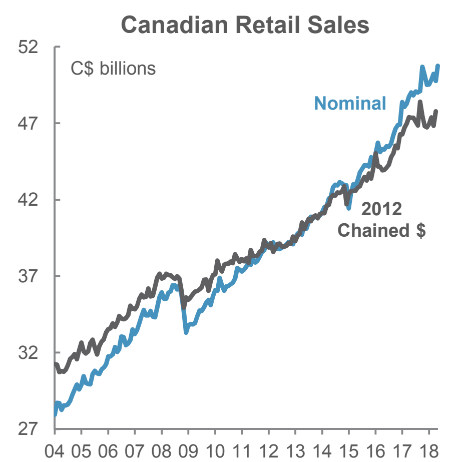
Actual: 2.0 / 1.4

Consensus: 1.0 / 0.5

Scotia: 1.2 / 0.7

Prior: -0.9 / 0.2 (revised from -1.2 / -0.1)

- The consumer is back. And how. **The strength to these numbers broadly supports the narrative that earlier weakness was a combination of two main transitory influences including a slower and more miserable start to Spring weather conditions than usual and negative spillover effects of B20 housing regs on related types of consumer spending.** Consumers declared they'd had enough of that and took their fattening wallets and income gains to the mall and on-line as soon as these effects began to dissipate at the margin.
- **Retail sales volumes were up 2% m/m and so all of the gain in the value of sales was driven by volumes** and none of it by price effects on average. Volumes were up in 19 of 25 categories.



Sources: Scotiabank Economics, Statistics Canada.

- **In quarterly terms, retail sales volumes are tracking an annualized and seasonally adjusted advance of almost 4% q/q in Q2 after retreating by 4.5% in Q1.** That reinforces the argument that the weakness at the start of the year was transitory and something to be set against the backdrop of solid income gains.
- **My monthly GDP model now points to 0.4% m/m GDP growth in May** with only Monday's pending wholesale report missing. That would be a significant rebound from a flat growth reading in April and further lean in favour of how soft growth was a function of transitory headwinds.
- **By province, sales were up in seven of ten provinces.** Just look at the eye-popping gains in the biggest provinces including Ontario (+2.6% m/m), Quebec (+3%), Alberta (+2%) and BC (+0.8%). Despite Toronto's housing challenges, retail sales were up 1.4% m/m there though they were little changed in Vancouver (+0.2%).
- **By category, there was indeed breadth to the spending gains.** E-commerce sales were up by 16.9% y/y and so click-and-buy shopping remains the fastest channel for consumption growth. In month ago terms, StatsCan does not do seasonal adjustments to on-line sales but unadjusted sales were up by almost 8% m/m.
- In month-ago seasonally adjusted terms, autos and parts were up 3.7% m/m led by a 3.6% increase in sales at new car dealers and a 4.4% rise in used vehicles while parts exploded with a gain of 8.1%. Building material and garden equipment and supplies dealers saw a 5.4% m/m sales jump which makes sense given the delayed start to Spring the prior month. Gasoline station sales were up 4.4% driven by higher prices. Sporting goods and hobby stores saw a 1% rise in spending that was also probably related to the delayed start to Spring. General merchandise stores advanced by 3.2%.
- Not all categories ripped, mind you, and some are still reflecting lingering softness. Weakness in the food and beverage stores category wasn't a surprise as we already knew that food prices were soft in May versus this morning's rebound in the June CPI report. Sales were flat at electronics/appliance stores and health and personal care stores and furniture and home furnishings stores.