Economics

FORECAST

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Not that 70s Show

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The 1970s are remembered for bell bottoms and stagflation, and if not in fashion, the early months of 2022 could harken back to those days. The latest wave of Covid-19 is likely to hold back economic activity in the first quarter. But inflation will remain elevated, as Covid hits goods prices by sending workers home from factories, ports and warehouses still trying to catch up to backlogged orders.

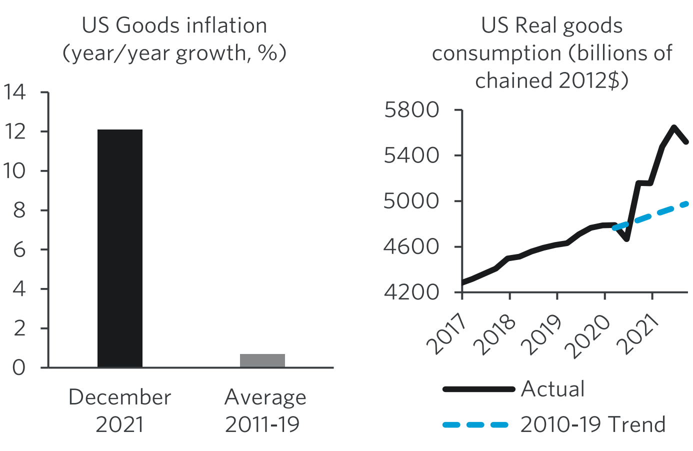
Still, looking further out, the coming two years are unlikely to be a replay of that 70s show, with more growth, and less inflation, than what a stagflation label would imply. Even with an omicron stall in Q1, Canada's growth should still be solidly in the 3½% range in 2022, with the US a touch higher, and while inflation will average above central bank targets (Tables 1 and 2), it will end the year at a tamer level.

Any economic forecast these days has at its roots a projection for the pandemic. Treatments that reduce hospitalizations, vaccines tailored to new variants or that target a broader range of them, alongside partial immunity from prior infections or vaccines, look promising for better times deeper into 2022. While some overseas economies will still be left with an output gap at year end, our global growth forecasts (Table 6) also hinge on diminishing pandemic impacts. For those who want to worry, Covid remains the most obvious downside risk to our projections.

But as long as we're not losing a battle against yet another variant at this time next year, a moderation in Covid-19 troubles will simultaneously propel growth and ease inflation, with the growth benefits centred on services, and the disinflation coming in goods prices. That will reverse what Covid has wrought, most notably in the US, where both the volume of goods consumption and prices for such products have been atypically strong (Chart 1), a development that's unlikely to be a coincidence given that inflation is always rooted in too much demand chasing too little supply.

Goods supply has been held back by Covid disruptions and delays in growing capacity to meet the needs of a recovering economy, factors that should improve if the virus fades out. Indeed, there were tentative signs of better news on these fronts before the omicron wave hit, with some shipping costs easing, and auto production recovering. Demand will tilt back to services as consumers see fewer risks in travel, restaurant dining and other activities. These sectors have ample excess capacity to take on customers, and while wages will run hotter as they rehire, such costs will be spread out over greater volumes.

Chart 1: Goods inflation driven by strong demand combined with supply disruptions

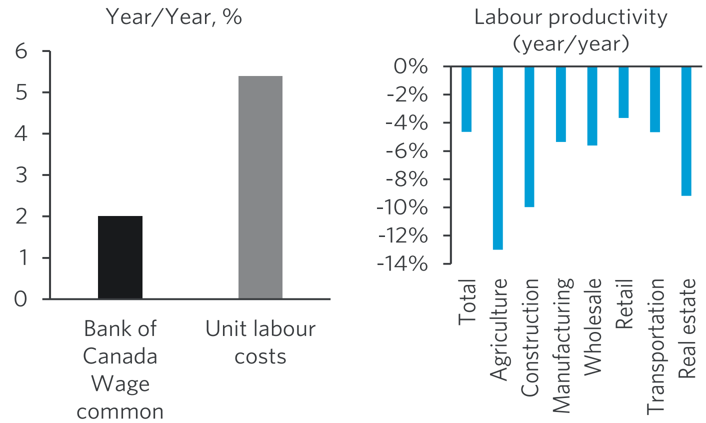


Source: BLS, BEA, CIBC

Covid's fingerprints have also been all over a major distortion in Canada's economy, in which GDP has run much weaker than hiring. That leaves ample room for GDP to significantly outpace employment growth in the year ahead as productivity rebounds.

That too will help ease inflation pressures somewhat. The Bank of Canada's Wage Common measure stood at a moderate 2% as of Q3 and looks likely to accelerate in the coming year. But unit labour costs were up 5.4% in the year to Q3 due to weak productivity, reflecting the gap between employment and GDP noted above. Challenges in filling orders due to supply chain disruptions and poor harvests have impacted manufacturing and agricultural goods output, Covid has slowed construction projects and impacted productivity in that sector, and retailers would improve productivity if brick-and-mortar stores had a stronger flow of customers (Chart 2).

Chart 2: Soft wage growth hiding weak productivity effect on unit labour costs



Source: Bank of Canada, Statistics Canada, CIBC

Inflation needs taming for 2023

A calming in Covid's fires will see the unusual combination in which the latter half of 2022 sees improved growth, slower inflation, but also a run of rate hikes by both the Fed and the Bank of Canada. If, as we expect, March brings an improvement on the Covid front, that month will also mark the start of a tightening cycle by the Fed with the Bank of Canada moving in April, aimed at keeping inflation running tame in 2023 and beyond as North America reaches full employment.

Our growth forecast trails that of the Bank of Canada, and is a reason why we see Governor Macklem's team hiking only 75 bps in 2022, with an equal dose in 2023. While that's tamer than some projections, the Bank has to be cognizant of a lagged impact on an indebted household sector when mortgages start coming due in 2024-25 at much higher rates than those they will be replacing. Moreover, some of the needed tightening in market rates further out the yield curve will come from the spillover from US policy moves.

