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Economic Development Winnipeg

WINNIPEG ECONOMIC DIGEST

WHAT IS KEEPING INFLATION HIGH IN MANITOBA AND CANADA?

FACTORS PUTTING PRESSURE ON OUR LOCAL ECONOMY AND SOME RECOMMENDATIONS ON WHAT MANITOBANS CAN DO TO EASE THE EFFECTS OF INFLATION AND RISING INTEREST RATES

Chris Ferris, Senior Economist

Bottom Line

External factors driving Canadian inflation are shifting. We are seeing supply chain congestion beginning to ease, but we are not out of the woods yet. We are still seeing an unusually high share of outbound containers leaving Port Metro Vancouver empty. **[1]**

The Russian invasion of Ukraine, sanctions on Russia and the recent sabotage of the two Nord Stream pipelines means a much-reduced flow of natural gas into Europe from Russia. The announced OPEC+ November production cuts will support crude oil prices so long as they are in effect. These two energy supply factors will result in high costs and weight on economic activity. **[2]**

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[1] A medium-term solution for container shipping looms on the horizon. The massive surge of new container ship orders will weight on container shipping prices, if we see a similar expansion of container ports and related logistics systems.
[2] Over the medium term, this will encourage European countries to accelerate their switch away from crude oil, and natural gas to other energy sources for heating and transportation particularly.

Bottom Line (continued)

Canadian housing markets have been cooling with rising interest rates, but we are still seeing other parts of the economy with increasing prices. So, while Canada's Consumer Price Index (CPI) inflation has begun to fall, core inflation still is a stubbornly high five per cent in August 2022.

The Bank of Canada (BoC) raised their policy rate to 3.25 per cent in September 2022. Bank of Canada Governor Macklem noted on October 6, 2022, that we need to see higher interest rates to bring inflation back down to the two per cent target. Given the Sep 21, 2022, US Fed dot plot analysis, the Fed is looking at a further 125 bps increase in the Federal Funds rate by the end of 2022. **The BoC may make a similar increase of 125 bps before the end of 2022. Thus, it would be prudent to review your borrowing and project ROIs under similar scenarios and put marginal projects on hold for the time being.**

ANALYSIS

Russian Energy Supplies

There are some factors driving inflation that originate outside of Canada. These include supply shortages, supply chain congestion and the disruption of commodity markets due to Russia's invasion of Ukraine.

Russia's invasion of Ukraine caused disruptions to food, fertilizer, and energy markets earlier in 2022 and will continue to cause disruptions. Over time, goods from other countries or similar goods are starting to be substituted for Russian goods. For example, European countries have built-up natural gas stocks for the winter, but prices are expected to be high over the heating season. **[3]** At the same time, the fertilizer industry will be **short of natural gas**, driving up fertilizer prices. Oil refineries will be **short of crude oil**, pushing up refined product prices. This is causing reduced economic activity in the broader European economies - a weakening of demand. **[4]** This will have a negative effect on Canada via trade channels.

Worsening the supply issue, last **week** a currently unidentified actor sabotaged both the Nord Stream 1 and 2 natural gas pipelines in the Baltic Sea from Russia into Germany. Thus, both parties cannot use the pipelines without significant repairs. This will support or even increase natural gas prices in Europe this fall and winter. Adding to this, the recently **announced** OPEC+ production cut of two million barrels per day (bpd) will support or increase crude oil prices while in effect. **[5]**

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[3] **Germany** is looking at easing energy price pressures on consumers and small businesses over the winter.

[4] Canada currently has no ability to export Liquified Natural Gas (LNG) yet, and the closest ones to completion are all on the West Coast. Canada will be providing other products for export to Europe, such as Hydrogen by 2025 **New 'hydrogen alliance' offers Canada an opportunity to export ammonia to Europe - Inside Logistics**.

[5] The OPEC+ production cuts are to begin in November 2022.

