Economics

IN FOCUS

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Who's on worst? Canada versus the US in the coming slowdown

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There's little doubt among market participants that both the US and Canada are in for a bumpy economic road ahead. Some see an outright recession, others a flat spot that lasts longer. Almost nobody expects that the battle against inflation, and the rate hikes brought on in that process, will be pain free for growth. Still, investors and businesses have decisions to make about where to put their assets, and while realizing that neither country is going to be a standout, they're wondering which faces the toughest path. Not who's on first, but who's on worst.

Bear with us, as the facts don't all line up one way. But in that sense, they're supportive of our general conclusion, which is that there's no strong case to be made that Canada's higher level of household debt, or its greater weight in cyclical resource industries, implies it faces a greater shock ahead.

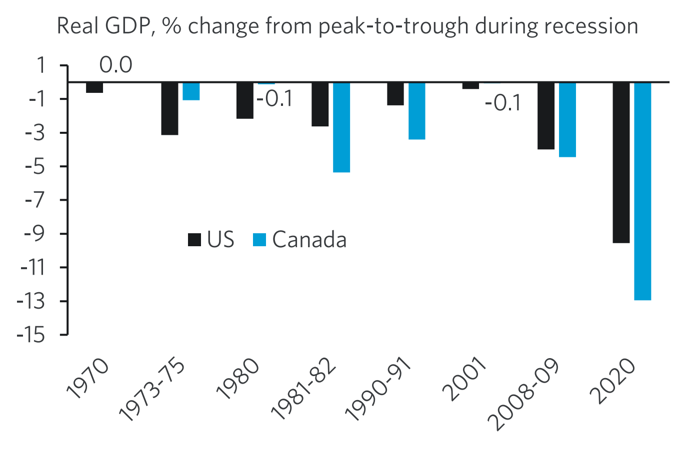
History shows a toss-up

Let's start with the historical record, since we're always warned about the consequences for those who fail to learn from its lessons. Looking at outright recessions, there's no clear pattern for either country to be hit harder, despite Canada long having been more resource oriented, and in recent decades, having a household sector that carries more debt that is subject to refinancing risks.

In the last two downturns, associated with the pandemic and the global financial crisis, which fared worse was a toss-up, and depended on whether you counted the damage in real GDP or the climb in the jobless rate (Charts 1 and 2). Further back, Canada fared worse in downturns in 1990-91 and 1981-82, but the US was the biggest loser in 2001, 1980, and 1973-75 and 1969-70.

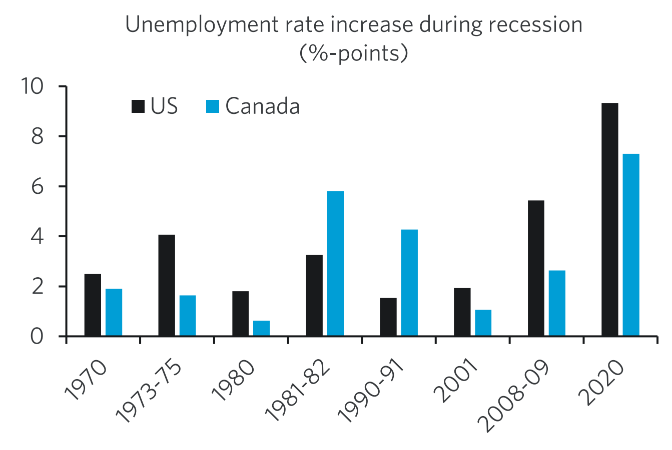
More broadly, what's clear from this historical record is that major divergences are rare. That reflects Canada's status as a small open economy, in which US demand plays a major role in driving results for its most cyclically-sensitive industries. US financial market turmoil, such as in the financial crisis, will have ripple impacts on Canadian investor sentiment. It also captures the fact that international shocks that hit the US, including most recently the pandemic, hit Canada at the same time.

