

ECONOMIC VIEWPOINT

No Shelter from Shelter Inflation in Canada

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Highlights

- ▶ One of the key takeaways from the Bank of Canada’s January 2024 Monetary Policy Report is that shelter inflation is likely to be the single most important driver of year-over-year price growth in the first half of 2024. According to our analysis, higher-for-longer shelter inflation will be the dominant driver of headline Canadian inflation for the foreseeable future. The sustained high pace of shelter inflation is expected to be almost entirely driven by rising mortgage interest cost.
- ▶ To ensure total CPI inflation gets back to the Bank’s 2% inflation target despite sustained high shelter inflation, growth in other price categories must be lower than in the past. Monetary policy has the most direct impact on interest-rate-sensitive parts of the economy. The drag from high interest rates will continue to ripple through the economy, weighing on the labour market and economic activity more broadly.
- ▶ As the Canadian economy tips into recession in the first half of 2024, the resulting economic weakness should help to apply additional downward pressure to non-shelter core CPI inflation. Fortunately for the Bank of Canada, food and energy prices look to be cooperating as well.
- ▶ All told, while shelter inflation is expected to remain elevated for the foreseeable future, other drivers of inflation are likely to offset that strength and help to bring inflation back to around 2% by the end of 2024.

One of the key takeaways from the Bank of Canada’s January 2024 Monetary Policy Report is that shelter inflation is likely to be the single most important driver of year-over-year price growth in the first half of 2024. While the Bank refrained from providing a forecast for shelter inflation beyond June of next year, it acknowledged that “shelter price inflation is high and is expected to put upward pressure on inflation for some time.” Our analysis supports this view, as prices for both rented and owned accommodation are projected to continue growing above their pre-COVID pace beyond the end of 2024 (graph 1).

According to our analysis, higher-for-longer shelter inflation will be the dominant driver of headline Canadian inflation for the foreseeable future. Shelter price growth is likely to see its contribution to headline CPI inflation increase through the first quarter of 2024 and only gradually diminish thereafter (graph 2 on page 2). With an average monthly contribution of 1.8 percentage points to the inflation outlook through the end of

2024, that’s almost four times the average level in the five years prior to the COVID-19 pandemic.

Graph 1
Shelter Inflation Is Expected to Remain Elevated over the Outlook



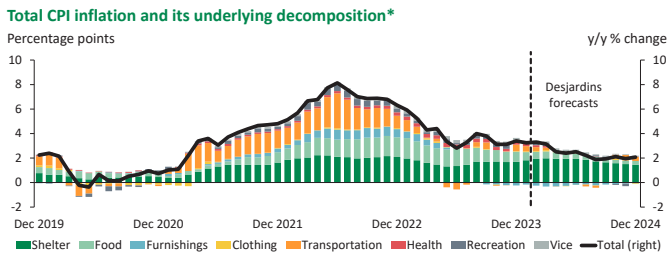
*Calculated using fixed basket weights
Statistics Canada and Desjardins Economic Studies

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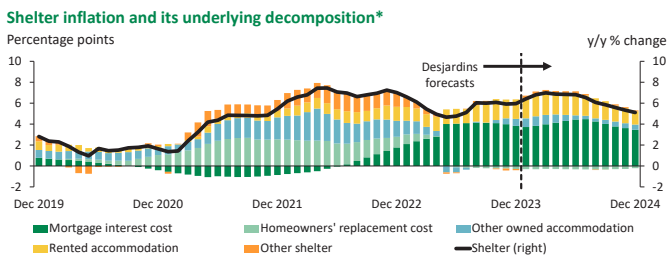
Graph 2 Shelter Price Growth Is the Main Driver of Our Inflation Outlook



*Calculated using fixed basket weights
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The sustained high pace of shelter inflation is expected to be almost entirely driven by rising mortgage interest cost (graph 3). Having averaged over 30% year-over-year in the second half of 2023, mortgage interest cost inflation set new records throughout the year. This trend will persist in 2024, as mortgages continue to renew at higher interest rates.

Graph 3 Mortgage Interest Cost Should Drive Shelter Inflation Higher

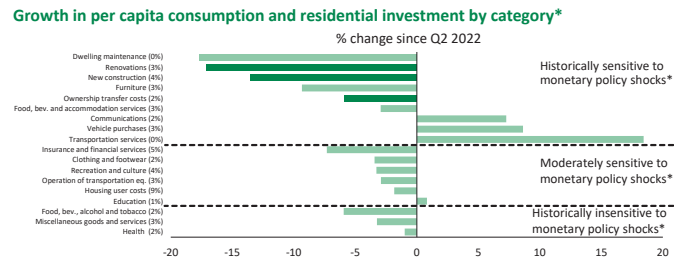


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To ensure total CPI inflation gets back to the Bank's 2% inflation target despite sustained high shelter inflation, growth in other price categories must be lower than in the past.

Monetary policy has the most direct impact on interest-rate-sensitive parts of the economy. As the Bank outlined in its October 2023 MPR, interest-rate-sensitive consumption categories are experiencing the greatest slowdown on a per capita basis. This is particularly true for housing-related consumer spending, as residential investment has also felt the gravitational pull of higher interest rates (graph 4). This diminishing demand should help to ease price pressures going forward. One notable exception to this weight of higher interest rates has been auto sales and other transportation services, which have benefitted from pent-up demand coming out of the pandemic. However, we think this tailwind to consumption and price growth has largely run its course as well.

