Economics
FORECAST

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You take the high road, they'll take the low road

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

There are two roads to a lower inflation world. An overshoot in interest rate hikes drives the economy onto the "low road," with a serious recession in the next few quarters, followed by an uphill growth path spurred by rate cuts later in 2023. But there's also a "high road" that sees rates moving to, but persisting at a lower plateau, keeping the economy on the precipice of a recession but seeing a smattering of growth here and there. The two paths end up at the same level for employment and GDP at the end of 2024, but the high road sacrifices less of 2023 output and employment in exchange for a less-rapid inflation plunge.

The Fed and the Bank of Canada are still trying to steer along that high road, but elevated inflation has them willing to edge close to a recession in upcoming quarters. Europe's energy-fueled price spike has its central bankers more willing to see a near term recession, in an economy more vulnerable to one given the energy shock. A recession across the Atlantic, and a sluggish China (see pages 11-13) will on balance help North America's inflation battle by constraining export growth and commodity prices, even if disruptions tied to the war, COVID or climate change will be detrimental to supply.

Avoiding a true recession will require the Fed and the Bank of Canada to pause on rate hikes soon so as to assess their impact (Tables 3 and 4), although at higher levels than we earlier expected. Another half point move this fall will put overnight rates in Canada at 3.75%, while the Fed, which has moved more slowly to step on the brake and faces even more inflationary momentum, takes the ceiling on the funds rate to 4.25%.

Even then, these will be hawkish pauses, with no pledge that further rate hikes are off the table until well into 2023, when more evidence of core disinflation is at hand. To ensure that enough slack opens up to keep inflation grounded, any easing in monetary policy seems unlikely until 2024, with Canada moving a bit earlier that year given the greater sensitivity of its household sector to elevated rates.

The persistence of some supply shocks will also see inflation decelerate less dramatically than we had earlier forecast (Table 1). To open up enough disinflationary slack, central bank rate hikes will have positioned Canadian real GDP growth to average 1% in 2023-24 (see pages 8-10) with the US even a bit slower (pages 5-7). With growth that tepid, the usual quarterly variance suggests that a negative quarter here or there will at some point be in the cards for both countries, as we already have seen in the US. Moreover, the best days for the unemployment rate are behind us.

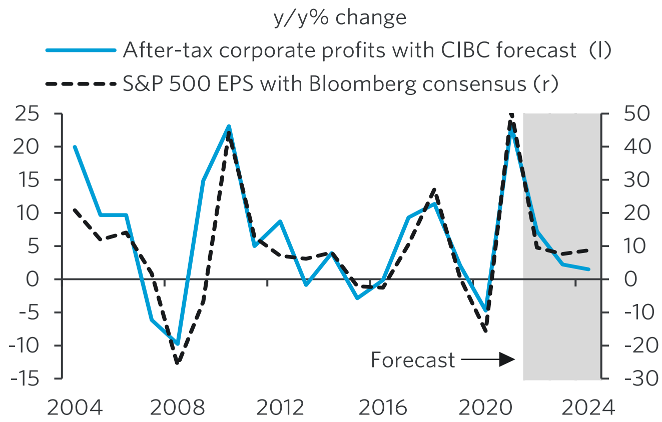
We're not nearly as optimistic as the Bank of Canada in terms of the degree to which the gap between supply and demand will come from supply improvements. COVID will still be disrupting hours worked globally, power-related disruptions threaten Europe, and droughts and other weather events do seem to be more problematic in a changing climate. Supply is also handicapped in Canada by demographics that will increase retirements.

Some pain before the gain?

If they can avoid a material recession, central banks will defend against some of the downside for equities, and pave the way for a rally when inflation fears abate. But this could still be a jittery stock market for the next several quarters. While rate hikes are essentially priced in, we haven't really felt the brunt force of the actual economic deceleration in terms of earnings expectations.

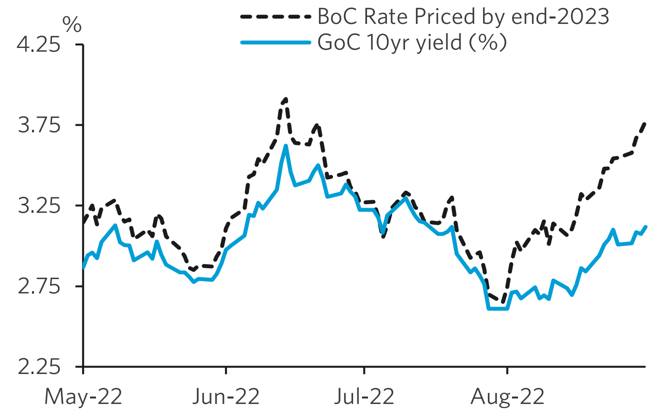
This year's volumes haven't been stellar, but prices and revenues have been. US Nominal GDP could see roughly 9% growth in 2022, and an alternative measure, gross domestic income (GDI) is tracking an even stronger gain, but is poised to average at only a third of that pace in 2023-2024 as volume gains slow to a trickle, and prices decelerate. The contrast in the two years will be even sharper in Canada given our commodity weighting.

Chart 1: US profit outlook suggests SPX EPS consensus is too rosy



Source: Bloomberg, Haver Analytics, CIBC

Chart 2: Summer bond rally was a bet on a premature easing



Source: Bloomberg, CIBC

GDI is the pie that gets divvied up into wages, profits, net taxes and other flows. Still-tight labour markets in the first half of 2023 are likely to see the share going to labour income expand. If so, that further squeezes the slice for profits and means that profits will advance more slowly than nominal GDI. The national accounts measure of after-tax US corporate profits has a reasonably strong correlation with S&P 500 EPS, and our call for a material deceleration in the former suggests that the EPS consensus is too rosy for 2023/24 (Chart 1).

Bonds weren't totally wrong, just much too early

The long end of the bond market staged a rally in July that's since been rapidly unwound, with even higher yields ahead. But it wasn't entirely wrongheaded, just much too early. As a result, the lessons from that rally are an interesting guide post on where 10-year rates in the US and Canada could sit in mid-2024, by which time we expect to revisit those lows in yields.

Part of that rally was based on a false premise that overnight rates could be dropping materially as we moved into 2023 (Chart 2). The market was expecting the Bank of Canada's target rate to have eased back to roughly 2.75% by the end of 2023. But by summer 2024, that might well be a reasonable expectation for year-end 2024 rates, as the Bank of Canada moves back to neutral after two years of sluggish growth and a defeat of core inflation.

The other key ingredient for long rates is where inflation expectations sit. Part of the July rally was fueled by a material easing in medium-term inflation expectations, as oil prices crested and central bankers showed resolve. That positive for long term bond yields hasn't reversed course, and with inflation on the ground easing in 2023, we expect that confidence in the return of a 2% inflation world will also support a rally in fixed income markets. But we'll need some months of softer economic data, and a convincing pause from central banks, to get the ball rolling in that direction. For now, the risks still point to higher yields through Q4 2022.

