RECENT INFLATION DYNAMICS IN THE U.S. AND CANADA

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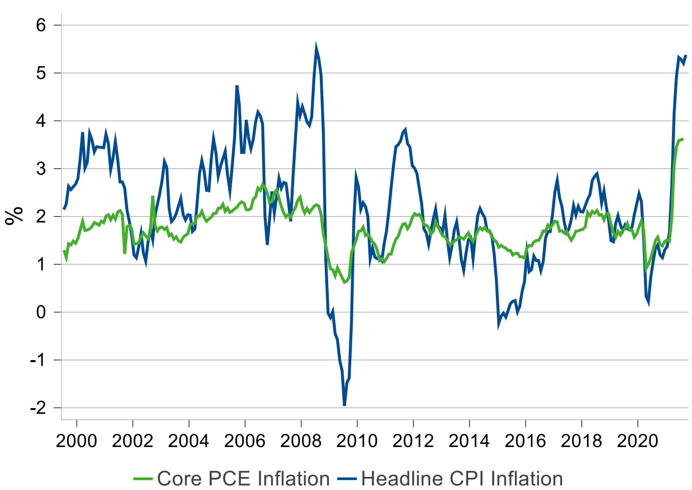
As the global economy continues to rebound post pandemic, much attention is being given to the rising rate of inflation. On October 12, 2021, the IMF cautioned central banks of the need to “be prepared to act quickly if the risks of rising inflation expectations become more material.”

In examining future inflation trends, IMCO has looked at U.S. and Canadian economic indicators and presents in this paper our assessment of where we think inflation is headed in both economies.

Headline inflation in the U.S. has remained above 5% since June (Chart 1) while the core measure – which excludes more volatile components (i.e., food and energy) – is at its highest mark in almost 30 years, prompting worries of a return to 70s-style inflation.

We believe, however, that this high-point is transitory and was partly driven by temporary pandemic-related factors, such as bottlenecks in both labour and production markets, and consequently does not reflect the longer-term inflation pressures of the economy.

CHART 1: United States Inflation

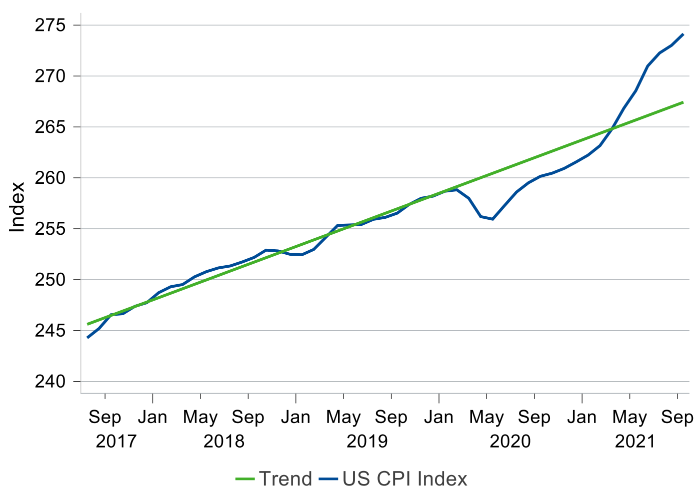


Source: Macrobond, U.S. Bureau of Labour Statistics, Bureau of Economic Analysis

BASE EFFECTS WILL FADE

When we examine inflation on a year over year basis, the transitory nature of the rate boost is evident. Gas prices, for example, which are a key component of the consumption basket, fell significantly in the early days of the pandemic as a result of the general lockdown, with the lowest point reached in April and May of last year (Chart 2). As the economy continues to open up again, rising gas prices have predictably played a role in pushing up inflation.

