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The New Inflation

by Jeff Rubin

Economics & Strategy

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"... exploding transport costs are removing the single most important brake on inflation over the last decade—wage arbitrage with China."

No one is saying that the Federal Reserve Board shouldn't have cut interest rates. After all, US payroll numbers have fallen for four consecutive months and are likely to continue to decline for at least another quarter, if not longer. But whether the Fed is prepared to recognize it or not, the new reality that it faces is reflation. And it's the type that isn't likely to be tamed by a slowdown in the American economy.

Food and energy prices may not count in the Fed's inflation metrics, but they sure count in the lives of everyday Americans these days. While core inflation may be barely over 2%, that's only of solace if you don't eat or drive. Headline inflation is running at almost double that and it isn't about to be coming down any time soon (see pages 8-11). Not when world oil prices are heading toward $200 per barrel, with grain price movements not far behind.

Food inflation isn't about the US economy any more than triple-digit oil prices are about motorists driving on interstate freeways. They're instead about hamburgers replacing rice bowls and millions of new Tata and Chery drivers on traffic-choked roads in China, India and the rest of the emerging market world.

But even more threatening to the outlook for price stability than the rise in oil prices, is the fact that exploding transport costs are removing the single most important brake on inflation over the last decade—wage arbitrage with China. Not that Chinese manufacturing wages won't still warrant arbitrage. In and of themselves, they will. But in today's world of triple-digit oil prices, distance costs money.

The cost of shipping a standard 40-foot container from East Asia to the US eastern seaboard has already tripled since 2000 and will double again as oil prices head towards $200 per barrel (see pages 4-7). Unless that container is chock full of diamonds, shipping costs have suddenly inflated the cost of whatever is inside. And those inflated costs get passed onto the Consumer Price Index when you buy that good at your local retailer. As oil prices keep rising, pretty soon those transport costs start cancelling out the East Asian wage advantage. They already have in steel. Soaring transport costs, first on importing iron to China and then exporting finished steel overseas, have already more than eroded the wage advantage and suddenly rendered Chinese-made steel uncompetitive in the US market.

That's great news if you are the United Steelworkers of America. Long lost jobs will soon be coming home. And the more that oil prices and transport costs rise for Chinese steel exporters, the more that US steel wages can grow. But if you're a steel buyer, your costs are going up regardless of whether you are sourcing it from China or Pittsburgh.

And if you're the Federal Reserve Board, you will soon be raising rates, and in a hurry.

MARKET CALL

- The Fed seems set on taking a pause on interest rates in June, and we no longer expect any action at that meeting. A final quarter-point cut is still a possibility for Q3, given our expectation for a drop in GDP in Q2 and some steeper job losses in the next few months. But that will be only short-lived comfort for the Treasuries market, which at the long end will have its eyes focused on a stubborn headline inflation rate, and a major dose of Fed tightening come 2009.

- The Canadian curve has already priced in our expectations for a further quarter-point cut at the next Bank of Canada rate-setting date. But further out the curve, markets will be increasingly looking at higher inflation risks and the prospects for a retightening by the central bank in 2009. We would sell government bonds into any minor rally that develops during what looks to be a quarter of still-sluggish growth ahead.

- We're nearing an expected turning point for the US$ against European majors, with the latter having one more push stronger if the Fed returns with an ease in Q3. Further dollar depreciation will be focused on the Pacific Rim and oil-exporting currencies where the trade deficit now lies. The loonie will join in that parade, but its appreciation will be cut short as the Fed outdoes the Bank of Canada in rate hikes in 2009.

INTEREST & FOREIGN EXCHANGE RATES

					2009			
END OF PERIOD:		**26-May**	**Sep**	**Dec**	**Mar**	**Jun**	**Sept**	**Dec**
CDA	Overnight target rate	3.00	2.75	2.75	2.75	3.00	3.25	3.75
	98-Day Treasury Bills	2.65	2.40	2.60	2.70	2.80	3.00	3.45
	Chartered Bank Prime	4.75	4.50	4.50	4.50	4.75	5.00	5.50
	2-Year Gov't Bond (3.75% 6/10)	3.01	2.85	3.10	3.35	3.50	3.70	4.15
	10-Year Gov't Bond (4% 06/17)	3.65	3.60	3.75	3.80	4.00	4.10	4.25
	30-Year Gov't Bond (5% 06/37)	4.09	4.10	4.25	4.25	4.30	4.35	4.60
U.S.	Federal Funds Target	2.00	1.75	1.75	1.75	2.25	3.00	3.75
	91-Day Treasury Bills	1.86	1.60	1.60	1.65	2.05	2.75	3.40
	2-Year Gov't Note (2.125% 4/10)	2.44	2.25	2.50	2.85	3.40	3.85	4.00
	10-Year Gov't Note (3.875% 05/18)	3.85	3.80	3.95	4.10	4.35	4.45	4.60
	30-Year Gov't Bond (4.375% 02/38)	4.57	4.55	4.70	4.75	4.80	4.80	4.90
Canada - US T-Bill Spread		0.79	0.80	1.00	1.05	0.75	0.25	0.05
Canada - US 10-Year Bond Spread		-0.20	-0.20	-0.20	-0.30	-0.35	-0.35	-0.35
Canada Yield Curve (30-Year — 2-Year)		1.08	1.25	1.15	0.90	0.80	0.65	0.45
US Yield Curve (30-Year — 2-Year)		2.13	2.30	2.20	1.90	1.40	0.95	0.90
EXCHANGE RATES	— (US¢/C$)	100.8	104.7	105.0	103.1	102.0	102.0	101.5
	— (C$/US$)	0.992	0.955	0.952	0.970	0.980	0.980	0.985
	— (Yen/US$)	103	103	103	98	96	95	93
	— (US$/euro)	1.58	1.62	1.56	1.50	1.49	1.49	1.50
	— (US$/pound)	1.98	1.99	1.96	1.90	1.90	1.88	1.90
	— (US¢/A$)	96.1	96.5	93.0	92.5	91.0	92.0	93.0

STRATEGY AND EARNINGS OUTLOOK

- With the CPI inflation rate set to almost double next year, we took off our overweight in bonds and shifted four percentage points of weighting out of the sector. While the Bank of Canada may still deliver another rate cut, reflation will compel it to raise interest rates by at least 100 bps next year prompting a 60-bp back-up in 10-year bond yields. Assets moved out of bonds were split equally between stocks and cash.

- With TSX earnings poised to surge 21% this year thanks to burgeoning resource rents, we moved to a slight overweight in equities but remain wary of further near-term turbulence from the financial sector. Within our equity portfolio we have added a percentage point of weighting to our already substantially overweight holdings of energy stocks, as well as adding another half-point of weighting to our overweight position in material stocks.

