Economics

# ECONOMIC INSIGHTS

May 12, 2021

## Herd on the street

by **Avery Shenfeld** avery.shenfeld@cibc.com

Epidemiologists are telling us that we're unlikely to reach the ultimate solution for our Covid-19 affliction, even if we can put the worst behind us soon. The human herd on our streets likely won't be sufficiently immune to wipe it off the planet. Vaccinations are rolling out too slowly around the word, too many will unfortunately decide to opt out, and we'll be chasing new variants with yet more booster shots designed to tackle them.

We'd provide a full feature story on what that means for the global economy in 2022 and beyond, but there's a catch. Nobody yet can say what an "endemic" coronavirus will actually mean. It could be no worse than a bad annual flu season, which also fills up hospital wards, but which doesn't forestall economic activity to any serious degree. Or It might be more troublesome. For now at least, we're assuming that it's the rosier of those two scenarios, at least for most of the developed world.

But what's clearer is that Covid-19 will still be holding back activity in what remains of 2021. Our view is that the clouds will not lift as definitively as many assume, until the turn of the year, and we've built that into our forecast, more so in Canada than in the US. That's key to why, having been generally more optimistic than the central bank, CIBC's outlook for 5.7% real GDP growth in 2021 (Table 2) now trails the Bank of Canada's 6.5% outlook.

As we are all now aware, Canada is dealing with a harsher, variant-driven Covid wave that has forced the shutdown of close contact services in many provinces. Relaxing those restrictions too soon, before case counts are down sharply and vaccinations are much further along, would risk a renewed summer wave.

The US has three "advantages" over Canada in this regard. Far more Americans have immunity from having already had Covid. Second, many more have completed their full vaccination program. Canada could catch up on vaccines by summer's end, but that's not the end of the story. If there's a fall Covid wave, or variants partially breakthrough vaccinations, the US has much more hospital and ICU capacity per capita, and some states seem more willing to let it fill up if that keeps the sports stadiums and bars open.

Still, in both countries, not all indoor services venues will immediately be allowed to return to full capacity. While sounding hopeful, Anthony Fauci would only stretch to say life would be back to normal by Mother's Day 2022. And as we may be seeing in the US, while infections are still out there, labour supply could hold back the pace of expansion if yet-to-be vaccinated workers fear becoming ill.

Make no mistake – economic conditions this fall should be much more open than what we're seeing now, particularly in provinces struggling with the third wave. But our Canadian outlook leaves a good deal of the service sector recovery for a 2022 story, given all of the constraints noted above. And as our feature story relates for the US (refer to pages 4-7), there are parts of our goods sector boom where we might run out of room to maintain the recent pace. The herd will have to be feeding at the service sector trough for the next big leg of the recovery, and will need enough immunity to make that happen.

Table 1: Canadian economic update

| Variable | 20Q4A | 21Q1F | 21Q2F | 21Q3F | 21Q4F | 22Q1F | 22Q2F | 22Q3F | 22Q4F | 2020A | 2021F | 2022F |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Real GDP growth (AR) | 9.6 | 6.5 | 1.0 | 5.0 | 5.6 | 5.3 | 4.2 | 2.7 | 2.3 | -5.4 | 5.7 | 4.3 |
| Real final domestic demand (AR) | 3.5 | 4.3 | 2.5 | 5.8 | 6.1 | 4.9 | 4.9 | 3.4 | 2.5 | -4.5 | 5.4 | 4.7 |
| Household consumption (AR) | -0.4 | 1.1 | 1.5 | 7.0 | 6.7 | 5.3 | 6.0 | 2.9 | 1.8 | -6.1 | 4.0 | 5.1 |
| All items CPI inflation (Y/Y) | 0.8 | 1.4 | 2.7 | 2.2 | 2.0 | 1.8 | 1.6 | 2.0 | 2.2 | 0.7 | 2.1 | 1.9 |
| Unemployment rate (%) | 8.8 | 8.4 | 8.4 | 7.4 | 6.5 | 6.2 | 6.0 | 5.8 | 5.7 | 9.5 | 7.7 | 5.9 |