The Fed is speeding up tapering to have the option of hiking in March as well, with two more over the rest of 2022 coming as no surprise to financial markets. Come 2023, we're looking for a further 100 bps from the Fed, which faces a less indebted household sector with locked in mortgage rates. That should see the Canadian dollar weaken slightly over the next two years, given that markets are currently assuming a faster track for overnight rates in Canada than in the US.

The bond market is well braced for 2022 hikes, but oddly tempered in what it's building in for subsequent years.

Assuming Covid fades out, with no obvious additional headwind, rates should be north of 2% in both countries at some point in 2024 to be consistent with where neutral rates lie. That leaves today's 10-year yields vulnerable to a further climb once the hiking cycle is underway, and markets add room for a more complete cycle (Tables 3 and 4).

Both Treasuries and Canadas will also feel the weight of central banks reversing some of what they did under quantitative easing. We expect the Bank of Canada to cease reinvesting the funds it receives from maturing bonds back into the Government of Canada market around the time it starts raising the overnight rate, as there is no obvious need to maintain such a large balance sheet once the policy objective is to push rates higher. That additional supply will have to be funded in the public market. The Fed is rushing to wind up its QE program, and may well opt to diverge from Bernanke's post-QE approach by going from net buying to allowing its balance sheet to shrink in short order.

For equities, the toughest sledding could come earlier in the year, as Covid troubles and labour cost pressures temporarily impede earnings growth. Rising rates over the balance of the year should actually prove to be less of a challenge, since we'll only see them as the economy, and therefore earnings, reaccelerate. S&P valuations aren't particularly cheap, but the TSX isn't overdone on a forward multiple basis. Even a modest gain for the index would see it outperform bonds on a total return basis, and that's the likely outcome as long as Covid proves less troublesome ahead. Fingers crossed.

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

Variable	2020	2021F	2022F	2023F
GDP at market prices	-4.5	12.4	5.1	4.5
GDP in $2012	-5.2	4.6	3.5	3.1
Consumer price index	0.7	3.4	3.1	1.8
Unemployment rate	9.5	7.4	5.9	5.6
Current account balance (C$ Bn)	-39.4	5.7	-3.2	-27.1
Pre-tax profits (net operating surplus)	-1.9	32.6	0.8	3.6
Housing starts (K)	219	278	239	225

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

Variable	2020	2021F	2022F	2023F
GDP at market prices	-2.2	10.0	7.8	5.5
GDP in $2012	-3.4	5.6	3.9	3.0
Consumer price index	1.2	4.7	4.4	2.1
Unemployment rate	8.1	5.4	3.7	3.5
Current account balance (US$ Bn)	-616	-830	-951	-983
Pre-tax profits (with IVA/CCA)	-5.2	22.1	9.2	4.0
Housing starts (K)	1,397	1,583	1,599	1,620

Table 3: Canadian interest rates (end of period)

Variable	2022 12-Jan	2022 Mar	2022 Jun	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
Overnight target rate	0.25	0.25	0.50	0.75	1.00	1.00	1.25	1.50	1.75
98-Day Treasury Bills	0.28	0.05	0.40	0.70	0.95	1.00	1.20	1.45	1.70
2-Year Government Bond	1.09	1.15	1.20	1.35	1.50	1.60	1.70	1.95	2.15
10-Year Government Bond	1.72	1.85	2.00	2.10	2.15	2.25	2.35	2.40	2.40
30-Year Government Bond	1.98	2.15	2.25	2.25	2.30	2.40	2.45	2.40	2.45
Canada - US T-Bill Spread	0.16	-0.30	-0.25	-0.20	0.05	-0.15	-0.15	-0.15	-0.10
Canada - US 10-Year Bond Spread	-0.02	0.00	0.00	0.00	0.00	0.05	0.05	0.05	0.00
Canada Yield Curve (10-year — 2-year)	0.63	0.70	0.80	0.75	0.65	0.65	0.65	0.45	0.25

Table 4: US Interest rates (end of period)

Variable	2022 12-Jan	2022 Mar	2022 Jun	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
Federal funds rate	0.125	0.375	0.625	0.875	0.875	1.125	1.375	1.625	1.875
91-Day Treasury Bills	0.12	0.35	0.65	0.90	0.90	1.15	1.35	1.60	1.80
2-Year Government Note	0.90	1.10	1.35	1.60	1.65	1.80	2.00	2.15	2.30
10-Year Government Note	1.74	1.85	2.00	2.10	2.15	2.20	2.30	2.35	2.40
30-Year Government Bond	2.09	2.10	2.30	2.30	2.40	2.45	2.50	2.60	2.65
US Yield curve (10-year — 2-year)	0.84	0.75	0.65	0.50	0.50	0.40	0.30	0.20	0.10

Table 5: Foreign exchange rates

Exchange rate	2022 12-Jan	2022 Mar	2022 Jun	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
CAD-USD	0.80	0.78	0.77	0.76	0.76	0.76	0.76	0.77	0.78
USD-CAD	1.25	1.29	1.30	1.32	1.31	1.31	1.31	1.30	1.29
USD-JPY	115	115	116	115	114	113	112	111	110
EUR-USD	1.14	1.11	1.10	1.10	1.10	1.11	1.12	1.13	1.15
GBP-USD	1.37	1.31	1.29	1.30	1.32	1.34	1.34	1.35	1.36
AUD-USD	0.73	0.73	0.74	0.75	0.76	0.77	0.78	0.79	0.80
USD-CNY	6.36	6.30	6.25	6.20	6.15	6.05	6.00	5.95	5.90
USD-BRL	5.56	5.70	5.70	6.00	5.70	5.90	5.70	5.50	5.30
USD-MXN	20.4	21.0	22.0	22.0	21.5	21.0	21.5	21.3	21.5

Table 6: Global real GDP growth rates

Region	2018A	2019A	2020A	2021F	2022F	2023F
World[1]	3.5	2.8	-3.3	5.6	4.0	3.3
US	2.9	2.3	-3.4	5.6	3.9	3.0
Canada	2.8	1.9	-5.2	4.6	3.5	3.1
Euroland	1.8	1.6	-6.5	4.9	3.8	2.7
UK	1.7	1.7	-9.7	6.6	4.4	2.8
Australia	2.8	2.0	-2.2	4.1	3.0	2.9
Japan	0.6	0.0	-4.7	1.7	2.6	2.1
China	6.7	6.0	2.3	8.0	4.8	5.0

[1] At purchasing power parity.