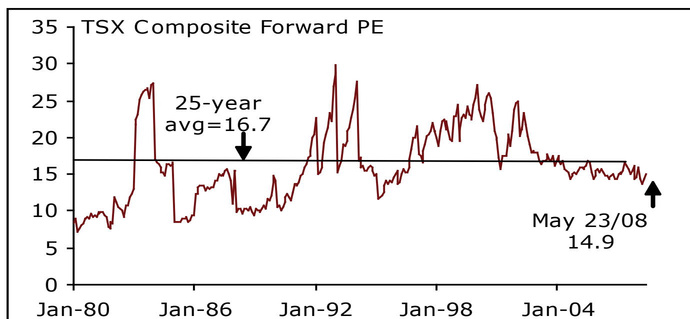
- To accommodate our greater weighting in energy and material stocks we moved a percentage point of weighting out of utility stocks and a half percentage point of weighting out of consumer staples. Utility stocks' renowned dividends are going to become less attractive in an environment of rising bond yields than they have in the past environment of falling bond yields. Key consumer staple components like food retailers and processors are getting decimated by soaring food costs.

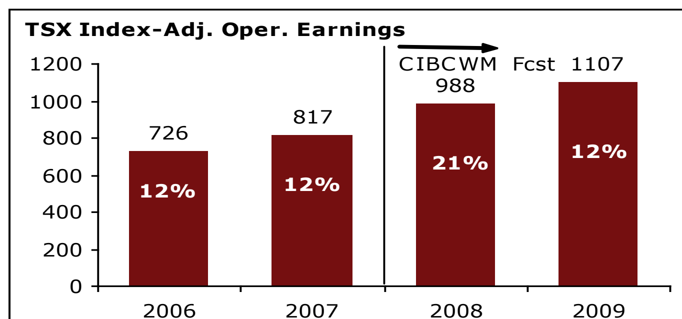
ASSET MIX (%)	Benchmark	Strategy Recommendation
Stocks	**53**	**55**
Bonds	38	38
Cash	9	7
GICS SECTOR EQUITIES (%)		
Consumer Discretionary	4.2	1.7
Consumer Staples	2.2	2.2
Energy	**30.1**	**37.1**
Financials	28.2	25.7
-Banks	15.7	13.7
-Insur., REITs, oth.	12.5	12.0
Healthcare	0.4	0.4
Industrials	5.4	3.4
Info Tech	4.9	3.9
Materials	**17.9**	**20.4**
-Gold	**6.9**	**7.9**
-Other Metals	**5.3**	**6.3**
Telecom	5.2	2.7
Utilities	**1.5**	**2.5**

Note: Bold indicates recommended overweight.

TSX - Earnings Outlook & Forward PE

	Operating Earnings (% ch)				4-qtr Fwd PE	
	2005	2006	2007	2008	Latest	Last 10 yrs.
Energy	45.4	8.5	8.0	56.0	14.0	12.0
Health Care	5.3	29.2	-38.8	8.2	14.7	22.0
Industrials	27.9	13.0	38.5	-22.4	18.0	14.9
Materials	40.7	79.9	-2.4	81.9	17.5	28.9
Utilities	17.9	-6.2	56.2	6.9	15.2	17.4
Consumer Staples	2.9	-1.2	-1.5	-0.9	14.5	15.7
Financials	13.8	17.6	11.2	-5.3	13.1	12.0
Info Tech	-40.1	46.5	153.8	65.7	26.3	44.5
Consumer Discretionary	2.3	18.0	12.8	2.7	14.5	15.7
Telecom Services	5.9	30.8	28.4	-10.3	14.7	29.8
TSX Composite	**31.2**	**12.1**	**11.8**	**20.9**	**14.9**	**16.1**





Source: Thomson First Call, CIBC WM

Will Soaring Transport Costs Reverse Globalization?

Jeff Rubin and Benjamin Tal

Globalization is reversible. Higher energy prices are impacting transport costs at an unprecedented rate. So much so, that the cost of moving goods, not the cost of tariffs, is the largest barrier to global trade today. In fact, in tariff-equivalent terms, the explosion in global transport costs has effectively offset all the trade liberalization efforts of the last three decades. Not only does this suggest a major slowdown in the growth of world trade, but also a fundamental realignment in trade patterns.

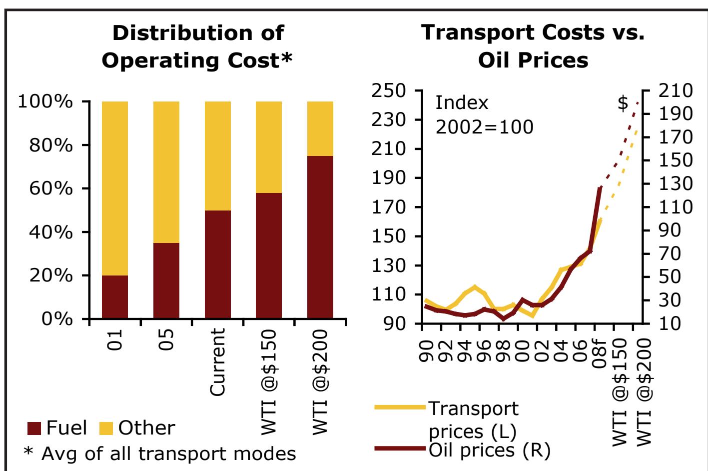
Soaring Transport Costs

Recent changes in transportation have led to increased sensitivity to higher energy prices. Most notable of these changes is the massive trend towards containerization that effectively makes shipping costs more vulnerable to swings in fuel costs. Container ships can be unloaded much faster than break cargos so they spend much more time at sea than in ports.

Another factor is speed. The shift to container ships has increased the importance of ship speed. Over the past two decades, container ships were built to go faster than bulk ships and since container ships were steadily gaining share, the world's fleet speed picked up. But greater speed requires greater energy, as it does in all other modes of transport. In global shipping, the increase in ship speed over the last fifteen years has doubled fuel consumption per unit of freight.

Chart 1

Transport Costs Highly Sensitive to Oil Prices



Source: RMT, CIBCWM

With oil prices now accounting for almost half of total freight costs, it should come as no surprise that soaring oil prices have translated directly into soaring transport costs (Chart 1). Over the last three years, every one dollar rise in world oil prices has fed directly into a 1% rise in transport costs.