Table 2: US Economic update

| Variable | 20Q4A | 21Q1F | 21Q2F | 21Q3F | 21Q4F | 22Q1F | 22Q2F | 22Q3F | 22Q4F | 2020A | 2021F | 2022F |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Real GDP growth (AR) | 4.3 | 6.4 | 9.5 | 6.3 | 5.4 | 4.3 | 2.7 | 2.5 | 2.3 | -3.5 | 6.6 | 4.4 |
| Real final sales (AR) | 2.9 | 9.2 | 7.0 | 6.0 | 5.9 | 4.5 | 2.5 | 2.3 | 2.5 | -2.9 | 6.1 | 4.3 |
| All items CPI inflation (Y/Y) | 1.2 | 1.9 | 4.0 | 3.3 | 3.5 | 3.1 | 2.3 | 2.6 | 2.7 | 1.2 | 3.2 | 2.7 |
| Core CPI inflation (Y/Y) | 1.6 | 1.4 | 3.0 | 2.5 | 2.6 | 2.9 | 2.4 | 2.8 | 2.9 | 1.7 | 2.4 | 2.7 |
| Unemployment rate (%) | 6.8 | 6.2 | 5.8 | 5.0 | 4.5 | 4.3 | 3.9 | 3.6 | 3.5 | 8.1 | 5.3 | 3.8 |

Table 3: Canadian interest rates (end of period)

| Variable | 2021 11-May | 2021 Sep | 2021 Dec | 2022 Mar | 2022 Jun | 2022 Sep | 2022 Dec |
|---|---|---|---|---|---|---|---|
| Overnight target rate | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.50 |
| 98-Day Treasury Bills | 0.10 | 0.10 | 0.15 | 0.20 | 0.25 | 0.25 | 0.35 |
| 2-Year Government Bond | 0.30 | 0.30 | 0.35 | 0.40 | 0.45 | 0.60 | 0.90 |
| 10-Year Government Bond | 1.54 | 1.65 | 1.45 | 1.65 | 1.75 | 1.80 | 1.85 |
| 30-Year Government Bond | 2.14 | 2.20 | 1.95 | 1.95 | 2.10 | 2.20 | 2.25 |
| Canada - US T-Bill Spread | 0.09 | 0.05 | 0.00 | 0.00 | 0.00 | -0.15 | -0.15 |
| Canada - US 10-Year Bond Spread | -0.09 | -0.10 | -0.05 | 0.05 | 0.05 | 0.00 | -0.15 |
| Canada yield curve (10-year — 2-year) | 1.24 | 1.35 | 1.10 | 1.25 | 1.30 | 1.20 | 0.95 |

Table 4: US Interest rates (end of period)

| Variable | 2021 11-May | 2021 Sep | 2021 Dec | 2022 Mar | 2022 Jun | 2022 Sep | 2022 Dec |
|---|---|---|---|---|---|---|---|
| Federal funds rate | 0.125 | 0.125 | 0.125 | 0.125 | 0.125 | 0.375 | 0.625 |
| 91-Day Treasury Bills | 0.01 | 0.05 | 0.15 | 0.20 | 0.25 | 0.40 | 0.50 |
| 2-Year Government Note | 0.16 | 0.15 | 0.25 | 0.40 | 0.50 | 0.85 | 1.15 |
| 10-Year Government Note | 1.62 | 1.75 | 1.50 | 1.60 | 1.70 | 1.80 | 2.00 |
| 30-Year Government Bond | 2.35 | 2.40 | 2.25 | 2.30 | 2.40 | 2.50 | 2.70 |
| US Yield curve (10-year — 2-year) | 1.46 | 1.60 | 1.25 | 1.20 | 1.20 | 0.95 | 0.85 |

Table 5: Foreign exchange rates

| Exchange rate | 2021 11-May | 2021 Sep | 2021 Dec | 2022 Mar | 2022 Jun | 2022 Sep | 2022 Dec |
|---|---|---|---|---|---|---|---|
| CAD-USD | 0.83 | 0.80 | 0.79 | 0.78 | 0.77 | 0.76 | 0.76 |
| USD-CAD | 1.21 | 1.25 | 1.27 | 1.28 | 1.30 | 1.31 | 1.31 |
| USD-JPY | 109 | 111 | 112 | 114 | 115 | 114 | 112 |
| EUR-USD | 1.22 | 1.21 | 1.20 | 1.20 | 1.19 | 1.18 | 1.17 |
| GBP-USD | 1.41 | 1.42 | 1.41 | 1.42 | 1.41 | 1.39 | 1.37 |
| AUD-USD | 0.78 | 0.82 | 0.83 | 0.84 | 0.85 | 0.86 | 0.87 |
| USD-CNY | 6.43 | 6.30 | 6.20 | 6.05 | 5.95 | 5.85 | 5.80 |
| USD-BRL | 5.25 | 5.50 | 5.30 | 5.10 | 5.30 | 5.50 | 5.70 |
| USD-MXN | 19.9 | 21.5 | 20.5 | 19.8 | 19.5 | 20.0 | 20.5 |