Rate hikes, both actual and expected, have been the major driver for currencies in the past couple of years, but relative economic risks have also played a role. The US dollar has been the beneficiary of the Fed's increasing hawkishness, but the greater downside economic risks in Europe and China, the two other largest economic blocs, have also lifted the greenback.

Against that backdrop of US dollar dominance, the Canadian dollar has been weaker than one might otherwise have expected in a period of monetary tightening and strong commodity prices. The increases in our targets for Fed tightening suggest an even softer loonie by year end. But come 2023, we expect that a somewhat earlier-than-expected end to the Fed tightening cycle will take a bit of steam out of the US dollar, and allow the Canadian dollar to be marginally stronger as the year progresses, even with commodity prices tamed by the global slowdown. Further out, the performance in 2024 could be impacted by which country is first to provide a dose of interest rate relief.

Overall, the next five or six quarters will be a period of transition, with inflation entering like a lion and exiting like a lamb. The uncertainties lie in just how large a bite the lion takes out of economic growth before it leaves the stage.

Table 1: Canadian forecast summary (% change except where noted)

Variable	2021A	2022F	2023F	2024F
GDP at market prices	13.0	11.3	1.9	3.7
GDP in $2012	4.5	3.1	0.6	1.4
Consumer price index	3.4	6.7	2.7	2.0
Unemployment rate	7.4	5.3	5.7	5.7
Current account balance (C$ Bn)	1.1	1.4	-21.0	-34.5
Pre-tax profits (net operating surplus)	32.3	16.2	-0.3	4.4
Housing starts (K)	277	260	229	224

Table 2: United States forecast summary (% change except where noted)

Variable	2021A	2022F	2023F	2024F
GDP at market prices	10.1	9.0	3.8	2.8
GDP in $2012	5.7	1.8	0.7	0.8
Consumer price index	4.7	7.9	2.7	2.0
Unemployment rate	5.4	3.7	4.1	4.4
Current account balance (US$ Bn)	-846	-1,059	-961	-948
Pre-tax profits (with IVA/CCA)	25.0	7.3	2.2	1.5
Housing starts (K)	1,605	1,482	1,442	1,503

Table 3: Canadian interest rates (end of period)

Variable	2022 13-Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec	2024 Jun	2024 Dec
Overnight target rate	3.25	3.75	3.75	3.75	3.75	3.75	3.25	2.75
98-Day Treasury Bills	3.28	3.80	3.70	3.60	3.50	3.40	3.00	2.40
2-Year Government Bond	3.75	3.60	3.50	3.25	3.10	2.90	2.60	2.45
10-Year Government Bond	3.23	3.50	3.40	3.20	3.00	2.90	2.75	2.55
30-Year Government Bond	3.19	3.40	3.30	3.10	2.95	2.80	2.50	2.45
Canada - US T-Bill Spread	0.05	-0.45	-0.55	-0.50	-0.55	-0.60	-0.90	-0.85
Canada - US 10-Year Bond Spread	-0.21	-0.15	-0.10	-0.20	-0.20	-0.10	-0.15	0.05
Canada Yield Curve (10-year — 2-year)	-0.52	-0.10	-0.10	-0.05	-0.10	0.00	0.15	0.10

Table 4: US Interest rates (end of period)

Variable	2022 13-Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec	2024 Jun	2024 Dec
Federal funds rate	2.375	4.125	4.125	4.125	4.125	4.125	4.125	3.375
91-Day Treasury Bills	3.22	4.25	4.25	4.10	4.05	4.00	3.90	3.25
2-Year Government Note	3.78	4.20	4.00	3.80	3.50	3.30	2.85	2.50
10-Year Government Note	3.45	3.65	3.50	3.40	3.20	3.00	2.90	2.50
30-Year Government Bond	3.53	3.65	3.50	3.30	3.15	3.00	2.75	2.60
US Yield curve (10-year — 2-year)	-0.34	-0.55	-0.50	-0.40	-0.30	-0.30	0.05	0.00

Table 5: Foreign exchange rates

Exchange rate	2022 13-Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec	2024 Jun	2024 Dec
CAD-USD	0.76	0.74	0.75	0.77	0.78	0.77	0.78	0.80
USD-CAD	1.31	1.35	1.34	1.30	1.28	1.30	1.28	1.25
USD-JPY	144	140	135	132	130	127	122	120
EUR-USD	1.00	0.98	1.00	1.02	1.04	1.07	1.11	1.13
GBP-USD	1.15	1.11	1.13	1.15	1.18	1.22	1.28	1.30
AUD-USD	0.68	0.67	0.69	0.70	0.70	0.71	0.72	0.73
USD-CNY	6.93	6.98	6.93	6.85	6.80	6.75	6.70	6.68
USD-BRL	5.18	5.70	5.90	5.70	5.50	5.30	5.50	6.00
USD-MXN	20.1	21.5	21.0	21.5	21.3	21.5	22.0	22.5

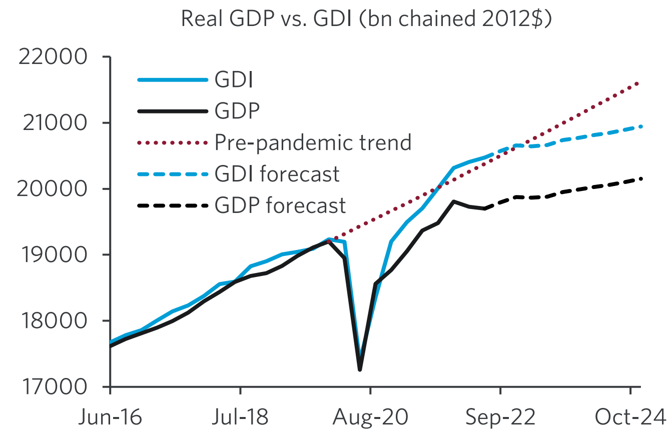
US: Tip toeing along the recessionary precipice

by **Katherine Judge** katherine.judge@cibc.com and **Avery Shenfeld** avery.shenfeld@cibc.com

With the Federal Reserve racing to bring interest rates further into restrictive territory, it's clear that buoyant growth in the coming year is virtually ruled out. Consumers are entering the last stages of this hiking cycle in a healthy position, supported by excess savings that total 9% of GDP, so the economy could still tip toe along the precipice of a recession without falling into one, but Fed tightening will make that a very close call. Returning inflation to the 2% target in late 2023 will necessitate a period of essentially no growth through the first half of that year, and an average growth rate of less than 1% over 2023-24. (Table 1).

That supposedly follows two consecutive quarters of contraction in real GDP at the start of 2022, a measure likely belied by continued growth in the alternative measure of output, real gross domestic income. While ongoing job gains suggest a return to positive real GDP growth in the second half of the year, leaning against that will be a continued slowing in interest-sensitive sectors and export volumes as global demand wanes. And whether measured in GDP or GDI terms, over the next two years, the economy will be on a slow trajectory due to a slim pool of untapped labour supply, and the resulting need for higher interest rates and their restraint on demand to quell inflation pressures (Chart 1).