Transport Costs and the Link to Trade

The last thirty years have seen an unprecedented growth in world trade—a phenomenon widely credited with providing the catalyst for the rapid industrialization of economies like China and India. In turn, the reduction in tariffs and non-tariff barriers over decades of multilateral trade negotiations was facilitated by the surge in global trade volumes. But in a world of triple-digit oil prices, soaring transport costs, not tariff barriers, pose the greatest challenge to trade.

Converting transport costs into tariff-equivalent rates provides a poignant perspective on just how trade-disrupting soaring energy costs have become. Even back at a $100 per barrel oil price, transport costs outweigh the impact of tariffs for all of America's trading partners, including even its neighbours, Canada and Mexico. Back in 2000, when oil prices were $20 per barrel, transport costs were the equivalent of a 3% US tariff rate. Currently, transport costs are equivalent to an average tariff rate of more than 9%. At $150 per barrel, the tariff-equivalent rate is 11%, going back to the average tariff rates of the 1970s. And at $200 per barrel, we are back at "tariff" rates not seen since prior to the Kennedy Round GATT negotiations of the mid-1960s.

Higher energy costs translate directly into higher shipping costs. At today's oil prices, every 10% increase in trip distance translates into a 4.5% increase in transport costs. The duration of a typical sea voyage from China to North America is four weeks. Including inland costs, shipping a standard 40-foot container from Shanghai to the US eastern seaboard now costs $8,000. In 2000, when oil prices were $20 per barrel, it cost only $3,000 to ship the same container. But at $200 per barrel, it will soon cost $15,000 in transport costs to ship from China to the US eastern seaboard (Chart 2).

Chart 2

Total Cost of Transporting a 40' Container From Shanghai to US East Coast

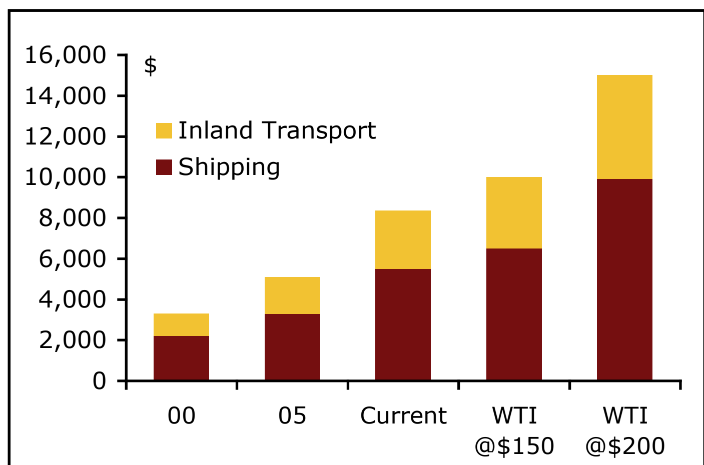
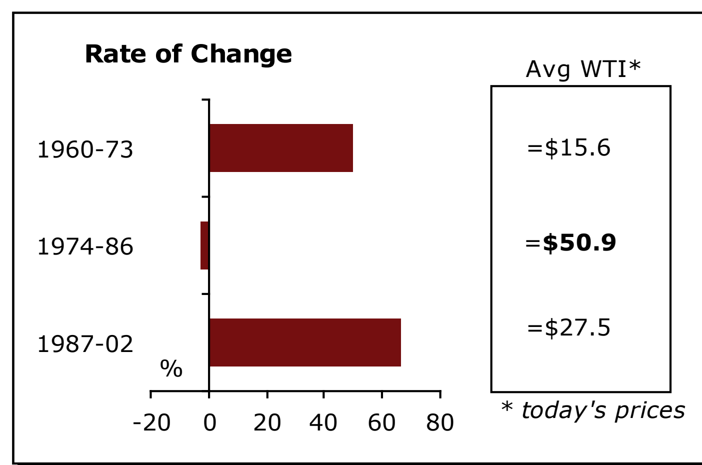


Chart 3

World Exports as a Share of Global GDP: Highly Sensitive to Oil Prices



Soaring transport costs suggest trade should be both dampened and diverted as markets seek shorter, and hence, less costly supply lines. And that's precisely what we have witnessed in response to past OPEC oil shocks.

Between 1960 and 1973, exports as a share of world GDP rose by over 50%, a function of both falling trade barriers and cheap transport costs when oil prices averaged less than $16 per barrel (in today's prices). Similarly 1987-2002 saw another quantum leap in world trade, spurred not only by a 30% drop in tariffs but by still relatively cheap transport costs grounded by an average $27 (constant dollars) per barrel oil. In sharp contrast, exports as a share of world GDP went absolutely nowhere between the first OPEC shock and the aftermath of the second, despite a 25% reduction in global tariffs (Chart 3).

No doubt the 1974 and 1981/82 recessions dampened trade, but trade should have rebounded strongly on the back of healthy recoveries from those recessions. Annual world GDP growth averaged 3.5%, roughly the same rate as from 1987-2002 which saw world trade grow by leaps and bounds. Trade failed to respond to a pick-up in global growth because transport costs were exploding due to soaring oil prices.

Trade not only failed to grow as a share of global GDP but it also diverted along increasingly regional lines. With the cost of trans-oceanic freight surging following the 1973 OPEC shock and into the early 1980s, the share of non-petroleum US imports from Europe and Asia fell by a stunning 6 percentage points in little over a half decade, while the share of imports from the Caribbean and Latin America rose by a comparable amount (Chart 4).

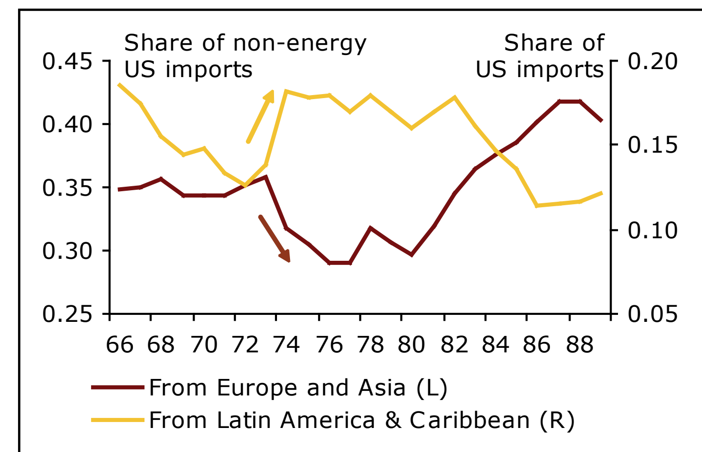
It's relatively easy to see why American importers shifted to regional trading. Trans-oceanic transport costs literally exploded during the two OPEC oil price shocks. The cost of shipping a standard cargo load overseas almost tripled, just as it did over the past few years. Ultimately soaring transport costs were borne by consumers, and markets responded accordingly, substituting goods that could be sourced from closer locations than half-way around the world carrying hugely inflated freight costs.