CHART 2: U.S. Consumer Price Index (CPI)



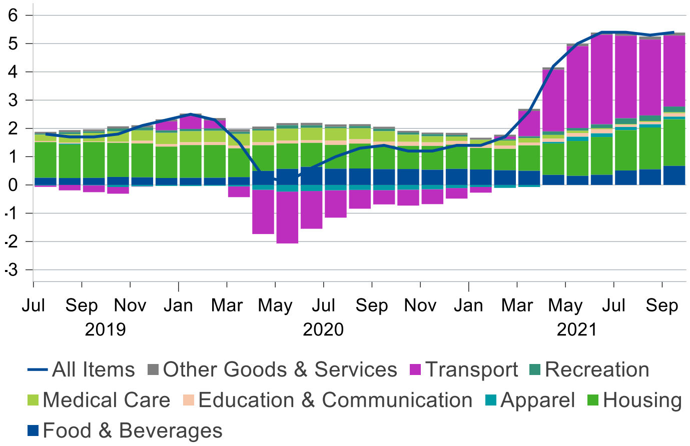
Source: Macrobond, U.S. Bureau of Labour Statistics (BLS)

AUTO SECTOR A KEY DRIVER OF U.S. INFLATION

The auto sector has been a key driver in exerting upward pressure on the U.S. inflation rate. In March of 2020, car production lines came to a standstill around the globe. As consumers eschewed public transport, demand for second-hand cars soared. Compounding the problem of increased demand and reduced supply was the disruption to the global supply chains and the shortage of semiconductor chips on which the auto sector is heavily dependant.

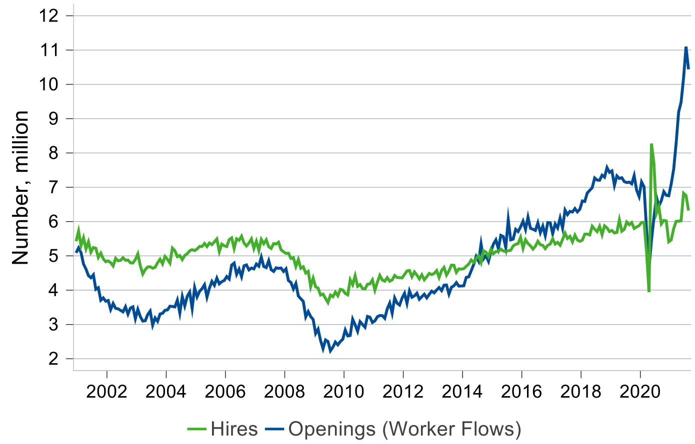
The result was a surge in car prices in the U.S. (Chart 3), with knock-on effects on both the core and headline inflation rates. However, we believe this is temporary phenomenon driven by supply and dynamics that is expected to level out over the coming year.

CHART 3: United States CPI Inflation, contribution to yearly change



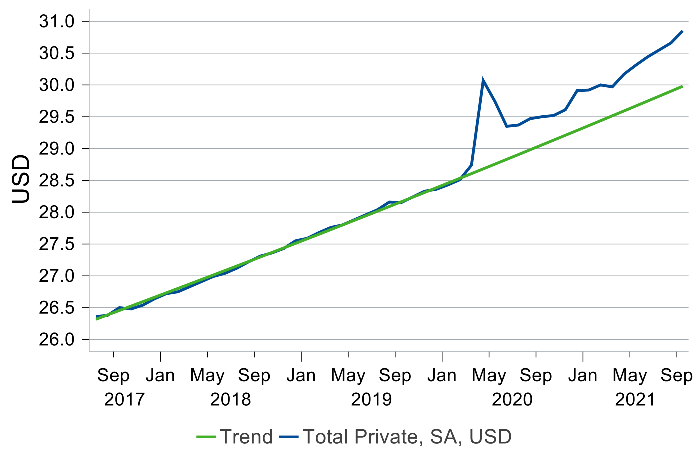
Source: Macrobond, U.S. Bureau of Labour Statistics (BLS)

CHART 4: U.S. Job Openings and Labour Turnover



Source: Macrobond, U.S. Bureau of Labour Statistics (BLS)

CHART 5: United States, Average Hourly Earnings



Source: Macrobond, U.S. Bureau of Labour Statistics (BLS)

LABOUR MARKET PRESSURE IS TEMPORARY

As the U.S. economy continues to open up, labour shortages are feeding into price pressures. In 2021, the number of job openings relative to hires soared (Chart 4). Average hourly earnings, which were boosted after the pandemic by higher unemployment rates among low-wage workers, have remained elevated despite unemployment numbers coming down, implying underlying wage pressures in the U.S. economy (Chart 5).