Chart 1: Tight labor supply and higher rates to slow growth trajectory



Source: BEA, CIBC

Table 1: US Forecast detail (real % change, s.a.a.r., unless otherwise noted)

Indicator	22 Q2A	22 Q3F	22 Q4F	23 Q1F	23 Q2F	23 Q3F	23 Q4F	2022F	2023F	2024F
GDP at market prices ($Bn)	24,883	25,347	25,658	25,791	25,908	26,117	26,299	25,069	26,029	26,759
% change	8.4	7.7	5.0	2.1	1.8	3.3	2.8	9.0	3.8	2.8
Real GDP ($2012 Bn)	19,700	19,794	19,875	19,865	19,880	19,952	19,986	19,774	19,921	20,086
% change	-0.6	1.9	1.6	-0.2	0.3	1.4	0.7	1.8	0.7	0.8
Final sales	1.3	1.7	1.4	0.2	1.0	1.8	0.9	1.0	1.1	1.0
Personal consumption	1.5	1.5	1.2	-0.3	0.6	1.4	0.9	2.4	0.7	0.9
Total government expenditures	-1.8	1.3	3.0	1.8	1.3	1.7	1.0	-1.2	1.5	1.2
Residential investment	-16.2	-16.8	-10.2	-13.9	-2.9	-0.2	0.0	-7.2	-9.4	0.1
Business fixed investment	0.0	6.0	1.6	1.2	0.4	1.6	1.7	4.6	1.7	1.1
Inventory change ($2012 Bn)	83.9	95.3	107.3	88.8	54.9	36.9	26.4	118.8	51.8	15.7
Exports	17.6	3.4	2.3	1.8	0.8	2.0	1.5	6.1	2.8	1.3
Imports	2.8	1.6	0.6	-0.9	-1.6	-0.3	1.8	9.6	0.0	0.8
GDP Deflator	8.9	5.3	3.3	2.3	1.5	1.8	2.1	7.0	3.0	2.0
CPI (yr/yr % chg)	8.6	8.3	6.9	4.9	2.5	1.8	1.8	7.9	2.7	2.0
Core CPI (yr/yr % chg)	6.0	6.2	5.5	4.0	3.0	2.1	2.0	6.0	2.8	2.1
Unemployment rate (%)	3.6	3.6	3.7	4.0	4.2	4.1	4.2	3.7	4.1	4.4
Housing starts (AR, K)	1,655	1,459	1,440	1,430	1,435	1,442	1,460	1,482	1,442	1,503

Lack of available labour caps growth rate

While hiring has continued at a pace above what's required to prevent a further tightening in the labour market, employment hasn't attained it's pre-pandemic trend (Chart 2, left). That's a result of the lack of recovery in the overall participation rate, which is only partly attributable to the aging population and the associated retirements.

The other piece of the puzzle is the impact of long-COVID on the working age population. While the participation rate has almost fully recovered in the 25-54 prime-age group, it sits far below where its pre-pandemic trendline implies it should be.

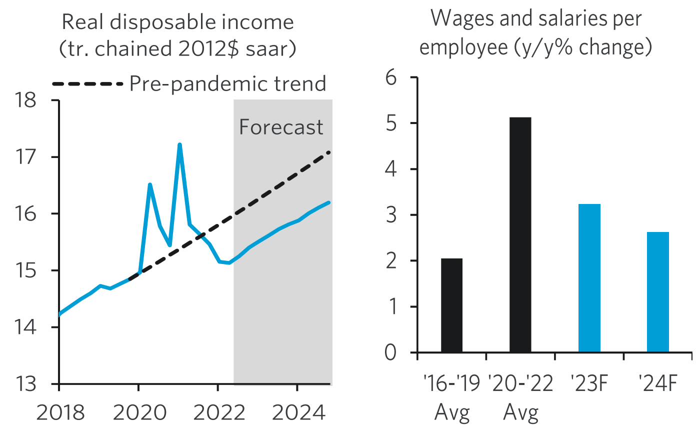
Estimates of the impact of long-COVID on the labour force suggest that up to 4 million Americans could be sitting on the sidelines due to symptoms that prevent them from working, accounting for the bulk of the missing labour force (Chart 2, right). Combined with the aging population, and limited immigration, that will cut into the pace of growth in the coming years. Although we see the unemployment rate drifting above 4.0% in 2023 as interest-sensitive sectors slow, that's still a reasonably low level.

Relief for consumers, but a squeeze on profits

Employers have tried to entice workers back into the labour force by offering higher wages, but that momentum has shown signs of flagging lately. Relief for consumers in the next two years will have to come from an easing of inflation back to target and the associated boost to real disposable incomes and purchasing power (Chart 3, left), which was dented this year by high inflation and the fading of government income support.

Although slower employment growth will be a headwind for aggregate labour income growth, the growth in pay per employee could remain above historical norms for the next few quarters, given the lasting limits on the labour supply pool

Chart 3: Real disposable income growth (L), and labour income gains (R) will support demand ahead



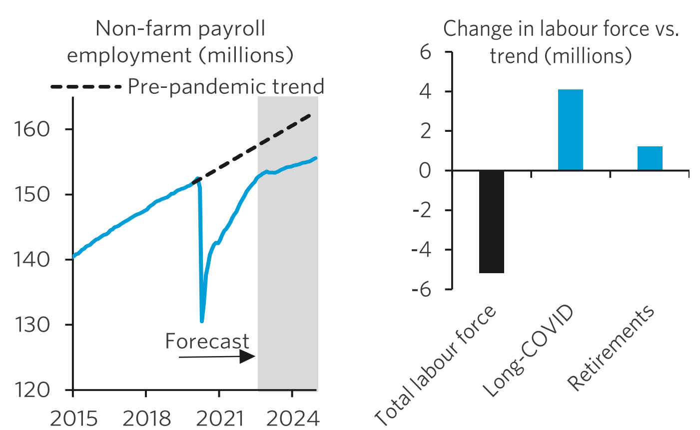
Source: BEA, BLS, CIBC

(Chart 3, right). That's something that will impinge on profits (Chart 4), and contribute to slower business investment, even if there are pockets of stronger capital spending in areas spurred by government subsidies, such as alternative energy and chipmaking.