Supply chain congestion and supply shortages

Intermodal shipping prices for China/East Asia to West Coast North America (FBX01) surged during 2021, peaking at just over US$20,000/day in September 2021. [6] Shipments remained backed-up until well into May 2022 due to the massive lockdown of Shanghai and its factories earlier in 2022. Since May 2022, FBX01 container shipping prices have dropped off sharply, falling to US$3,441/day on September 23, 2022. The reverse leg of the trip (FBX02) has been trading essentially sideways since July 2022 and was around US$960/day on September 23, 2022. There is still some upside risk associated with supply and supply chains tied to China's COVID-Zero policy, but for now, the key FBX01 container shipping prices have been easing.

In the October 6, 2022, remarks by the BoC, Governor Tiff Macklem noted that global supply bottlenecks are beginning to ease as illustrated by **chart 3** (see following page). This correlates with similar indices, such as the Global Supply Chain Index (GSCI) from the US NY Fed, [7] and the JPMorgan Global Manufacturing Purchasing Manager's Index (PMI). [8]

The GSCI chart is on the following page.

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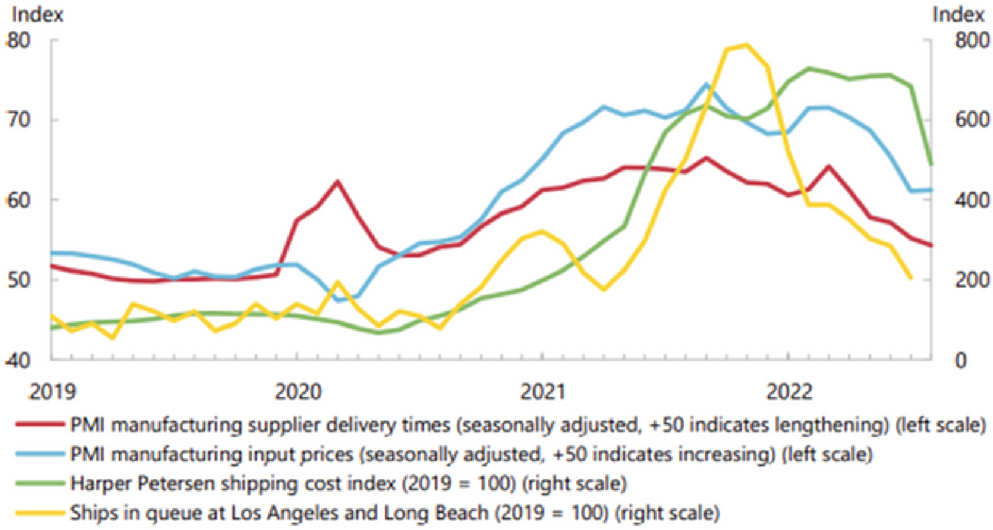
[6] See the chart from MacroMicro **FBX01 Asia to West Coast | Maritime Shipping | Collection | MacroMicro**. The data source is **Freightos**. This is for forty-foot containers, or two Twenty-foot equivalent units (TEU).

[7] The GSCI ties in the Baltic Dry Index (BDI), the Harpex index, airfreight cost indices, and Purchasing Managers' Index (PMI) surveys (China, the euro area, Japan, S. Korea, Taiwan, the UK, and the US).

