

Economics

THE WEEK AHEAD

May 8 - 12, 2023

Can you solve the neutral rate challenge?

by Avery Shenfeld avery.shenfeld@cibc.com

Today's labour market data put the kibosh on any near-term rate cuts in the US and Canada. Indeed, another rate hike in Canada is still an open risk, although we see enough of a deceleration in inflation to give the Bank of Canada license to wait and see.

If what comes next is just a long pause through 2023, markets will remain as convinced as the cab driver who asked me about his 2024 mortgage renewal that next year will bring a substantial policy ease. But a fairly deep slide in policy rates is needed for 10-year rates to rally a lot from here, or for a variable rate mortgage to be the right pick in early 2024.

In its most recent Monetary Policy Report, the Bank of Canada kept its estimate of the neutral rate at 2.5%. That mirrored the FOMC's choice for "long term" fed funds rate outlook, and the BoC puts a heavy weight on the US neutral rate in its own estimates for Canada.

While conceptually we think of the neutral rate as where overnight yields will average over a cycle's ups and downs, prior to 2020, that wasn't the case. Instead, Canada's policy rate was persistently below the neutral rate (Chart). That allowed 10-year bond yields to hover below the neutral rate, while still preserving the usual upward-sloping yield curve.

The mystery is why that was true, since the answer will have a lot to say about whether we can again expect a long period where overnight rates are below neutral. Was it just that the neutral rate was misestimated, and was really a lot lower? If so, and 2.5% is now an accurate measure of the neutral rate ahead, we won't see as much relief on short or long rates as markets now think. Or were there persistent economic headwinds, like the sharp drop in oil prices in 2015 and its hit to Canada's energy sector, that required an offsetting tailwind from stimulative monetary policy?

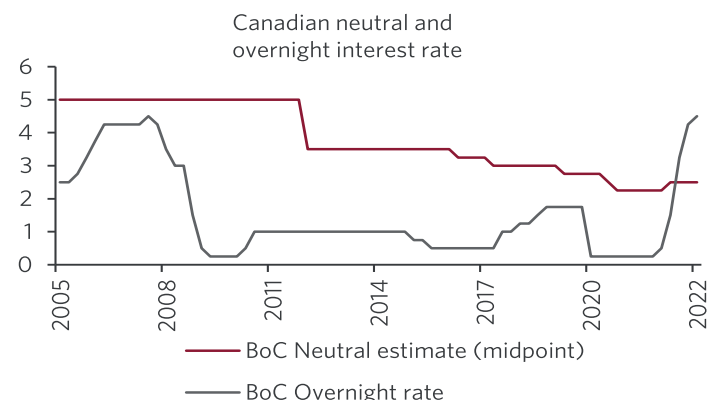
Frankly, we aren't too sure. Our clients can take their own stab at solving the neutral rate challenge. But there are some forces that could lean to rates being closer to neutral in the years ahead. The prior cycle benefited from a steady diet of cheap

goods prices, allowing central banks to let the service sector run hotter. That might not be as achievable if trade barriers and the costs of energy transition keep goods inflation on a somewhat firmer trend, although there is a lot of government subsidization helping on the cost side of both green energy and industries being induced to produce closer to home.

Fiscal restraint, seen in overall federal/state spending during the latter half of Obama's presidency, can also auger for a more stimulative monetary stance. But despite the debts incurred during the pandemic, it might not be in the cards. In both the US and Canada, voters on the right clamor for lower taxes, and those on the left for new social and health spending, with not too many votes for eschewing both lower taxes and more spending.

If all of this results in the neutral rate actually becoming the central tendency for the next decade's overnight rate, then an upward sloping yield curve might require 10-year bonds to settle near 3%. We'll probably see a sharper rally when overnight rates do finally start to ease, as bond markets are prone to overshooting. But if neutral is the norm for overnight rates, that won't be sustainable.

Chart: Canadian neutral and overnight interest rate



Source: Bank of Canada, Haver, CIBC

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, May 8	-	-	-	-	-	-	-
Tuesday, May 9	-	AUCTION: 3-M BILLS \$11.6B, 6-M BILLS \$4.2B, 1-YR BILLS \$4.2B	-	-	-	-	-
Wednesday, May 10	-	AUCTION: 2-YR CANADAS \$4.75B	-	-	-	-	-
Wednesday, May 10	8:30 AM	BUILDING PERMITS M/M	(Mar)	(M)	-	-	8.6%
Thursday, May 11	-	-	-	-	-	-	-
Friday, May 12	10:30 AM	Senior Loan Officer Survey	-	-	-	-	-