However, we believe that the labour shortages are for the most part temporary, driven by pandemic-related factors, including lack of childcare and generous unemployment insurance payouts. With unemployment at 4.8% (above the 3.5% pre-crisis level), and labour force participation also lower (Chart 6), it looks likely that these labour supply pressures will ease somewhat once the pandemic is over.

CHART 6: United States, Labour Force Participation Rate

Source: Macrobond, U.S. Bureau of Labour Statistics (BLS)

TEMPORARY, BUT HOW HIGH?

We do not see U.S. inflation moving well beyond 5% in the near-term, as the base effects discussed above should dissipate and supply bottlenecks should ease. In fact, used car price increases, one of the major drivers of recent inflation in the U.S., have started to stabilize (Chart 7), and the monthly rate of inflation has slowed from its peak in June.

CHART 7: Manheim Used Car Price Index (Wholesale)

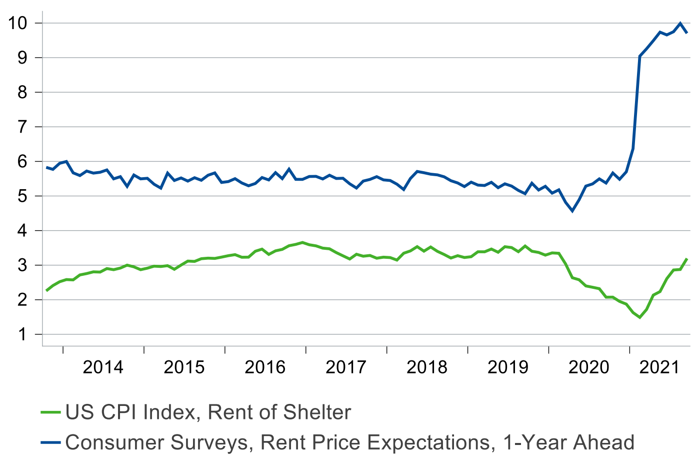
Source: Bloomberg

OTHER NEAR-TERM INFLATION PRESSURES

Despite the easing of some key inflationary pressures across the economy, rent prices are on the rise and will continue to have an impact into next year.

The U.S. Federal ban on evictions, which had been in place since September 2020, expired at the end of August. Renters, who represent 30% of the U.S. population, expect large rent increases in the coming year (Chart 8). Indeed, some price pressure in rent of shelter has already materialized, a metric which tends to lag housing price increases. This trend is likely to accelerate as the forbearance program in the U.S. expired at the end of September, which may push more renters into the market. For now, however, most of the rent increases we are seeing can still be associated with base effects, as rental prices have not yet returned to trend.

CHART 8: Consumer Prices and Expectations, Rent of Shelter, U.S.



Source: Macrobond, Federal Reserve Bank of NY, Bureau of Labour Statistics

STRUCTURAL SHIFTS OVER THE LONGER-TERM ADD TO UPSIDE INFLATION RISKS IN THE U.S.

