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High inflation, low inflation risk

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Highlights

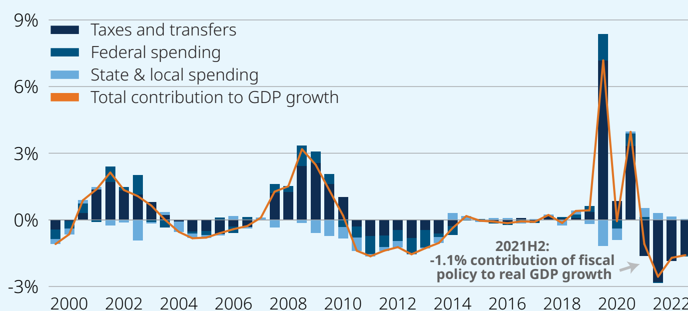
- While realized inflation has surged in recent months, long-term inflation risks have moderated, mostly due to expected pivots in US monetary and fiscal policy.
- Earlier this year, loose US monetary and fiscal policy at a time of rapid growth and tight labour markets could be seen as sources of persistent inflationary pressure. However, a hawkish shift by the Federal Reserve in June and the expected decline in US deficits in coming years have blunted this concern.
- The risk of high and volatile inflation is even lower in Canada, given a more hawkish central bank, stronger Canadian dollar and smaller fiscal stimulus compared to the US.

Prices have accelerated in recent months in the US, alarming some investors. In May, year-on-year inflation hit 5.0%, and 3.8% excluding volatile food and energy prices. However, much of the current pick-up in inflation appears to be driven by transitory factors: a dash for used cars, manufacturing constrained by stretched supply chains, energy prices bouncing back from their nadir in the pandemic, and service sectors reverting to pre-pandemic levels. While current price pressures are likely to be transitory, many investors remain concerned they could be the harbingers of more persistent kinds of inflation.

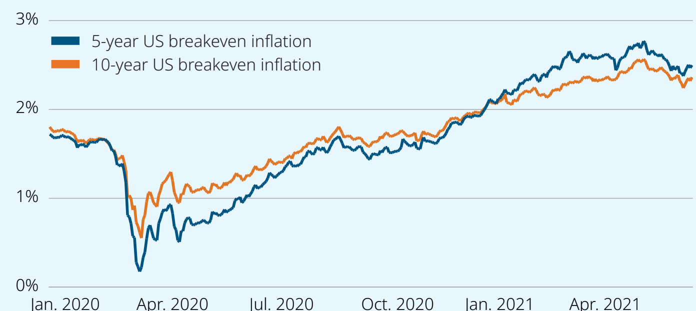
Consistent with our view in January, we continue to believe that persistently high and volatile inflation is unlikely in the long term. The two biggest risk scenarios in our forecast were: (1) additional rounds of fiscal stimulus from an ambitious Biden administration, and (2) the Fed tolerating high inflation for too long, letting inflation expectations become unhinged because of the recent uptick in post-pandemic inflation. But these two risks now appear less likely, with the Fed taking a more hawkish tone at its June policy meeting and Congressional moderates insisting that new spending is "paid for" by higher revenues.

Figure 1 | Tighter fiscal and monetary policy should blunt long-term inflation risks

Fiscal policy will soon become a drag on growth



Market inflation expectations are rolling over



Notes: Left chart: fiscal impulse semi-annual series calculated from Brookings Institute data. Right chart: data via Bloomberg as of June 27, 2021

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The Fed slightly shifted its policy stance at its June meeting, dipping its toes into tapering discussions and talking up the strength of the economic recovery. The median Fed official pulled forward its expectation of the first interest rate hike from 2024 to 2023. While there is some uncertainty around the thought process behind the pivot, the market took it as a sign that the Fed is reasserting the inflation component of its dual mandate. The Fed's hawkish turn provided momentum to the ongoing pullback in 'breakeven' inflation, a broad measure of expected inflation implied by inflation-linked bonds, which is trending towards our expectation of 2% inflation in the long term (Figure 1).