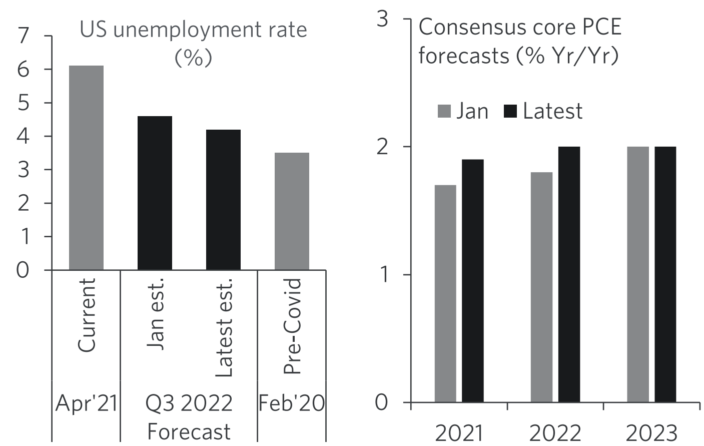
# US Outlook: Can we have our cake, and eat it too?

by **Andrew Grantham** andrew.grantham@cibc.com

Is it all too good to be true? Since the start of the year, in response to strong fiscal stimulus and Q1 growth, forecasts for US GDP growth have ramped up significantly. Indeed, the consensus now sees economic activity actually surpassing the level it would have reached under the pre-pandemic growth trend by the middle of next year (Chart 1). That would leave a positive output gap of around 3% of GDP, based on our forecasts of potential, typically a signpost of overheating.

However, that same consensus also sees the mid-2022 unemployment rate still around 1% higher than pre-pandemic levels, and inflation on, but not above, target. While growth forecasts have been raised significantly, projections for unemployment and inflation have changed much more modestly (Chart 2). Can we really have our cake, eat it in full in terms of very strong GDP growth, without feeling some inflation indigestion?

Chart 2: Next year's unemployment (L) and inflation (R) Forecasts little changed




Source: BLS, BEA, Bloomberg, CIBC.

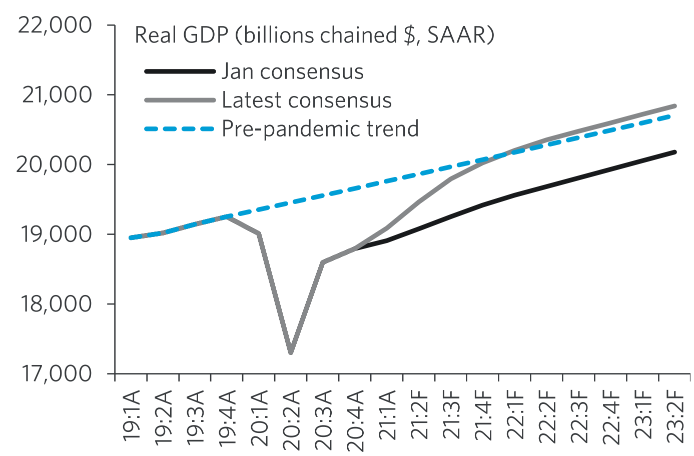
## High productivity sectors led the way

Squeezing out a lot of output, while retaining room in the labour market and tame inflation, has indeed been the story thus far. Following strong growth in the first quarter, the US economy is only 1% below its pre-pandemic level for GDP, and a little more than 3% beneath its pre-Covid trend. However, after some disappointing hiring figures, employment is still roughly 5½% below its pre-pandemic level and nearly 7% below its prior trend. That discrepancy will likely grow even further in the second quarter, with GDP growth set to reach nearly 10% annualized.

The mix of growth has been key to explaining that divergence. While services spending was still nearly 15% below its pre-pandemic trend in Q1, spending on goods, residential investment and even business equipment investment had not just fully recovered to their pre-pandemic trend, but had actually exceeded that mark (Chart 3).

