QV UPDATE

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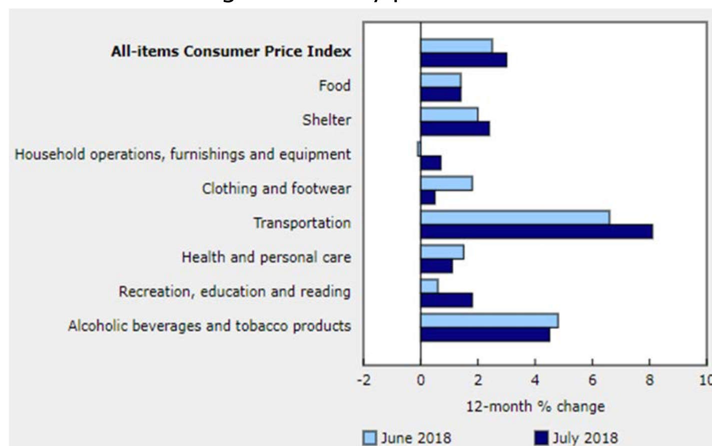
Summer Activity

Like many Canadians, I enjoy spending the summers exploring our great country and this often involves a lot of driving. As I travelled the highways in BC, Alberta, and Saskatchewan this summer, I noticed more traffic and a lot more trucks hauling cargo than in previous years. The ferries, campsites, restaurants and hotels seemed full. All anecdotal evidence of a bustling economy.

Given this heightened summer activity, it was not too much of a surprise that Canada's latest annual inflation rate rose to 3.0% in July, the highest level since September 2011. Rising airfares and gasoline prices accounted for a good portion of this increase. However, every component of the Consumer Price Index (CPI) rose in July, as shown in the table below. Demand is strong, spare capacity is scarce, and input costs are rising. These factors are all indicative of rising inflationary pressures.



Source: Statistics Canada

The Bank of Canada is focused on an inflationary target of 2.0%. Monetary policy is either accommodative or restrictive based on this objective. Typically, they focus on the core measure of inflation, which excludes prices for more volatile items, to track inflationary pressures. The Bank of Canada's preferred core measure recorded a lower gain at 1.9% year over year, perhaps justifying their gradual approach to policy rate increases thus far.

Canada's overnight policy rate, currently at 1.5%, is lower than both inflation measures, implying a negative real interest rate (the interest rate less the inflation rate) environment. Negative real bond yields persist across Canada's sovereign bond yield curve when factoring in total CPI. With our economy growing at an annual rate of 2.9%, based on second quarter Gross Domestic Product (GDP) data, we are hardly experiencing recessionary conditions that would warrant negative rates as incentive for investment. A worry is that the Bank of Canada's gradual pace of tightening is too slow, and inflation expectations will accelerate. With very little movement in bond yields through the summer despite the high inflation reading, it appears that bond investors and the Bank of Canada are betting that total CPI will quickly fall to 2.0%, in line with more moderate economic growth.

A slowing housing market and the threat of trade disruptions have continued to weigh on Canada's growth outlook over the last year. Given our heavy reliance on exports and the housing sector to support the Canadian economy, it is not surprising that expectations are low for another inflation reading above 3.0%. The surprise comes from the fact that our economy continues to experience decent growth with accompanying inflation pressures despite the imposition of tariffs, tighter lending conditions, and the threats of a NAFTA termination. We can attribute some of this growth to our accommodative interest rate policies and low unemployment, supporting consumption. We can also thank a strong US economy which is helping to boost exports.

Time will tell whether this inflation reading is a summer anomaly, or a sign of a stronger economy. As they confirmed this week with the decision to maintain the overnight rate, we expect the Bank of Canada to continue its gradual rate increases providing their preferred inflation gauge is near 2.0%. Maintaining a lower overnight rate and slower pace of tightening compared to the US should keep our dollar lower, supporting our exports. This may also potentially help to buffer any negative impacts to our exports if a North American free trade agreement cannot be reached.

Our bond strategy remains focused on achieving a positive real yield when adjusted for inflation. That has meant investing primarily in higher yielding corporate, provincial, and municipal bonds. It has also meant maintaining a bond portfolio with a short average term to maturity in the view that longer term bond yields are too low and do not compensate for rising inflationary risks.

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