Canada: Investors Should Pay Attention to Some Budding Inflationary Signals

At the renewal of its mandate last year, the Bank of Canada (BoC) announced that it would follow three measures of core inflation. These were constructed to better disregard transient disruptions and more closely reflect the economy’s excess capacity. The measure best performing this task is the common component of consumer price index (CPI) although with some lag.

In the first half of the year, this measure had fallen to 1.3%, 0.7 percentage points below the target, reflecting the increase in excess capacity caused by the 2015–2016 oil price shock. As the economy recovered from the shock, the common component of CPI recovered somewhat. It stood at 1.5% in August. If the trend dictated by the output gap is reliable, it can be expected that core inflation will continue to converge towards the BoC’s target. Another positive signal for inflation came from the Business Outlook Survey this week. The proportion of businesses expecting inflation to exceed the target over the next two years has risen to its highest level in five years.

IMPLICATIONS

Inflation expectations as approximated using real return bonds, have recorded a notable increase over the summer. Nevertheless markets are positioned for Canadian inflation trending at about only 1.60% over the next ten years. By way of comparison, between 2010 and 2014, the implied inflation expectation over a 10-year horizon evolved around an average of 2.08%. At a time when main street is starting to see things less negatively, and where capacity pressures are on the rise, long positions in breakevens still look attractive.

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