US: Light at the end of another tunnel

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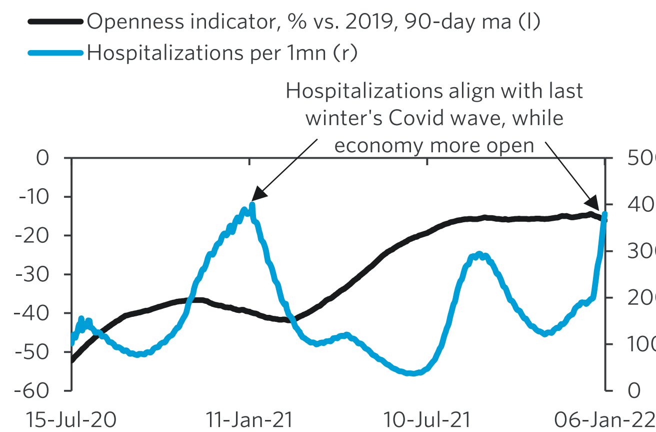
Our working assumption is that 2022 will be a year of transition, from pandemic to endemic. That scenario is consistent with a weak first quarter, followed by a strong spring and summer. The end result should be GDP growth of around 4% in 2022, slower than the 2021 pace, but still miles above potential.

While we expect first quarter activity to be bruised substantially by the omicron wave, Chart 1 clearly illustrates that the economic damage relative to previous waves will be more muted. The US economy is notably more open despite the fact that the current hospitalization rate is at the level seen in the early 2021 Covid wave. At the same time, apocalypse fatigue along with the belief that the symptoms resulting from omicron are not as severe as those inflicted by delta will work to ease the fear factor that dominated previous waves.

Chart 1: Economy more open despite rising hospitalization rate



Source: Google, TSA, OpenTable, Our World in Data, CIBC

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

Indicator	21:4F	22:1F	22:2F	22:3F	22:4F	23:1F	23:2F	2021F	2022F	2023F
GDP at market prices ($Bn)	23,919	24,208	24,582	24,953	25,322	25,654	25,953	22,975	24,766	26,138
% change	12.9	4.9	6.3	6.2	6.1	5.4	4.7	10.0	7.8	5.5
Real GDP ($2012 Bn)	19,734	19,815	20,077	20,289	20,467	20,593	20,715	19,409	20,162	20,771
% change	5.3	1.7	5.4	4.3	3.6	2.5	2.4	5.6	3.9	3.0
Final sales	2.8	1.2	5.3	4.0	3.1	2.5	2.5	5.4	3.0	2.9
Personal consumption	4.4	0.8	5.6	5.2	4.0	2.3	2.0	8.0	3.9	3.1
Total government expenditures	2.0	1.5	1.3	1.3	1.6	1.8	1.7	0.8	1.2	1.7
Residential investment	4.2	4.5	5.3	3.6	2.4	1.8	3.2	9.3	1.7	2.7
Business fixed investment	3.4	5.7	7.0	3.7	3.8	3.5	4.4	7.4	4.8	4.1
Inventory change ($2012 Bn)	54.0	76.0	82.0	96.0	122.0	124.0	121.0	-67.4	94.0	116.8
Exports	12.5	6.0	6.1	6.7	5.5	5.3	4.7	4.0	5.9	4.9
Imports	15.8	7.3	4.7	7.3	7.3	3.8	3.3	13.9	8.0	4.6
GDP Deflator	6.7	3.2	0.9	1.8	2.4	2.8	2.3	4.1	3.7	2.4
CPI (yr/yr % chg)	6.7	6.9	4.9	3.5	2.3	1.9	2.0	4.7	4.4	2.1
Core CPI (yr/yr % chg)	5.0	5.8	4.3	3.3	2.5	2.1	2.2	3.6	3.9	2.3
Unemployment rate (%)	4.2	4.1	3.7	3.5	3.5	3.5	3.5	5.4	3.7	3.5
Housing starts (AR, K)	1,584	1,575	1,588	1,597	1,608	1,612	1,618	1,583	1,599	1,620

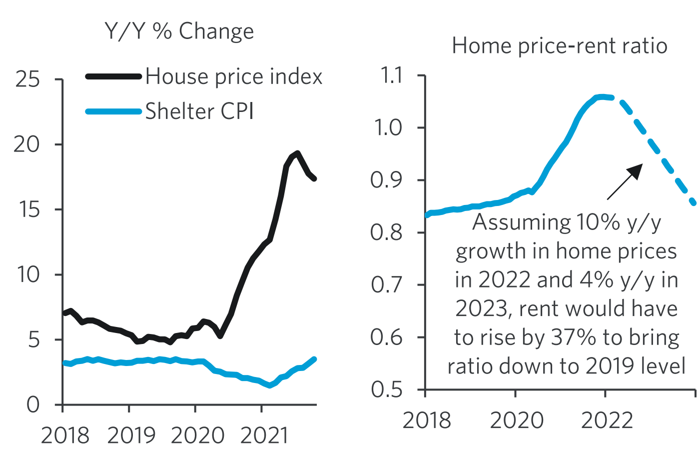
So, assuming no other vaccine-resistant mutations arise during the course of 2022 (yes, a strong assumption), the economic trajectory is, in a way, predictable. What is much less predictable are the side effects of that trajectory, namely inflation. Yes, inflation is no longer transitory, but that doesn't imply that it's permanent either. At the end of the day, it's really not about long-lasting inflation, but more about the pain central banks will have to inflict on the economy to bring inflation back to target. The Fed will not toss away decades of hard work establishing its reputation as an inflation fighter. And that monetary response will be directly linked to the path and sustainability of the multiple sources that are behind the current 39-year high inflation rate.