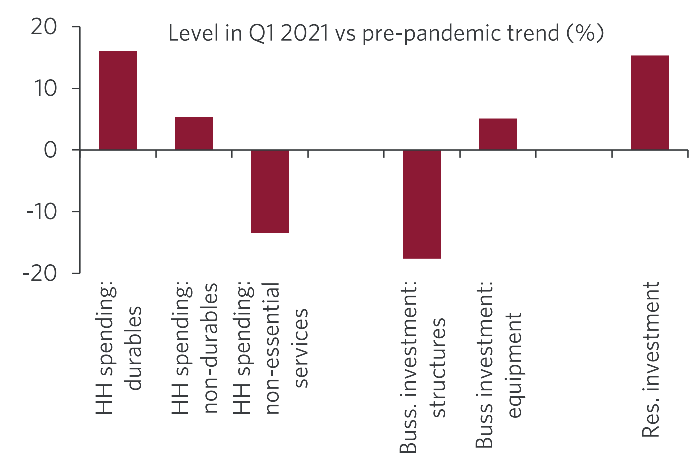
On an industry basis, those areas of the economy that are already running hot, including real estate, finance and wholesale trade, account for a much larger share of GDP than they do of employment (Chart 4). The shift towards these sectors, and away from low-productivity services, is the main reason that total economy productivity was up around 4% year-over-year as of Q1.

Chart 1: Consensus now forecast GDP to rise above pre-pandemic trend



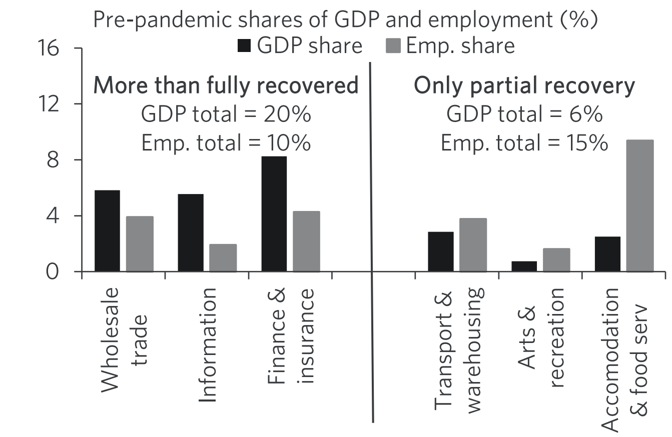

Source: BEA, Bloomberg, CIBC.

Chart 3: Some areas of GDP already above pre-pandemic trend by Q1



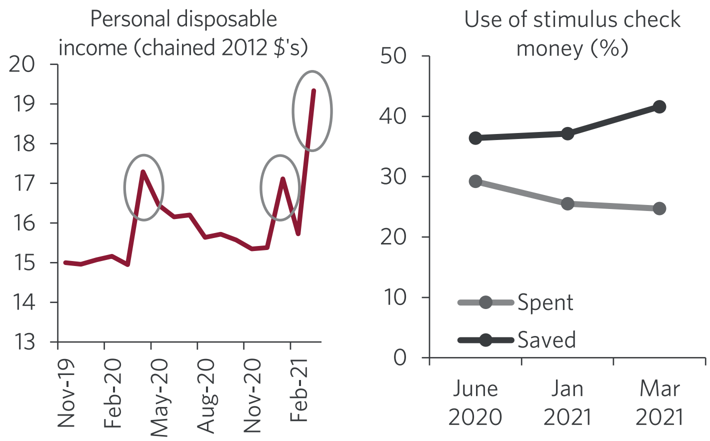

Source: BEA, CIBC.

Chart 4: Industries running hot have a greater impact on GDP than employment




Source: BLS, BEA, CIBC.

Chart 6: Disposable income receives an even bigger boost (L), but less expected to be spent (R)



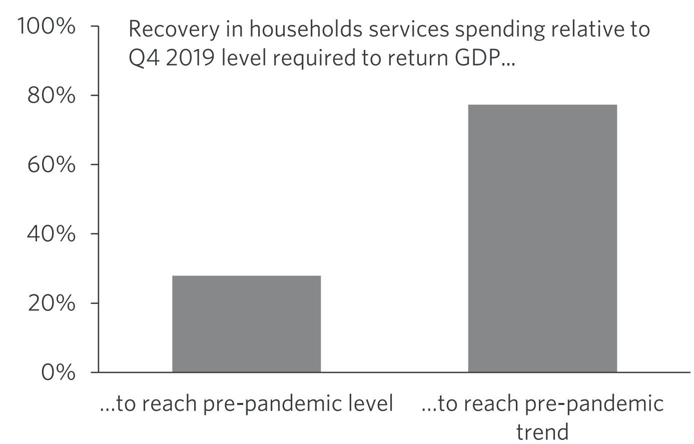

Source: BEA, NY Fed, CIBC.