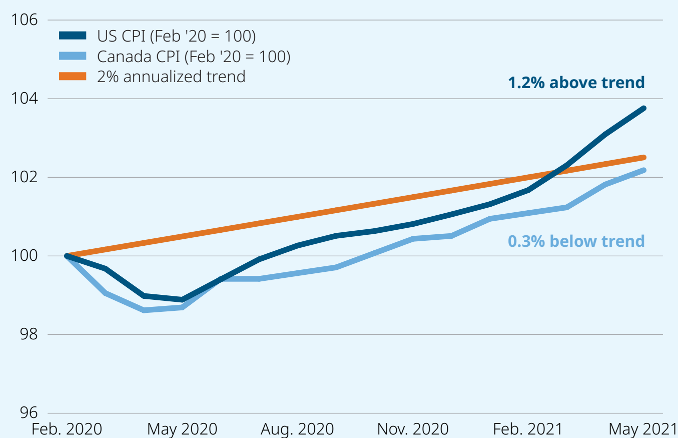
The likelihood of excessive government spending overheating the economy has also fallen since the Biden's administration's early days. Moderate Democrats are pushing back against further deficit-financed spending, the filibuster looks here to stay, and 26 states are cutting off emergency federal unemployment benefits ahead of schedule to encourage a return to work. In addition, the US debt profile could take an unsustainable path if interest rates rise. With centrist Democrats holding on to their belief of balancing budgets in the long-term, a falling budget deficit from today's high levels could weigh on demand. The US fiscal impulse, i.e., the contribution of fiscal policy to real GDP growth, is expected to turn negative in the second half of 2022 as deficits begin to fall (Figure 1).

In Canada, domestic inflation is dependent on price dynamics south of the border. Excess US demand pressures tend to leak into Canada, US monetary policy is an important determinant of financial conditions in Canada and supply chain constraints impact both countries. Hence, a lower risk of unhinged inflation in the US implies a lower long-term inflation risk for Canada. But there are also key distinctions in Canada, which contribute to an even tamer inflation picture in Canada.

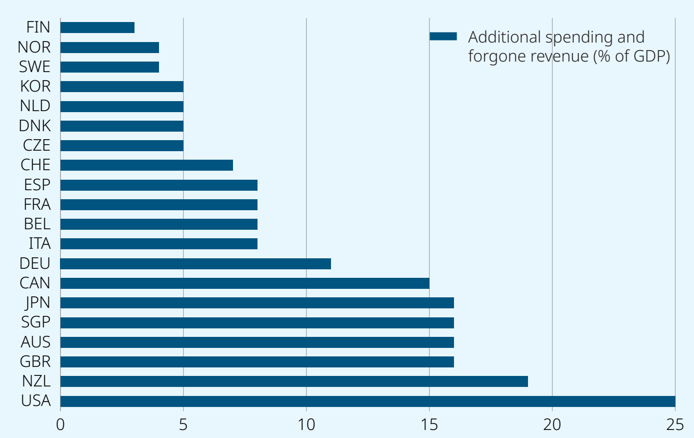
First, while prices have undoubtedly been growing rapidly in the US in recent months, inflation readings have been lower in Canada. Indeed, the 3.6% May inflation print in Canada is almost entirely explained by the rolling over of low inflation numbers from a year ago. As Figure 2 shows, the price level is still below its trend from last year. A strengthening Canadian dollar, a delayed reopening compared to the US and more restrained fiscal stimulus are probable explanations for lower Canadian inflation relative to the US.

Figure 2 | In Canada, current inflation largely reflects "base effects" from depressed 2020 prices

The price level in Canada is still below pre-pandemic trend



Covid fiscal stimulus was more restrained in Canada



Notes: Left chart: Consumer price index (CPI) data via Bloomberg as of June 27, 2021. Right chart: International Monetary Fund estimates.