Multiple inflationary sources

Let's start with shelter, which accounts for roughly 40% of the core CPI basket, and no less than 17% of the core PCE price basket. With home prices having risen by a cumulative 26% since the beginning of the pandemic, and rent prices, as measured by the CPI's shelter sub-index, having risen notably more slowly (Chart 2 left), the price-to-rent ratio is now at the highest level on record, reflecting the fact that those with existing leases haven't yet seen their rents adjust to current conditions. With housing inventories at extremely low levels, the consensus in the market is that US home prices will rise by an additional 10% in 2022 and 4% in 2023, and we have no reason to dispute that forecast. If so, rent inflation will have to climb notably to close that gap. Chart 2 right is not a forecast; its aim is to put that potential rent inflation into perspective. In order to bring the price-to-rent ratio back down to its pre-crisis level in the coming two years, rent would have to rise by no less than 37%. Granted the process can take longer, but the point here is that rent will be an important source of inflation in the coming years.

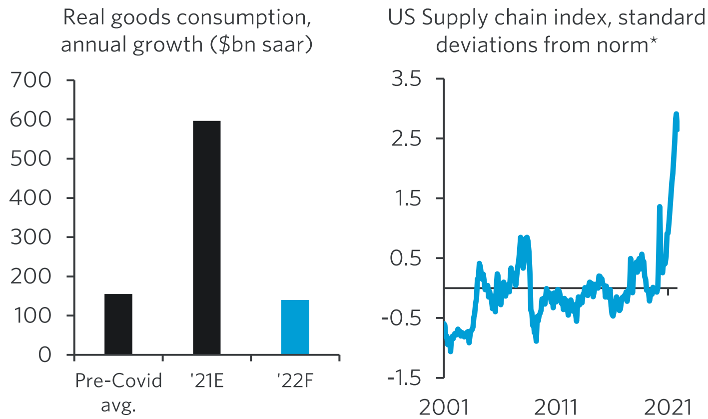
One other important source of inflation has been outsized demand for goods during the pandemic as services were shuttered. Growth in real consumption of goods in 2021 was equivalent to the combined growth of four years during the pre-crisis era (Chart 3, left). Put differently, the additional demand seen in 2021 is akin to a situation in which the US population increases by 75 million overnight, economically speaking. Such a demand shock would have tested even a normally functioning supply system, and the current supply system is far from normal for obvious reasons (Chart 3, right).

Chart 2: Rent inflation to accelerate in the coming years



Source: BLS, FHFA, CIBC

Chart 3: Elevated demand for goods (L) and supply chain bottlenecks (R) are temporarily boosting inflation



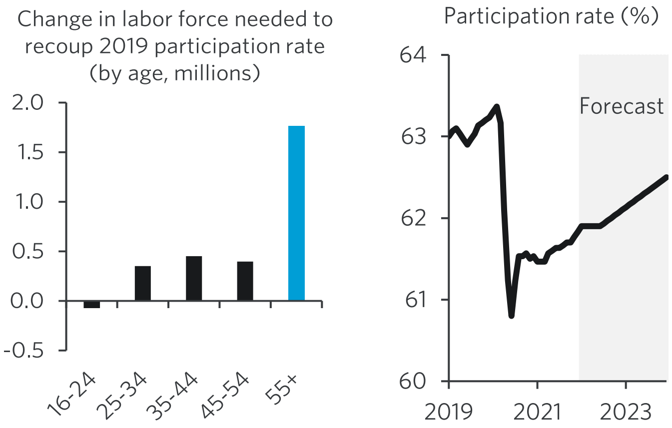
Source: BEA, Census Bureau, ISM, Bloomberg, CIBC. *Supply chain index averages the number of standard deviations from normal for several supply-side indicators.

We expect that source of price pressures to ease gradually during the course of 2022. With spending on goods elevated by every measure, it's clear that demand is becoming saturated, particularly for durable goods that have long lifespans. By mid-2022, we therefore expect to see widescale substitution towards services that are able to safely reopen, and growth in real spending on goods will be lower than it is in a typical pre-Covid year (Chart 3, left). That will work to restore services as the main driver of inflation, while goods inflation will take a back seat.

Fading supply chain issues will also contribute to the alleviation of inflation in goods, particularly in the market for new and used cars. Prior to the omicron wave, there were early indications of supply chain issues starting to fade in those areas as international trade began to pick up, and surveys showed that supplier deliveries for US producers were somewhat less delayed, while container shipping rates to the US west coast from China eased off. Still, supply bottlenecks remain widespread, and could worsen on omicron in the winter months. It likely won't be until the latter part of 2022 when those issues fade materially.

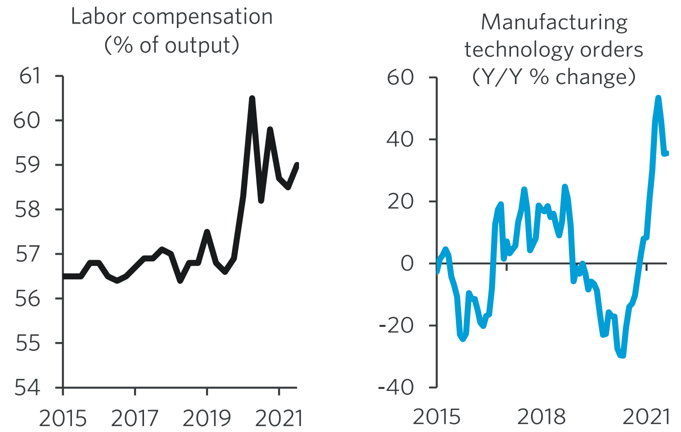
The Fed's worries about inflation lie in the labor market's wage pressures that are being exacerbated by the labor shortage. The job openings rate has remained within reach of the all-time high hit in July despite continued strong wage gains, as the participation rate has made little progress and is likely to see its recovery stall as omicron rages. Even thereafter, a full recovery

Chart 4: Labor force deficit skewed towards retiree age group (L), suggesting permanent downshift in participation rate (R)



Source: BLS, CIBC

Chart 6: Early stages of labor-capital substitution?