Chart 1: No clear loser in terms of GDP lost during recession



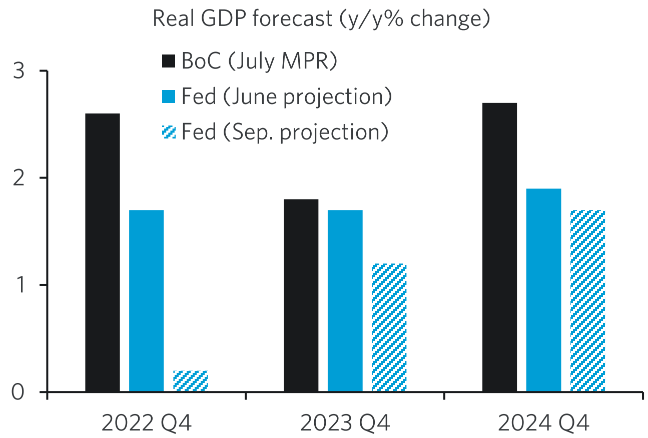
Source: BEA, StatCan, CIBC

Chart 2: Canada and US took turns leading unemployment climbs



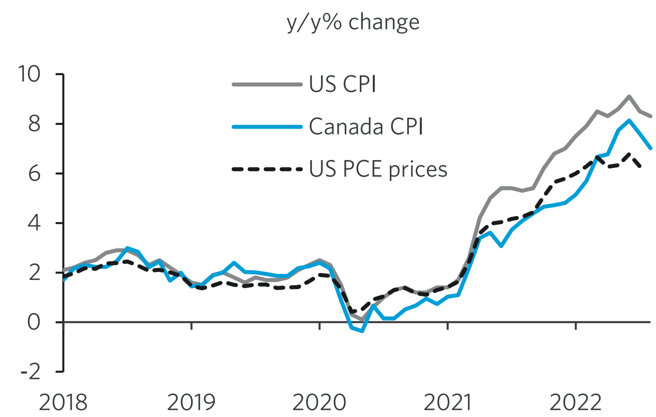
Source: BLS, StatCan, CIBC

Chart 3: BoC sees less of a hit to growth in returning inflation to target



Source: Fed, BoC, CIBC

Chart 4: US seeing more CPI inflation than Canada



Source: BEA, BLS, StatCan, CIBC

Which central bank *wants* a bigger slowdown

Central banks can of course err, and get more than they bargained for when trying to slow demand growth to quell inflation. But a useful starting point is to assume that each steers their respective economies on their desired path. If so, the economy that will be the biggest loser will be the one that is most in need of additional slack to get inflation back to target over a reasonable timeframe.

The growth outlook of the FOMC, essentially what they see as needed to contain inflation, looks much weaker than that of the Bank of Canada (Chart 3). That's a bit of an unfair comparison, since the Bank's forecast dates back to July, when there was more hope that supply chain improvements would come quickly. Still, even relative to the June FOMC forecast, the Bank of Canada was a bit more optimistic than the Fed in terms of how much growth it could allow over the next two years while still making progress on inflation.

So, at least in the eyes of the central banks, the US seems to need a bigger economic crunch to contain its inflation. That's material to our outlook, since they are the ones in control of interest rates. But of course, either or both of these central banks could get evidence that they have misjudged the degree to which a slowdown is required. In particular, the Bank of Canada may have been too optimistic about the degree to which improvements in supply will come to our rescue, and thereby reduce the need to quell economic growth to dampen inflation, a reason why our GDP growth outlook for the country is more pessimistic than the BoC's last published projections.

Which *needs* a bigger slowdown to contain inflation?

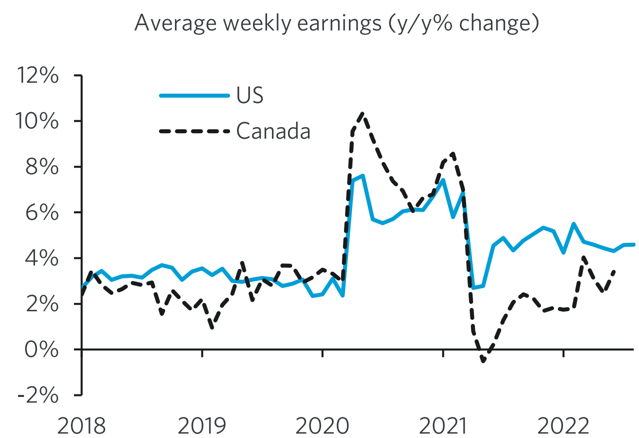
Other indicators make it less obvious that the US really needs a deeper economic hit than Canada to reach its inflation objectives.

The simplest, and most obvious of these, is what's been happening to inflation itself, and how far we are from target. True, the numbers aren't strictly comparable, particularly in the way that inflation for owner-occupied housing is measured. But these are the indicators that each central bank uses for its scorecard.

Many readers will recognize that the US CPI has been hotter than Canada's. But the Fed's targets are expressed in terms of the PCE price index, and it's not as far above 2% as Canada's CPI (Chart 4). So this score reverses what we would conclude from looking at the central bankers' growth projections.