Second, the Bank of Canada (BoC) follows a more plain vanilla variety of inflation targeting compared to the Fed's new average inflation targeting approach. While the Fed now allows for a sustained period of inflation overshooting to compensate for past periods of low inflation, the BoC's framework still targets 2% inflation in any given year. The BoC is expected to raise interest rates earlier than the Fed to prevent inflation. In our May commentary, we outlined why it makes sense to expect an earlier monetary tightening in Canada, like what we saw after the 2001 and 2008 recessions. The BoC has already begun slowing bond purchases, while the Fed is months away from tapering. To be clear, inflation may still rise in Canada, especially with the economy reopening through the summer. House price growth, which has begun bleeding into consumer prices via higher rents, could also boost households' inflation expectations. But the balance of probabilities is tilted towards low and stable inflation in the long term.

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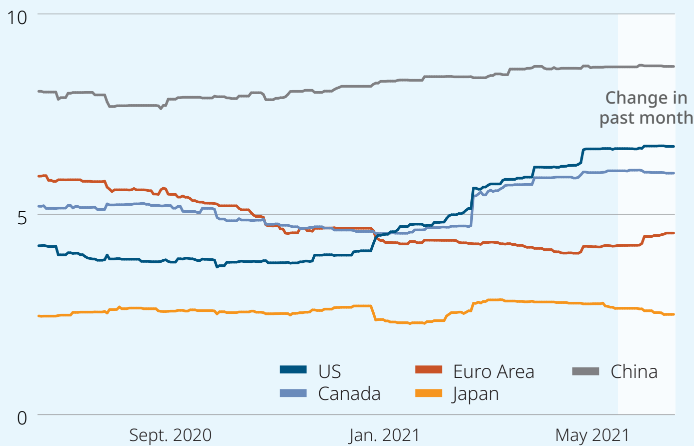
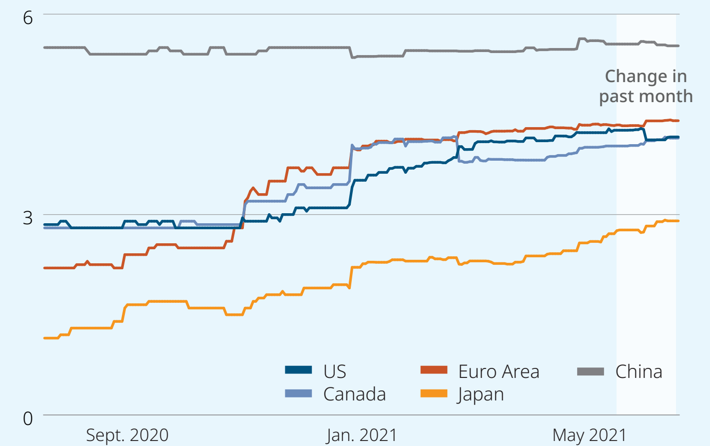
Global macro update

- With **inflation** readings for the month of May beating forecasts in the **US**, **Canada** and **Europe**, consensus forecasts for 2021 CPI inflation forecasts rose in past weeks. Economists now foresee 3.5% annual inflation this year in the US and 2.5% in Canada. They also expect the current inflationary pressures to partially bleed into 2022.
- The macro picture in **Europe** improved markedly in the past month. Vaccination campaigns are still going strong in Western Europe and economies are reopening. The Purchasing Manager's Index (PMI) for the Eurozone, a leading indicator of economic production, is well above its neutral level. GDP growth expectations for both 2021 and 2022 inched up in June, as did inflation expectations. The €800 billion Eurozone recovery fund, currently getting rolled out, should provide much needed economic support to the worst hit countries, including Spain and Italy.
- The emergence of the Delta Covid-19 variant could be a threat to the **global recovery**. A UK-based study did find that current vaccines offer solid protection against the variant, which reinforces the importance of countries' "breadth" of vaccination, which we explored in the Emerging Theme section of last month's commentary.