Source: BEA, AMT, CIBC

in the participation rate is unlikely given the composition of the change in the labor force that resulted from accelerated retirements during the pandemic. Half of the over 3mn Americans that would have to rejoin the workforce to see the participation rate fully recover are in the 55+ age group (Chart 4, left). Even assuming that half of those rejoin the labor force, the participation rate would still be well below its pre-pandemic level at the end of 2023 (Chart 4, right).

Businesses and consumers will not sit still

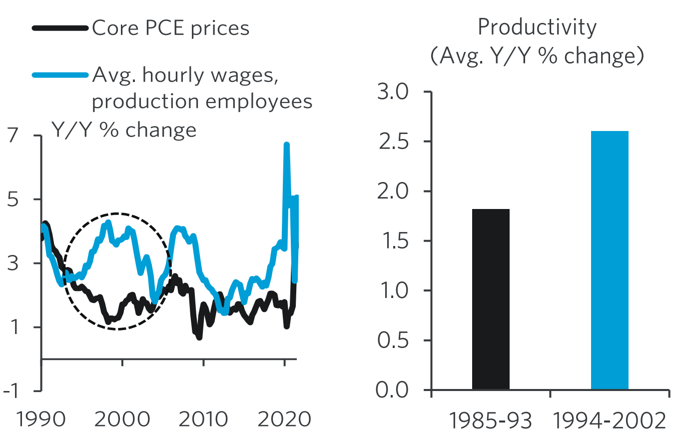
But how inflationary is the current rise in wages? Clearly, if corporate America remains static and deals with the shortage of labor by only raising wages, inflation will follow. But corporate America is anything but static. To the extent that companies use the excess cash they are sitting on, along with low rates and inviting credit markets, to invest in productivity-enhancing equipment, higher wages will not be as inflationary as feared. As shown in Chart 5, in the 1994-2002 period, elevated wage inflation did not boost overall inflation due to the strong increase seen in productivity. As long as productivity rises alongside wages, thereby preventing unit labor costs from rising, inflation will be shielded.

And there are early signs that that's starting to happen. With the share of labor compensation in output rising notably during the pandemic, firms are increasing their orders of tech goods in an attempt to replace labor with capital (Chart 6). We believe that this trend will continue in 2022, leading to some improvement in productivity while easing some of the wage pressure on inflation.

At the same time, we don't expect consumers to be static either. The share of items exhibiting above average inflation in the CPI basket has risen by 3%-pts since the pandemic began. Logic suggests that consumers will soon begin substituting spending towards cheaper items, another factor that will slow inflation down from its torrid pace.

The economy is likely to see a sub-2% annualized pace of growth in the first quarter as omicron weighs, but it will be launched towards a sharp services-led reacceleration in activity in the spring and summer, with growth expected to average over 4% annualized in the year's subsequent quarters. Inflation will remain elevated but start to slow as supply chain issues and demand for goods fade. That will mask a heating up in cyclical components and services inflation, which the Fed will be focused on, as we expect core CPI to average 2.5% in the final quarter of 2022, and to remain around that pace in 2023.

Chart 5: Productivity—an inflation shield



Source: BEA, BLS, CIBC

Canada: Questioning what comes first

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

For the economy, the question of what comes first is not about chickens and eggs, but rather rate hikes or a recovery in services sector spending. Up until very recently it was assumed that a combination of high vaccination rates and pent-up demand for discretionary service activities would bring a strong recovery in consumer spending well before the need for interest rate hikes to cool other areas of the economy. However, strong inflation towards the end of last year, resulting in a hawkish pivot from the central bank, and the emergence of the omicron variant, place a big question mark over that assumption.

As a result, even though we expect that weakness in the first quarter from the latest wave of infections should be fairly short-lived, and that growth will see a meaningful rebound thereafter, our projections for 2022 and 2023 combined are modestly weaker than where they stood six months ago (Table 1). An easing in some of the external pressures placed on inflation at the moment should, however, see price pressures ease more quickly than most now expect in the second half of this year and encourage a fairly cautious path higher in interest rates.

Omicron...and gone?

We, like many others, are hoping that this wave will be the final one that is big enough to result in widespread restrictions on business. That's not guaranteed given Canada's disadvantage in hospital capacity relative to peer countries — something we previously highlighted as a major risk. However, the high infection rates, resulting in more natural immunity being built up, and the acceleration in booster shots provide a base to the view that this could be the final big wave.

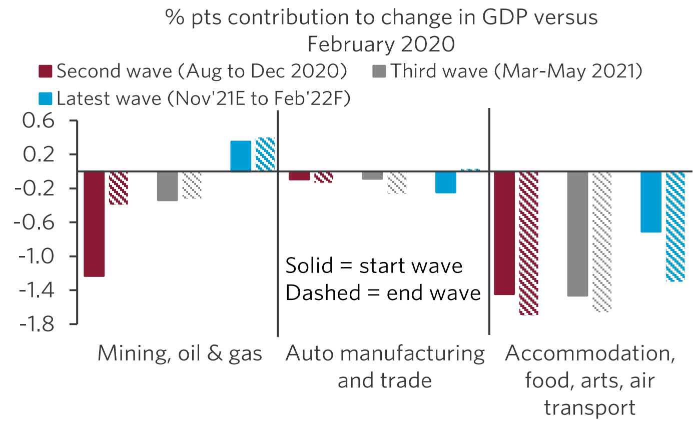
In terms of the near-term damage to the economy from the Omicron wave, prior experience can only tell us so much. During the second wave, when the economy actually managed to grow at a healthy clip, service sector industries most impacted by tightening restrictions were already operating at very depressed levels relative to those seen pre-pandemic, so there wasn't much room to fall further. In contrast, there was room for a big recovery in oil & gas, as rebounding prices

