Inflation set to keep Bank of Canada cautious

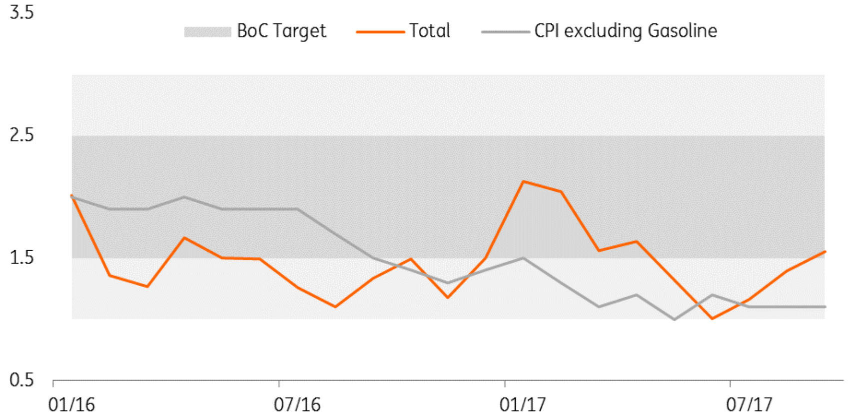
With headline inflation noticeably below target, we expect the central bank to remain on hold this year, before hiking twice in 2018

Source: Bank of Canada

CPI inflation has increased in recent months, coming in at 1.6% in September, a considerable improvement from the 1% low of June. This has been down to increases in gasoline prices, dissipating economic slack, and the fading effects of low food prices.

However, the stronger CAD (reflecting higher commodity prices), electricity rebates and low food prices are still keeping inflation below target. The Bank of Canada (BoC) is expecting CPI inflation to be similar to July's figure of 1.4% during the second half of 2017, only reaching its 2% target later in 2018 and expecting it to stay at this level in 2019.

Impact of gasoline on headline CPI



Source: Statistics Canada

Many central banks have come under scrutiny for recent inflation softness, and the Bank of Canada is no exception. All of the Bank's key measures of core inflation are below target; albeit have been moving closer to target in recent months.

In response to all of this, Governor Poloz (pictured) gave a speech on 'understanding inflation' where he emphasised "the laws of supply and demand have not been repealed" and that it has just been a consequence of excess supply.

We think the Bank will keep their policy rate on hold at 1% through to year end with two further rate hikes in 2018. This was backed up by Deputy Governor Wilkins' (pictured) speech this week, where she discussed the reasons behind the Bank's cautious approach to future interest rate decisions.

NAFTA talks are a big uncertainty for the Bank at the moment, but she also emphasized that the BoC is focused on keeping track of wages and potential output, as well as the possible impact of the two rate hikes on household debt.

Wilkins also highlighted the Bank is placing greater weight on downside risks when inflation is already low, noting that it has been low for some time now.

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