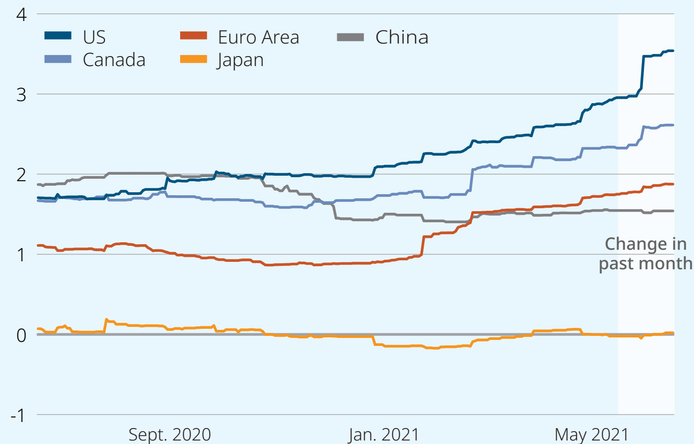
2021 real GDP growth forecast (%, consensus)



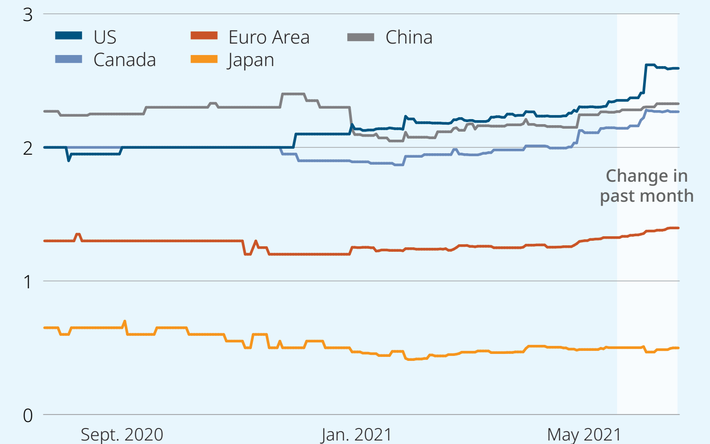
2022 real GDP growth forecast (%, consensus)



2021 inflation forecast (%, consensus)



2022 inflation forecast (%, consensus)



Source: Forecast surveys from Consensus Economics as of June 30, 2021.

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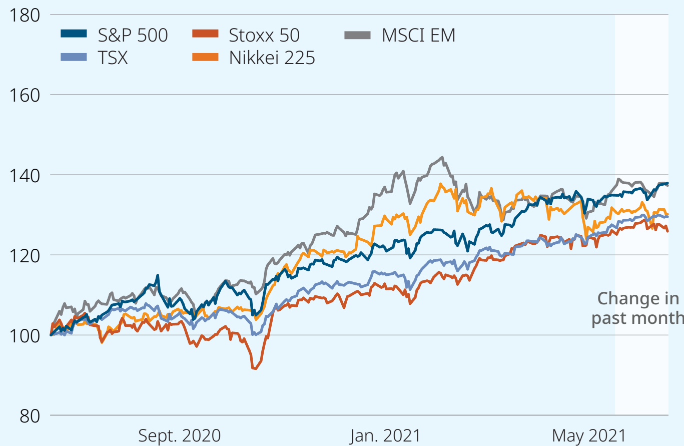
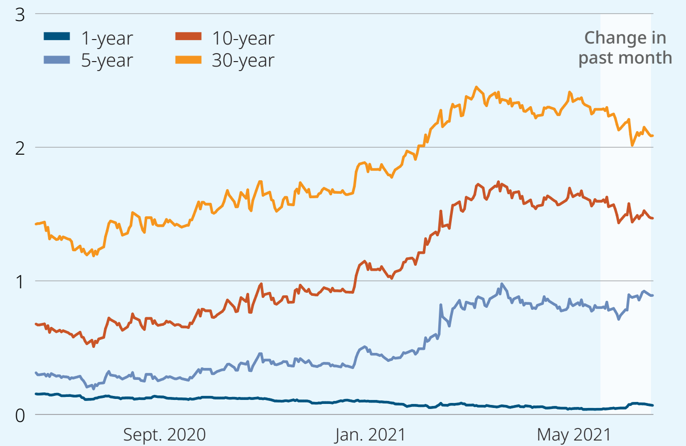
Capital markets update