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, May 8	10:00 AM	WHOLESALE INVENTORIES M/M	(Mar)	(L)	-	0.1%	0.1%
Tuesday, May 9	-	AUCTION: 3-YR TREASURIES \$40B	-	-	-	-	-
Tuesday, May 9	8:30 AM	Speaker: Philip N Jefferson (Governor) (Voter)	-	-	-	-	-
Tuesday, May 9	12:05 PM	Speaker: John C. Williams (Vice Chairman, New York) (Voter)	-	-	-	-	-
Wednesday, May 10	-	AUCTION: 10-YR TREASURIES: \$35B	-	-	-	-	-
Wednesday, May 10	7:00 AM	MBA-APPLICATIONS	(May 5)	(L)	-	-	-1.2%
Wednesday, May 10	8:30 AM	CPI M/M	(Apr)	(H)	0.5%	0.4%	0.1%
Wednesday, May 10	8:30 AM	CPI M/M (core)	(Apr)	(H)	0.4%	0.3%	0.4%
Wednesday, May 10	8:30 AM	CPI Y/Y	(Apr)	(H)	5.1%	5.0%	5.0%
Wednesday, May 10	8:30 AM	CPI Y/Y (core)	(Apr)	(H)	5.5%	5.4%	5.6%
Wednesday, May 10	2:00 PM	TREASURY BUDGET	(Apr)	(L)	-	-	-\$378.1B
Thursday, May 11	-	AUCTION: 30-YR TREASURIES \$21B	-	-	-	-	-
Thursday, May 11	8:30 AM	INITIAL CLAIMS	(May 6)	(M)	-	-	242K
Thursday, May 11	8:30 AM	CONTINUING CLAIMS	(Apr 29)	(L)	-	-	1805K
Thursday, May 11	8:30 AM	PPI M/M	(Apr)	(M)	0.3%	0.3%	-0.5%
Thursday, May 11	8:30 AM	PPI M/M (core)	(Apr)	(M)	0.2%	0.3%	-0.1%
Thursday, May 11	8:30 AM	PPI Y/Y	(Apr)	(M)	-	2.4%	2.7%
Thursday, May 11	8:30 AM	PPI Y/Y (core)	(Apr)	(M)	-	3.3%	3.4%
Thursday, May 11	10:15 AM	Speaker: Christopher J. Waller (Governor) (Voter)	-	-	-	-	-
Friday, May 12	8:30 AM	IMPORT PRICE INDEX M/M	(Apr)	(L)	-	0.3%	-0.6%
Friday, May 12	8:30 AM	EXPORT PRICE INDEX M/M	(Apr)	(L)	-	0.2%	-0.3%
Friday, May 12	10:00 AM	MICHIGAN CONSUMER SENTIMENT	(May P)	(H)	-	63.0	63.5
Friday, May 12	7:45 PM	Speaker: James Bullard (St Louis)	-	-	-	-	-
Friday, May 12	7:45 PM	Speaker: Philip N Jefferson (Governor) (Voter)	-	-	-	-	-

Week Ahead's market call

by Avery Shenfeld

In the **US**, an inflation surprise would be a real market mover, particularly if the surprise was to the upside, and thereby added to the fears stoked by wage gains in the payrolls report. Our call is in fact a hair above the consensus for core CPI, but at 0.4% monthly advance isn't a big change from what we've been seeing. Core inflation is still on a decelerating track, but still too high for the Fed's tastes, and we can't see it calming sufficiently until labour markets soften and take the wind out of spending power and unit labour costs. The daily watch on banks is still very much in play, and any renewed tensions there could readily offset the CPI report.

In **Canada**, we get a one week rest from significant economic releases, so look for markets here to follow earnings news and the general mood south of the border. Normally, the senior loan officers survey is a snooze fest, but it might be worth a look given the attention being given to lending conditions in the US, and the fact that we're getting at least some questions about the potential trends in bank credit north of the border.

There are no major Canadian data releases next week.

Week Ahead's key US number: CPI—April

(Wednesday, 8:30 am)

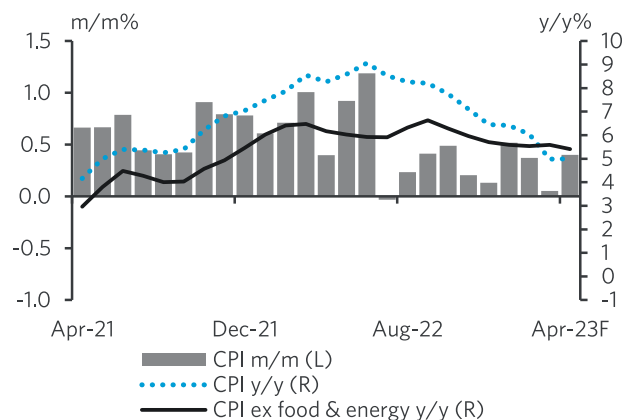
Katherine Judge katherine.judge@cibc.com

Variable (%)	CIBC	Mkt	Prior
Headline CPI m/m	0.5	0.4	0.1
Headline CPI y/y	5.1	5.0	5.0
Core CPI m/m	0.4	0.3	0.4
Core CPI y/y	5.5	5.4	5.6

Core prices likely maintained a 0.4% monthly pace in April, in line with the strengthening in the labor market that will have supported demand. That will have offset any softness in the shelter sub-index, which would reflect the easing in new rental rates seen last year. The core services group outside of shelter will garner the most attention, given that it's a better predictor of the underlying output gap and where inflation is headed. On that front, the acceleration in the labor market could portend firmer price pressures.

Adding food and energy prices back into the mix likely showed faster price increases, at a 0.5% m/m pace, as the OPEC+

Chart: US consumer price index



Source: BLS, Haver Analytics, CIBC

announcement to cut oil production fed through to higher prices at the pump.

Forecast implications — Continued momentum in core service prices would reinforce the notion that rate cuts aren't in the cards for the Fed this year. Indeed, we'll need to see a slowing in wage growth and a rise in the unemployment rate in order for the Fed to consider cutting, which likely won't happen until 2024 given the strength in the April employment report.

Market impact — We're only marginally above the consensus expectation, which should limit the scale of the market reaction.

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