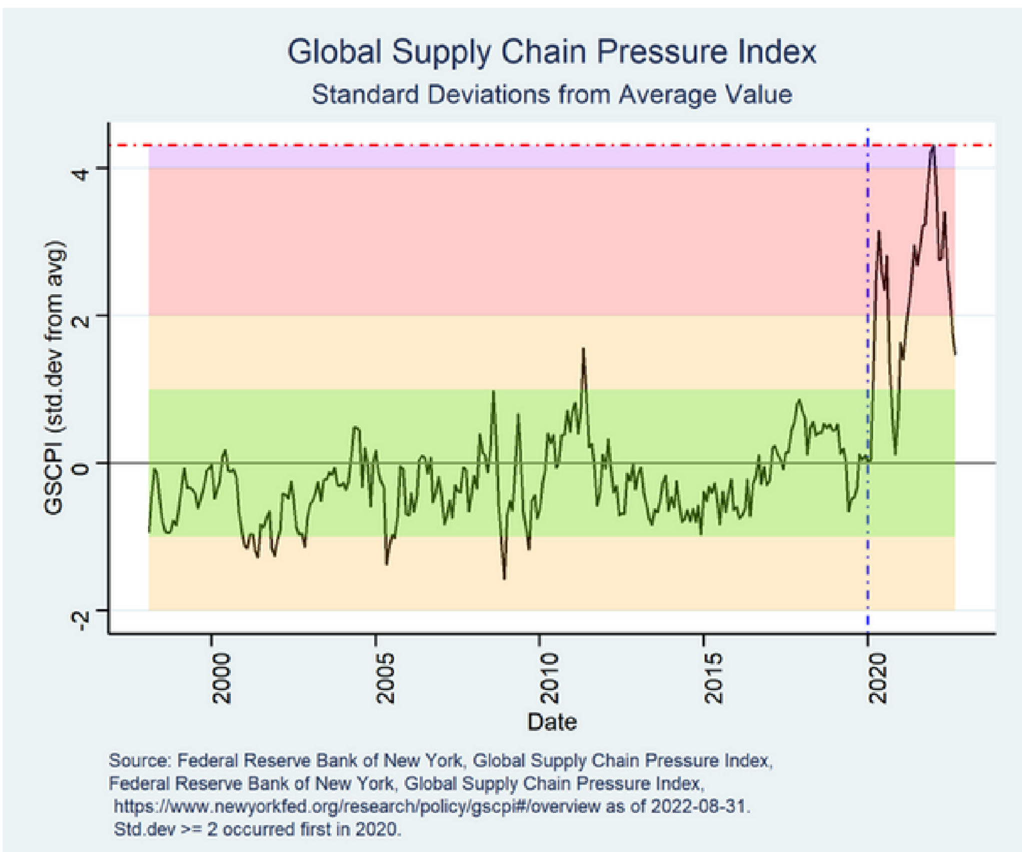
[8] We are seeing easing of the broader JPMorgan Global Manufacturing PMI to 49.8 in September from 50.3 in August. The neutral level is 50.0, as noted in an October 4, 2022, **article** from S&P Global's IHS Markit.

ANALYSIS

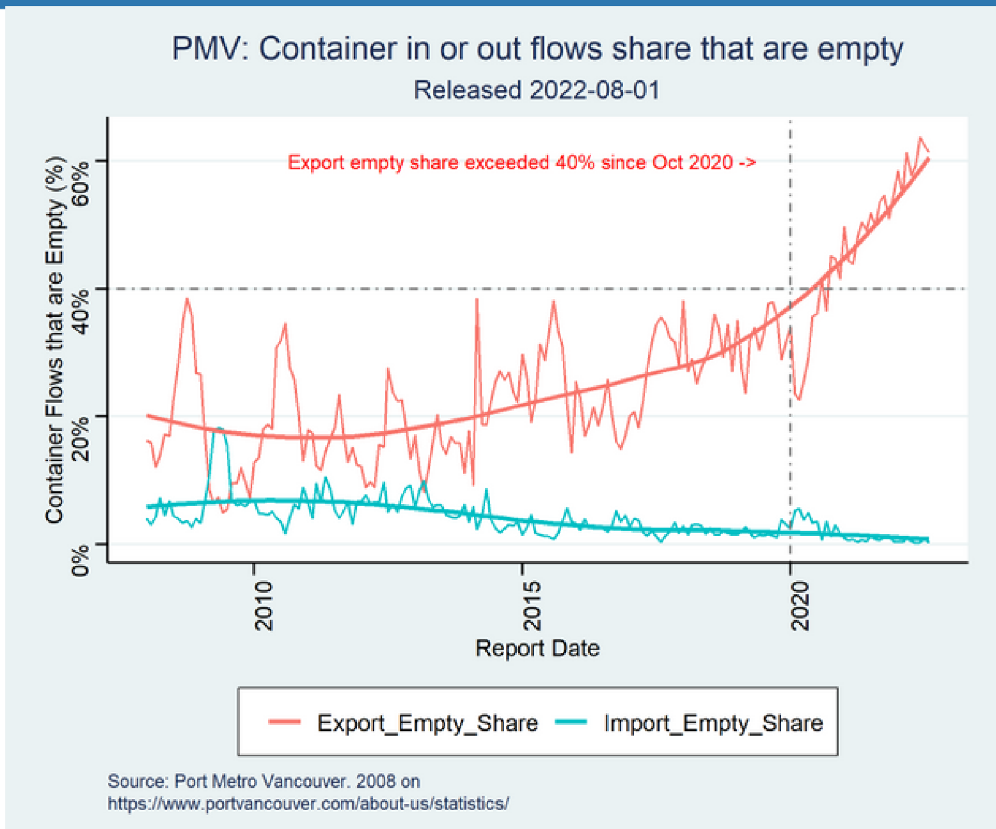
Chart 3: Global supply bottlenecks are beginning to ease but remain elevated
Monthly data