Housing market could reach bottom in 2023

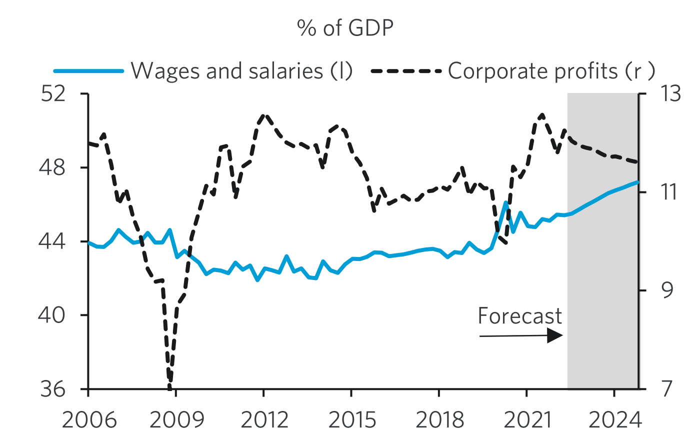
As is typically the case in a rising rate environment, the housing sector will bear a disproportionate burden in the economic slowing ahead. That will have ripple effects beyond contractors directly engaged in construction, with decelerations or outright declines in furniture, appliances and other housing-related goods and services. Adding these sectors to homebuilding, the housing sector collectively accounted for almost a fifth of GDP at the peak of pandemic-era housing market activity. With mortgage rates set to rise further this year and remain elevated in 2023, most facets of housing-related spending will be in retreat in the coming year (Chart 5, left).

Chart 2: Employment growth on slower trend (L), due to labour supply issues from long-Covid and retirements (R)



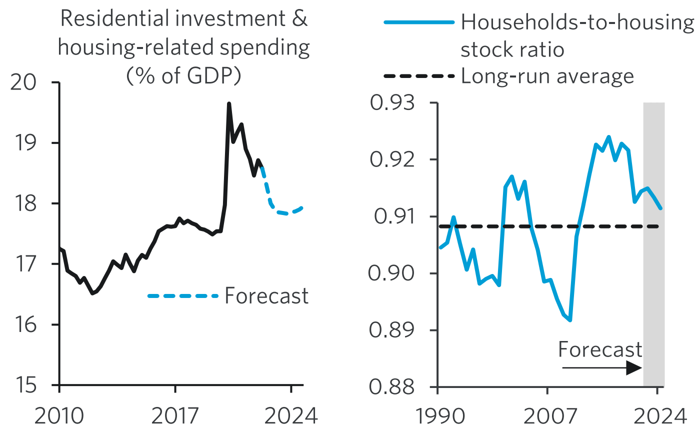
Source: BLS, OECD, Brookings, CIBC

Chart 4: Labour income growth will impinge on profits ahead



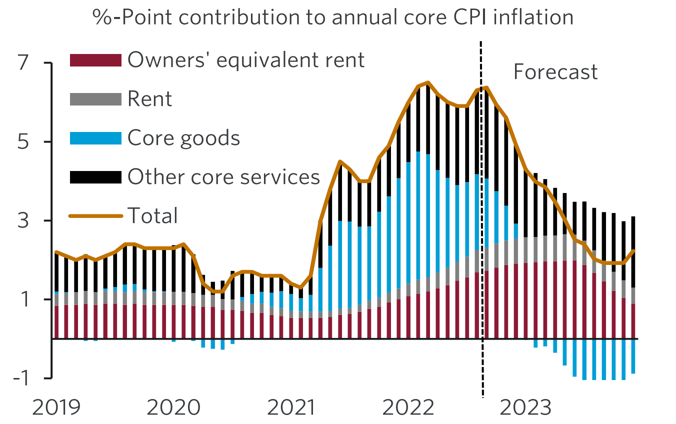
Source: BEA, CIBC.

Chart 5: Housing activity and spending moderating (L), but could see relief in 2024 (R)



Source: BEA, CIBC

Chart 6: Core CPI deceleration driven by services ex. shelter and core goods as supply chain issues ease



Source: BLS, CIBC

But there could be some relief in the cards after 2023, if the market starts to build in expectations for a lower fed funds rate by the end of 2024, bringing 30-year fixed rate mortgages to tamer levels. If borrowing costs ease after 2023, pent-up demand for housing will still be out there, as sluggish homebuilding in the post-financial crisis era has resulted in a deficit in housing supply. That could see homebuilding start to rebound in 2024, and there is scope for further growth later in the decade to bring the ratio of households to housing stock back down to historical norms (Chart 5, right).

Keep the faith: inflation will be much lower in 2023

August's core CPI readings were a huge disappointment, but those worried that there's no sign of a turning point need to keep the faith: inflation will be much lower by this time next year. August's data came perhaps a bit too early to capture the impact of decelerating growth on prices. Remember, these on-the-ground readings capture an economy with the fed funds rate that had another 175 basis points of hikes yet to come, and the lagged impact that will have on demand.

There's still a path to getting core inflation back to 2% in 2023, but we'll need to look past a few components that aren't likely to turn just yet. Housing features prominently in the CPI, with its costs representing the single largest component. Changes in rent and home prices feed through to that index with a lag of over a year, since a jump in prevailing market rental rates only shows up as leases come due each month. That will limit the deceleration in CPI in the near term, as pandemic-era housing strength is still materializing in that index.

But rents for new units, as opposed to those being renewed under existing leases, seem to be decelerating, which will see a lower shelter inflation rate in the second half of 2023 (Chart 6). In addition to the cooling in gasoline and other commodity prices that's already underway, the coming year should benefit from an easing in prices for vehicles and other core goods that were the most heavily hit by supply chain disruptions. None of that will make the task of grinding inflation lower a pain free exercise, since we'll also need two years of weak growth to open up slack in the labour market, and thereby dampen household purchasing power and business labour costs.

In the next few months, the US economy should benefit from at least some fading of supply chain issues and pent-up demand for services, as well as a make-up in real GDP data that likely understated growth in the first half of 2022. But while we could still be surprised in terms of the dose of rate hikes needed to do the job, there's much less doubt about the Fed's intention to tighten the monetary policy screws enough to slow growth to a crawl as we move into 2023. In the absence of a full blown recession, the elevated starting point for inflation suggests that the Fed will be in no hurry to start reinvigorating growth with interest rate relief until the latter half of 2024.

Tighten your seatbelts: Bumpy landing ahead for Canadian economy

by **Andrew Grantham** andrew.grantham@cibc.com and **Karyne Charbonneau** karyne.charbonneau@cibc.com

Investors and even central bankers are now less convinced that a "soft landing" for the economy, in which inflation falls smoothly back to 2% without too much economic damage, is possible. But the alternative doesn't have to be the "hard landing" of a full recession. A bumpy landing, in which the Canadian economy on average sees two years of sub-trend growth, would also do the job of bringing inflation back down to target. However, an even sterner course for interest rates than our prior forecast has us marking down that flight path to an even closer brush with recession.

More than one way to close an output gap

Knowing just how far above or below potential the economy is running at any given point in time has been even more difficult than it was before COVID-19 struck. Atypical supply constraints, including those tied to the pandemic, have meant that measures of the output gap tied to deviations from trend GDP have failed as predictors of future inflation.