Advantage US

To what extent will astronomical increases in transport costs alter the huge (but shrinking) wage differential

Chart 4

Trade Diversion During the OPEC Oil Shocks



between Chinese labor and North American labor remains to be seen. But we are already starting to see some change in capital-intensive manufacturing whose products carry a high ratio of freight costs to final selling prices.

Take the steel sector for example. With little over an hour and a half of labor time embodied in the production of a ton of steel, and relatively high freight costs, the global cost curve of the steel sector is changing rapidly. Given that most parts of China (and Asia in general) are short iron ore, getting the raw materials to the steel mill (mainly from Australia and Brazil) adds an additional and growing cost not typically incurred by US steel producers. Add to it the $90 freight cost of shipping a ton of hot-rolled steel sheet from China to the US, and the transport component is large enough to turn the global steel cost curve on its head. Even at today's oil prices, rising transport costs have already more than offset China's otherwise slim cost advantage, giving US steel a competitive advantage in its own market for the first time in over a decade (Chart 5).

The rapidly changing economics of steel is already reflected in the trade statistics. China's steel exports to the US are now falling by more than 20% on a year-over-year basis—the worst performance in almost a decade. While many might attribute this decline to the slowdown in the US economy, it is noteworthy that US domestic steel production has risen by almost 10% during the same period (Chart 6).

Mexico—Another Chance at Bat?

Exactly how much trade, soaring transport costs divert from China (or for that matter anywhere else) depends ultimately on how important those costs are in total costs. Goods that have a high value to freight ratio carry implicitly small transport costs, while goods with low value to freight ratios typically carry significant moving costs.

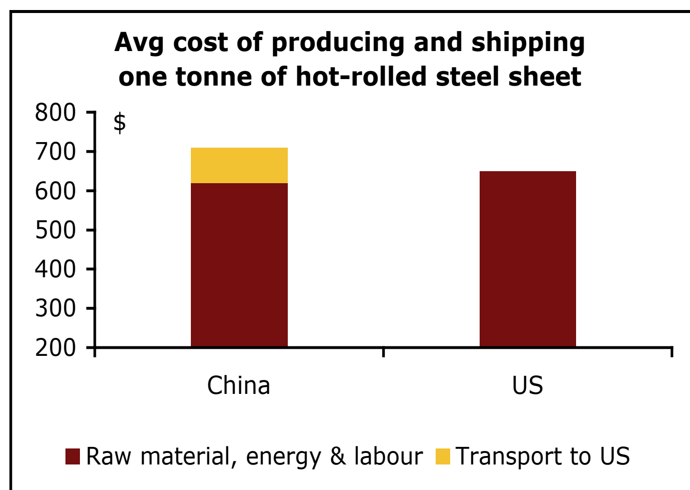
A surprisingly high percentage of Chinese exports to the US fall in the later category. Furniture apparel, footwear, metal manufacturing, and industrial machinery—all typical Chinese exports, incur relatively high transport costs.

And there is already evidence that Chinese exports of freight-intensive goods are already beginning to slow under the pressure of rapidly rising transport costs.

While there has been a general slowdown in export growth to the US over the past year, it is notable that the slowdown is far more pronounced in goods that carry relatively high freight costs compared to those that do not. On a year-over year basis, this category is now falling for the first time in more than 10 years (Chart 7, left). Freight-sensitive Chinese exports to the US now account for 42% of total exports—down from 52% in 2004. In fact, we estimate that if it were not for the dramatic increase in transport costs, growth in Chinese exports to the US since 2004 would have been 30% stronger than the actual tally (Chart 7, right).

Chart 5

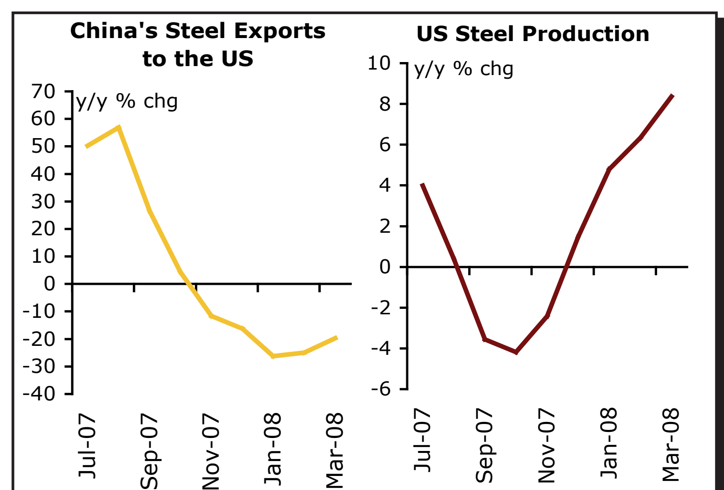
US Steel Producers Now Have a Cost Advantage Over China



Source: IRST, AISI, JP Morgan, CIBCWM

Chart 6

China's Steel Exports to US Fall While US Steel Production Rises



Source: US Census Bureau, CIBCWM

How much of Chinese manufacturing production will be coming home remains to be seen. But there is certainly no reason why we should not expect to see at least comparable if not greater trade diversion than we saw during the OPEC oil shocks of the 1970s.

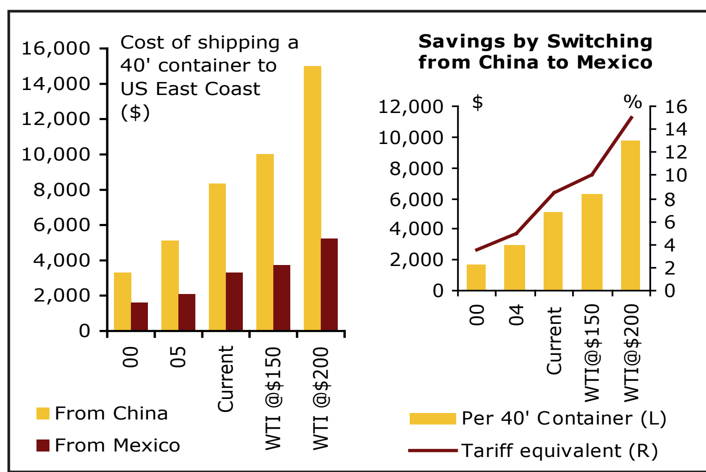
While there remains a strong imperative in the world economy to arbitrage wage costs, the arbitrage will increasingly take place within the constraints imposed by soaring transport costs. Instead of finding cheap labor half-way around the world, the key will be to find the cheapest labor force within reasonable shipping distance to your market.