- After the Federal Reserve took a hawkish turn at its June 16 policy meeting, we saw a sharp bear flattening of the **yield curve**: long bonds rallied in subsequent days, while the belly of the curve sold off. On Friday June 18, the 30-5 spread closed at its lowest level since November 2020. The bid for long bonds was mostly driven by a drop in long-term inflation expectations, as markets saw the Fed's shift as a signal it would be more proactive in pushing back against possible runaway inflation.
- The hawkish US monetary policy surprise, which sent real yields higher across the curve, caused a sharp appreciation of the **US dollar** against most major currencies. The Bloomberg DXY dollar index climbed 1.5% in the 24 hours following the FOMC announcement.
- **Oil** prices rose on the month, a sharp contrast to other commodity futures selling off, including copper, lumber and most agricultural staples.

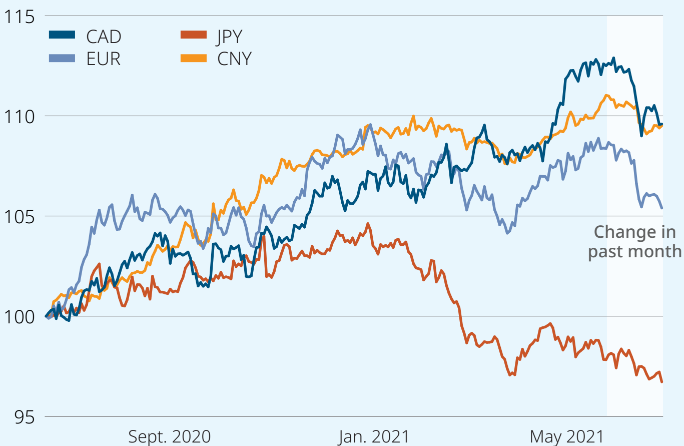
Equity indices (one year ago=100)



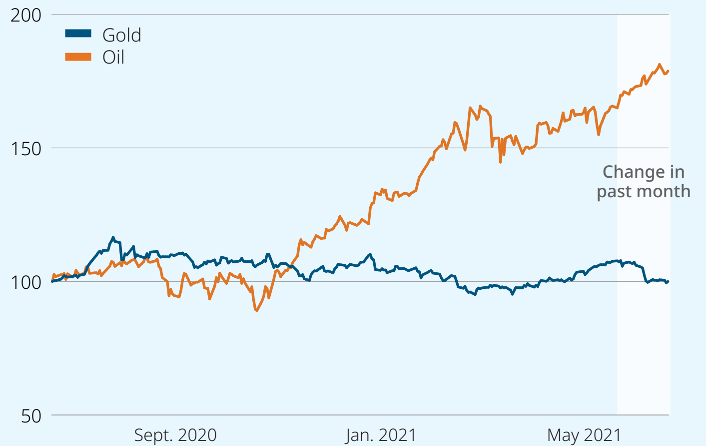
US Treasury yields (%)



Currencies (relative to USD, one year ago=100)



Commodity prices (in USD, one year ago=100)



Source: Financial data from Bloomberg as of June 30, 2021.

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What we'll be watching in July

July 13: US June CPI release

- While we agree with the Federal Reserve in seeing current US inflation as mostly transitory, price pressures won't disappear overnight. For annual 2021 inflation to end up below 3.5%, the current consensus forecast as shown on page 3, inflation for the final seven months of the year will have to clock in below 2% (annualized) on average.
- While some sources of temporary price pressures have begun to moderate – used auto prices seem to have plateaued, non-energy commodity prices are pulling back – others, like chip shortages, will take longer to normalize.

July 14: Bank of Canada rate decision

- Since the Bank of Canada's last policy meeting on June 9, inflation rose to 3.6% year-on-year, Covid lockdowns were eased across Canada, and the Fed took a slightly hawkish policy turn. These developments are probably not enough to push the BoC to pull forward its initial rate hike, but they do reinforce our expectation that it will announce further tapering of its asset purchases at its July meeting.

