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HIGHLIGHTS

- Core inflation did not moderate as much as could have been expected given the severity of the recession.
- A robust recovery in demand for Canadian goods and services has supported the return of core inflation to the Bank of Canada's 2% target.
- As the year progresses a strong Canadian dollar, the slack in the Canadian economy, and moderating food prices will offset some of the inflationary pressures stemming from the domestic economy's strength over the year.
- Core inflation is expected to moderate slightly to the range of 1.6-1.8% for much of 2010, and only gradually climb back to its 2% level by mid-2011.
- Increasing borrowing rates will temper domestic demand in the latter half of 2010 and 2011. As such, we expect core inflation will be subdued at 2% for the second half of 2011.

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CANADIAN INFLATION - STICKY TO THE CORE

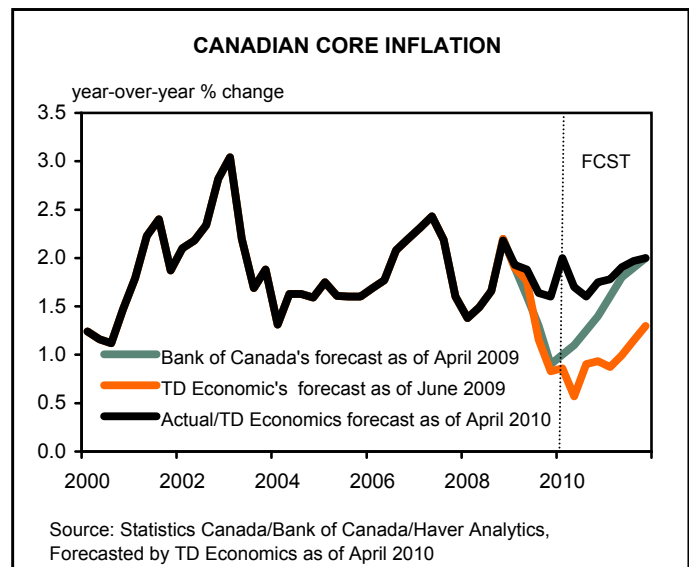
Canadian core inflation has taken centre stage as markets attempt to pin-point the future path of monetary policy. Over the first three months of 2010, core inflation hovered near 2%, taking markets by surprise. The March data saw core inflation ease to 1.7%, partly due to the unwinding of temporary price increases due to the Olympics in February. Even so, this rate of inflation is high by historical standards at this stage of the economic recovery. If we rewind to April 2009, when the Bank of Canada lowered the overnight rate to just 0.25% and made its conditional commitment to keep it there until the end of the second quarter of 2010, the outlook at that time was for core inflation to average 1.1% over the first half of 2010. Our

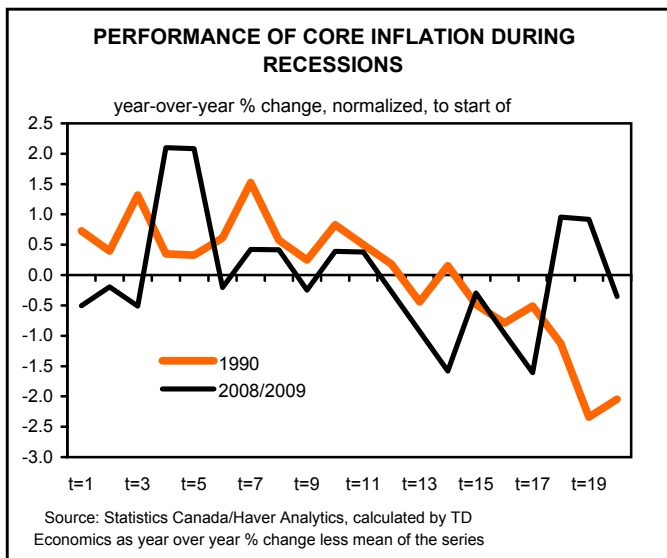
own view was slightly more dovish. The unanticipated stickiness in core inflation in early 2010 cannot be fully explained by credible inflation targeting. Indeed, until recently markets were also anticipating a greater moderation in core inflation. This begs the question, what prevented core inflation from falling more convincingly given the degree of economic slack that

accumulated over the recession. Core inflation did not slow as much as could have been expected given the severity of the recession. The explanation for the surprise was the strength in domestic demand. And, this has implications for the inflation outlook. Firm domestic demand through the end of 2009 and the beginning of 2010 has made it highly unlikely that inflation will deviate too far from its current pace of 2%. In particular, we anticipate the recent strength in the housing market will bolster core inflation through the year. However, the good news is that inflation is unlikely to get out of hand. A strong Canadian dollar, slack in the Canadian economy, and moderating food prices will offset some of the inflationary pressures stemming from the domestic economy's strength over the year. As a result, core inflation is expected to hold in a range of 1.6-1.8% for much of 2010, and only gradually climb back to its 2% level by mid-2011.