Because these other areas of the economy have been so strong, household spending on services would have to recover only 25% of its remaining gap to restore the pre-pandemic level of GDP, and 75% to set aggregate GDP back to its pre-pandemic path (Chart 5). As such, judging just how far the economy could exceed potential in the near-term is as much a question of whether other areas of the economy are going to cool down, as it is about fully reopening service industries.

## Blowing hot then....cooler

With interest rates remaining low by historical standards, and given the scale of fiscal stimulus, there's plenty of reason to expect these hot areas to remain above their pre-pandemic trend. The question is, how far above and for how long? Here, there are already signs of a levelling off in some areas.

Chart 5: If other areas remain hot, a full recovery in services is not needed for a "full" GDP recovery



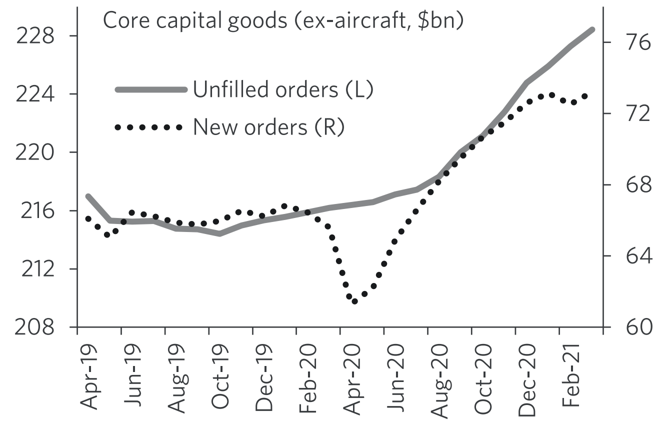

Source: BEA, CIBC.

In terms of consumer spending, there have already been signs from rising hotel occupancy and the sharp increase in restaurant sales since February that households are desperate to get out and spend more on services again. The sheer size of the recent fiscal stimulus package and its impact on household incomes (Chart 6, left) means that goods spending should remain elevated for at least another couple of quarters. And as we detailed last week, there remain pockets of pent-up demand in areas such as auto sales.

However, the fact that recent surveys suggest that households are looking to save a greater proportion of their stimulus checks (Chart 6, right), even as service sectors open up, suggests that appetite for home gym equipment, sporting goods, electronics and other areas that have benefitted from the pandemic may be set to cool later this year.

Business equipment investment should also stay hot for a couple more quarters, but could cool down thereafter. In the immediate aftermath of the pandemic, demand for electronics/communications equipment in particular soared, driving capital goods orders higher. Recently, however, those orders have levelled off, albeit still at a level above what prevailed before the pandemic. But business investment spending captures the sale when equipment is delivered, not ordered. And supply delays for some critical parts have meant that unfilled orders continue to rise sharply (Chart 7). In other words, for a couple of quarters, there's plenty in the pipeline when it comes to business investment. However, unless we see a big acceleration again in orders ahead, investment should cool off later in the year and in 2022.

Chart 7: Capital goods orders have plateaued, but unfilled orders continue to rise




Source: BEA, CIBC.

Residential investment is already starting to cool, with permits for homebuilding as well as mortgage approvals for purchases (Chart 8) coming down from earlier highs. While mortgage rates remain low by historical standards, the upward drift since the start of the year, reflecting the move in the bond market, as well as material shortages for builders, seem to already be taking some of the heat out of this area.

## How much can services serve up?

When it comes to the recovery in services spending, there are clearly areas that won't return to pre-pandemic levels of activity until we attain higher rates of vaccination, or even booster shots against variants. That would leave a gap still relative to pre-pandemic norms, as large indoor events such as basketball games and concerts were previously accustomed to seeing capacity or near-capacity crowds. (Chart 9).