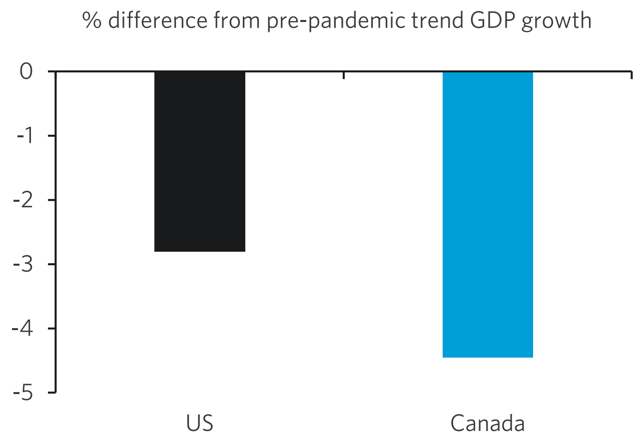
The Fed and the Bank of Canada are also eyeing wage inflation, as entrenched pay hikes could feed into a wage-price spiral. Again, there are some issues with data comparability, but using average weekly earnings from both payrolls reports, Canadian pay gains haven't looked quite as heated (Chart 5). A measure that controls for changes in industry composition for average hourly earnings in Canada has run hotter, however, and is roughly in line with the fixed-weight measure for wages and

Chart 5: More sizeable pay hikes south of the border



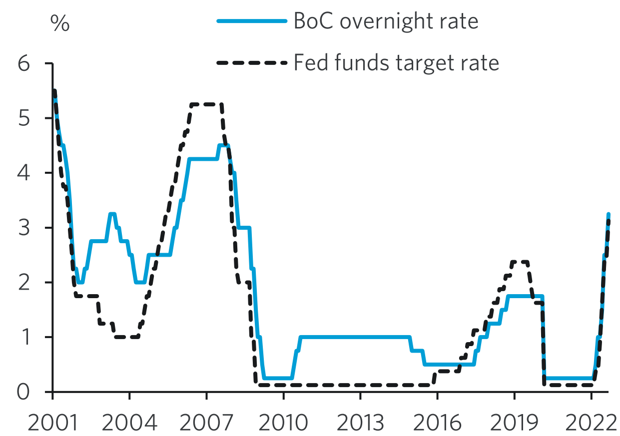
Source: BLS, StatCan, CIBC

Chart 6: US GDP closer to pre-pandemic trend



Source: BEA, StatCan, CIBC

Chart 7: BoC has stopped hiking earlier than the Fed historically



Source: Fed, BoC, CIBC

salaries in the US employment cost index. That said, major union contracts settled so far in Canada have not seen the gains extended to US rail workers.

Canada has one thing going for it on the labour cost front: faster immigration. Faster immigration does of course bring additional demand for goods and services, but is being targeted towards filling key labour market gaps, and might therefore cap wage inflation somewhat.

And Canada might have more room for a productivity gain that lets businesses absorb some of the pay increases, and allow real GDP growth to have a better showing for any given pullback in employment. Both economies have seen soaring employment, and each seems to have surpassed what would be considered to be full employment.

But in GDP terms, the US has seen a more of a complete recovery (Chart 6). In auto production, Canadian plants appear to have been harder hit by chip shortages, since the available chips tended to be allocated to US plants that on average produce higher-end vehicles with better margins. Until recently, Canadian activity was also more heavily constrained by public health measures design to contain COVID, leaving more excess capacity, for example, in hospitality, tourism, and recreational services.

But what about that household debt?

If there's no case to be made that the Bank of Canada is, or should be, aiming for a greater economic slowdown or downturn than the Fed, could it still end up generating one? A miscalculation by either central bank could of course cause conditions to see a sharper deterioration on one side of the border, even if unintended. In that regard, some point to two features of Canada's domestic economy that pose risks: the greater debt/income ratio in its household sector; and, in contrast to the US, existing mortgages are typically locked in for no more than five years, and therefore get hit by higher rates on renewals.

That would put Canada at a more material risk should the Bank of Canada choose to match the Fed's rate hike pound for pound. But the Bank of Canada is well aware of that greater sensitivity. Indeed, the last revision to its forecasting model was specifically aimed at adding greater richness to its modelling of the household sector to better capture the impacts of higher rates and debt burdens.

Historically, Canadian and US overnight rates have been highly correlated, a consequence of the strong correlation between the two countries' business cycles. But they've been close cousins, not identical twins. Commodity prices, for example, can impact the terms of trade and require more or less monetary tightening in Canada. And in the last business cycle, the Bank of Canada ceased hiking at a 1.75% overnight rate, sensing a slowing in interest-sensitive housing and autos, and strong headwinds from trade tensions, while the Fed pressed on into the mid-2% range (Chart 7).

Futures markets are currently pricing-in a lower peak overnight rate for Canada than the US. If they're right, and we think they are, that should be an important offset for Canada's additional drag from mortgage resets.

Canada's resource weighting is sometimes an additional negative in a downturn, but we didn't ramp up oil and gas capital spending nearly as much as in past upcycles for fossil fuel prices, leaving less downside risk. And in other commodities, the world is seeking alternatives to Russia and its allies that should promote volume gains for Canada.

Add it all up, and there's not much to choose from in terms of who's on worst. Both the US and Canada are destined for at least a two year period of weak growth, or a shorter outright recession, as monetary tightening takes aim at inflation.

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