Surprise! The Inflation story so far....

Given historical experience, it was reasonable to expect core inflation to moderate to below 1% in the initial stages of a recovery. First, non-labour input costs fell significantly over the downturn, and remained soft through to February of this





year. Annual core inflation follows the industrial producer price index with a three to four-month lag. History suggests that given the degree of cost reductions, core consumer price inflation should have slowed to below 1%. Second, right up until the end of 2009, core inflation followed the same growth path taken during the 1990's recession. The output gap, a measure of the amount of slack in the Canadian economy, is identical to that during the initial stages of economic recovery after the 1990's recession. Yet over the last three months, core inflation has begun to significantly exceed the trajectory of growth experienced during the two years following the start of the 1990's recession. Part of the rise in core consumer prices over the first two months of this year can be linked to temporary effects, such as a sharp jump in the price of travel services due to the olympics in February, and a base year affect in January. Even as these

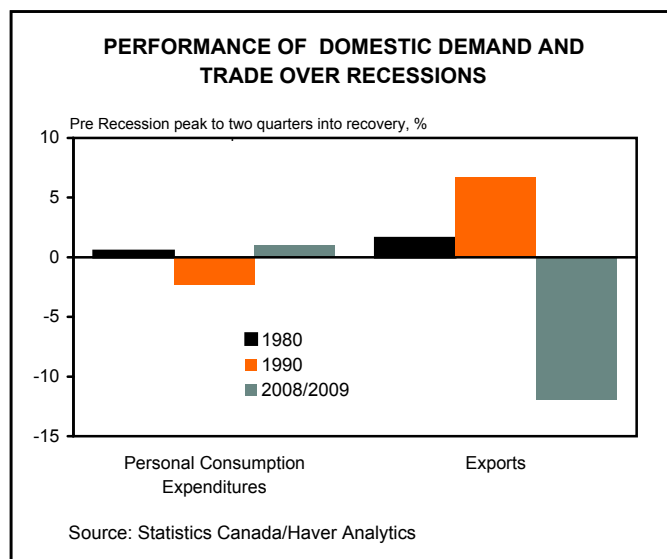
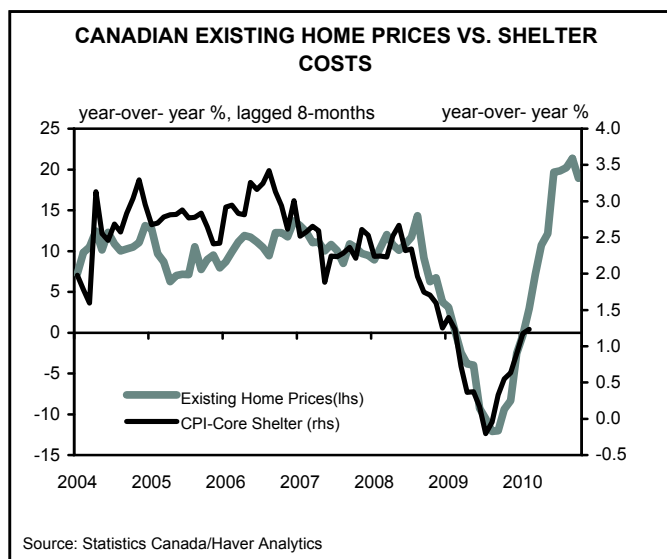
temporary effects fell out of the equation in March, core inflation remained elevated at 1.7% relative to historical experience. If annual core inflation had taken the same path as in the 1990s, inflation would currently be moderating to below 1%.

