

Beware of the inflation expectations boogeyman?

By Taylor Schleich & Ethan Currie

Remember when markets were solely focused on the employment side of the Fed's dual mandate, the triggering of the Sahm rule last summer coinciding with expectations for steady rate cuts back to 3%? Inflation then was assumed to be on cruise control to target but the script has since flipped. The U.S. job market has firmed up, and inflation is back in focus, more so after this week's red-hot CPI report. Whichever measure you favour will show inflation above target, a streak extending close to four years. That's not the case everywhere, including in Canada, where a sequence of 2%-or-below inflation prints are piling up.

There is still good reason to believe U.S. inflation will moderate eventually. After all, policy is restrictive by almost anyone's estimate of neutral. However, the longer inflation continues to run hot, the more likely inflation expectations are to embed which could make complete inflation victory more difficult. Self-reinforcing price pressures are the stuff central bankers' nightmares are made of.

As recently as this week, Fed Chair Powell stressed inflation expectations are well-anchored. Sure, they may not be on a runaway train, but they *have* risen materially whether one looks at consumer

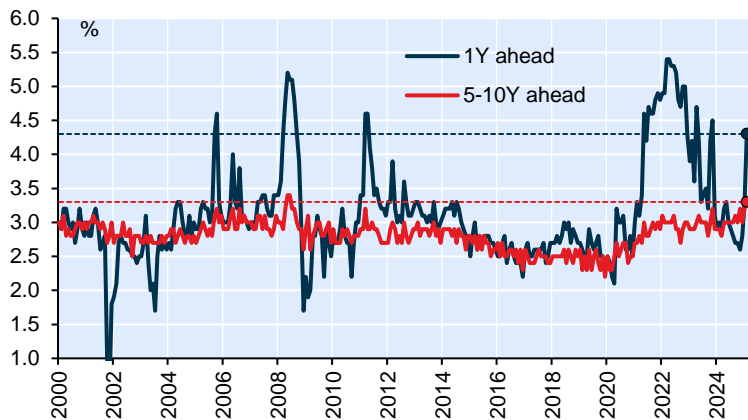
surveys or market-based measures. It's not time to sound the alarm, but this bears close monitoring as further increases may be problematic.

Cross-country context is instructive here too. In Canada, consumer inflation expectations haven't experienced the same recent uptick seen stateside and are largely back to 'normal'. True, our lower-frequency data doesn't provide as timely readings, but the BoC's latest survey was conducted after the U.S. election (so, there's presumably *some* tariff expectation baked in). Likewise, business inflation expectations are close to, even if not *all the way* back to, normal. Breakevens reinforce soft data too. While these are up in the U.S. *and* Canada, Canadian expectations hover right at 2% and U.S. breakevens have risen faster.

We'd again stress that expectations aren't at a point that warrant direct Fed intervention (i.e., via rate hikes) but this certainly supports a patient policy posture. It also represents even more justification for BoC-Fed divergence and GoC outperformance. To us, there's even room for these rate gaps to widen further in coming months given the non-trivial slack to absorb in Canada. Indeed, we still see scope for further BoC rate relief. For now, inflation and its expectations are *not* an obstacle.

Chart 1: U.S. consumer inflation expectations are growing...

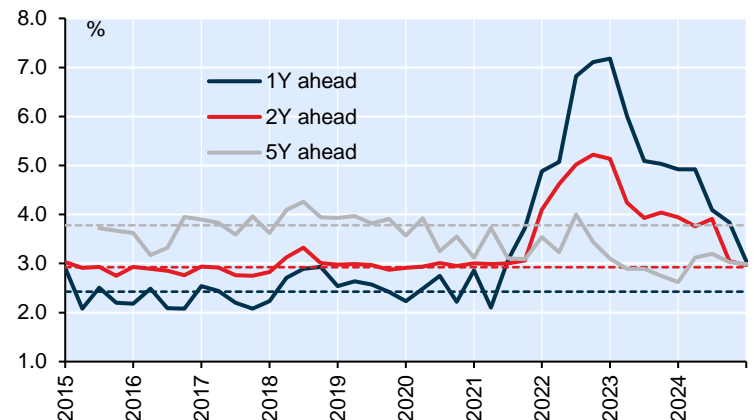
University of Michigan expected price changes: Next 12 months, next 5-10 years



Source: NBC, BBG | Note: Dotted lines denote latest available levels

Chart 2: ...which isn't true of Canadian consumers (as of Q4:24)

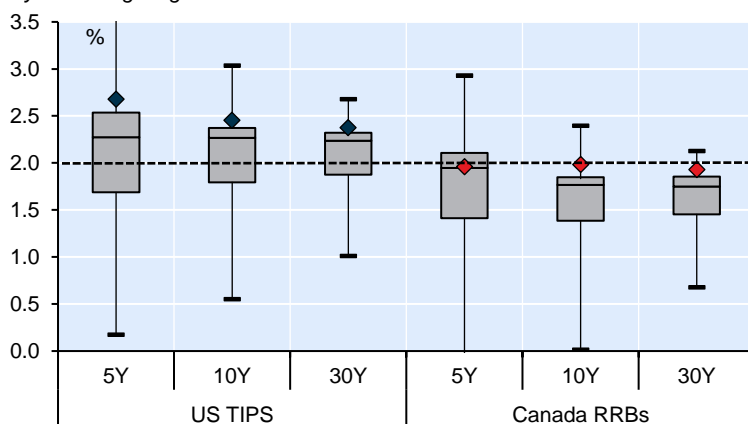
Canadian consumer inflation expectations for various time horizons



Source: NBC, Bank of Canada | Note: Dotted lines denote pre-COVID avg for horizon

Chart 3: Inflation-linked bonds tell a similar story...

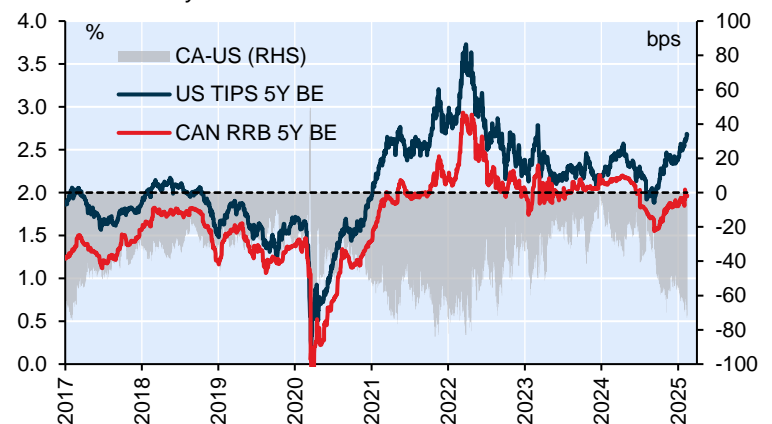
5-year trading ranges of select breakeven levels: TIPS and RRBs



Source: NBC, BBG | Note: Dots denote current level. Box shows middle 2 quartiles.

Chart 4: ...as implied inflation climbs faster stateside

Canada and US 5-year inflation breakevens and its differential



Source: NBC, BBG | Note: dotted line denotes 2% inflation 'target'



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