The Bank of Canada has attempted to measure these supply constraints, and currently sees them reducing supply by 2½% relative to its long-term potential. That's the basis of their assessment that the output gap was between +0.5-1.5% as of Q2 2022, with our assessment closer to the top end of that range (Chart 1, left).

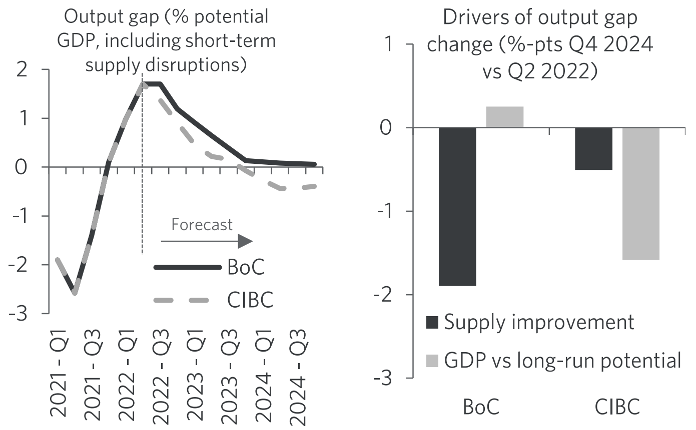
Interestingly, though, the Bank's forecasts still appear to be relying on an easing of supply constraints, rather than below-trend GDP growth, to shrink the positive output gap and return inflation to target (Chart 1, right). That confidence appears at odds with its rate hike path, which has pushed interest rates into restrictive territory to tamp down domestic demand.

Table 1: Canadian forecast detail (real % change, s.a.a.r., unless otherwise noted)

Indicator	22 Q2A	22 Q3F	22 Q4F	23 Q1F	23 Q2F	23 Q3F	23 Q4F	2022F	2023F	2024F
GDP at market prices ($Bn)	2,812	2,794	2,794	2,800	2,811	2,835	2,865	2,775	2,828	2,933
% change	17.9	-2.6	0.0	0.8	1.6	3.4	4.3	11.3	1.9	3.7
Real GDP ($2012 Bn)	2,158	2,161	2,161	2,160	2,163	2,171	2,178	2,155	2,168	2,197
% change	3.3	0.5	0.0	-0.2	0.6	1.4	1.3	3.1	0.6	1.4
Final domestic demand	2.9	0.6	0.7	0.6	0.5	1.4	1.3	3.1	0.9	1.6
Household consumption	9.7	2.7	1.2	0.7	0.2	1.7	1.1	5.5	1.6	1.1
Total government expenditures	-1.2	1.3	2.0	1.1	1.2	1.1	1.1	1.7	1.2	2.0
Residential construction	-27.6	-18.0	-10.0	-4.0	-4.0	-2.0	-1.0	-10.0	-8.4	0.0
Business fixed investment[1]	11.6	0.7	2.1	2.0	2.8	2.3	4.5	6.3	2.8	3.8
Inventory change ($2012 Bn)	46.2	30.0	30.5	27.0	24.0	22.0	21.0	30.3	23.5	15.9
Exports	10.9	7.6	2.7	1.6	4.3	3.0	3.8	2.7	3.9	3.3
Imports	30.5	-2.2	5.1	1.9	1.9	1.7	3.1	7.9	3.6	2.7
GDP Deflator	14.0	-3.0	0.0	1.0	1.0	2.0	3.0	8.0	1.3	2.3
CPI (yr/yr % chg)	7.5	7.1	6.2	4.8	2.1	1.8	2.2	6.7	2.7	2.0
Unemployment rate (%)	5.1	5.1	5.2	5.4	5.7	5.9	5.9	5.3	5.7	5.7
Employment change (K)	188	-60	39	20	13	10	62	674	96	211
Goods trade balance (AR, $bn)	49.9	22.8	13.5	9.6	9.7	9.7	9.2	29.8	9.5	4.4
Housing starts (AR, K)	271	270	255	240	231	225	219	260	229	224

[1] M&E plus Non-Res Structures and Intellectual Property and NPISH.

Chart 1: Output gap to close by end 2023 (L), but need weak growth. Can't rely on supply improvement (R)



Source: Bank of Canada, CIBC.

We suspect that demand will slow more than the Bank has been forecasting, but the recovery in supply could be less swift. With Europe's energy crisis and China's COVID-zero policy likely to see supply chain disruptions continue for some time, and COVID-19 related staff absenteeism impacting domestic services, supply issues could persist well into 2024 and beyond. Globally, droughts tied to climate change are also impacting agriculture, hydro power and river transport. Because some supply issues will linger, a two-year period of sub-trend growth will be needed to bring inflation back to target.

Our assumption for the long-run potential growth rate of the economy (excluding short-run supply constraints) is also modestly less optimistic than the Bank of Canada's. True, productivity growth should improve relative to its recent trend, and immigration will fuel population growth. But the latter will be unable to fully offset the ageing population and its impact on labour supply. With more Canadians reaching retirement age, the overall participation rate within the economy will continue to trend lower (Chart 2, left) and labour force growth will trail that of the overall population (Chart 2, right).

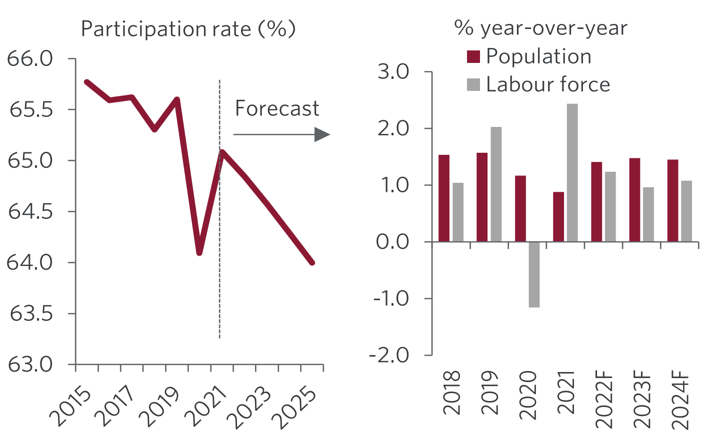
Inflation: a completely different beast?

A narrowing of the domestic output gap may not, however, by itself be sufficient to bring inflation sustainably back to its 2% target, particularly in a small open economy such as Canada's. The recent reduction in gasoline prices and stabilization in raw food commodities should see headline inflation fall below 2% next summer (Table 1). However, goods price inflation excluding these two areas has also been a larger contributor to movements in the overall CPI index than it was before the pandemic.

Excess consumption on goods during the pandemic, most notably in the US, has cut into inventories and pushed prices up in Canada as well. However, so too have continued supply chain issues. While interest rate hikes both here and in the US will cool demand for goods, seeing inventory-to-sales ratios climb and reducing inflationary pressures, ongoing supply issues will mean that this process takes longer than previously anticipated. Moreover, a period of goods price deflation to partly correct for big price hikes over the past year also seems less likely (Chart 3, left).