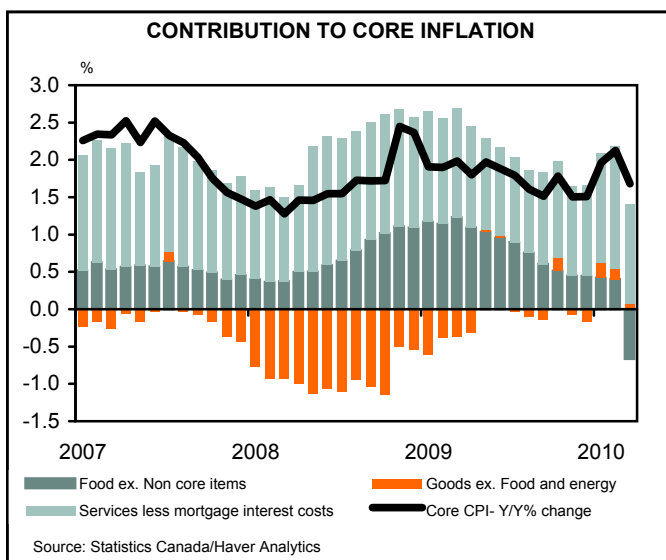
The surprise in core inflation has been broad based. In fact the only component of core inflation that has behaved as expected has been food prices. Food prices included in the core measurement (which only excludes fresh fruit and vegetables) slowed from a high of 5.6% in March of 2009, to just 1.6% in March of 2010. This was unrelated to a base year affect, as food price inflation has cooled significantly on a 3-month moving average.

Strength in domestic economy drives inflation

However, it turns out that the 1990's was a poor guide as to what to expect this time around because the nature of the recession was very different. During the 1990's recession, the downturn was largely concentrated in the domestic economy, while growth in international trade remained positive. In contrast 2008/2009 was not a made-in-Canada recession, and Canada's economic woes stemmed from external pressures.

Canada's domestic demand experienced a very short-lived contraction at the onset of the recession. As fears of a global depression abated, domestic demand recovered rather quickly. Personal consumption expenditures have not only rebounded from the downturn, but have grown 1.1% above the pre-recession peak. This contrasts to the 1990's recession, when personal consumption expenditures were still 2.3% below the pre-recession peak at the same point of the economic recovery.





Above all, never in history has the housing market bounced back so quickly after a recession so deep. Home prices do not feed directly into core consumer prices except through the homeowner’s replacement costs. However, the increase in housing demand, as evidenced by the increase in home prices, bolsters demand for housing-related services. The astonishing uptick in housing demand that began in the spring of 2009 has influenced the price of services with a seven to nine-month lag. Likely related to housing demand, consumers have experienced a sharp rise in the costs of internet, home phones, and television services.

This strength in the domestic economy has meant that service inflation did not moderate as much as would have been expected.

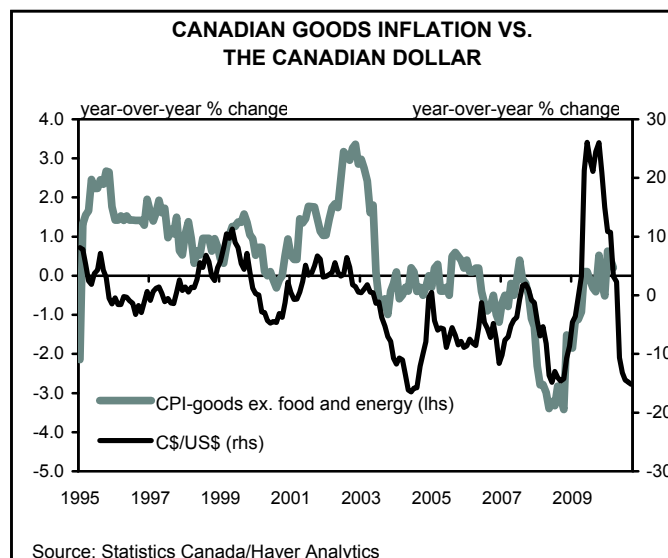
High labour costs likely reflected in consumer prices

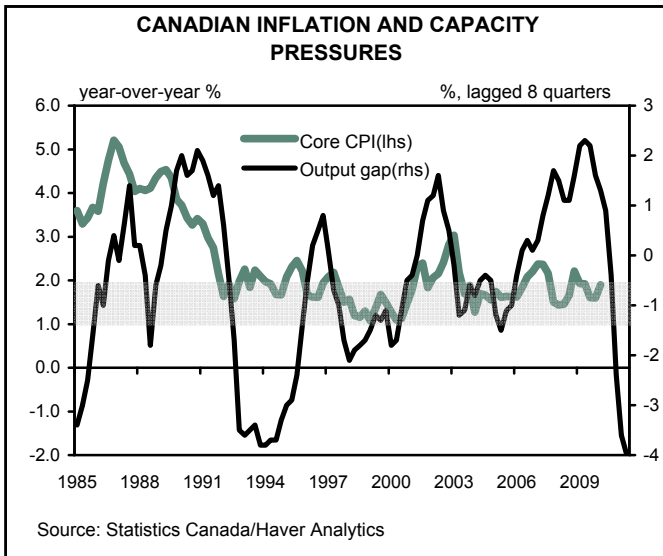
Moreover, while the 3.6% peak-to-trough decline in real GDP was equal to that of the 1990s’ recession, the employment losses this time around were less severe. The unemployment rate only increased 2.8 percentage points, peaking at 8.7% – about half the increase experienced over the 1990’s downturn. Not only have labour markets remained relatively healthy when compared to the 1990s’ recession, the peak of 8.7% was lower than the 10% expected at the onset of the recession. This has meant that labour input costs increased significantly over the recession, as employers did not shave employment by as much as could have been the case given the severity of the downturn. Indeed, real personal incomes rose 1.7% over the downturn. While this is not great, this is the first economic recession for which real personal disposable income did not decline. These higher labour costs in turn get passed onto consumer prices.

