

The Central Bank Conundrum



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Only a few months ago, Canadian and U.S. inflation appeared to be gliding steadily closer to target. Bond markets were increasingly confident that central banks would soon have room to ease, particularly as pockets of stress were emerging in private credit, and concerns around artificial intelligence and trade uncertainty weighed on the growth outlook. Market pricing increasingly reflected confidence that the next move in policy rates would be lower.

That narrative has since been disrupted. The escalation of conflict in the Middle East and the resulting disruption to global energy flows have pushed oil prices sharply higher, lifting headline inflation away from target and reintroducing a familiar dilemma for policymakers. Central banks now face opposing signals, with growth and employment arguing for patience while inflation argues for vigilance. The result has been a reinforced data-dependent pause, keeping interest rates range-bound with an upward skew in yields.

Labour Markets: Bending but Not Breaking

Labour market dynamics help explain why the policy debate is so finely balanced. In the United States, job growth has slowed and hiring intentions have softened, particularly in manufacturing and other trade-exposed sectors. Business surveys point to weak employment momentum, yet layoffs remain limited. Initial jobless claims fell to 189,000 in late April, the lowest level since 1969, underscoring that employers are reluctant to shed workers even as they pull back on new hiring.

This has produced a “low-hire, low-fire” labour market. A key contributor to this environment is the unusual combination of slowing labour demand alongside a decline in labour supply. Restrictive immigration policy has reduced the available workforce at the same time that hiring appetite has softened. The Federal Reserve has acknowledged this balance, noting that as a result, the unemployment rate has been little changed in recent months.

Canada shows a similar pattern. Employment rose modestly in March following significant job losses earlier in the year, leaving year-to-date job losses near 95,000. The unemployment rate was unchanged at 6.7% in March and has risen only slightly year to date, as the labour force has also declined in size due to lower immigration targets, especially for non-permanent residents. The composition of job losses points to underlying softness: roughly two-thirds of recent losses have come from full-time employment, while part-time employment has been declining more modestly. Wage growth, however, has accelerated, with average hourly wages rising more than 4.5% year over year, a development the Bank of Canada has flagged as a risk should energy-driven inflation broaden.

Taken together, labour markets appear fragile but stable. This delicate equilibrium, however, could be easily disrupted.

Inflation: Energy Shock First, Broader Passthrough Later?

The renewed inflation pressure is, for now, overwhelmingly an energy story. The effective closure of the Strait of Hormuz has disrupted a significant share of global oil supply, driving a sharp rise in crude and gasoline prices. Politically, the situation remains stalled; a ceasefire is in place, but the blockade continues and the strait largely remains closed to tanker traffic.

This shock has already passed through to headline inflation in both the U.S. and Canada. In the U.S., headline CPI rose 3.3% year over year in March, up sharply from February, driven by a 21% monthly surge in gasoline prices.

So far, however, second-round effects remain limited. Core inflation rose just 0.2% on the month and 2.6% year over year, underscoring the limited pass-through beyond energy. Services inflation has not shown broad-based acceleration, and diffusion measures suggest price pressures remain narrow.

Canada’s experience has been similar. Headline CPI rose to 2.4% in March from 1.8% in February, again driven by a sharp 21% monthly increase in gasoline prices. Some energy-intensive categories, including airfares and food purchased from stores, rose notably during the month. For now, however, broader contagion remains contained. Core measures, including CPI-median and CPI-trim, remain just above the Bank of Canada’s 2% target.

Energy futures curves have shifted higher, reflecting expectations that inventory rebuilding and the difficulty of rerouting global energy supply chains will keep oil prices elevated for longer, even if the Strait of Hormuz disruption ultimately resolves. As a result, the risk to inflation expectations is asymmetric, with greater potential for repricing to the upside than the downside. That risk would increase materially if higher energy costs begin to generate second-round effects, particularly through

transportation and distribution channels. For now, near-term inflation expectations have moved higher, while longer-term expectations remain relatively contained, suggesting markets continue to view the shock as transitory rather than structural.

The key question for policymakers is whether this shock remains temporary or evolves into something more persistent as restocking, inventory rebuilding, and broader price pass-through take hold.

