

Is Slack Back?

The Bank of Canada’s three preferred core inflation metrics averaged 2.0% in March, back at the target after a four-month run below. South of the border, core CPI inflation inched down a tenth to 2.0% in March, indicating that the Fed’s preferred measure, the core PCE price index, is likely to drift further below the 2% target, to 1.7% by March from 1.8% in January (the latest available data). Since June 2010 (a year after the end of the recession), both central banks have had a hard time hitting their targets (*Chart 1*)¹. Allowing a one-tenth range around 2.0%, the Bank of Canada has achieved it 29% of the time and has come up short 71%. Average core CPI inflation has never exceeded 2.1% this cycle. The Fed has achieved the target 23% of the time and has come up short 77%. Core PCE inflation has, also, never exceeded 2.1% this cycle. Note the complete lack of symmetry within a very narrow range around the targets.



The fact that both central banks have had similar disappointing core inflation performances, despite differently-constructed price indices and differently-structured economies, emphasizes the common disinflationary forces they are facing. These include an aging population, automation and digitalization. These secular forces have effectively countered the cyclical inflation pressures that accumulated as economic slack was taken in and output gaps shrank. And, in the oscillating tug-of-war between cyclical inflation pressures and secular disinflation forces, it now seems that the cyclical side might not be as strong as originally posited. The output gap appears to be getting larger in Canada, as America’s budding positive output gap is proving to lack net inflationary punch.

Back in January, the Bank of Canada judged the output gap was between -1% and 0% for Q4, representing an increase from the range-around-zero October estimate as real GDP growth was expected to be weak in the period (it turned out to be just 0.4% annualized) (*Chart 2*)². However, most of the economy was deemed to be operating “close to capacity” with the increase in slack occurring in the oil-producing regions as that sector reacted to low prices. Not only has the latter slack escalated subsequently, but it appears to have spread to non-oil sectors.

One metric that factors into the Bank’s output gap judgement is the quarterly Business Outlook Survey’s assessment of capacity pressures. For Spring 2019, the share of firms perceiving difficulty in meeting unanticipated increases in demand dropped sharply to 31% from a cycle-high run of 56%-to-57% in the prior three periods. This was the largest quarterly decrease since the survey

Chart 1
Hard Time Hitting Target

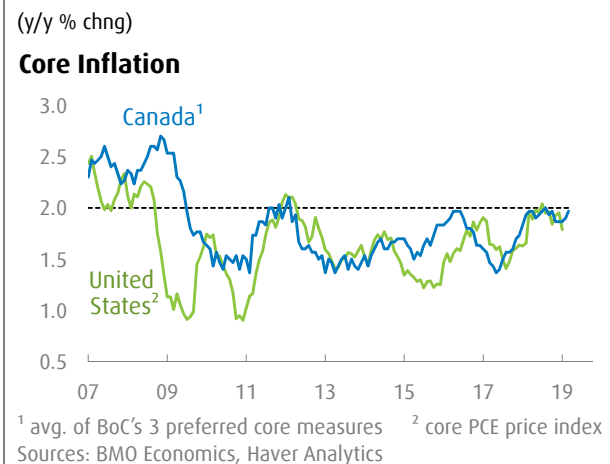
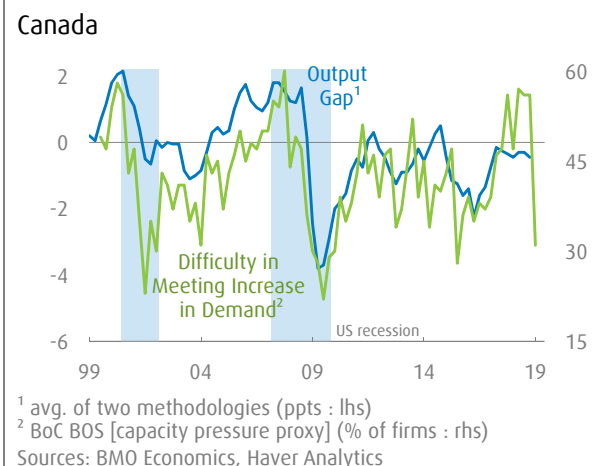


Chart 2
Economic Slack Coming Back



¹ Officially, the 2% target is meant for headline inflation but both central banks employ core inflation as an operational guide.

² This was consistent with the -0.5% average of the BoC’s two point estimates, which is what we show in Chart 2.

