Economics

THE WEEK AHEAD

March 14-18, 2022

Will the *real* real rate please stand up

by **Avery Shenfeld** avery.shenfeld@cibc.com

Investors have done a U-turn in their assessment of what Russia's invasion of Ukraine will mean for US monetary policy ahead. A brief flirtation with the idea that the war's economic costs would temper the rate hike path has been quickly reversed, with the February CPI data being a further reminder that inflation is breaking out in just about every major category of goods and services.

There's no disagreement about what the Fed needs to do. It has to find the path for interest rates that will moderate demand growth and prevent a further tightening in labour markets, so as to bring inflation down to earth, while not sending the economy into recession in the process. It can and should tolerate a CPI overshoot from a supply shock in energy and grains, but not the broader run we're seeing in categories like rent that are tied to domestic demand, or an escalation in wages that would push up pricing power and costs across the board.

In assessing the war's impact on Fed policy, it comes down to whether which Russia's invasion will have changed the interest rate needed to engender that economic moderation. In a word, our answer is "no". Assuming, that is, the Fed is successful.

Success would mean getting inflation back to 2% by late 2023 and keeping it there in 2024. That would likely require a deceleration in economic growth to 2% or a bit less in 2024. To do that, we would likely need a real short term rate near what economists see as the so-called "neutral rate". Model based estimates suggest a real neutral rate of roughly 0.5%, hence our forecast for a gradual path towards an overnight rate in the 2½% range by early 2024, tacking on a 2024 inflation rate of 2%.

Some would argue that you need to tack that real rate onto today's elevated inflation rate, implying that the nominal neutral rate is now sky high. But that's true only for the short term real rate, and its deeply negative state will be fleeting if Fed tightening works to bring inflation lower again. Further out the yield curve, medium term inflation expectations are well grounded. If an aggressive Fed tightening pushed nominal 10-year rates to 4% this year, that wouldn't be a low real yield for borrowers if, as is true for now, inflation is expected to be much lower after 2023.

As long as those expectations stay grounded, the fact that the war has elevated the scale of this year's inflation peak should mean little to the dose of rate hikes needed to moderate growth and inflation further out. Indeed, the Fed would risk triggering a recession if it moves too quickly, and combines a sharp squeeze on borrowers with the hit to consumer purchasing power and confidence emanating from higher gasoline prices.

The need to be careful in that regard is a reason why we expect the Fed to take some pauses en route to pushing rates over 2%, in order to ensure that the economy is still moving forward. Any upturn in Covid severity could be part of that story, something we're still watching given that in the wake of dropping all public health restraints, the UK is seeing an upturn in Covid hospitalizations and cases.

The FOMC appears to sense the need to balance such risks, with the leadership seeming to reject the voices on the committee calling for a 50 basis point first step. Better to avoid roiling markets that are already on edge as a result of the invasion of Ukraine.

What's been a puzzle for us has been futures market's pricing for yields beyond 2024, which implied a quick turn to easier monetary policy after that. That could indeed happen if the economy got hit by a new shock that year. But otherwise, it makes more sense to assume that we'll need to retain rates in the mid-2% range for a while. The market might be sensing that too, with 10-year Treasuries nudging above 2% as markets rethink their early flight to safety rally.

Week Ahead Calendar And Forecast—Canada

H, M, L = High, Medium or Low Priority
SAAR = Seasonally Adjusted Annual Rate
Consensus Source: Bloomberg