Market Implications: Policy Paralysis and Rangebound Rates

Faced with the tension between hawkish policy to combat inflation, and dovish policy to support growth and the labour market, central banks have opted for patience. The Federal Reserve held its policy rate at 3.50% to 3.75% at its April meeting, but the decision highlighted deep internal disagreement. The 8 to 4 vote was the most divided since 1992, with three officials dissenting against language implying future easing and one dissenting in favour of an immediate rate cut. The policy statement explicitly cited higher global energy prices as a source of elevated inflation and uncertainty.

The Bank of Canada has taken a similar stance of patience. It held its overnight rate at 2.25%, near the lower end of the estimated neutral range, noting that it can look through a temporary energy shock so long as inflation expectations remain anchored. At the same time, Governor Macklem acknowledged that persistently high oil prices could require a different response, particularly if wage growth and core inflation begin to reaccelerate or if higher energy prices feed into broader inflation expectations.

For fixed income markets, the near-term implication is continued range-bound trading. Sensitivity to individual data releases has increased, contributing to short-term volatility.

Over time, this prolonged uncertainty could also translate into higher term premia, as investors demand greater compensation for holding longer-duration risk.

Tug-of-War: Which Side of the Mandate Wins?

Base Case View: Inflation Dominates Near-term Narrative

Our current view is that inflation risks are likely to dominate as labour markets stabilize and show early signs of bottoming. Consumer spending remains resilient, particularly among higher-income households, and this resilience is being reinforced by fiscal tailwinds in both the U.S. and Canada, albeit on different timelines.

In the U.S., household cash flows are receiving a near-term boost from seasonal tax refunds and ongoing fiscal relief under the *One Big Beautiful Bill Act*, supporting consumption at a time when inflation pressures have re-emerged. In Canada, fiscal policy is also turning more supportive, though the impulse is more medium-term in nature. The 2025 *Canada Strong* budget, with its emphasis on infrastructure investment and defence spending, is expected to feed into activity gradually as projects are approved and spending is deployed. Taken together, these fiscal forces add to demand just as headline inflation is rising, reducing the likelihood of a sharp growth slowdown and tilting the policy balance toward inflation persistence.

In Canada, policy rates sit near the lower end of the estimated neutral range, leaving the Bank of Canada more exposed should inflation pressures broaden. In contrast, the Federal Reserve has greater scope to remain on pause while awaiting clearer evidence on inflation persistence and labour-market dynamics. As a result, our near-term expectation for central bank policy is a hawkish hold, limiting downside in yields and skewing risks modestly higher within an otherwise range-bound environment.

Potential Labour Market Softness Could Challenge the Outlook


That said, the outlook remains fluid. A meaningful deterioration in labour markets would quickly tilt the balance back toward easing. Accelerating job losses or a sustained rise in unemployment would challenge the current stance.

One way this downside risk could unfold is if higher gasoline prices begin to function more clearly as a tax on consumption. While households have so far absorbed higher energy costs, a prolonged rise would increasingly crowd out discretionary spending, particularly among lower- and middle-income households with limited flexibility over essential expenses. In this environment, corporate profits could rotate away from discretionary industries and become more concentrated in the energy sector, where gains are less likely to translate into incremental hiring or capital expenditure. Taken together, this dynamic could weigh on discretionary spending and aggregate employment, triggering a growth scare and placing downward pressure on inflation over the medium term. For now, however, this channel remains a downside scenario rather than a realized outcome.

Trade uncertainty also remains an important risk. For Canada, trade frictions are already weighing on investment and manufacturing activity while raising costs for trade exposed sectors. The review of the United States-Mexico-Canada Agreement begins in July 2026 and any breakdown in negotiations or material adverse changes in the agreement would likely further dampen business investment and domestic growth, while simultaneously increasing cost pressures across integrated supply chains.

Another risk to the labour market outlook is that artificial intelligence (AI) adoption begins to materially reduce labour demand. If productivity gains increasingly translate into slower hiring, weaker wage growth or outright displacement, particularly across white collar and knowledge oriented sectors, labour market slack could emerge more quickly than expected. Importantly, this risk is likely to unfold over a longer time horizon and would represent a more structural shift in labour-market dynamics rather than a near-term cyclical shock.

Closing Thoughts

With multiple forces pulling at both sides of the inflation and growth outlook, our focus remains squarely on the data. Inflation diffusion, inflation expectations and labour market job losses will ultimately determine which side of the mandate prevails. We are watching closely for signs of reacceleration or deterioration and remain prepared to pivot and manage portfolios accordingly as the conundrum evolves. 

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