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

Indicator	21:4F	22:1F	22:2F	22:3F	22:4F	23:1F	23:2F	2021F	2022F	2023F
GDP at market prices ($Bn)	2,549	2,543	2,592	2,628	2,664	2,685	2,710	2,480	2,607	2,723
% change	6.8	0.5	6.8	5.2	5.6	3.3	4.2	12.4	5.1	4.5
Real GDP ($2012 Bn)	2,121	2,121	2,156	2,180	2,197	2,207	2,225	2,091	2,163	2,231
% change	5.2	0.0	6.8	4.7	3.0	2.0	3.2	4.6	3.5	3.1
Final domestic demand	2.4	-0.7	4.2	4.8	3.4	2.7	3.3	5.3	2.5	3.3
Household consumption	3.1	-2.8	4.3	5.6	4.7	3.5	5.0	5.3	3.7	4.3
Total government expenditures	1.4	1.2	1.9	2.1	2.1	1.1	1.2	4.9	1.4	1.5
Residential construction	1.2	1.0	3.4	2.0	-2.0	0.8	-2.1	14.6	-4.3	-0.2
Business fixed investment[1]	2.0	5.2	10.1	9.1	4.1	3.7	3.6	-0.3	5.5	4.8
Inventory change ($2012 Bn)	7.0	11.0	19.1	14.5	12.2	9.9	8.1	-0.7	14.2	8.3
Exports	4.0	5.8	7.3	6.1	3.5	4.8	5.8	1.0	4.3	5.1
Imports	4.8	5.6	3.9	3.4	3.5	5.6	5.2	6.5	3.5	4.8
GDP Deflator	1.5	0.5	0.0	0.5	2.5	1.3	1.0	7.5	1.6	1.3
CPI (yr/yr % chg)	4.8	4.7	3.4	2.5	1.8	1.6	1.9	3.4	3.1	1.8
Unemployment rate (%)	6.2	6.2	5.9	5.8	5.6	5.6	5.6	7.4	5.9	5.6
Employment change (K)	287	-16	213	139	134	101	99	867	658	465
Goods trade balance (AR, $bn)	9.7	8.3	8.0	6.7	3.1	-0.3	-2.2	6.6	6.5	-0.6
Housing starts (AR, K)	263	248	242	236	230	227	226	278	239	225

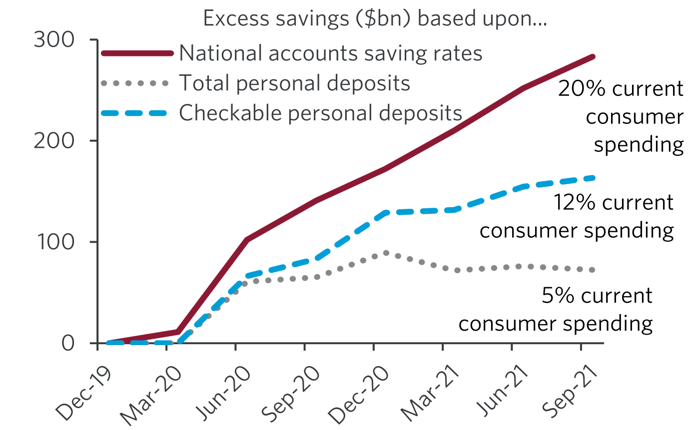
[1] M&E plus Non-Res Structures and Intellectual Property and NPISH.

Chart 1: In terms of economic impact, all waves are different



Source: Statistics Canada, CIBC

Chart 2: How much excess savings? It depends how you define it



Source: Statistics Canada, CIBC

encouraged production cuts to be scaled back (Chart 1). Fast-forward to the third wave, and a weakening in the service sector, albeit again from low levels, was exacerbated in terms of the overall economy by production disruptions in auto manufacturing/trade.

This time around? Service sector industries still hadn't fully recovered to pre-pandemic levels, but they were a lot closer than they were at the start of the second or third waves. New restrictions, particularly the fairly harsh ones in populous provinces such as Ontario and Quebec, mean these areas will be big negatives to GDP in January. Added to that, worker absenteeism due to positive Covid tests will impact other industries to a much greater extent than prior waves. Fighting against those negatives should be continued improvement in auto production and sales, with prior supply issues easing.

Overall, our current expectation is for an approximately 1% decline in monthly GDP, likely split over two months, but Q1 as a whole to come in broadly flat as the economy should once again rebound quickly once case numbers start to come down.

Size matters, but so does timing

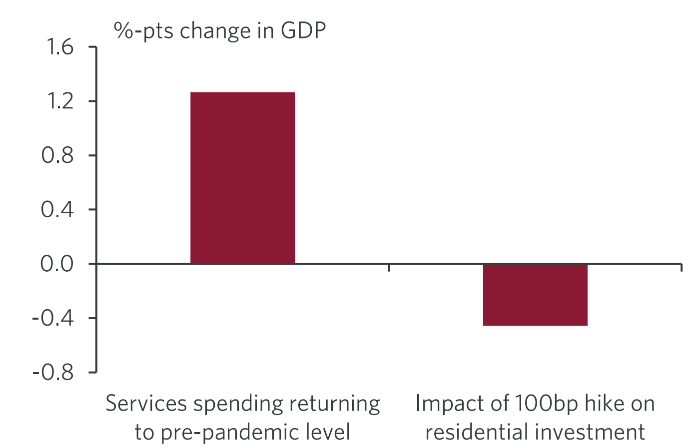
After the current, and hopefully final, round of restrictions, the building blocks for a strong rebound are mostly still in place. There's still plenty of pent-up demand for eating out, vacations and other service activities, and households generally have the means to spend in those areas once it is safe to do so. However, it's debatable just how large that pot of excess savings is (relative to the pre-pandemic trend).

Judging by the national accounts' household savings rate, it could amount to nearly $300bn, or 20% of current annual spending. However, that measure includes money that may have been invested, placed as a downpayment for a house, gifted to children etc. The spare funds sloshing around in household savings accounts is a smaller, but admittedly still sizeable, share of current consumption. Interestingly, these household deposit figures suggest that there has been little to no build up in savings since the end of 2020 (Chart 2). In other words, the longer the pandemic has gone, the more likely households have been to find alternative uses for unspent earnings, rather than just leaving them in readily available savings accounts.