Date	Time	Economic Releases, Auctions and Speakers	Month	Priority	CIBC	Consensus	Prior
Monday, March 14	-	Government Bond Purchase Program (GBPP): 10-YR	-	-	-	-	-
Monday, March 14	-	AUCTION: 10-YR CANADAS $340M	-	-	-	-	-
Tuesday, March 15	-	AUCTION: 3-M BILLS $8.6B, 6-M BILLS $3.2B, 1-YR BILLS $3.2B	-	-	-	-	-
Tuesday, March 15	8:15 AM	HOUSING STARTS SAAR	(Feb)	(M)	235K	-	230.8K
Tuesday, March 15	8:30 AM	MANUFACTURING SHIPMENTS M/M	(Jan)	(M)	-	-	0.7%
Tuesday, March 15	9:00 AM	EXISTING HOME SALES M/M	(Feb)	(M)	-	-	1.0%
Wednesday, March 16	8:30 AM	CPI M/M	(Feb)	(H)	1.0%	-	0.9%
Wednesday, March 16	8:30 AM	CPI Y/Y	(Feb)	(H)	5.6%	-	5.1%
Wednesday, March 16	8:30 AM	CPI Core- Common Y/Y%	(Feb)	(M)	-	-	2.3%
Wednesday, March 16	8:30 AM	CPI Core- Median Y/Y%	(Feb)	(M)	-	-	3.3%
Wednesday, March 16	8:30 AM	CPI Core- Trim Y/Y%	(Feb)	(M)	-	-	4.0%
Wednesday, March 16	8:30 AM	WHOLESALE TRADE M/M	(Jan)	(M)	-	-	0.6%
Thursday, March 17	-	Government Bond Purchase Program (GBPP): 2-YR	-	-	-	-	-
Thursday, March 17	-	AUCTION: 3-YR CANADAS $205M	-	-	-	-	-
Friday, March 18	8:30 AM	INT'L. SEC. TRANSACTIONS	(Jan)	(M)	-	-	$37.56B
Friday, March 18	8:30 AM	RETAIL TRADE TOTAL M/M	(Jan)	(H)	2.4%	-	-1.8%
Friday, March 18	8:30 AM	RETAIL TRADE EX-AUTO M/M	(Jan)	(H)	-	-	-2.5%

Week Ahead Calendar And Forecast—United States

H, M, L = High, Medium or Low Priority
SAAR = Seasonally Adjusted Annual Rate
Consensus Source: Bloomberg

Date	Time	Economic Releases, Auctions and Speakers	Month	Priority	CIBC	Consensus	Prior
Monday, March 14	-	-	-	-	-	-	-
Tuesday, March 15	8:30 AM	NEW YORK FED (EMPIRE)	(Mar)	(M)	-	7.2	3.1
Tuesday, March 15	8:30 AM	PPI M/M	(Feb)	(M)	0.8%	1.0%	1.0%
Tuesday, March 15	8:30 AM	PPI M/M (core)	(Feb)	(M)	0.5%	0.6%	0.8%
Tuesday, March 15	8:30 AM	PPI Y/Y	(Feb)	(M)	-	10.0%	9.7%
Tuesday, March 15	8:30 AM	PPI Y/Y (core)	(Feb)	(M)	-	7.2%	6.9%
Tuesday, March 15	4:00 PM	NET CAPITAL INFLOWS (TICS)	(Jan)	(L)	-	-	$114.5B
Wednesday, March 16	7:00 AM	MBA-APPLICATIONS	(Mar 11)	(L)	-	-	8.5%
Wednesday, March 16	8:30 AM	RETAIL SALES M/M	(Feb)	(H)	0.6%	0.4%	3.8%
Wednesday, March 16	8:30 AM	RETAIL SALES (X-AUTOS) M/M	(Feb)	(H)	1.0%	0.8%	3.3%
Wednesday, March 16	8:30 AM	RETAIL SALES CONTROL GROUP M/M	(Feb)	(H)	0.2%	0.4%	4.8%
Wednesday, March 16	8:30 AM	IMPORT PRICE INDEX M/M	(Feb)	(L)	-	1.6%	2.0%
Wednesday, March 16	8:30 AM	EXPORT PRICE INDEX M/M	(Feb)	(L)	-	1.6%	2.9%
Wednesday, March 16	10:00 AM	BUSINESS INVENTORIES M/M	(Jan)	(L)	-	1.1%	2.1%
Wednesday, March 16	10:00 AM	NAHB HOUSING INDEX	(Mar)	(L)	-	81	82
Wednesday, March 16	2:00 PM	FOMC RATE DECISION (UPPER BOUND)	(Mar 16)	(H)	0.50%	0.50%	0.25%
Wednesday, March 16	2:00 PM	FOMC RATE DECISION (LOWER BOUND)	(Mar 16)	(H)	0.25%	0.25%	0.00%
Wednesday, March 16	2:30 PM	Speaker: Jerome H Powell (Chairman) (Voter)	-	-	-	-	-
Thursday, March 17	8:30 AM	INITIAL CLAIMS	(Mar 12)	(M)	-	-	227K
Thursday, March 17	8:30 AM	CONTINUING CLAIMS	(Mar 5)	(L)	-	-	1494K
Thursday, March 17	8:30 AM	HOUSING STARTS SAAR	(Feb)	(M)	1685K	1695K	1638K
Thursday, March 17	8:30 AM	BUILDING PERMITS SAAR	(Feb)	(H)	1850K	1865K	1895K
Thursday, March 17	8:30 AM	PHILADELPHIA FED	(Mar)	(M)	-	15.0	16.0
Thursday, March 17	9:15 AM	INDUSTRIAL PRODUCTION M/M	(Feb)	(H)	0.2%	0.5%	1.4%
Thursday, March 17	9:15 AM	CAPACITY UTILIZATION	(Feb)	(M)	77.8%	77.9%	77.6%
Friday, March 18	10:00 AM	EXISTING HOME SALES SAAR	(Feb)	(M)	-	6.2M	6.5M
Friday, March 18	10:00 AM	EXISTING HOME SALES M/M	(Feb)	(M)	-	-4.6%	6.7%
Friday, March 18	10:00 AM	LEADING INDICATORS M/M	(Feb)	(M)	-	0.3%	-0.3%
Friday, March 18	1:20 PM	Speaker: Thomas I. Barkin (President, Richmond)	-	-	-	-	-
Friday, March 18	2:00 PM	Speaker: Michelle W Bowman (Governor) (Voter)	-	-	-	-	-