In that type of world, look for Mexico's maquiladora plants to get another chance at bat when it comes to supplying the North American market. In a world where oil will soon cost over $200 per barrel, Mexico's proximity to the rest of North America gives its costs a huge advantage.

Compare, for example, how relative transport costs have recently changed between the Pacific Rim and Mexico. If in 2000 American importers paid 90% more to ship goods from East Asia to the US east coast, today they pay 150% more, and when oil prices reach $200 per barrel, they will pay three times the amount it costs to ship the same container from Mexico (Chart 8). To put things in perspective, today's extra shipping cost from East Asia is the equivalent of imposing a 9% tariff on East Asian goods entering the US. And at oil prices of $200, the tariff-equivalent rate will rise to 15%.

Chart 8

Relative Shipping Costs to the US East Coast: Mexico versus East Asia

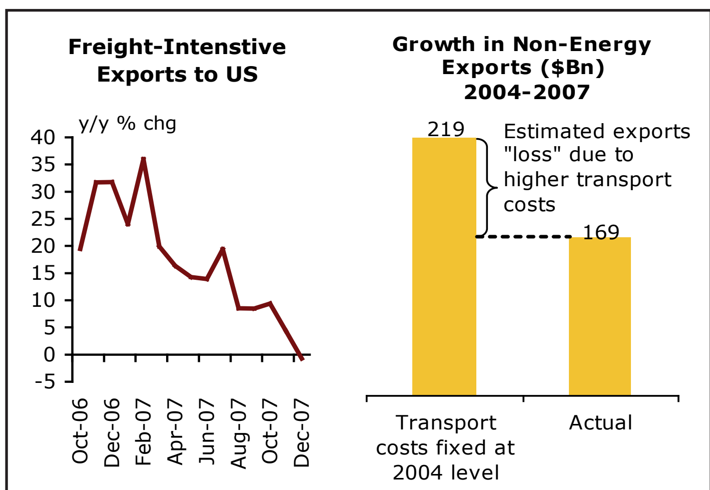


It seems that American importers are starting to do the math and already shifting some business from China to Mexico. While the pace of shipments from China to the US is slowing—mainly among freight-intensive goods, even non-energy Mexican exports to the US are still rising at a healthy annual rate of more than 7%. And interestingly, the goods that have seen the fastest growth are the ones that, on average, are more freight-intensive and directly compete with China, such as furniture, iron and steel, rubber and paper products (Chart 9).

In a world of triple-digit oil prices, distance costs money. And while trade liberalization and technology may have flattened the world, rising transport prices will once again make it rounder.

Chart 7

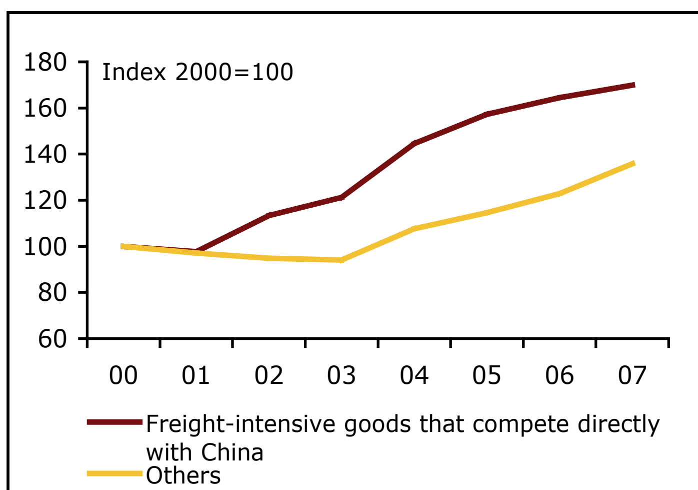
Elevated Freight Rates Are Already Impacting China's Trade with US



Source: US Census Bureau, Golisticsmgnt, De 2007, CIBCWM

Chart 9

Mexico's Non-Energy Exports to the US



Source: US Census Bureau, CIBCWM

Inflation: Rising Up in 2009

Avery Shenfeld and Meny Grauman

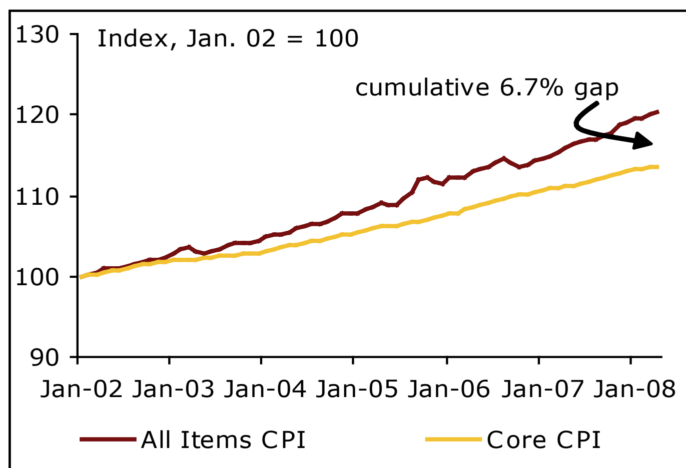
America's been ignoring it, and Canada has yet to really see it, but for those looking beyond the next quarter or two, inflation is poised to be the next big story for North American markets. Bernanke can't afford to fight price hikes while he's fending off a global financial crisis and a mild US recession, but he will have to confront this simmering battle once the economy begins to recover towards the end of the year. Meanwhile, north of the border, inflation is a sleeping giant, but is set to reawaken. In both cases, the safety of government bonds is poised to evaporate as rates begin to creep up later this year, and rise sharply in 2009.

Misleading to the Core

In the US, inflation has been low only for those prepared to ignore what is staring them in the face—sharply rising energy and food costs. Of course, the convenient "core" CPI index does just that, but the rationale for focusing on core price measures no longer exists. Food and energy prices are not seeing short-term volatility anymore. They are simply trending consistently higher. As a result, the headline CPI rate has steadily drifted further and further away from core CPI, to a total of 6.7% on a cumulative basis since 2002 (Chart 1). Core inflation is dead. It won't be long before the Fed and the bond market both have to pay much more attention to headline rather than core prices.