Note: "Ships in queue at Los Angeles and Long Beach" is an "end-of-period value".
"Harper Petersen shipping cost index" is an average of weekly data.
Sources: Harper Peterson, The Marine Exchange of Southern California and S&P Global via Haver Analytics Last observation: September 2022



BOX 1: PORT METRO VANCOUVER CONTAINER FLOWS



One of the consequences of strong export demand from East Asia to West Coast North America has been the high price differential in intermodal prices out of China/East Asia (FBX01) vs the reverse trip (FBX02). [9] As a result, quickly returning empties has been very lucrative on the return trips back to China/East Asia.

There is still an elevated empty share of containers leaving Port Metro Vancouver (PMV). From 2008 through 2019, there was never a case where the share of outbound empties from PMV was higher than 40 per cent.[10] Since October 2020, there has not been a month where the share of outbound empties was below 40 per cent.

As container shipping prices from China/East Asia to West Coast North America (FBX01) fall more in line with the reverse trip (FBX02), we expect that the share of empties out of West Coast North America should start falling back. With weakness in the global economy starting to show, this softening of demand should show up in Q4-2022 and the first half of 2023 numbers. This should reduce inflation pressures coming from supply chain congestion from China/East Asia.

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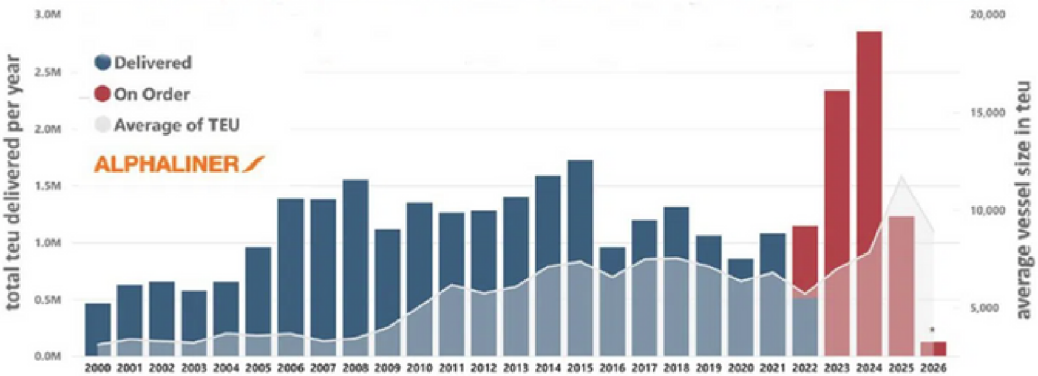
[9] A similar pattern to Europe from China/East Asia also exists. In May 2022, the FBX01/FBX02 ratio was 16.5 to 1, in July 2022 it fell to 7 to 1, and on Sep 23, 2022, it has fallen to 3.6 to 1.
[10] The (Empties/Total_Outbound) ratio has been elevated since 2017.

BOX 2: CONTAINER SHIPPING/HANDING CAPACITY GROWTH

Actual and projected container ship deliveries from 2000 to 2026



Note: Currently orderbook stretches out only to early 2026 (*) Low value for 2026 is not a forecast (Chart: Alphaliner)

The sharp increase of container ships on order for 2023 and 2024 delivery will add capacity to the container supply chain, as noted in Freight Waves on **October 5, 2022**. This will encourage the expansion/development of further port capacity, drayage, and related truck/rail capacity to move containers from the port onwards.

This is good news for the port project announced in 2021 for Mazatlán, Mexico that has a Centreport Canada component to the project. **[11]** The project is expected to be ready in about 3.5 years, as noted in a May 2022 article in **the Mazatlán Post**.