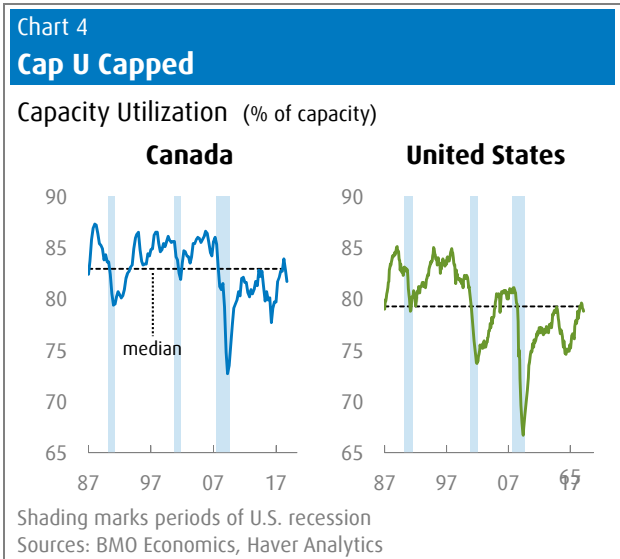
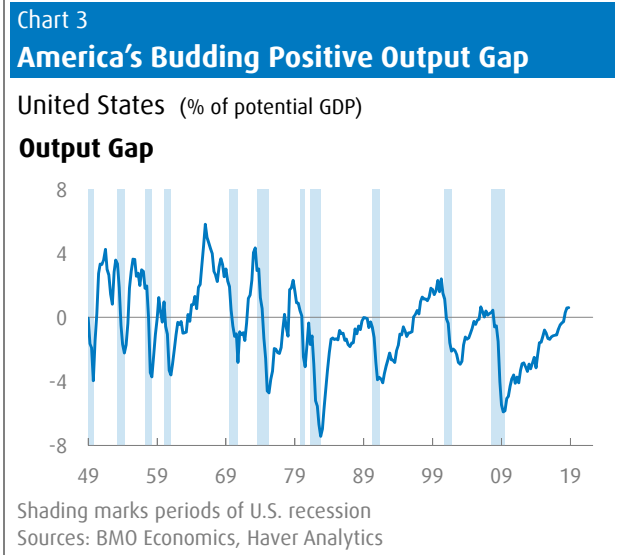
commenced in 1999, with the share now hovering at a level last seen during the oil-led downturn in 2015 and, before then, the first quarters following the recession. We reckon the key culprit was the Alberta government’s mandated oil production cuts, but the negative spending responses on both sides of the border to last year’s plummet in equity prices and extreme winter weather (record precipitation across the U.S. and in parts of Canada, not to mention a polar vortex) were also factors.

We estimate real GDP expanded at a 0.7% annual rate in Q1, posting a second consecutive quarter well under the Bank’s 1.8% estimate of potential economic growth, and increasing the output gap again. While we look for the economy to expand above potential during the middle quarters of this year (around 2.3%), this won’t be sufficient to re-close the output gap.

The U.S. economy currently sports a positive output gap of 0.6%, according to the CBO (*Chart 3*). It first emerged in 2018 Q2 as annualized real GDP growth topped 4% owing to fiscal stimulus. However, the emergence and persistence of a positive output gap has done little to visibly drive the inflation process. As recently as last July, core inflation was 2.0% with the shorter-term trends (3- and 6-month changes) pointing to some acceleration. The latest reading was 1.8% with the shorter-term trends pointing to further deceleration.

It may simply be too soon to expect an inflation reaction, or the reaction is being overwhelmed by the secular disinflation forces, but the positive output gap will probably get a bit smaller in Q1 anyway. In addition to the stock market and winter weather headwinds mentioned above, the government shutdown will act as a drag on economic growth. We estimate U.S. real GDP expanded at a 1.8% annual rate, slightly below the CBO’s 2.2% estimate of (quarterly) potential economic growth. Like in Canada, the U.S. economy will probably rebound in Q2 but we doubt the positive output gap will get any bigger than what it has been, which has already proven, so far, to be ineffective in fuelling inflation.

Capacity utilization rates provide another perspective on economic slack. The latest readings dipped below their medians on both sides of the border, and remain well below the levels attained in previous business cycles (*Chart 4*). Whether seen in below-median and decreasing industrial capacity utilization rates, increasing output gaps or impotent positive output gaps, cyclical inflation pressures could be losing steam. For the Bank of Canada and Fed, this would be another reason to be “patient” in the period ahead.



General Disclosure

"BMO Capital Markets" is a trade name used by the BMO Financial Group for the wholesale banking businesses of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K. and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited and BMO Capital Markets Corp are affiliates. This document is issued and distributed in Hong Kong by Bank of Montreal ("BMO"). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (CE No. AAK809) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Research

Our publications are disseminated via email and may also be available via our web site <http://economics.bmocapitalmarkets.com>. Please contact your BMO Financial Group Representative for more information.

Conflict Statement

A general description of how BMO Financial Group identifies and manages conflicts of interest is contained in our public facing policy for managing conflicts of interest in connection with investment research which is available at http://researchglobal.bmocapitalmarkets.com/Public/Conflict_Statement_Public.aspx.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., Member FDIC. Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets. BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A, BMO Ireland Plc, and Bank of Montreal (China) Co. Ltd. and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC), BMO Nesbitt Burns Securities Limited (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, BMO Capital Markets Limited in Europe, Asia and Australia and BMO Advisors Private Limited in India.

"Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Inc., used under license. "BMO Capital Markets" is a trademark of Bank of Montreal, used under license. "BMO (M-Bar roundel symbol)" is a registered trademark of Bank of Montreal, used under license.

© Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ Trademark Bank of Montreal in the United States and Canada.

© COPYRIGHT 2019 BMO CAPITAL MARKETS CORP.

A member of BMO Financial Group