CONTACTS

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

My personal bias is to fade the market reactions to weaker than expected inflation and retail prints into next week. CAD depreciated by about a half cent to the USD and Canada's two year yield fell about 4bps. September CPI probably undershot where subsequent reports will land including what we know about October so far such that the BoC should be as inclined to look through a possible near-term undershoot in September as it was an overshoot on earlier headline readings. Notwithstanding the freshest readings, the core narrative that remains intact points to the BoC a) probably revising up Q3 GDP growth, b) inflation for the overall quarter coming in a little firmer than the last forecasts in the July MPR anticipated and notwithstanding a soft September, and c) a probable upward revision to projected GDP growth—or at least unchanged and hence still above potential growth—and that adds the Kitimat LNG terminal's impact into 2020 and possibly lessens some of the negative NAFTA forecast judgement. Overall, the output gap framework as an input into projecting future inflation is unlikely to be under less pressure than the BoC indicated in the July MPR and more likely to be under marginally greater pressure. In my view, a hike that retains 'gradual' guidance and data dependent language will be delivered. At the margin, it is not September CPI or August retail sales that matter as much as how developments inform the future forecast bias.

Canadian CPI Softer Than Expected — For Now

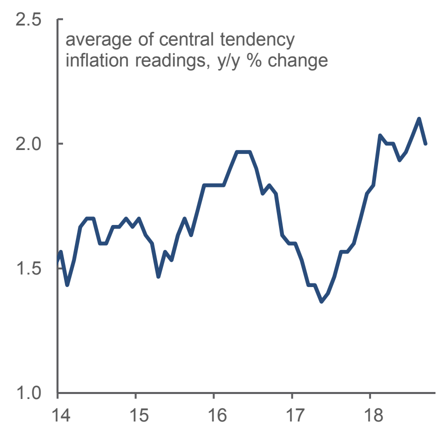
Canada, CPI, y/y / m/m NSA %, September :
Actual: 2.2 / -0.4
Scotia: 2.6 / 0.0
Consensus: 2.7 / 0.1
Prior: Unrevised from 2.8 / -0.1

Core inflation, y/y %, September:
Average: 2.0 (prior 2.1%)
Common component: 1.9 (prior 2.0%)
Weighted Median: 2.0 (prior 2.1%)
Trimmed Mean: 2.1 (prior 2.2%)

- Inflation eased in September and much more so in terms of the headline reading than core pressures. I don't know what he thought September would look like, but broadly speaking, hats off to Governor Poloz for arguing that at least the headline reading was to be subject to transitory upsides that would fade. I thought I was going low enough at the bottom end of consensus for headline, but nowhere nearly low enough. The more important matter is that core inflation eased only slightly and it still remains on target. Further, no one should get too carried away with September as it's possible that inflation undershot even where it might go in the very next report.

- I still think the BoC hikes next week. Core inflation is holding onto on-target readings as the chart below demonstrates. The BoC will probably retain a similar above-target headline CPI forecast that they had in the July MPR, and partly because they'll probably revise up GDP growth for Q3 and perhaps in future. The BoC might lessen some negative forecast judgement for NAFTA and add to their 2020 forecast because of the LNG/Kitimat terminal. At the margin, it's not September's CPI that matters. It's the case to stress the output gap framework a little further in their forecasts that will matter.

Canadian Core Inflation



Sources: Scotiabank Economics, Statistics Canada.

- Be careful with respect to the forecast implications to the BoC. The July MPR had expected 2.5% y/y CPI inflation in Q3 and we got 2.7%. They underestimated earlier pressure that then dropped out somewhat at the end of the quarter but the overall effect still left a higher reading than they anticipated for the full quarter. If Governor Poloz sticks to his narrative that individual data points matter less than broad trends, then he shouldn't over react to September CPI given the volatility of the readings.
- September was a seasonally unusual month for price effects. Normally, headline CPI has been little changed in September in month-ago terms but this time prices fell 0.37% m/m NSA with CPI excluding food and energy also falling 0.3% m/m by contrast to more seasonally usual gains in September. Whether this is just noise within volatile price figures or a trend clearly needs more data to settle, but I'm tempted to think that the next inflation report for October is going to see prices shoot right back up. October is normally a fairly strong seasonal up-month for CPI and CPI ex-food and energy and that could be especially the case on the back of an unusually weak month of September.
- My early call for October CPI expects headline CPI to pop back higher to at least 2.4% y/y. It's important to counsel caution that whereby the upswing in headline CPI was transitory, September may have undershot where we'll wind up into subsequent rounds. Over reacting now could well have market participants over correcting to the other side of the sailboat as it tacks into the next inflation report.
- By category, prices fell in four of eight main CPI categories in seasonally unadjusted terms. The transportation sector (-2.1% m/m) led the way partly due to a 1.1% drop in gas prices, but food (-0.7% m/m), health and personal care (-0.5%) and recreation and reading (-0.4%) also contributed. Clothing and footwear prices were the one standout to the upside (+2.5% m/m).
- In seasonally adjusted terms, headline CPI was down 0.1% m/m. Transportation (-0.6% m/m) and rec/reading/ed (-0.7%) drove most of the softness.