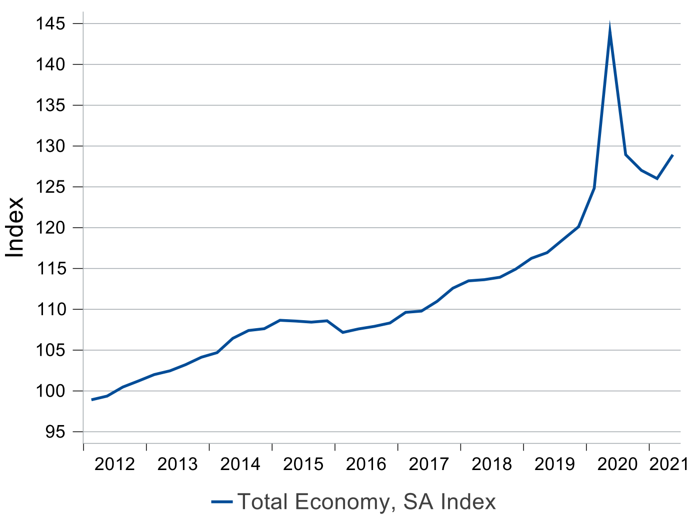
We believe U.S. inflation could trend higher over the next decade – not to the level of the 1970s, but instead averaging around the 2.5% level (versus the 1.75% it averaged over the previous decade), which is broadly in line with breakeven inflation rates. The pandemic helped change public perception on the role of government spending in managing the economy. With central bankers being constrained by the limits of how low interest rates can be cut and how many assets can be purchased, there is a new consensus that government spending needs to play a more prominent role. The fiscal boost that is a consequence of these dynamics should feed into inflation pressure going forward. This added spending may persist over time if addressing inequality continues to be a policy concern, propping up longer-term U.S. inflation pressure. On the monetary side, the U.S. Federal Reserve's new inflation targeting framework – which was updated in August 2020 to a 2% average over time - means that the U.S. central bank will allow inflation to rise above 2% for some time, given the shortfall in recent years. Both of these factors – increased fiscal spending and average inflation targeting -– could contribute to a weakening USD over time, which might also add additional inflationary pressure in the U.S. Rising protectionism and the risk of onshoring of supply chains, as well as the new "green" climate policy consensus could also help nudge up global inflation going forward. And finally, any shifts in demographic trends will also need to be monitored closely.

U.S. VS CANADA

There are a number of key differences between the U.S. and Canada as it relates to recent inflation dynamics.

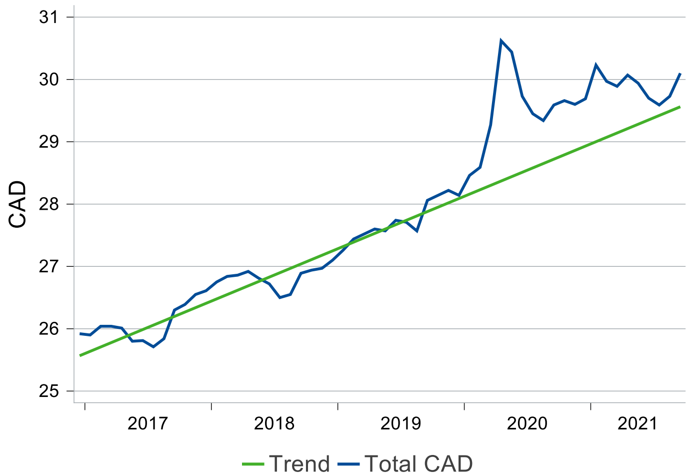
Because the U.S. economy reopened at a much earlier stage than Canada and chose a different policy approach for supporting workers and businesses through the pandemic, it experienced broader labour supply issues (with many workers not returning to work for various reasons). We have not seen the same level of labour supply issues, and therefore wage pressures, in Canada. On an hourly basis, wages in Canada (which were boosted after the pandemic due to higher unemployment rates among low-wage workers) have normalized to pre-crisis trends (Chart 9), and average wages have come down (Chart 10). Further, Canada did not experience the same supply and demand dynamics for passenger vehicles following the pandemic as the U.S., which has also contributed to lower inflation pressures in Canada.

CHART 9: Canada, Compensation Per Hour Worked



Source: Macrobond, Statistics Canada

CHART 10: Canada, Average Hourly Wages



Source: Macrobond, Statistics Canada

The combination of high vaccination rates in Canada coupled with abundant fiscal spending bode well for the country's economic growth and therefore more sustainable inflation. IMCO will be watching whether the Bank of Canada will follow the U.S. Fed, and more recently the ECB, in updating its inflation targeting framework to allow for higher inflation. So far, despite some built in flexibility in Canada's 1-3% inflation target, markets have kept their longer-term inflation expectations for Canada low, and the Canadian dollar has benefitted. If the Bank of Canada makes substantial changes to its inflation mandate at its scheduled update later this year, this may change, with key implications for long-term inflation and the Canadian dollar. We will continue to watch this closely.