Chart 1

"Core" Misses US Inflation Trend



A rapidly growing developing world continues to press up against limited world supply of both food and fuel, providing a strong fundamental justification for steadily rising commodity prices. Strip out gas liquids that can't be easily used for vehicle transport, and crude oil supply will grow by only 0.7% per year over the next two years. With growing energy demand in the developing world and in oil-exporting countries themselves, crude oil should average as much as US$140/Bbl next year in order to ration demand growth down to that pace, (see *StrategEcon* April 24, 2008: *"How Much Higher Will Oil Prices Go"*). Natural gas prices are also climbing, as oil becomes too expensive for industrial use and as coal is deemed too dirty for new electricity generation. LNG, once thought to be a safety valve, is now in shorter supply as other global markets bid for it.

Washington's plan to shift 30% of the corn crop into heavily subsidized ethanol production was touted as a key part of the "solution" to America's dependence on imported oil. But whatever minor impact it had on energy inflation, has been swamped by its impact on food prices. The premium earned by corn over other crops has cut back production and lifted prices of important staples like soybeans and wheat. This has also boosted worldwide fertilizer prices, making it too expensive for many low income developing-world farmers to afford. That, in turn, has cut into crop yields at exactly the time when demand is swelling.

To be sure, large speculative positions have heightened the volatility in grain prices lately, but the longer-term growth in caloric consumption in the developing world, and particularly increased meat demand, is providing fundamental support for the observable price changes. Meat consumption requires far more grain and land use than less protein-intensive diets, and as economic development continues to sweep through Asia, demand for meat will also continue to head higher. At the same time, drought conditions have left stores of grain perilously low, which has pushed up feed costs, and will eventually also show up in meat prices. US food inflation is already running at 5.1% year-over-year and based on these trends should accelerate to 6% next year.

Chart 2

House Prices Don't Affect Owner's Equivalent Rent

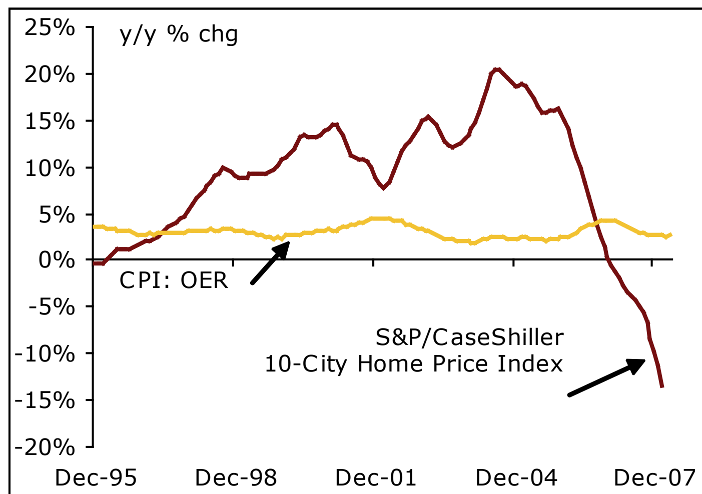
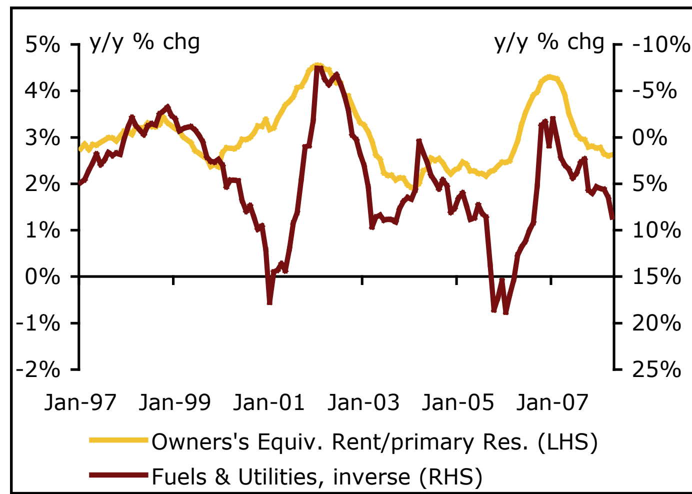


Chart 3

Owner's Rent Inversely Tracks Utility Prices



Food and energy costs are not being offset by disinflation in the core CPI basket. Of course US home prices are dropping like a stone and should be down by a cumulative 25-30% from their peak before the market stabilizes in 2009. But because the CPI calculates price growth in owner-occupied housing by looking at the cost of renting an equivalent house, rapidly declining real estate values will fail to moderate measured inflation by very much. It is worth noting that soaring house prices never fed into the CPI earlier in this decade (Chart 2), and they shouldn't have a material impact on their way down either.

The only visible correlation with the "owners' equivalent rent" component of the CPI is its artificial negative relationship to utility prices (Chart 3). That arises because the BLS deducts an estimate for utility costs to calculate a pure rent measure, and since rental rates are not reset monthly, the pure rent figure goes down when utility prices rise. The recent disinflation in owners' equivalent rent is therefore capturing rising gas and electricity bills, and will vanish once rents that include utilities are adjusted to these new costs.

Elsewhere in the core CPI basket, many consumer goods are no longer falling in price as they were in 2007. As in the case of food and energy, global forces are partly to blame, with non-petroleum import prices moving sharply higher over the past few months (Chart 4). That's a function of the US dollar's ongoing weakness, but also reflects rising inflation rates in many foreign economies that sell into the US market. Wages and prices are rising in China, India and other developing economies, and some of those gains will be passed on at the factory door. Furthermore, sharply rising shipping costs are giving price tags for imported goods an unwelcome added boost.

Mild Recession No Cure-All

For now, inflation is taking a backseat to worries about a US recession and the economic impact of a shaky global financial system. With Q2 GDP likely to show a decline, inflation doves are already arguing that the current economic slump will take the heat off future price pressures, but the historical evidence does not bear this out. More importantly, there are growing signs that the bond market is also having trouble accepting that