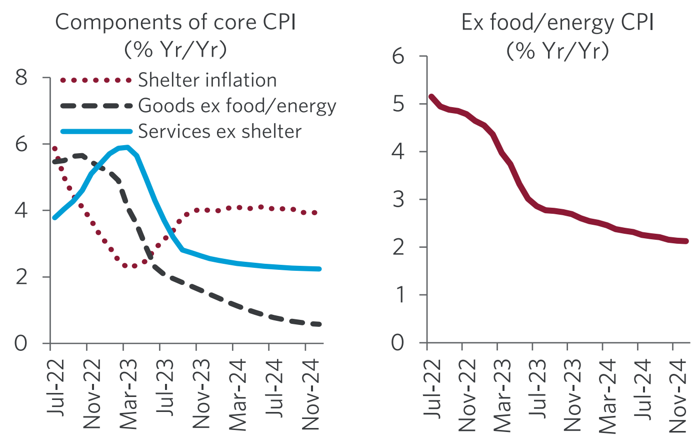
Combined with the lagged impact of the domestic output gap on services inflation, the persistence of some price pressures on the goods side will likely leave inflation ex-food/energy above 3% until mid-2023 (Chart 3, right). With housing prices stabilizing but mortgage interest costs still making a positive contribution by 2024, our economic outlook isn't weak enough to see a sustained period of below-2% inflation. That will handcuff the BoC's ability to start cutting interest rates in 2023, even with economic growth trailing its current expectations. It's only as a negative output gap opens up in our forecast in 2024 that interest rates could be trimmed, and even then just back towards the mid-point of the BoC's neutral range.

Chart 2: Demographics to see participation rate fall further (L), limiting labour force growth relative to population (R)



Source: Statistics Canada, CIBC

Chart 3: Output gap led services inflation to peak in early 2023 (L), bringing ex food/energy inflation much closer to 2% (R)



Source: Statistics Canada, CIBC

Skirting a recession

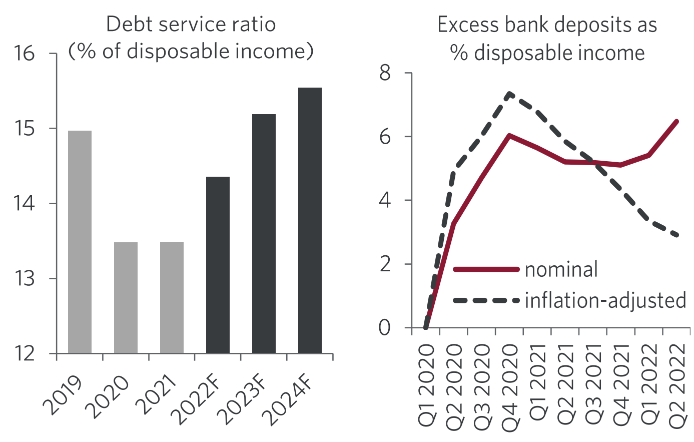
Of course, should US and Canadian rate hikes overshoot, and send North America into a meaningful recession, that would entail a faster retreat for inflation, and an earlier easing in interest rates. With overnight rates in the US set to top 4% and Canada only a shade below that, the probability of such a scenario has certainly risen since the start of the year.

However, it isn't our base case forecast, as there are a few silver linings surrounding the storm clouds currently hovering above the economy. Firstly, even though interest rates have risen higher and faster than we were expecting at the start of the year, strong income growth has meant that our forecast for the household debt service ratio hasn't worsened too much (Chart 4, left). At just above 15½% by 2024, it will still be higher than it was pre-pandemic, but not markedly so.

Moreover, Canadian households are still sitting on excess savings that can be used to fuel spending in the future, even if the labour market weakens modestly. In nominal terms, this pool of excess savings has actually risen in recent months, thanks in part to cheques distributed by provincial governments seeing fiscal windfalls or facing elections (Chart 4, right). While the excess savings look slimmer in inflation-adjusted terms, relative to the pre-pandemic trend it is still worth some 3% of current annual disposable incomes.

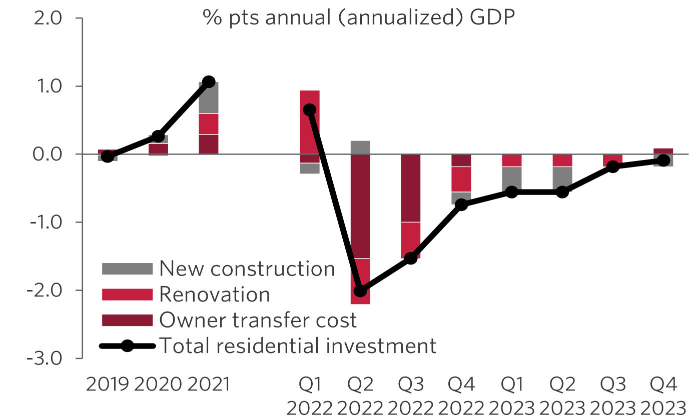
You have to look a bit harder to see the next point as a silver lining, but it is becoming abundantly clear that the downturn in residential investment will be very front-loaded. A sharp decline in housing resales, and renovation activity, took a big bite out of growth in Q2 and will do the same in the third quarter as well. However, resale activity is already showing signs of stabilizing, albeit below levels seen pre-pandemic, which will mean that residential investment will be a much smaller drag on growth by Q4 2022 and throughout 2023 even if most of the easing in construction spending (which lags sales) is still ahead of us (Chart 5).

Chart 4: Household debt service ratio now expected to rise above 2019 level (L), but some savings remain even after inflation adjustment (R)



Source: Statistics Canada, CIBC

Chart 5: Housing will become a much smaller drag on GDP after Q3 2022

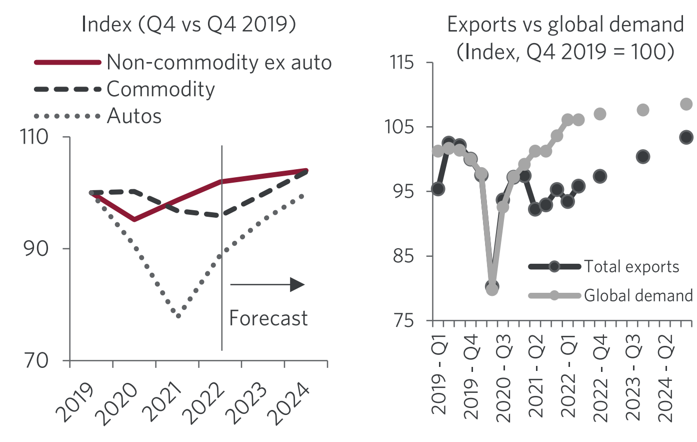


Source: Statistics Canada, CIBC

Finally, the outlook for Canadian exports may be brighter than its typical correlation with global demand, which is clearly worsening given the slowdown in the US and likely recession in Europe. For one, exports haven't benefitted like they typically would have during the rapid post-COVID recovery, in large part due to constraints placed on the auto industry by the semiconductor shortage. These constraints should ease over time. Moreover, global demand for Canada's resources is clearly on the rise as developed economies look for non-Russian alternatives. So even as softer global growth negatively impacts other exports, gains in autos and resources should leave total export volumes on a moderate uptrend (Chart 6).