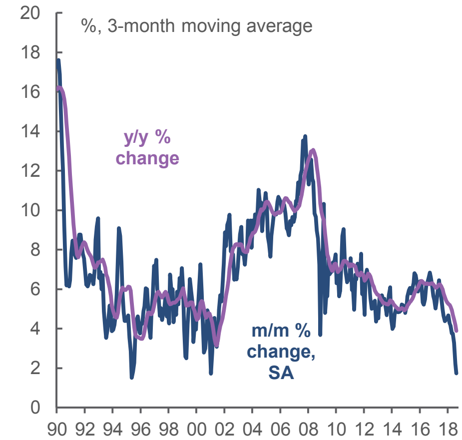
Canadian Retail Sales Disappoint

nominal sales, m/m%, headline / ex-autos, August:
Actual: -0.1 / -0.4
Consensus: 0.3 / 0.1
Scotia: 0.4 / 0.2
Prior: 0.2 / 0.8 (revised from 0.3 / 0.9)

- Retail sales disappointed expectations on headline readings and the broad underlying details.
- It's clear that the Spring renaissance in consumer spending that drove Q2 higher took a breather again in Q3. My bias is that this sets up a somewhat more favourable fourth quarter but one should still temper near-term expectations for the consumer cycle.
- I *think* that what's happening is that a) the Q2 rebound after a soft Q1 pulled some demand out of Q3, b) that we're still adjusting to the softer H1 housing market post-B20 that is impacting complementary forms of spending, and c) underlying fundamentals are mixed but generally point to moderate trend consumption growth and d) there is ongoing payback to prior stimulus. Key to this latter point is that annualized personal disposable income growth was about 2.8% q/q SAAR in Q2 and only 1% after stripping out inflation and this followed a dip in Q1 of -0.3% q/q SAAR. Income dynamics have not been great this year compared to the juiced numbers we were getting largely through the child benefit boost to income gains in 2016–17. At the same time, the credit cycle has slowed partly due to tighter mortgage rules and so the ability of households to smooth consumption through credit at the near-term expense of the saving rate has been mitigated. Witness the charts below that show continued deceleration of mortgage credit growth and possible stabilization of growth across other lending products combined into one measure that includes fixed and variable rate installment loans plus revolving credit such as cards and lines. If the latter is stabilizing, then that could be constructive to smoothing income and consumption fundamentals going forward.
- For the consumer, this means that a) we need more distance from the brought forward effects of the money that was doled out to households through the child benefit stimulus that pulled consumption demand forward as we are possibly stilling paying the price for that earlier boost to income and consumption. I think we need to look through the moderated period now just as much as we needed to look through the period when child benefit cheques were spent with no strings attached. The hope is that 2019 will provide enough distance from this distortion to set a somewhat better picture for consumption growth.

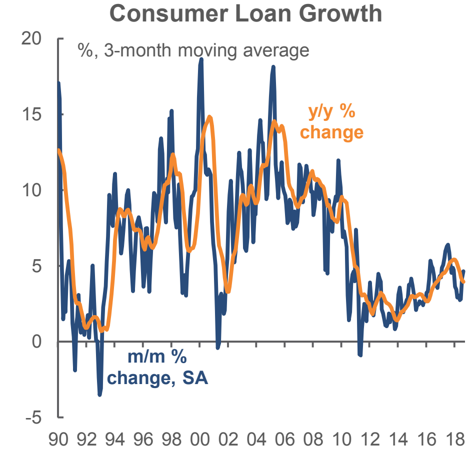
- But I also think that the rotation of the sources of growth toward business investment and exports and relatively away from consumption and housing possibly with a mild federal fiscal policy assist into next year becomes more important with each passing data point. For much of this cycle, we've become too accustomed to watching housing and consumption figures as the bees knees to overall GDP growth; there are risks to the adjustment phase to different growth drivers, but I find too much of the narrative is rooted in the past cyclical drivers and not enough is being sunk into the forward looking implications to possible investment and export strengths given capacity pressures, a solid US economy and reduced NAFTA risks.
- Sales volumes fell by 0.3% m/m.
- By sector, the value of sales fell in 7 out of 11 categories.
- By province, it was Quebec that did much of the damage with a decline of 0.7% m/m. Ontario was up 0.3%, while BC and Alberta slipped by just 0.1% m/m. Saskatchewan fell 2.7% m/m for the weakest absolute performance, but the province only accounts for about 3% of total retail sales.
- On implications for growth forecasts:
    - **August GDP:** I'm tracking a small rise of +0.1% m/m but with the caution that there is not much breadth to the inputs. The rise is heavily dependent upon a modest rise in hours worked as the main catalyst. Existing home sales were up by almost 1% m/m which should aid ancillary services. Manufacturing volumes slipped a little and housing starts were slightly lower. Wholesale is pending release on Monday.
    - **Q3 GDP:** up a tick to 2.1% q/q SAAR based on the above August GDP expectation and assuming a flat September to focus on what we know so far. This uses monthly GDP figures whereas there can be significant differences compared to quarterly expenditure based GDP figures. Using the latter, the BoC was at 1.5% in the July MPR and it probably has to revise up somewhat and perhaps in part because it may have overestimated the Syncrude impact upon GDP.
    - **Retail sales volumes are tracking poorly at 0.6% q/q SAAR in Q3.** Volumes have been down in four of the past five months, but only slightly each month and against the large gain in May. Q2 retail sales volumes were up 3.6% q/q SAAR so we're getting a bit of payback from a delayed consumption boost in Q2 that followed the soft Q1 partly due to a harsher than usual winter and delayed Spring.

Residential Mortgage Growth



Sources: Scotiabank Economics, Bank of Canada.

Consumer Loan Growth



Sources: Scotiabank Economics, Bank of Canada.