Bull's eye....close enough anyways

Canadian CPI (Jan) 1.9% y/y, Core 2.0% y/y

CPI comes in largely in line with street expectations, rising 0.3%m/m on the headline and 0.1%m/m on the core. Year over year, headline prices are up 1.9% while the core is running at 2.0%, largely in line with the BoC objective to target a 2% inflation rate.

On a seasonally adjusted basis, x-food and energy, CPI declined -0.1%m/m or 1.2%y/y.

Underneath the change in headline prices, gasoline prices ran stronger than expected, rising by 3.6% m/m vs the 2.4% m/m we had assumed and contributing more than 0.1ppt to the total change in monthly CPI. Auto prices were up 1.0% m/m, again contributing nearly 0.1ppt to CPI. Although it is quite common to see some discounting in the auto sector at this time of year, brisk sales and lean inventories are believed to have helped maintain pricing points. Food prices rose 0.4% m/m on the back of seasonal increases for perishables.

On the downside, apparel prices failed to recover any pricing power in January with prices continuing to decline, dropping -0.6% m/m in January, following December's -4.7% m/m plunge. Recreation prices dropped -1.7% m/m in line with expectations. Weaker prices largely a function of the -8.2% m/m drop in travel services costs in keeping with seasonal norms. February will see travel services recoup price declines as the travel season kicks into high gear.

Headline CPI is up 1.9% y/y while the core is running at 2.0% y/y. That puts CPI in line with the BoC's target rate at 2%. However, the picture on prices is marred by the impact of gasoline prices. Year over year CPI continues to be propped up by the base effect associated with the price for gasoline which are up 23.9% y/y (accounting for 0.9ppt of total CPI). This is in contrast to last year when in January 2009 gasoline prices were plunging at a rate of -23.5% y/y (pulling 0.9ppt out of headline CPI).

With nearly half of the growth in headline prices flowing from what is expected to be a transitory pricing shock associated with gasoline, the BoC is unlikely to be overly ruffled by the fact that inflation is on target so early on into the economic recovery.

Instead, the BoC and for that matter much of the developed world's central banks, which continue to struggle with scads of excess capacity, there is a willingness to discriminate between price shock inflation and inflation that flows from capacity constraints and economic bottlenecks. If for no other reason than the fact that for Canada the impact is expected to be transitory with the gasoline base effect dissipating by May of this year.

But so too the idea that for the BoC the base effect is more of a mathematical problem than a policy problem given that the base effect is unlikely to have an impact on consumer inflation expectations as it is a function of that which has already happened to prices rather than a function of current changes to pricing levels which have a greater impact on consumer expectations. On this front the BoC can take some considerable comfort from its own survey data that suggests inflation expectations remain well contained, anchored around the BoC's own 2% inflation target.

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And then there is the output gap. Assumptions here continue to suggest that there is a significant slug of economic capacity that continues to lay idle. A view again supported by the BoC's own survey data that suggests that the economy is unlikely to bump up against any significant capacity constraints anytime soon.

On that basis, the current readings on headline and core CPI pose little threat to BoC policy or the Bank's pledge to hold rates at 25bps through to the end of Q2/10. We do not see the BoC raising rates until September of 2010.

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Disclosure appendix

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