The flight path for the economy will be lower because of the rise in interest rates and weaker global outlook. But that doesn't necessarily mean we will experience the hard landing of a deep recession. A bumpy landing, in which the economy sees two years of weak growth and a moderate rise in the unemployment rate, appears the most likely path to getting inflation sustainably back to a 2% rate.

Chart 6: A recovery in autos and strength in commodities (L), should bring decent export growth despite slowing global demand (R)



Source: Bank of Canada, Statistics Canada, CIBC

Global outlook: Teetering on the edge

by **Karyne Charbonneau** karyne.charbonneau@cibc.com and **Andrew Grantham** andrew.grantham@cibc.com

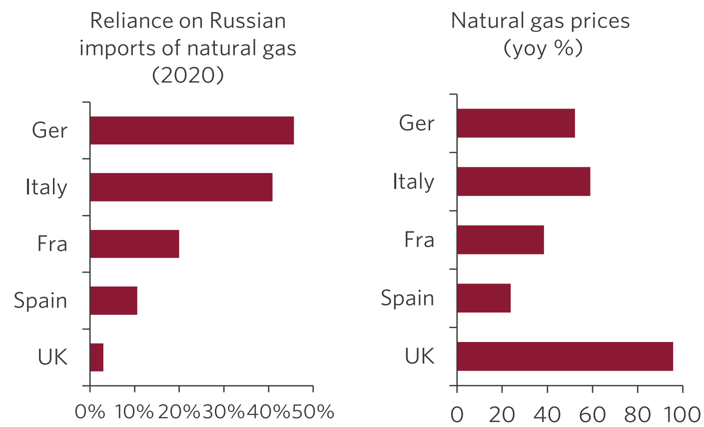
While swift rate hikes have dimmed the outlook for Canada and the US relative to where we stood at the start of the year, forecasts for Europe (including the UK) and China have actually seen bigger downgrades. The war in Ukraine, sanctions on Russia and the energy crisis that has resulted will see the UK and Eurozone fall into recession before the end of this year. Meanwhile, COVID-19 related lockdowns, combined with other factors, will mean China won't be able to provide an offset to weaker developed economy growth. The end result is a much softer global economic outlook relative to where we started the year, with a return to stronger growth rates not expected until 2024 (Table 1).

Europe lacking energy

The European outlook has clearly seen the greatest impact from the outbreak of war in Ukraine and the sanctions placed on Russia as a result. Given the reliance of countries in the region on Russian energy (Chart 1, left), gas prices have escalated (Chart 1, right) and are placing pressures on households and businesses alike. Even countries that don't import a significant amount of gas directly from Russia, such as the UK, are seeing big increases in the cost of energy.

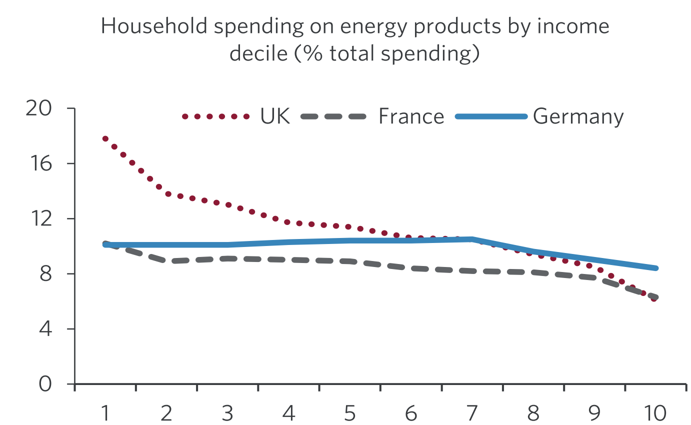
In fact, the rising cost of energy is possibly an even bigger threat to household spending in the UK than it is in many European countries that have a greater dependance on Russian energy. Even before prices escalated, UK households spent a larger proportion of their disposable incomes on energy than their counterparts in large European countries. Moreover, this is even more pronounced among lower income households whose ability to spend on other items will be most severely impacted by surging energy bills (Chart 2).

Chart 1: European reliance on Russian gas varies (L), but surges in prices more uniform (R)



Source: IEA, Bloomberg, CIBC

Chart 2: UK low income households already spent more on energy



Source: IMF, CIBC

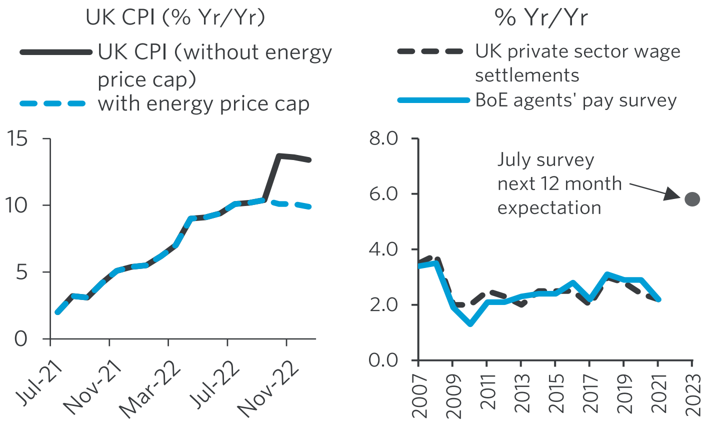
Table 1: Real GDP growth rates

Region	2019A	2020A	2021A	2022F	2023F	2024F
World[1]	2.9	-3.1	6.1	2.8	2.2	2.7
US	2.3	-3.4	5.7	1.8	0.7	0.8
Canada	1.9	-5.2	4.5	3.1	0.6	1.4
Eurozone	1.6	-6.2	5.2	2.7	-0.1	1.8
UK	1.7	-9.3	7.4	2.9	-0.4	1.9
Australia	2.0	-2.1	4.9	3.8	1.6	1.8
Japan	-0.4	-4.6	1.7	1.6	1.7	1.2
China	6.0	2.2	8.1	2.9	5.1	5.5

That makes the new Prime Minister's cap on future price increases vitally important for the economic outlook. While it won't prevent a recession, the lower peak in inflation (Chart 3, left) would ensure that household spending on other items doesn't contract as far as it otherwise would have done. Still, with recent strike activity and wage expectations showing a de-anchoring of inflation expectations (Chart 3, right) the Bank of England will be forced to continue raising interest rates even as a recession is underway.