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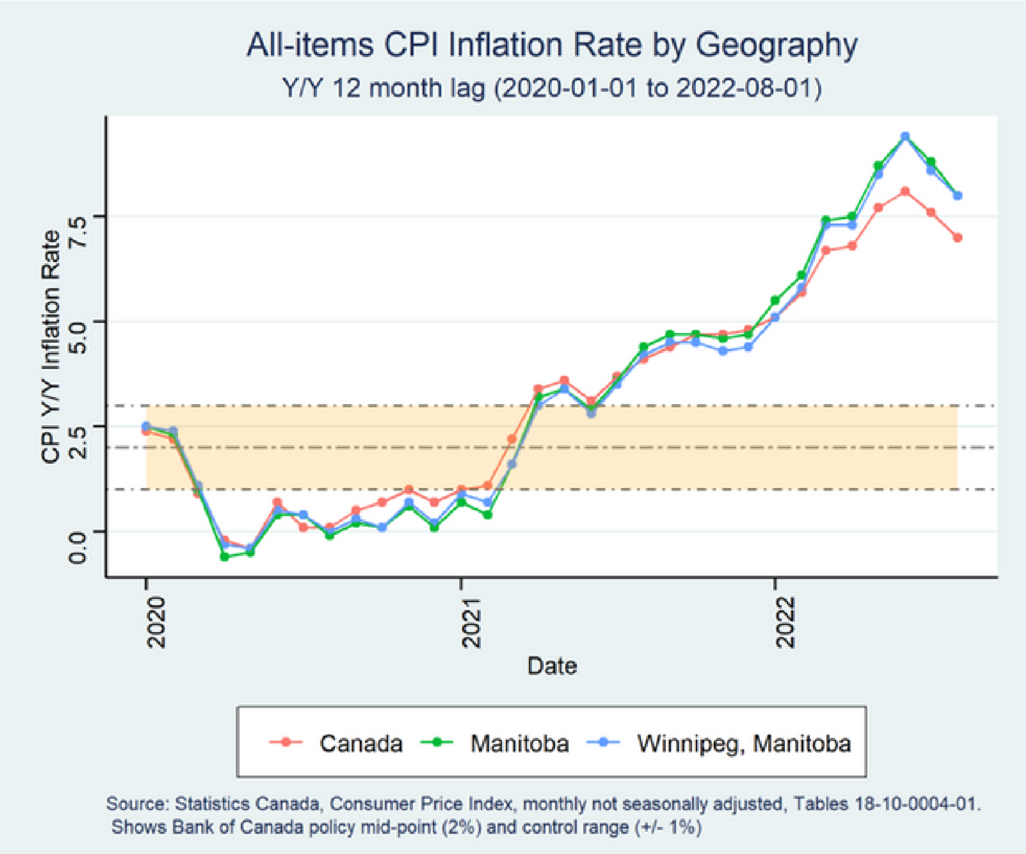
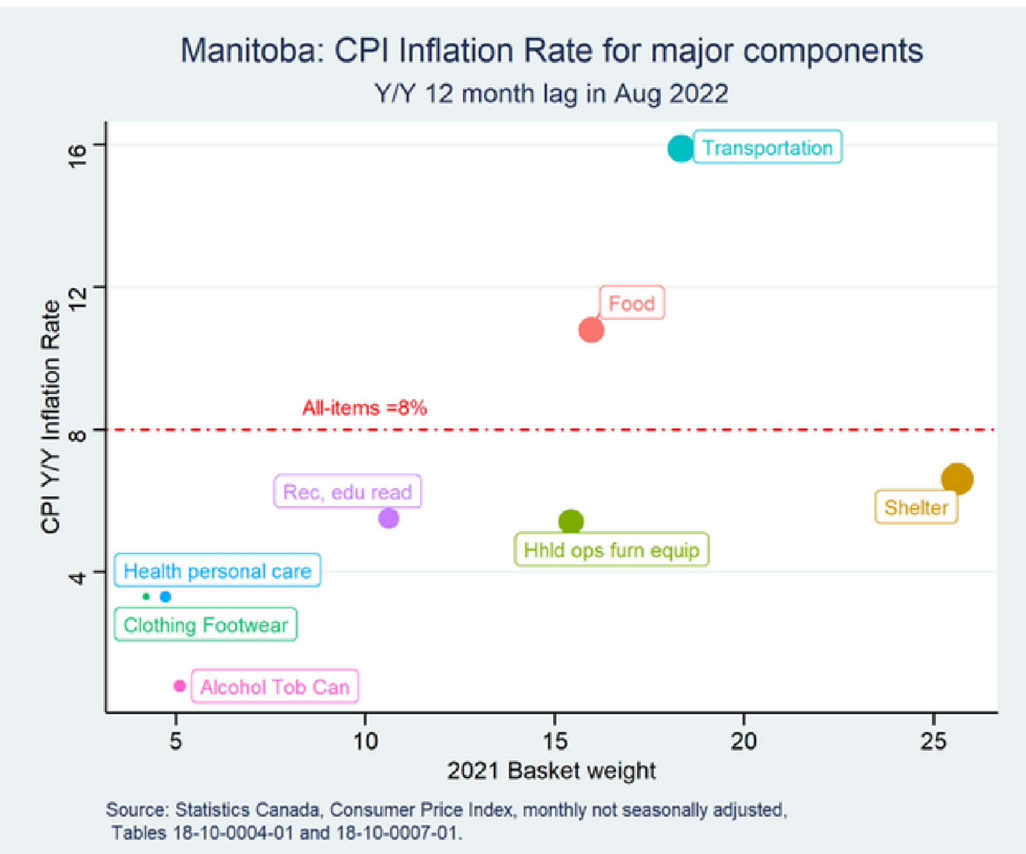
[11] A The Mazatlán port will have rail connections to Centreport Canada, as noted in our Weekly Economic Digest, Vol.2, **Issue 16** in 2021.