Loonie ups the ante in February

Meanwhile, goods prices are not the source of disinflation as they once were. The prices of goods, excluding food and energy went through three years of disinflation. This downward pressure on inflation has now ebbed, and goods inflation turned slightly positive in the first three months of 2010. Goods in Canada are highly tradeable, and as such the price of these items are sensitive to currency movements. Many have interpreted the last few months of strong core inflation to mean that the cost savings associated with the recent currency appreciation were not being passed through to Canadian consumers. However, in our view, consumers were likely still paying the price of the sharp depreciation in the loonie that began in late 2008. Annual percent changes in the value of the Canadian dollar feed into consumer goods inflation with a six-month lag. From October 2008 to September 2009, the loonie depreciated an average of 16% from year-ago levels. At 0.92 U.S. cents in September of 2009, the Canadian dollar was still slightly below its year ago level of 0.95 U.S. cents – and likely remained an upward inflationary pressure until February 2010. This influence has likely run its course, and the Canadian dollar should return as a disinflationary source in the coming months. There may be some preliminary evidence that this is taking root. Excluding the purchase of autos and motor vehicles the price of goods included in the core consumer price index fell in March.

Moreover, the sharp ascent in the Canadian dollar since October of 2009 left many concerned that manufacturers and Canadian exporters would be left reeling, even as global economic growth picked up steam. This has certainly not





been the case over the last few months. Manufacturing and wholesale trade data have been beating expectations, despite upward pressure on the Canadian dollar. The inventory-to-sales ratios for the two major sectors have now returned to historical levels, leaving firms with less incentive to provide discounts to attract buyers. An example is in the automotive industry where dealers have ended the deep purchase incentive programs offered to customers over the recession, contributing significantly to the rise in goods inflation over the first three months of 2010. Even here, there are early signs that auto dealers are starting to reintroduce some discounts due to the rise in the Canadian dollar.

Inflation to hover near 2%

Stronger than anticipated demand for Canadian goods and services has supported core inflation of 2% over the beginning of 2010. Our view is that core inflation will slip slightly to a 1.6-1.8% range as 2010 progresses. In fact, the Bank of Canada’s outlook survey conducted in the first quarter of 2010 supports this view. The survey showed that the bulk of firms expect inflation to remain in the 1-2% range over the next two years. Moving further into 2010, there will be offsetting forces. On the one hand, firm domestic demand in the first half of the year will exert some upward pressure on inflation. In particular, the lagged impact from the housing rebound will continue to influence the price of housing related services over the year. On the other hand, the lagged impact from the slack in the Canadian economy, and a strong Canadian dollar will temper the strength stemming from the domestic economy.

Excess capacity will limit upside to core inflation

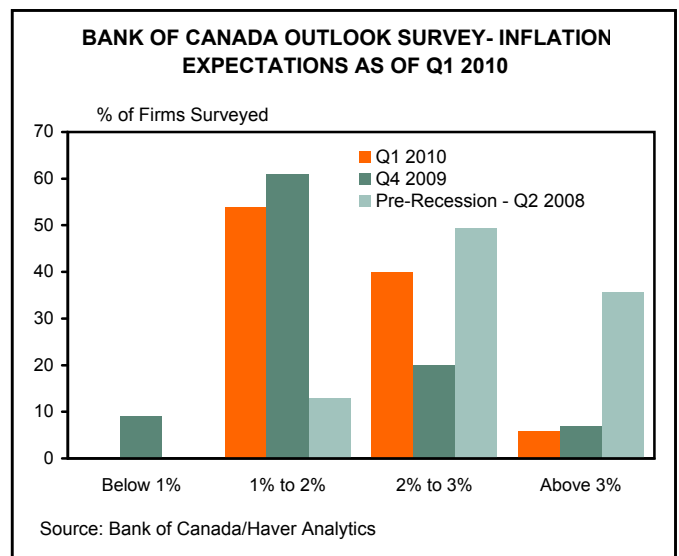
First, a lagged effect of the past slack accumulated in the

economy over the downturn will continue to exert downward pressure on prices. We don’t think that core inflation will adjust as significantly as it has during past downturns, but we do think that the overall amount of excess capacity will have some dampening impact on firms’ pricing power. It can take time for inflationary/disinflationary pressures, as gauged by the traditional output gap to feed into prices and wages. This suggests that the past slack accumulated over the economic downturn can continue to exert downward pressure on prices and wages over the rest of 2010, even as economic momentum remains firm.