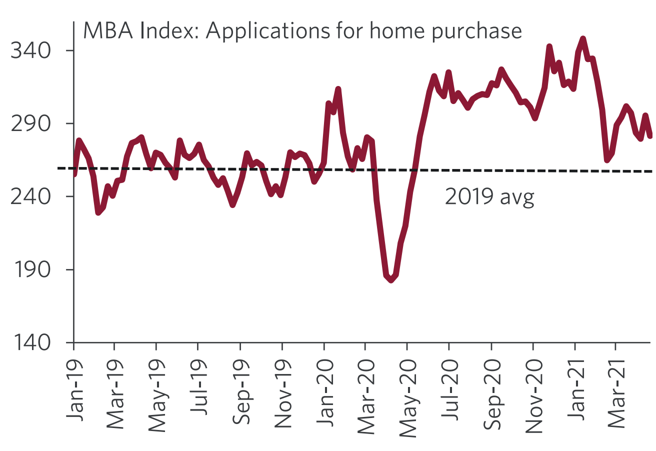
However, as we spelled out earlier, we don't need a full rebound in services spending to take GDP above its prior trend and the output gap into positive territory whilst other areas of the economy are still running hot. And there are some service sector areas that could return to, or even above, their pre-pandemic level this year.

Outside of opening nights for major blockbusters, multiplex cinemas are rarely close to operating at full capacity. As such, constraints still in place in many states shouldn't be too much of a dent on operating levels. Demand will be the key, and industry reports suggest that after a year of watching streaming services at home, people have been keener than expected to get back to the big screen and some studios have moved up the release date of films in response. Hotel capacity use has also rebounded nicely, and is closing in on 2019 averages, even though people remain cautious about flying.

Judging by the surge seen in March, however, which brought sales from 17% to only 5% below pre-pandemic levels, restaurants could be the big winners from the reopening. And again, apart from peak times at the weekends there's probably plenty of scope for growth even working under continued capacity constraints in some parts of the country.

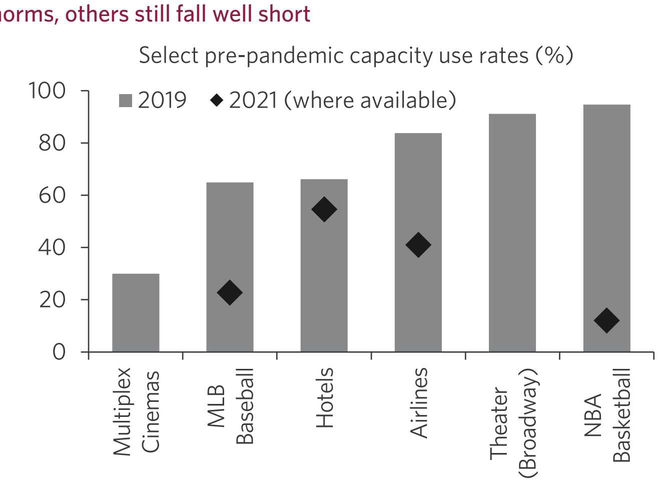
However, restaurants are also a good example of the possible short-term inflation impact of such a rapid return in demand. As restaurants have seen diners return in droves, they've found themselves suddenly short-staffed. And with some workers still likely wary of serving customers given health concerns, they are having to pay a higher wage to entice those workers back (Chart 10). A big increase in unfilled job openings also suggests that it was a limited supply of willing workers, rather than weak demand for said workers, that was behind last week's disappointing payrolls figure. Those increases in wage costs, as well as those of foodstuffs, improved ventilation etc., are likely to be passed onto the customer.

Chart 8: Mortgage demand already not quite as hot as it was



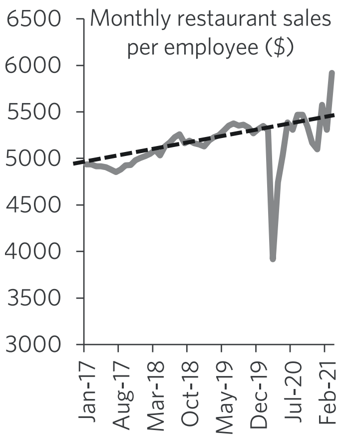

Source: MBA, Bloomberg, CIBC.