ANALYSIS





Canadian and Manitoban Inflation

For CPI year/year inflation peaked in June 2022. It has fallen in July and August 2022.

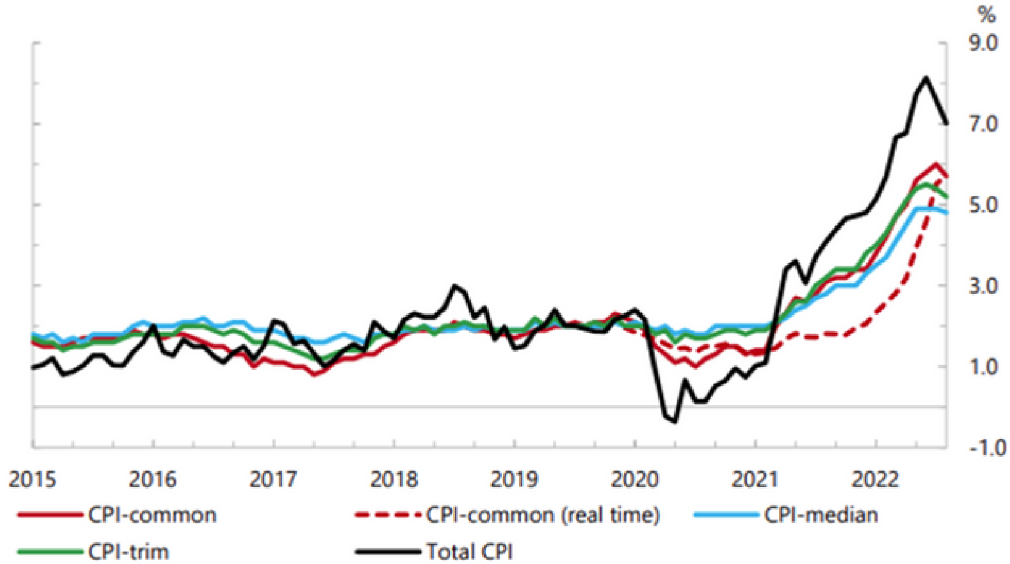
Manitoba's food and transportation inflation remains above the all-industries average of eight per cent.

Core inflation for Canada remains high at approximately five per cent, as noted in Governor Macklem's October 6 remarks (BoC **Chart 5** on the next page).

ANALYSIS

Chart 5: **Core measures show strong underlying inflationary pressures**

Year-over-year percentage change



Note: Real-time refers to the initial unrevised reading of CPI-common over each month of the pandemic.