While the labour market was not hit as hard on the way down, it may not benefit as much from a pick-up in economic activity on the way up. After falling from its peak of 8.7%, the unemployment rate has stalled at 8.2% over the first three months of 2010. This rate of unemployment is elevated compared to the last decade. When it comes to wage settlements, the slack in the labour market has meant that bargaining power remains in the hands of the employers. Annual average hourly wage growth has averaged 2% over the first three months of 2010 – just enough to keep up with inflation. This contrasts with 2009, when average hourly wages grew 2-3 percentage points above core inflation. We acknowledge that wages were not hit as hard through the recession as could have been the case, but we feel there is scope for continued sluggishness in wage growth going forward.

The strong dollar will pull prices back

Second, the recent strength in the Canadian dollar will weigh on prices. The Canadian dollar has appreciated an average of 15% from year ago levels from October 2009





to April 2010. Firm commodity prices, a relatively sound fiscal position, positive sentiment about Canada's economic prospects, and anticipation that the Bank of Canada will raise interest rates ahead of the Fed will likely keep the currency strong for quite some time. The loonie is expected to hover around parity for all of 2010 – representing a 16% appreciation from 2009 levels. With a typical six-month lag for a currency movement to feed into goods inflation, the Canadian dollar should become a disinflationary pressure on prices by the Spring. We have estimated that the Canadian dollar will shave an average of 0.6 percentage points off core inflation for the rest of 2010.

Moreover, we should continue to see core consumer food prices ease over 2010. Input costs for food producers have come down significantly over the last year, and we expect them to contract through to mid-2010, largely owing to the appreciation in the Canadian dollar. It takes about a year for these lower costs to show up in the final price paid by consumers. Therefore, we expect food prices, excluding fresh fruit and vegetables, to moderate over the next year.

Inflation pressures to remain subdued in 2011

The landscape for inflation will change markedly in 2011. The blockbuster performance of 5% annualized growth in real GDP in the fourth quarter of 2009, followed by what is looking to be a repeat performance in the first quarter of 2010 means that the slack accumulated over the downturn will be eaten up at a much quicker pace than originally anticipated. However, the current 5% pace of domestic demand is unsustainable, and we anticipate that it will cool in the range of 2-2.5% in the second half of 2010, and carry through to 2011. This will offset some of the capacity pressures that are building for 2011. It has become more likely that the Bank of Canada will move with the first interest rate hike in June. We anticipate that the Bank of Canada will move with gradual 25 basis point hikes over each fixed rate announcement in 2010 and 2011. This will work to cool the recent momentum in the housing market. Five-year

mortgage interest rates have already risen by 0.6 percentage points in anticipation of the first Bank of Canada rate hike. Moreover, the increased indebtedness of Canadian households has likely left households more vulnerable to rising interest rates. As such, increasing borrowing rates will temper domestic demand in the latter half of 2010 and for all of 2011. As such, we expect core inflation to hold at 2% for the second half of 2011, with the output gap closing at that time.

Conclusion

The return of core inflation to the Bank of Canada's 2% target through the beginning of 2010 took many economists by surprise as it was a pace not anticipated for at least another year. Given the degree of excess capacity in the Canadian economy, it seemed reasonable to anticipate a further dampening in core inflation than actually occurred. As it turns out, the overall slack in the Canadian economy was not a good measure of inflationary pressures. Most of the country's economic woes stemmed from external pressures with trade being hit the hardest. Meanwhile, domestic demand has recovered much more quickly than in past downturns. This was not a made-in-Canada recession, and the nature of this recession has meant that inflation movements were influenced by strong domestic conditions, while external demand shocks had less of a negative impact than was anticipated.

Going forward, firm demand for Canadian goods and services in the second quarter of 2010 will continue to exert upward pressure on price growth. However, as the year progresses, the slack in the Canadian economy, a strong Canadian dollar, and moderating food prices will temper this influence. As such, we anticipate that core inflation will slip slightly in the range of 1.6-1.8%, and only gradually rise to 2% by mid-2011. At that time, the dominant constraint on inflation will be a slowing in domestic demand over the next two years