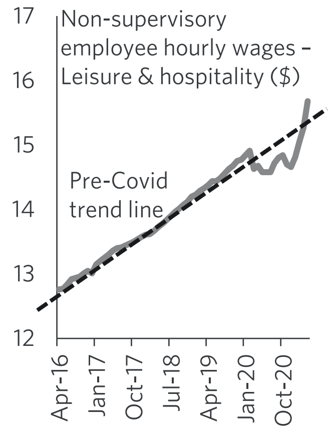
Chart 9: Capacity use in services varies greatly. Some could exceed norms, others still fall well short




Source: ESPN, STR, BTS, CIBC.

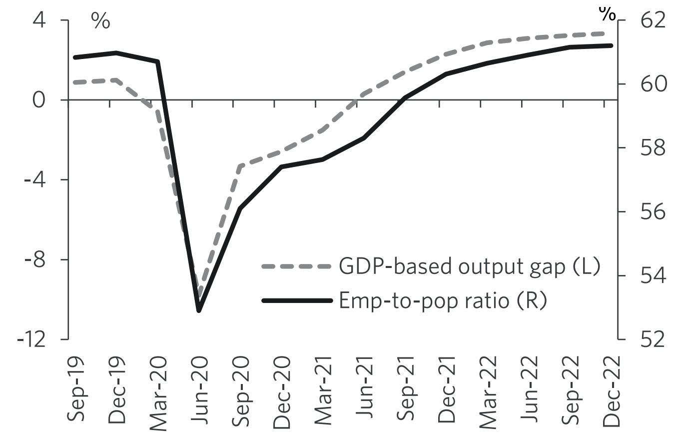
**Chart 10: Restaurant sales have surged (L), wages are having to be raised to attract workers (R)**




Source: BEA, BLS, CIBC Source: BEA.

**Chart 11: Labour market tightness to return in mid-2022, around a year after output gap turns positive**




Source: BEA, BLS, CIBC.

## Jobs vs GDP

With the pipeline for business investment, home buying and even goods consumption not looking quite as hot as it was earlier in the year, it is likely that by the end of this year, and certainly in 2022, we will be increasingly reliant on the services recovery to keep GDP above its pre-pandemic trend.

Provided there are no major back-steps in reopening plans, we suspect that there is plenty of pent-up demand to be unleased in 2022 on travel, indoor sporting events, concerts and other areas where some restrictions are still in place at the moment. With such areas generally more labour intensive than those parts of the economy that are currently running hot, at that stage of recovery we will likely see a reversal of the current relationship between jobs and GDP. In other words, GDP growth could look good, but not great, whereas monthly job gains appear strong. Labour market conditions would then more closely mirror the tightness in the economy shown by the output gap (Chart 11).

## Having their cake, and eating it too

They say that you can't have your cake and eat it too. However, that appears to be exactly what the consensus of forecasters and the Fed are trying to do. In other words, expecting very strong growth, but also little inflation due to continued labour market slack.

That may be possible if the mix of growth remained similar to that seen up until now, with some high productivity areas running well above pre-pandemic trends. After all, a hot real estate market, for example, impacts asset and lumber prices, but doesn't have as much of an impact on targeted inflation as it probably should do.

The problem with that view is that the current "red-hot" areas of the economy appear poised to cool down to just "warm" levels of activity. Growth later this year, and certainly into 2022, will become increasingly reliant on a fuller return of service sector spending. Given pent up demand for travel and leisure, as well as the padding of bank accounts through fiscal stimulus, strong growth in service spending should certainly be seen. And, with many service sectors more labour intensive than those areas driving growth currently, the labour market will continue to tighten.

However, as we have seen recently with restaurants struggling to recruit staff and having to pay higher wages as a result, a surge in demand for those services could also bring price pressures. With services inflation heating back up, and goods price inflation continuing to run above pre-pandemic trends due to supply chain and other issues, overall inflation will likely be stickier above 2% than the Fed and the consensus of forecasters expects. The strong growth rates that are expected to be seen are certainly possible, and are mirrored in our own forecasts (refer to Table 2, page 2). But they will also bring an earlier return to full employment, a more persistent inflation overshoot, and, we suspect, rate hikes before the end of next year.

## Contacts:


Avery Shenfeld
416 594-7356
avery.shenfeld@cibc.com

Benjamin Tal
416 956-3698
benjamin.tal@cibc.com

Andrew Grantham
416 956-3219
andrew.grantham@cibc.com

Royce Mendes
416 594-7354
royce.mendes@cibc.com

Katherine Judge
416 956-6527
katherine.judge@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
Bloomberg @ CIBC

economics.cibccm.com