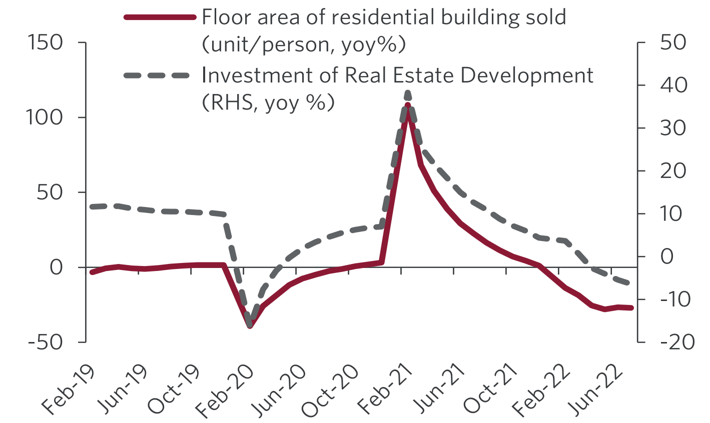
[1] At purchasing power parity.

Chart 3: Energy price cap will limit inflationary impact somewhat (L), BoE needing to respond to wage inflation and expectations (R)



Source: ONS, BoE, CIBC

Chart 5: China housing downturn gathering steam



Source: Bloomberg, CIBC

For large European Union countries such as Germany, the impact of the energy crisis is also being felt by its manufacturing sector. With the sector seeing its use of natural gas rise even further in the past few years (Chart 4, left), a recent survey suggested around 15% of companies were curtailing production due to the price and availability of power. What was supposed to be a rebound year for German industrial production as supply chain disruptions in autos eased has become anything but (Chart 4, right). Supply chain linkages mean that the implications of that will stretch beyond national borders, due to Germany's production of intermediate goods as well as autos.

No offset from China this time around

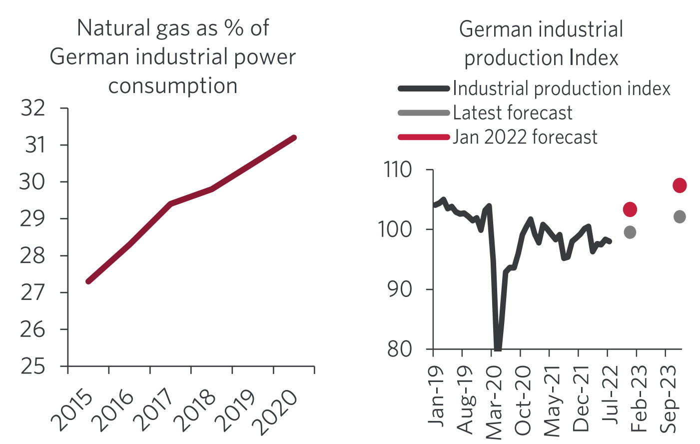
As advanced economies slow, we normally turn to China to buttress global growth. But China is not the engine of growth that it once was. The property market has turned from a driver of growth to a drag. Repeated lockdowns related to China's zero-COVID policy are impeding activity. Even the weather is wreaking havoc on the economy, with a drought hitting agriculture and hydro power. Monetary and fiscal stimulus likely won't be enough to offset these drags, leaving growth around 3% in 2022, much lower than what we have come to expect from this erstwhile powerhouse. Moreover, 2023 and 2024 aren't expected to see a catch up period of above-target growth even if COVID lockdowns ease somewhat.

The property market had been the linchpin of Chinese growth in recent years, but housing activity is now depressed. Home sales are down about 30% and investment down about 6% relative to a year ago (Chart 5). This leaves growth in housing activity well below the pre-pandemic trend. The severity of the situation is evident in the willingness of many Chinese homeowners to boycott mortgage payments — a bold step in a country with little public dissent. The size of the Chinese property market means that without a robust recovery, it will have a persistent negative impact on growth.

In past downturns, fiscal and monetary policy have been used to prop up the property market. The government has dusted off its old playbook by encouraging banks to lend more, lowering mortgage costs and relaxing some ownership rules. But this stimulus is likely to be insufficient this time as the government is trying to mitigate the slowdown without reigniting housing excesses.

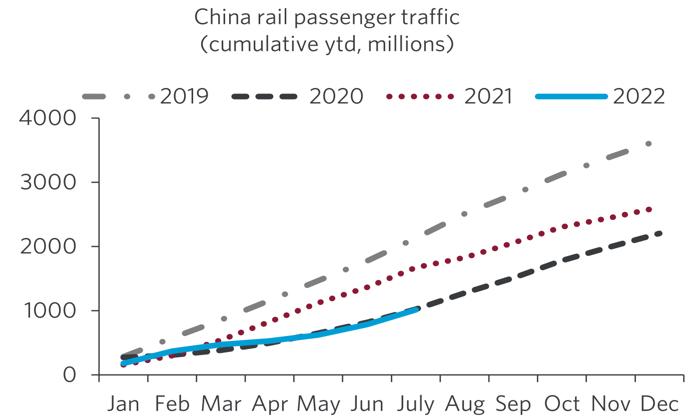
Meanwhile, China's strict zero-COVID policy is compounding the growth challenges. The most severe restrictions were imposed in the spring, but with cases rising again, lockdowns are again disrupting economic activity. More than 70 cities with a total population of more than 300 million people have gone into full or partial lockdown since late August. Passenger rail

Chart 4: German manufacturing's dependance on gas has risen (L), disruptions cause downgrades to production forecasts (R)



Source: Bloomberg, CIBC

Chart 6: China rail passenger data tracking closer to 2020 than 2021. Not close to 2019



Source: Bloomberg, CIBC

traffic — a proxy for mobility — is tracking 2020 levels, well below not just 2019 but also 2021 (Chart 6).

Adding to the gloomier outlook is drought and weather-related power shortages, and indicators suggesting that manufacturing activity has slowed. Power shortages have hindered production, bringing some plants (e.g., Toyota and Volkswagen) to a halt. Extreme heat has also slowed construction activity. Together with COVID lockdowns, these weather-related disruptions to production are hampering supply chains and adding to global inflationary pressures as well as slowing China's growth rate.

Looking ahead, as inflation, war and higher interest rates slow growth in advanced economies, demand for Chinese exports will weaken. Relief in the form of US-China tariff reduction is unlikely following the heightened tensions associated with Speaker Nancy Pelosi's visit to Taiwan. More generally, frayed relations with the West will inhibit technology transfer and weigh on Chinese productivity growth. The demographic outlook also looks bleak, with the population now expected to start shrinking this year, 5 years earlier than previously projected. Overall, while this year's very weak performance should be an anomaly, China's growth prospects for the next few years are also weaker than they have been in decades.

Contacts:

Avery Shenfeld
416 454-4982
avery.shenfeld@cibc.com

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

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

Karyne Charbonneau
613 552-1341
karyne.charbonneau@cibc.com

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

FICC Strategy
Ian Pollick
416 594-7057
ian.pollick@cibc.com

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

economics.cibccm.com