Chart 4

Import Prices Threaten Core Goods Inflation

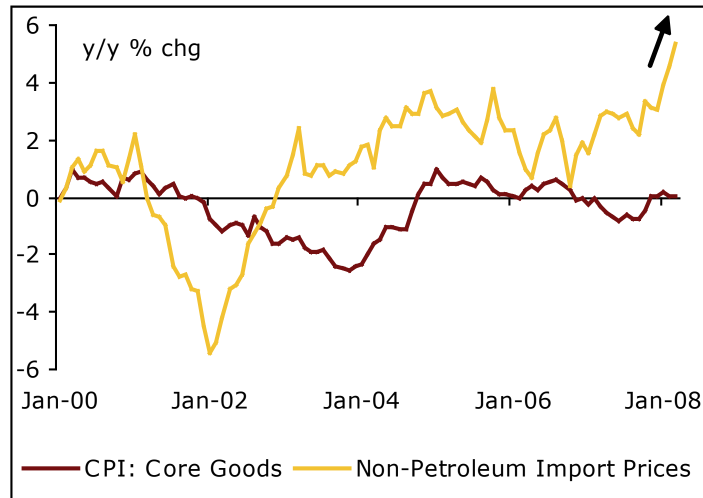


Chart 5

US Inflation Trends in Past Recessions

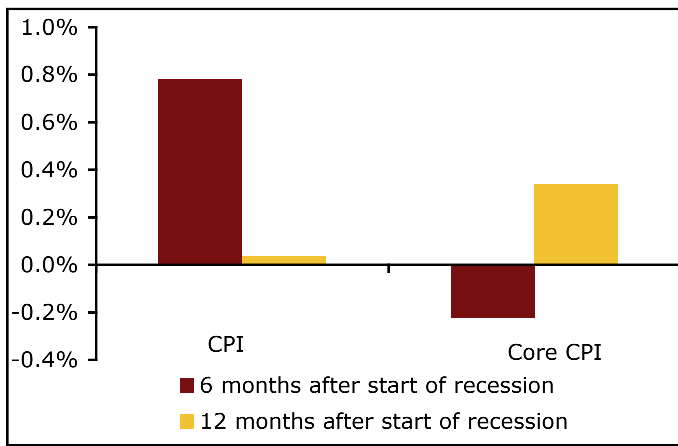
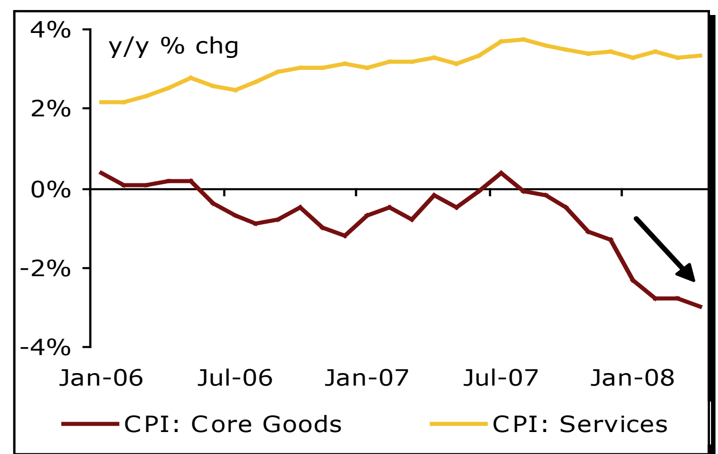


Chart 6

Canada's Inflation Tame Only in Core Goods



line. Over the last five US recessions headline inflation has actually risen slightly six months after the start of the economic downturn and has remained essentially unchanged one year out (Chart 5).

Future price pressure is also expected to come from wages. The US economy entered the year with a labor market beyond its non-inflationary unemployment rate. Productivity gains have delayed the pass-through to unit labor costs, but slower capital spending could eat into productivity growth in the coming year. The unemployment rate will almost certainly head higher, but the current slowdown might not last long enough to throw cold water on pay scales, particularly since a weak US dollar means that there is slightly less competition for American workers from abroad. Tighter borders after 9-11 may also stem the inflows of lower cost illegal workers.

US inflation should not be any higher in 2009 than we are already seeing this year. After all, energy inflation will already be off the charts on a year-on-year basis come this June. But the CPI's failure to come back to earth —still running in the 4% range next year—will be a big disappointment for both policy makers and the bond market, both of which are currently counting on recession to wipe inflation off the map. Instead, the Federal Reserve is going to have to lean in with rate hikes and constrain the pace of 2009's economic rebound as it begins to get more worried about headline inflation.

Canada Loses its Inflation Immunity

Canada appears to stand as a stunning exception to the rising global inflation trend. However, if not for a huge run-up in the Canadian dollar, inflation on the north side of the 49th parallel would also be climbing well above target. After all, Canadian services prices, largely unchecked by imports, are already advancing at a 3.3% pace (Chart 6), even with the benefit of a one-point GST cut. Wage growth has also accelerated, and the slowdown in GDP growth has failed to open up material slack in the labor market because of softer productivity gains.

Canadian core goods prices are dropping by 3% year-on-year, which is its largest divergence from the comparable US measure since 1994. However, much of that gap lies in food prices, which are soaring in the entire developed world except for Canada (Chart 7).

Three factors account for that temporary shelter from the storm. First, a 12% rise in the C$ in the year to April 2008 had fruit and vegetable prices falling at a similar year-on-year pace. Currency moves tend to be quickly translated into these high-turnover goods, but the impact could be gone as early as August, when domestic produce takes over. Second, food costs were held back by a grocery store price war that might already be cooling off after a period of profit-destroying margin cuts. Thirdly, marketing board pricing for dairy, poultry and eggs tends to smooth out adjustments to cost increases, but higher

Chart 7

Canada's Food Prices an Unsustainable Exception

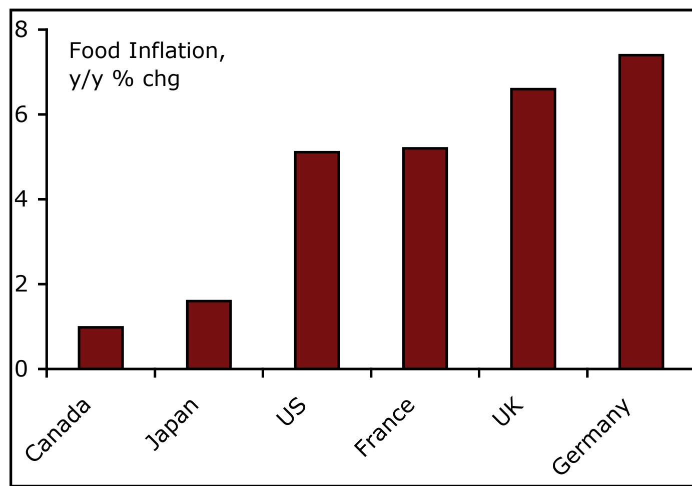
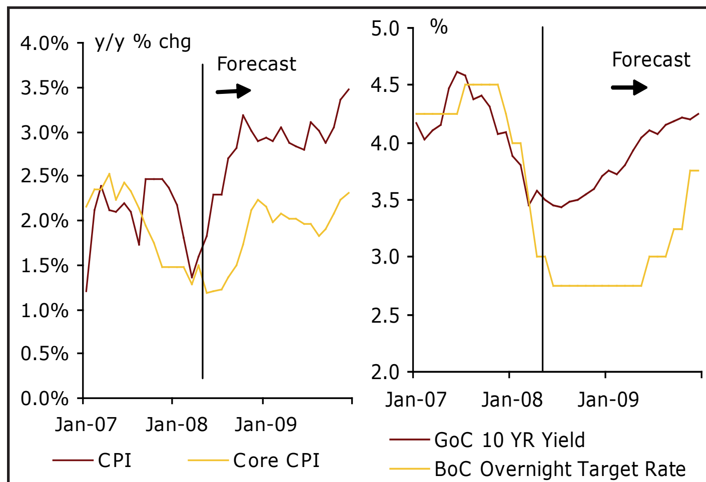


Chart 9

Canadian CPI and Interest Rates Set to Climb



feed and energy costs point to large price hikes ahead for fluid milk, eggs and poultry next year. Prices for other food products are also poised to climb as grocery store bills have not kept pace with the prices charged by food manufacturers (Chart 8).