Still, even if savings aren't quite as bountiful as some assume, spending on services should be a key driver of growth as Omicron cases fade and economies reopen again. And even as interest rate hikes begin and start to act as a drag on housing, based on prior sensitivities the negatives from higher rates should be much smaller than the potential gains from increased consumer spending (Chart 3).

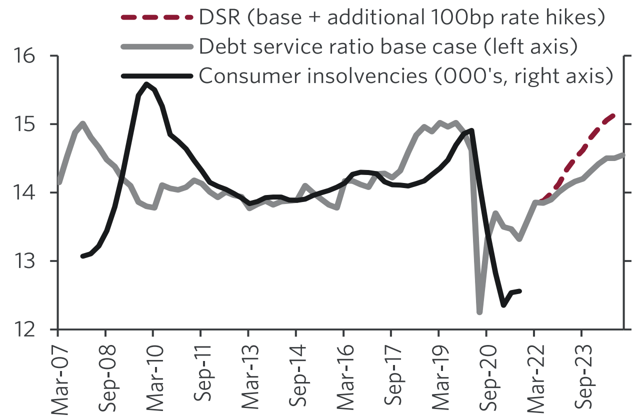
However, with the Bank of Canada expected to start hiking interest rates fairly soon, but also with vaccinations not providing the silver bullet to economic openness that everyone hoped, it is possible that some of the drag from higher rates occurs before the recovery in services spending is fully realized.

Chart 3: Recovery in services spending should dwarf negative impacts from interest rate hike



Source: Statistics Canada, Bank of Canada, CIBC

Chart 4: Debt service ratio would rise above pre-pandemic levels with an extra 100bp in hikes than base case



Source: Statistics Canada, CIBC

Moreover, as we have discussed previously, it is also likely that households will be even more sensitive to higher interest rates in the years ahead than they were in the past, due to debt taken on during and before the pandemic. Based on our fairly gradual projection for interest rate hikes, the household debt service ratio is expected to rise to around 14.5% by the end of 2023. However, it wouldn't take much more in terms of rate hikes to bring that ratio back to, or even above, the 15% level that in the past has coincided with a climb in consumer insolvencies (Chart 4).

Inflation: Not exactly here, there and everywhere

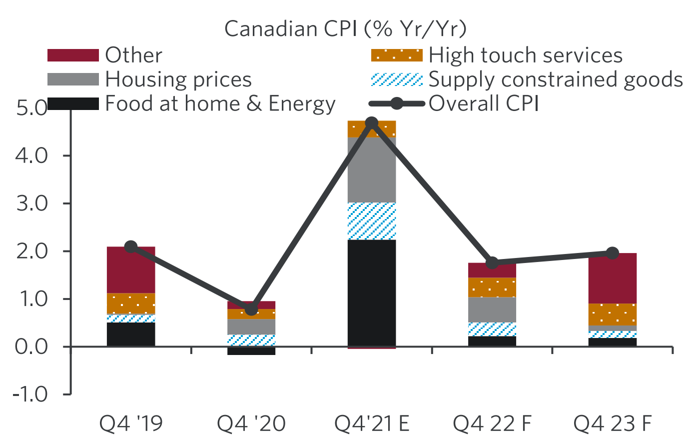
The sensitivity of households to rate hikes is only one reason, however, to expect a fairly gradual path higher for interest rates. We also don't see current elevated inflation readings as being quite as concerning as others do. After all, almost two-thirds of the 4.7% inflation rate estimated for Q4 last year stemmed from food, energy and elevated goods prices linked to supply chain issues (Chart 5). While we can't rule out further price increases in the near-term due to omicron-related supply chain disruptions, by year-end we should see some relief. Moreover, price increases in these areas are mainly internationally, rather than domestically, driven.

The same, obviously, can't be said of housing prices, which represent the next largest slice of the inflation pie. And, if anything, inflation in this area could firm a little further in the near-term as buyers have rushed to use mortgages that were fixed before rates started to rise. However, after that we should see some cooling. Interest rate hikes, even the gradual ones we expect, will weigh modestly on demand. Meanwhile, there could be some relief coming on the supply front. While housing starts in 2021 were remarkably strong, only a small proportion of those accelerated starts were actually completed. A stronger trend in completions going forward could help ease price pressures (Chart 6). While the prevailing logic is that strong immigration will add fuel to the housing fire, that same logic was behind calls for a slump in housing when the pandemic started and immigration ground to a halt — clearly now an incorrect call.

Outside of housing, there has been little sign of domestically driven inflation yet. Even though job vacancies have been high, and the unemployment rate moved to within touching distance of its pre-pandemic level in December, we have seen little in terms of accelerated wage growth and the inflation within service industries which typically follows. As we have discussed before, vacancies haven't been quite as widespread as they have been stateside, and population growth has been much stronger.

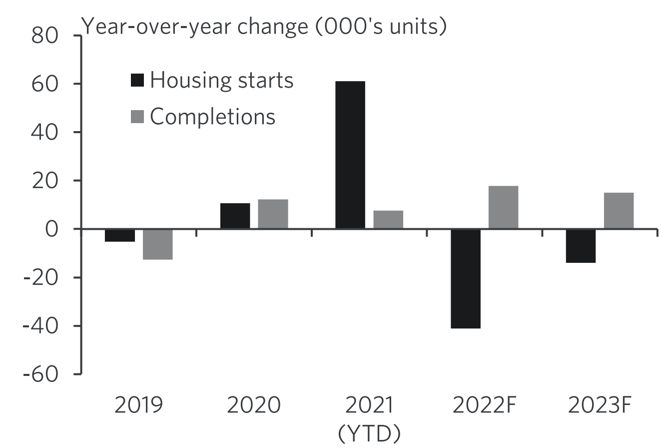
However, that's not the case across all provinces within Canada. Because of that, the supply of labour and its potential impacts on growth and inflation are of greater consequence for our provincial forecasts than for our national figures. Quebec, for example, has recently recorded more job openings than