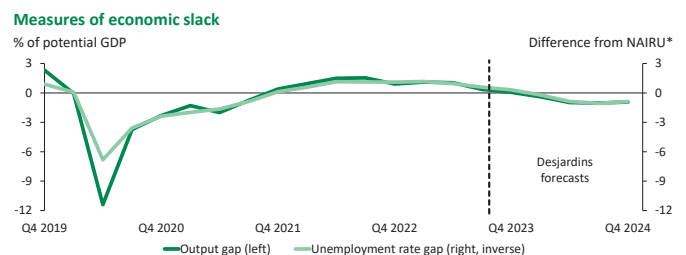
Graph 4 Interest-Rate-Sensitive Consumer Spending Has Slowed Sharply



*Categories are grouped based on 2018 analysis by the Bank of Canada; in parentheses after the y-axis label is the weight of each expenditure category as a percent of nominal GDP in 2021, just before interest rates rose
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The drag from high interest rates will continue to ripple through the economy, weighing on the labour market and economic activity more broadly. We estimate that the output gap likely tipped into negative territory at the end of 2023 and that the unemployment rate should begin to inch above its long-run trend soon (graph 5). The output gap is expected to move further into negative territory in the first half of 2024 as the Canadian economy experiences a short and shallow recession. The ensuing increase in labour market slack will help to take pressure off wage growth. It should also induce Canadians to save more, further diverting disposable income away from consumption and the housing market.

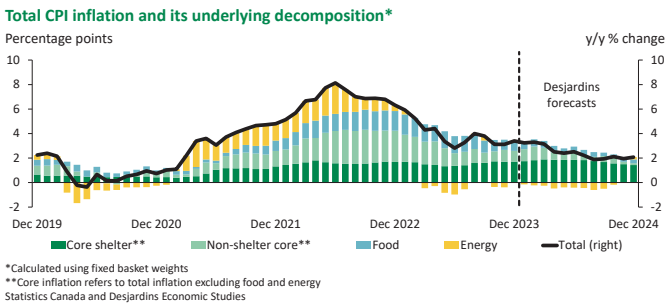
Graph 5 Excess Demand Is Giving Way to Increasing Economic Slack



*NAIRU: Non-Accelerating Inflationary Rate of Unemployment
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As the Canadian economy tips into recession in the first half of 2024, the resulting economic weakness should help to apply additional downward pressure to non-shelter core CPI inflation (graph 6 on page 3). It will need to, as non-shelter core inflation—total inflation excluding shelter, energy and food—must come in sustainably below its pre-pandemic pace to offset higher-for-longer core shelter inflation—the shelter component of inflation but with energy removed. We think it will. Non-shelter core inflation categories that are more sensitive to interest rates and economic slack have already begun to show signs of cooling. And with the unemployment rate only expected to rise further from here, slowing demand will make it more

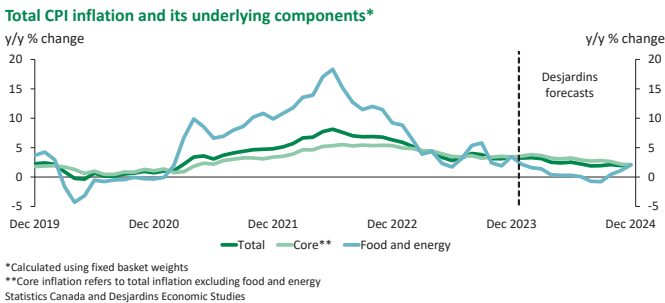
Graph 6
Core Shelter Price Growth Is the Main Driver of Our Inflation Outlook



challenging for businesses to pass higher prices on to consumers. The Bank’s most recent Business Outlook Survey points to as much.

Fortunately for the Bank of Canada, food and energy prices look to be cooperating as well (graph 7). This should also help to pull down core inflation categories that are indirectly impacted by commodity prices, through channels such as transportation costs. At the same time, global supply chain constraints have eased significantly since the pandemic, and Chinese export prices have become deflationary. While recent tensions in the Middle East pose upside risk by raising shipping costs in the near term, it is too early to conclude that we are about to see a material and sustained escalation in the prices of traded goods.

Graph 7
Commodity-Linked Prices Should Soon Weigh on Headline Inflation



All told, while shelter inflation is expected to remain elevated for the foreseeable future, other drivers of inflation are likely to offset that strength and help to bring inflation back to around 2% by the end of 2024 (graph 8). For now, the Bank of Canada will remain on hold, waiting for further signs that inflation is on a sustained path back to 2%. But in our view, the anticipated recession in the first half of 2024 and ensuing labour market weakness will be key markers. That’s because these trends will further validate the effectiveness of the BoC’s tightening, something that was already apparent during the second half of 2023. This should allow the Bank to begin a gradual rate-cut cycle by this spring, well before headline inflation has touched down at the 2% target.

Graph 8
Total CPI Inflation Is Expected to Return to 2% by the End of 2024