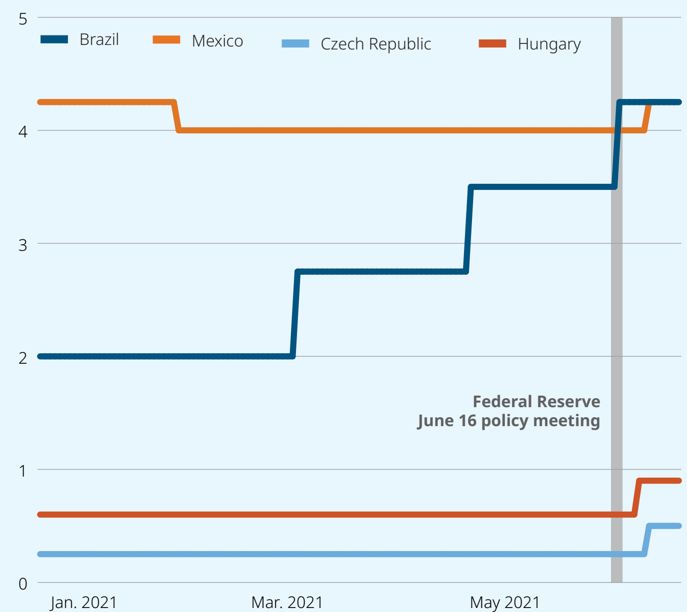
July 14: China Q2 GDP release

- China's stats agency will release a slew of data on July 14, including its reading for 2021Q2 GDP.
- With the Chinese government having withdrawn monetary and fiscal support in the first half of the year, household consumption must pick up the slack left by the pullback in private and public investment for economic growth to maintain its momentum.

Emerging theme

- While G10 central banks plan to **hold their policy rates at their pandemic floors** for at least a few more months, some smaller countries have begun their hiking cycles.
- The central banks of Brazil, Mexico, Hungary and the Czech Republic all hiked their overnight rates in the second half of June, citing **rising domestic inflation as a major concern**. The Fed's hawkish turn at its June meeting might have forced their hands: the resulting USD appreciation could generate further short-term inflation in periphery countries through exchange rate pass-through.
- **The Bank of Mexico's monetary tightening** is most worrying from a macro point of view. Mexico's government rolled out the smallest fiscal stimulus of all G20 as a percentage of GDP, its economy contracted heavily in 2021Q1 and Covid cases have recently started trending up again.
- On the other hand, **Brazil's tightening** comes in a somewhat more favorable context. Brazil's economy is benefitting from the global surge in commodity price, which has supported its undervalued currency in recent months. Its economy is growing and domestic businesses are investing. But not everything is rosy: its Covid situation is still out of control, and political instability is looming.

Periphery central banks begin raising their policy rates



Notes: Via Bloomberg as of June 30, 2021.

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Appendix:
Capital market returns in June

Group	Asset	Return
Major Asset Classes	Global Equity	2.49%
	Global Bonds	-0.76%
Regional Equity (local)	S&P 500	2.20%
	TSX	2.83%
	Nikkei	-0.08%
	FTSE 100	0.20%
	EuroStoxx 50	0.42%
	MSCI EM	0.33%
Styles	US Small Cap - Large Cap	-0.49%
	US Value - Growth	-8.06%
Sovereigns	USA 10-year Treasury Future	0.32%
	CAN 10-year Gov't Bond Future	0.83%
	GBR 10-year Gilt Future	0.65%
	DEU 10-year Bund Future	0.49%
	JPN 10-year JGB Future	0.22%
Fixed Income	US High Yield Bonds	1.25%
	US Investment Grade Bonds	1.85%
	US Leveraged Loans	0.12%
	CA Provincial Bonds	1.16%
	CA Corporate Bonds	0.60%
	CA Inflation-Linked Bonds	1.24%
Alt	Gold	-7.80%
	Oil	10.80%
	Global REIT	3.79%
	Global Infrastructure	-0.70%
FX Spot	CAD/USD	-2.79%
	GBP/USD	-2.61%
	EUR/USD	-2.72%
	JPY/USD	-0.81%

Axis: -10, -5, 0, 5, 10, 15

Source: Market data from Bloomberg as of June 30, 2021. Index returns are for the period: 2021-06-01 to 2021-06-30. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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