

The wayward child called inflation behaves.

Canadian CPI (Mar) flat in March, up 1.4% on the year.

CPI comes in considerably softer than expected. Headline consumer prices were flat in March, while the market median and ourselves had been forecasting a marginal 0.2% m/m increase. Year over year, the inflation settles in at 1.4%, down from February's 1.6%. Removing the impact of energy knocks annual consumer inflation back to an easily digestible 1.0%. The BoC targets a 2% inflation rate inside of a 1-3% inflation band.

Core prices actually declined -0.2%. The market median and our own forecasts had been looking for a slight increase of 0.1%. The decline in core prices yielded a year over year rate of 1.7%, well back of February's 2.1% rate.

Cry havoc and let slip the monetary dogs of war.

Today's CPI report makes for some interesting press with some softening up in the pricing data coming in on the back of the BoC move to drop the conditional pledge to hold rates at 0.25% through to the end of Q2/10.

It's just optics really. The BoC does not set policy on the back of the ebb and flow of any single set of numbers. And while we would have argued that the upward migration in inflation expectations that was seen in the latest BoC business outlook survey was largely due to higher gasoline prices and worth discounting on that factor alone, it is none the less time for the BoC to begin moving away from a rate policy which was brought to bear at a time of great uncertainty, massive market dislocation and economic recession that seemed doomed to turn into economic depression.

Instead the Bank's move to telegraph its interest in starting up the rate cycle and remove some of that monetary policy that has become superfluous is instead in response to a number of factors including improving external demand, a robust housing market, rising consumer debt and greatly improved market conditions to name just a few of the reasons to move clear of the current monetary policy.

We are looking for the BoC to begin raising rates at the June 1 meeting. An opinion shared by the bulk of the primary dealer community and an event that is largely priced into market expectations.

Behind today's numbers, well we are seeing that which has already been talked about. It turns out that all that gold Canadian Olympic athletes were minting in February was indeed inflationary. On this there is no surprise. February's readings on consumer prices showed a 3.0% m/m rise in recreation prices (primarily related to traveller accommodation) which would have added 0.4ppt on to the headline inflation rate. With the winding down of the Olympic games in March, recreation prices cascaded lower (again led by traveller accommodation), dropping by -1.5% m/m which would account for 0.2ppt falling out of the headline CPI and core rates. With the Para Olympic games winding down at the end of March, the expectation is that we will see some further pricing declines coming out of this category.

Travel services suffered an unexpected seasonal decline, dropping by -8.4% m/m, knocking out a little over 0.1ppt out of the headline prices. Travel services are typically adding to the CPI during the peak winter travel season. Winter travel packages are added into the index for the months of January through March. Shelter costs also declined by -0.1%. On the upside, gasoline prices were on the rise, up 3.7% adding a little more than 0.1ppt to the index. Apparel prices were higher as well, rising 2.6% m/m as the new spring seasonal lines hit retailer shelves at full prices.

Going forward, as we look towards the month of April, some additional cooling in recreational prices is expected as the last of the Olympic venues winds down. Moving into May and June, the impact of a base effect will help to lop some of the topside off the headline inflation rate, further reducing the overall CPI footprint. Recall that gasoline prices were on the move in May (+8.3% m/m) and June (6.8% m/m) of 2009 which raised the base index over which the year over year number will be calculated.

Net, net, there is a need to look beyond the one report and concentrate on the broader economic story as being told by the BoC. Monetary policy isn't about what prices were doing in March 2010, but what are the expectations for prices in March 2011. On that basis, policy is more about what the BoC assumptions are as they pertain to output gaps and capacity utilization, along with the flavoring afforded by changes in inflationary expectations. In that vein, with the output gap closing rapidly, (BoC advanced its expectations for its closing by a full quarter) and while we would argue that the upward drift in inflation expectations was potentially a bit of a red herring, the BoC is likely focusing its efforts on these factors rather than the historical look back on prices afforded by today's CPI.

Disclosure appendix

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