Week Ahead's market call

by Avery Shenfeld

In the **US**, and everywhere else, markets will continue to be swayed by developments in Ukraine, and on varying assessments of what sanctions on Russia will mean for energy and other commodities. But it's also a busy week ahead for economic news. The Fed will deliver a widely telegraphed quarter point hike, but its statement will have to sound very hawkish, since it needs to justify that move and warn of a lot more to come. Elevated inflation will mean that nominal series like retail sales will exaggerate their real growth implications, and we're a bit below consensus on control group sales as well as industrial production. If you're still watching Covid, keep an eye on UK case counts and hospitalizations, which are creeping up, perhaps foreshadowing where the US could head given that Boris Johnson led the way in dropping masks and other public health restraints.

In **Canada**, while not yet as alarming as the US figures, the February CPI will be alarming enough, with a further gasoline-driven spike coming in March. January retail trade showed a rebound in the flash estimates after a weak December, and we'll be eyeing February's flash figures for the first signs of how a huge job gain that month impacted activity. Our forecast has been for another three quarter point hikes from the BoC, but if Q1 growth also tops our projections, we might bring forward one of our 2023 hikes into this year.

Week Ahead's key Canadian number: Consumer price index—February

(Wednesday, 8:30 am)

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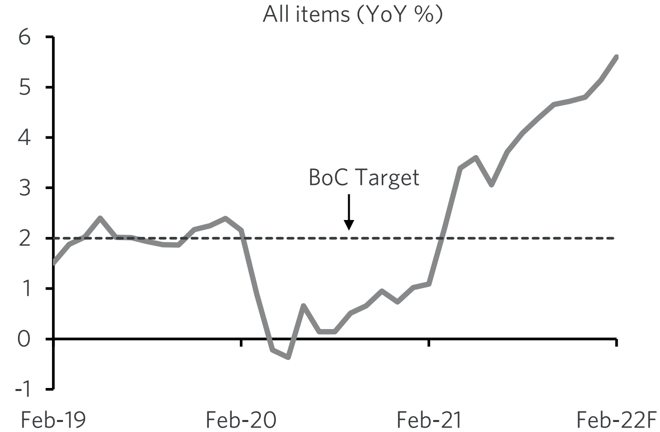
Variable (%)	CIBC	Mkt	Prior
CPI NSA (m/m)	1.0	-	0.9
CPI (y/y)	5.6	-	5.1

Chart: Canadian consumer price index (YoY %)



Source: Statistics Canada, Haver Analytics, CIBC

Inflation shot higher in January, and a repeat performance is expected in February, with the usual suspects leading the way. Increases in food prices, including a big jump in dairy costs, will accompany further gains in energy and a reacceleration in owned accommodation expenses. The reopening of service industries may have also brought stronger price increases for restaurants, air fares and other such activities.

The 1.0% monthly gain that we expect would see the headline reading climb to 5.6%. If stronger price increases are seen in reopening services as well as goods, the average of the Bank of Canada's three core measures could also continue to creep higher.