Sources: Statistics Canada and Bank of Canada calculations

Last observation: August 2022

In volume 1, **issue 1** of the Winnipeg Economic Digest, we noted that the BoC credited commodity price effects (food, energy and other commodities) and global supply and shipping costs as being key, unexpected external drivers of inflation. Typically, these types of goods and services get sorted out relatively quickly, but a massive switch in spending from services to goods, long COVID lockdowns in a major port and large invasions of major commodity producers are not typical situations.

The key domestic unexpected factor came from house price increases. With increasing interest rates, there is a softening in house prices and activity in real estate markets. Interest rate hikes appear to be having a dampening effect on Manitoba's and Canada's CPI inflation. Rising rates are expected to continue to pressure residential real estate prices lower.**[12]**

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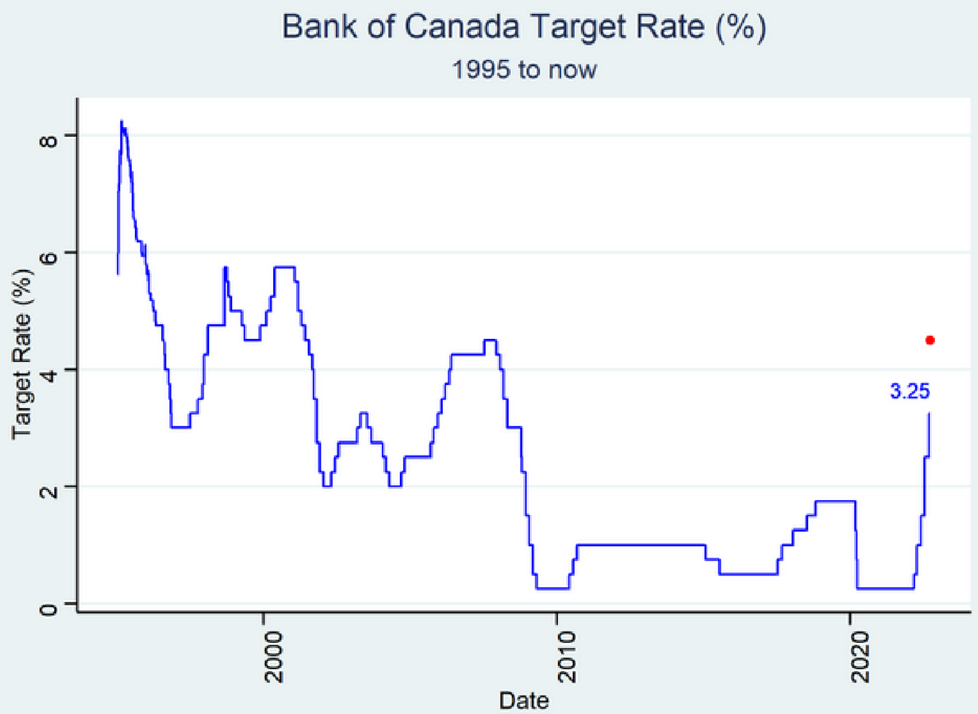
[12] Looking forward over the medium to longer term: The Winnipeg CMA's population was recently projected by **Statistics Canada** to rise by 30 per cent between now and 2041 (low scenario: 15% increase, high scenario: 44% increase), as found in Table 17-10-0146-01. This is a significant opportunity to grow our population and our GDP per capita.

We want to avoid sharp house price increases that are plaguing the Lower Mainland and Southern Ontario. To do this will require removing unnecessary barriers and adding encouragements to adding sufficient housing supply. Issues were noted in many reports and/or articles in 2022, including:

- in a June 2022 **CMHC** research **paper**, "**Housing Shortages in Canada: Solving the Affordability Crisis**."
- a report by Moffatt, M., Dudu, A., Hosseini, M. (2022). "**Ontario's Need for 1.5 million More Homes**," Smart Prosperity Institute, **link**,
- various blog posts by Jens Von Bergmann and Nathan Lauster from Vancouver: such as (October 2022) **Still Short: Suppressed Households in 2021**, and (May 2022) **Estimating Suppressed Household Formation**.
- See also Paul Vieira (October 2022). "Canada's Immigration Problem: Not Enough Homes for Newcomers," WSJ **article**.