Our above-consensus forecast for the loonie calls for only modest year-on-year currency appreciation over the next 12-months and should therefore only have a very small moderating influence on inflation. As a result, Canadian CPI should accelerate over the next six quarters, reaching 3½% year-over-year by the end of 2009, and catching the eye of a central bank that aims to keep this measure at 2% (Chart 9, left). These developments should boost administered rates by 100 bps higher in 2009, and send 10-year Canada yields sharply higher (Chart 9, right).

The upcoming implications for financial markets are clear. Government bonds, which seemed like the safe place to be earlier in 2008 when credit markets crashed, will be anything but safe in the year ahead. At the same time, stocks whose bottom lines benefit from rising commodity prices will outperform those sectors that traditionally get hit by rising rates like banks, REITs and utilities (Chart 10).

Chart 8

Cdn Wholesale Minus Retail Food Inflation

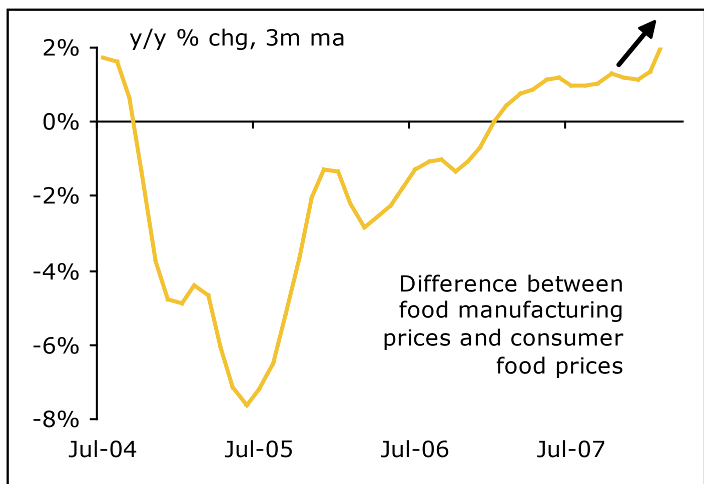
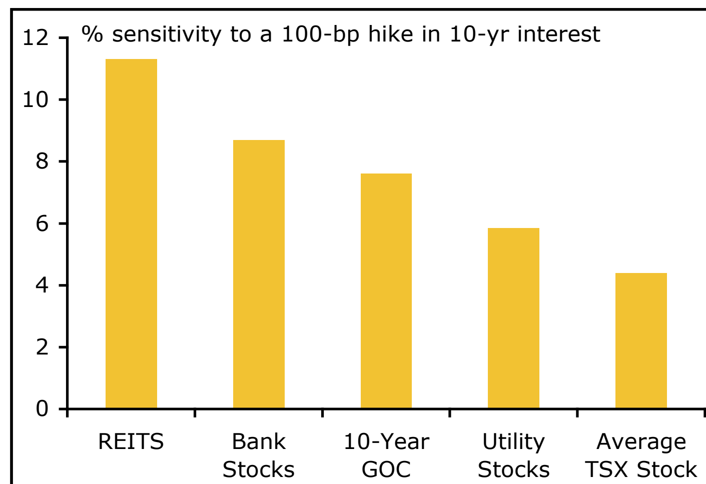


Chart 10

Equities Most Sensitive to Interest Rate Hit



ECONOMIC UPDATE

CANADA	07Q4A	08Q1A/F	08Q2F	08Q3F	08Q4F	2007	2008F	2009F
Real GDP Growth (AR)	0.8	0.2	0.7	1.2	3.0	2.7	1.3	2.7
Real Final Domestic Demand (AR)	6.9	2.7	3.5	2.7	3.0	4.3	4.1	3.3
All Items CPI Inflation (Y/Y)	2.4	1.8	1.9	2.6	3.0	2.1	2.3	3.0
Core CPI Ex Indirect Taxes (Y/Y)	1.6	1.4	1.2	1.4	2.0	2.1	1.5	2.0
Unemployment Rate (%)	5.9	5.8	6.2	6.5	6.4	6.0	6.2	6.3
Merchandise Trade Balance (C$ Bn)	37.1	50.9	49.7	43.5	43.5	49.4	46.9	49.5
U.S.								
Real GDP Growth (AR)	0.6	0.6	-0.8	-0.5	2.8	2.2	1.1	2.2
Real Final Sales (AR)	2.4	-0.2	-1.0	-0.5	2.2	2.5	1.0	2.1
All Items CPI Inflation (Y/Y)	4.0	4.1	3.9	4.3	4.2	2.9	4.1	4.0
Core CPI Inflation (Y/Y)	2.3	2.4	2.3	2.2	2.3	2.3	2.3	2.8
Unemployment Rate (%)	4.8	4.9	5.2	5.5	5.5	4.6	5.3	5.3

CANADA

First-quarter growth looks to have been negligible, despite the drag from net exports easing off relative to Q4. Reduced production for inventories and an inevitable slowdown from the prior quarter's torrent consumer spending pace are to blame for Q1 weakness, and another export drop in Q2 will keep that quarter tame. But this year's brush with near-recession will give way to a commodities-linked spike to inflation in 2009.

UNITED STATES

US first-quarter real GDP growth surprised to the upside, but the outlook for the second quarter is much less favourable. The American consumer continues to exhibit phenomenal resiliency in the face of mounting economic challenges, but cracks are showing. We continue to expect a mild and short-lived recession in the United States, but this should not have a material impact on inflation, which is likely to remain at roughly 4% year-over-year. Although the Fed has signaled a pause in its current easing campaign, we see another quarter-point cut in the cards before policymakers start ratcheting up rates towards the end of the year.

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