Chart 5: Drivers of inflation have been very narrow, mostly externally driven



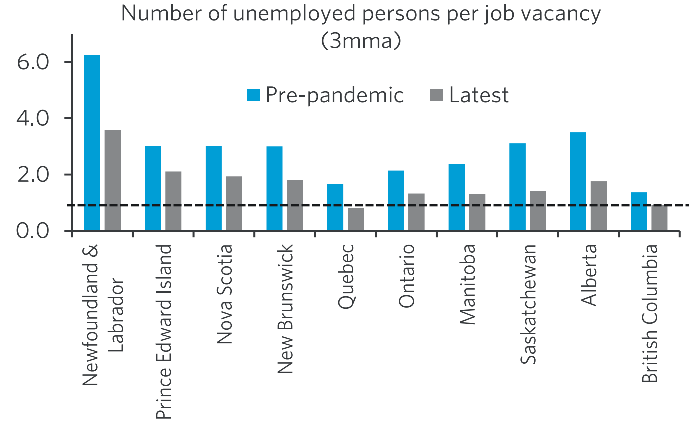
Source: Statistics Canada, Bank of Canada, CIBC

Chart 6: Lagged completions should help housing supply in 2022



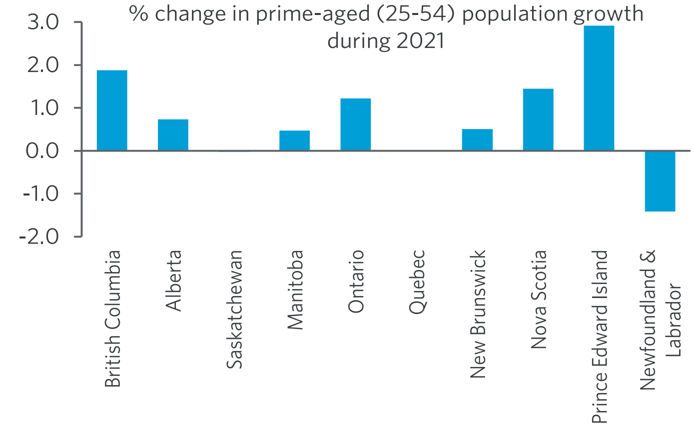
Source: CMHC, CIBC

Chart 7: Still not many provinces where vacancies outnumber unemployed persons



Source: Statistics Canada, CIBC

Chart 8: Population growth has picked up, but not everywhere



Source: Statistics Canada, CIBC

unemployed persons (Chart 7), and also has seen very little in terms of population growth due to slower immigration (Chart 8). So, even as restrictions are lifted again after the Omicron wave, there appears to be less scope for further strong growth there. In contrast, in BC, which also has had a tight labour market, population growth has been much stronger which points to higher growth potential going forward (Tables 2-4).

Questioning what comes first

Our forecast assumes that the current wave of virus cases passes quickly, allowing for a reopening before March, and that future waves don't require the same sort of restrictions imposed on service industries. Both of those assumptions could well prove overly optimistic, but have some scientific basis given the rapidly rising numbers who have either received a booster shot or built up some natural immunity through contracting Omicron.

However, even under that assumption our growth forecasts for the coming two years are a little weaker than we had previously assumed. High inflation and the interest rate hikes that it appears to be bringing will at least start to have an impact on growth before a full recovery of consumer services spending is seen. The good news is that some of the global factors driving inflation higher should fade, allowing the Bank of Canada to hike interest rates at a slightly slower pace this year than markets currently expect.

Provincial forecast tables

Table 2: Real GDP (Y/Y % chg)

Province	2020E	2021F	2022F	2023F
British Columbia	-3.4	4.2	3.4	2.9
Alberta	-7.9	6.3	4.0	3.5
Saskatchewan	-4.9	3.9	3.0	2.7
Manitoba	-4.6	3.9	3.0	2.4
Ontario	-5.1	3.9	4.1	3.4
Québec	-5.5	5.8	3.0	2.5
New Brunswick	-3.2	3.3	2.3	2.4
Nova Scotia	-2.5	3.4	2.4	3.0
Prince Edward Island	-1.7	2.7	2.7	3.1
Newfoundland and Labrador	-5.4	3.4	3.0	2.2
Canada	**-5.2**	**4.6**	**3.5**	**3.1**

Table 3: Nominal GDP (Y/Y % change)

Province	2020A	2021F	2022F	2023F
British Columbia	-0.5	11.2	5.0	4.5
Alberta	-16.1	25.3	6.0	4.7
Saskatchewan	-6.6	15.9	5.0	3.7
Manitoba	-1.4	8.9	4.5	4.0
Ontario	-2.8	9.4	5.5	4.9
Québec	-2.4	11.3	4.5	4.2
New Brunswick	-1.3	8.3	3.6	4.0
Nova Scotia	0.7	7.9	3.7	4.6
Prince Edward Island	0.9	7.7	4.0	4.7
Newfoundland and Labrador	-10.7	17.4	5.0	3.4
Canada	**-4.5**	**12.4**	**5.1**	**4.5**

Table 4: Unemployment rate (%)

Province	2020A	2021F	2022F	2023F
British Columbia	9.0	6.5	5.3	4.8
Alberta	11.5	8.6	7.2	6.6
Saskatchewan	8.4	6.5	5.4	5.0
Manitoba	8.0	6.4	5.2	5.2
Ontario	9.6	8.0	6.0	5.7
Québec	8.9	6.1	4.9	4.6
New Brunswick	10.1	8.9	7.7	7.6
Nova Scotia	9.8	8.4	7.7	7.4
Prince Edward Island	10.6	9.3	8.0	7.7
Newfoundland and Labrador	14.2	12.9	11.8	11.4
Canada	**9.5**	**7.4**	**5.9**	**5.6**

Source: Statistics Canada, CMHC, CIBC.

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