ANALYSIS



Source: Statistics Canada, Table 10-10-0139-01, and Bank of Canada announcement. Chart by @chrisferris3. Current neutral rate estimate is from 2 - 3 per cent. Current rate is 3.25%. Aside: As of Sep 22, 2022, the Fed Fund rate is expected to be 4.4% by end of 2022, and 4.6% by end of 2023. Expect to drop to 2.9% by end of 2025. So could see as much as 125 bps increase before the Fed tops out. May influence the BoC.

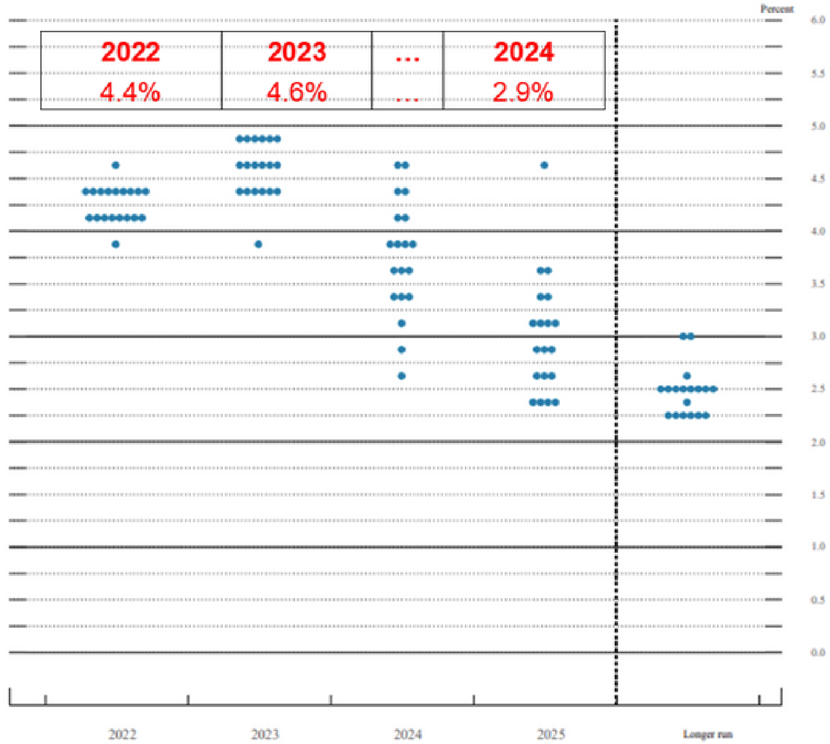
Monetary Policy Action

The BoC made a 75-basis point (bps) increase to the overnight rate (ONR) on September 7, 2022. This was in line with market estimates the week before.

The US Federal Reserve's 75 bps increase on September 21 saw the federal funds rate range increase to 3.00 to 3.25 per cent. The survey of FOMC committee members represented by the DOT plot estimates a federal funds rate of 4.4 per cent by the end of 2022, 4.6 per cent by the end of 2023 and 2.9 per cent by the end of 2025.

The higher expected US federal funds rate will likely influence the BoC's ONR decisions. We have two more BoC rate decision dates in 2022: October 26 and December 7. If the BoC follows a similar pattern as the Fed expect to, an increase of up to 125-bps would deliver a **4.50** per cent ONR by the end of 2022 or early in 2023 (see red dot in the chart of the BoC Target rate). If a 125-bps increase occurs, Canadians can expect mortgage rates to rise by the same number of bps. This will put pressure on the economy in general and interest-rate-sensitive sectors like real estate.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



Given Governor Macklem's October 6 speech and his emphasis on core inflation of approximately five per cent being too high, it seems likely some or all that 125-basis point increase in the ONR can be expected before interest rates ease back.

So, it is highly recommended individuals and businesses review their borrowing and project ROIs considering higher expected interest rates.

INQUIRIES AND CONTACTS

If you require help accessing government programs, contact our YES! Winnipeg team through the **Help us help you form**.

General inquires: **wpginfo@edwinnipeg.com**

Marketing & communications inquiries: **marketingandbranding@edwinnipeg.com**

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