Reflation: Is That All There Is?

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Two key, inter-related developments drove markets in an unexpected direction this week—mostly into reverse on the inflation trade. First, **commodity prices displayed some clear exhaustion** after a blazing sprint over the past year, weighed further by China's steps to slow resource demand. Second, the Fed reined in the uber-dovishness at Wednesday's FOMC meeting, with Jay Powell openly allowing that **taper talk had arrived**. This backstopped the U.S. dollar, and sent commodities skidding further, triggering a significant equity market rotation and knocking resource-heavy currencies off their pedestal. After testing the $1.20 level at the start of the week, the **Canadian dollar** promptly sagged almost 3.5% to around $1.245 (80.3 cents) by Friday, staggered by the one-two punch of the commodity reversal and the Fed's turn. Similarly, **equities** took a small step back (exception, Nasdaq) after reaching record highs early in the week.

Even with the pronounced pullback in most commodities, **bond yields** mostly stepped higher in a flattening move. Treasuries see-sawed notably after the FOMC, but the net result was a 12 bp ratchet up in 2-year yields (a big move in that space), about a 1 bp rise in 10s, but an 11 bp dip in 30s. The gap between 30s and 2s has shriveled below 180 bps, the narrowest since early February and down 50 bps from the peak just three months ago. The **over-rated dot plot** caught some attention, with a slim majority of members now expecting rate hikes to begin in 2023, and some members are already asserting they'll be pushing for rate hikes as soon as next year (e.g., Bullard). But Chair Powell's comments on tapering and a flash of concern on the persistence of inflation were more meaningful, and really drove the back-up in short-term yields. Still, Powell picked his timing well to turn "hawkish"—in the midst of sagging commodities and rallying bonds—thereby limiting markets to a **tiny taper tantrum**, **lasting all of about 30 minutes.**

The bigger issue for markets is whether this week spells the end for the furious year-long rally in commodities, or if it is just a pause for breath. After all, it's not really surprising to many that the Fed is preparing to lift its foot slightly off the gas—the **prevailing wisdom** (i.e., our view) had been that **tapering would begin around the turn of the year and rates would begin rising roughly a year later**. But few were clear on how far and how fast the commodity rally could run. **Lumber** did its best imitation of bitcoin, falling roughly 20% in a week to below $1,000, after its historic rally earlier this year. **Agricultural prices** fell heavily on good prospects for crops, while **copper** led all metals down with a 7% setback. But—and it's a very big but—**oil** fought back at week's end to around $72 for WTI, while **natural gas** hung on to the $3.20 level. Energy prices clearly march to their own drummer, but, weighing in at about half of many major commodity indices, their resiliency looms large.

On balance, **we view this pullback as more a pause** than the end of the rally for the commodity complex. While not in the super-cycle camp, we do look for a robust rebound in global growth to support prices for some time yet. In turn, we suspect that this is also not the turning point for commodity currencies, and that's especially the case for the loonie if oil prices stay anywhere close to current levels.

Still, the **sudden swoon in a wide swathe of resource prices has removed the steam from the inflation debate**. And that's just as CPI readings were beginning to heat up in many economies. To this point, the fiery CPI increases had mostly been a U.S. story, with the 5.0% y/y headline price in May towering over all other advanced economies. Canada posted its biggest rise in a decade in the month but was behind the leader at 3.6%—and that may well be the high for the year (easy comps almost certainly point to a big dip next month). Meantime, while inflation has perked up in the rest of the G10, the rise has been mostly due to base effects and remains mild at 2.1% in Britain, 2.0% in the Eurozone, 1.3% in China, and -0.1% in Japan. American exceptionalism indeed.

Calmer commodities and a mindful Fed have **tamped down the inflation trade**. However, note that the steady grind in oil prices still has the potential to lift headline inflation further and almost everywhere. Thus, the **transitory debate** is **far from settled**. The latest forecasts from Fed participants revealed a leap in expectations for the 2021 inflation rate, but almost no move in ensuing years. Less convinced that the recent upswing is fully transitory, the consensus now expects the U.S. PCE core deflator to average 2.7% this year and 2.5% in 2022 (BMO is at 3.2% and 3.0%), up from 1.9% and 2.0% just three months ago. The forecasts for Canadian CPI are weirdly similar almost across the board.

While it won't change many minds on the transitory debate, the key U.S. data release in the coming week will be Friday's **personal income and spending** report for May, and particularly the **PCE inflation** reading. After piercing the 3% threshold in the prior month, the core deflator is expected to post another meaty rise of 0.6% m/m, lifting the annual pace to a three-decade high of around 3.5%. We would also point out that the two-year trend rate for this preferred measure of core inflation would thus push above 2.0% (to 2.2% in fact), for the first time since October 2008. A two-year trend of underlying inflation above 2% seems to tick the sustainable box—next task: healing the labour market, and that looks to be a bigger job.

Arguably one factor keeping a tight lid on long-term bond yields even amid the recent inflation scare is the likelihood that long-term growth prospects have been weakened, not strengthened, by the pandemic. One key building block of said growth prospects is the **size of the labour force**, and it's taken a hit from a sagging participation rate. But even more fundamentally, **population growth** has softened in both the U.S. (continuing a long-term trend there) and in Canada (abruptly reversing the trend there).

Canada reported this week that its population edged up 0.2% in Q2 to 38.1 million, but that left the tally up just 0.4% y/y (an increase of 150,000 people)—which just happens to precisely match the estimated U.S. population growth rate in the past year. That is a shadow of the surging pre-pandemic trends in Canada of 1.5% y/y growth (or more than 575,000 people). A near-50% drop in the number of immigrants and an outright drop in non-permanent residents has nearly stalled population growth. While Ottawa aims to crank up immigration in the years ahead to fill in for the near absence in the past year, the current cool increases would normally put a chill into housing demand as well as labour supply. Watch this space.

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