Forecast implications — Prior to Russia's invasion of Ukraine, February was shaping up to be the peak for inflation. Clearly that's no longer the case, given the spike higher in energy prices and likely pass through from agricultural and other commodity prices onto consumer as well. Even though oil has pulled back from its peak, headline inflation could well accelerate close to, or even just above, 6% in March. The deceleration later in the year may also be slower than we had previously expected due to renewed supply chain disruptions.

Other Canadian releases: Retail sales—January

(Friday, 8:30 am)

Advance data suggested a healthy 2.4% rebound in retail sales during January, and we have little reason to suspect a significant revision to that figure. More interesting will be whether sales built on that gain in February's advance estimate. Auto sales appear to have improved slightly that month, and clothing sales could have seen a healthy gain as shoppers prepared for more social gatherings once again. However, given the scale of inflation, a 1-1½ % gain in headline retail sales would equate to little growth in real terms.

Housing starts—February

(Tuesday, 8:15 am)

Permit applications have decelerated a little in recent months, albeit still continue to point to a pace of building activity that is above the pre-pandemic average. We see starts coming in at a 235K pace in February, little changed from the 231K rate in the prior month.

Week Ahead's key US number: Retail sales—January

(Wednesday, 8:30 am)

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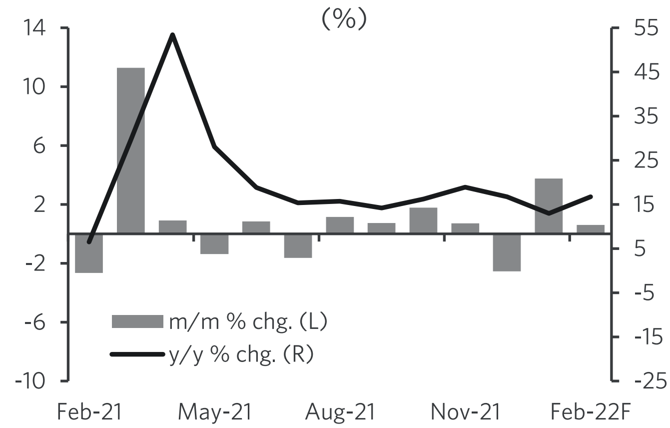
Retail sales (m/m %)	CIBC	Mkt	Prior
Retail sales	0.6	0.4	3.8
– ex auto	1.0	0.8	3.3
– control group	0.2	0.4	4.8

Chart: US Retail sales



Source: Census Bureau, Haver Analytics, CIBC

The fading of Omicron in February should have supported activity in service sectors of the economy, limiting spending on goods, and causing the pace of retail sales growth to cool to 0.6% on the month. Within retailing categories, a drop in unit auto sales will have been offset by an increase in traffic at restaurants, and higher prices will work to flatter the headline figure. The mammoth growth reported in online sales in January will likely have partly reversed in February, which will weigh on the control group of sales (ex. restaurants, autos, gasoline, building materials), causing growth to slow to 0.2%.

Forecast implications — With prices amplifying gains in retail sales, February likely saw a drop in the volume of goods consumed, as demand shifted towards services. The jump in prices at the pump will work to squeeze consumption ahead, and demand for goods, apart from autos, is expected to soften as pent-up demand for services is realized.

Market impact — We are above the consensus on the headline and below on the control group which could limit any market reaction.

Other US Releases: Industrial production—February

(Thursday, 9:15 am)

Plummetng temperatures saw utilities production grow at a record pace in January, something that likely reversed in February. While hours worked rebounded in manufacturing and rig counts continued to rise as the price of oil increased, the expected drop in utilities production will offset most of that strength, likely showing that growth in total industrial production slowed to 0.2%, leaving capacity utilization at 77.8%.

Housing starts—February

(Thursday, 8:30 am)

The gap between building permits and housing starts has widened recently, adding to the previous overhang of permits, and builders continued to report roadblocks to construction in February related to material and labor shortages. That could have limited the rebound in housing starts, which likely clocked in at a 1685K pace, while permit issuance could have subsided to an 1850K pace as home purchase intentions fell along with the rise in mortgage rates. As supply chain issues fade over the rest of the year, the overhang of permits should be worked down.

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