FORECAST
September 7, 2016

Economics

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.ca

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.ca

Andrew Grantham
(416) 956-3219
andrew.grantham@cibc.ca

Royce Mendes
(416) 594-7354
royce.mendes@cibc.ca

Nick Exarhos
(416) 956-6527
nick.exarhos@cibc.ca

A Longer Fuse

by Avery Shenfeld

It's not a case of "now or never", but rather a wait for "later". As it seeks to replace the role previously filled by energy sector capital spending, Canada will find that there's a longer fuse for the stimulus now in place to spark a return to full employment.

Anemic capital spending plans, even outside the energy sector, suggest that the draw of a cheaper Canadian dollar isn't yet enough to offset sluggish global growth and the resulting lack of pressure to add fresh capacity. That has us trimming our growth rate for 2017 by three ticks to 1.8%, and holding growth in 2018 to 1.9% (Table 1). The US economy didn't have as much weight in the energy sector, and unlike Canada, its less-costly oil plays will become profitable for fresh investment as early as 2018. But after a hotter 2.1% growth year in 2017, it will bump up against full employment limitations to growth.

By today's standards, these subdued growth rates might be counted as good years, fast enough to narrow economic slack. A slowing in Canadian labour force growth as the population ages, and a shift in activity from a highly productive energy industry to other sectors has reduced the non-inflationary speed limit of the economy to as little as 1.2% for 2017, and 1½% in 2018 (Chart 1).

It's not that different in other developed economies. Even China is destined for a deceleration, driven by both demographics and the well-trodden path to slower growth that other developing economies have seen as they reached higher living standards. The Eurozone still has ample slack that is gradually narrowing, but is still at risk due to its unwillingness to tap into fiscal stimulus. Add it all up, and global growth will be only a touch above 3% in the next two years, although that's still an improvement from a mid-cycle trough of 2.8% in 2016.

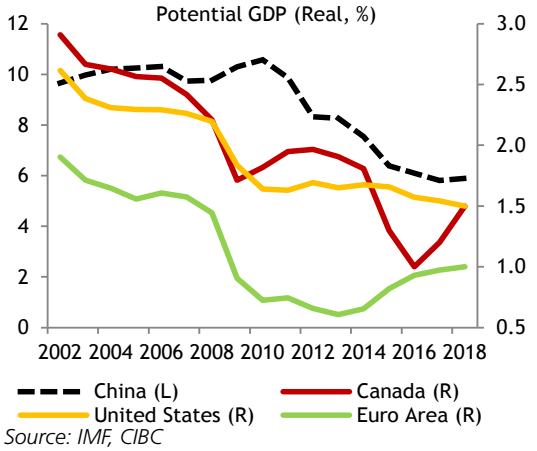
Bonds: Old Cyclical Rules Needn't Apply

The lack of fiscal stimulus left global central banks relying excessively on monetary policy to right the ship. Negative rates and QE in major developed economies meant that the old rules no longer applied in the bond world.

Rallies in government bonds are typically a signpost of economic fears that push credit spreads wider and hurt equities. But both corporate bonds and stocks rallied in North America in the past year as investors sought shelter from low or even negative rates on sovereign debt. Spreads could therefore

Chart 1

Lower GDP Growth Bar to Full Employment



Source: IMF, CIBC

https://economics.cibccm.com/economicsweb

Table 1

FORECAST SUMMARY

(% Change Except Where Noted)

CANADA	2012A	2013A	2014A	2015A	2016F	2017F	2018F
GDP at Market Prices	3.0	3.8	4.3	0.5	**1.6**	**4.2**	**4.4**
GDP in $2007	1.7	2.2	2.5	1.1	**1.2**	**1.8**	**1.9**
Consumer Price Index	1.5	0.9	1.9	1.1	**1.7**	**2.3**	**2.2**
Unemployment Rate	7.3	7.1	6.9	6.9	**7.0**	**6.9**	**6.5**
Current Account Balance (C$ Bn)	-65.7	-59.7	-44.9	-62.6	**-73.1**	**-65.5**	**-62.3**
Pre-tax Profits (net Operating Surplus)	-5.3	0.8	7.0	-15.8	**-9.3**	**6.1**	**7.5**
Housing Starts (K)	215	188	189	194	**193**	**182**	**178**

UNITED STATES	2012A	2013A	2014A	2015A	2016F	2017F	2018F
GDP at Market Prices	4.1	3.3	4.2	3.7	**3.0**	**4.6**	**4.4**
GDP in $2009	2.2	1.7	2.4	2.6	**1.5**	**2.1**	**1.9**
Consumer Price Index	2.1	1.5	1.6	0.1	**1.3**	**2.5**	**2.6**
Unemployment Rate	8.1	7.4	6.2	5.3	**4.9**	**4.7**	**4.6**
Current Account Balance (US$ Bn)	-447	-366	-392	-463	**-527**	**-577**	**-607**
Pre-tax Profits (with IVA/CCA)	10.0	1.7	5.9	-3.0	**-2.3**	**8.5**	**10.4**
Housing Starts (K)	784	928	1,001	1,108	**1,195**	**1,324**	**1,397**

Table 2

INTEREST AND EXCHANGE RATE FORECAST

		2016		2017				2018	
END OF PERIOD:		**6-Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**	**Jun**	**Dec**
CDA	Overnight target rate	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00
	98-Day Treasury Bills	0.51	0.45	0.45	0.45	0.45	0.45	0.70	0.95
	2-Year Gov't Bond	0.59	0.55	0.65	0.80	0.85	0.90	1.20	1.45
	10-Year Gov't Bond	1.06	1.25	1.45	1.50	1.60	1.80	1.85	2.00
	30-Year Gov't Bond	1.66	1.80	2.00	2.10	2.25	2.35	2.35	2.40
U.S.	Federal Funds Rate	0.375	0.625	0.625	0.875	0.875	1.125	1.375	1.625
	91-Day Treasury Bills	0.31	0.50	0.50	0.75	0.80	1.00	1.25	1.55
	2-Year Gov't Note	0.78	0.85	0.95	1.10	1.20	1.30	1.65	1.90
	10-Year Gov't Note	1.59	1.90	2.10	2.20	2.25	2.35	2.40	2.40
	30-Year Gov't Bond	2.26	2.55	2.70	2.80	2.85	2.90	2.90	2.90
Canada - US T-Bill Spread		0.20	-0.05	-0.05	-0.30	-0.35	-0.55	-0.55	-0.60
Canada - US 10-Year Bond Spread		-0.53	-0.65	-0.65	-0.70	-0.65	-0.55	-0.55	-0.40
Canada Yield Curve (30-Year — 2-Year)		1.07	1.25	1.35	1.30	1.40	1.45	1.15	0.95
US Yield Curve (30-Year — 2-Year)		1.48	1.70	1.75	1.70	1.65	1.60	1.25	1.00
EXCHANGE RATES	CADUSD	0.77	0.74	0.75	0.74	0.74	0.73	0.75	0.76
	USDCAD	1.29	1.35	1.34	1.36	1.35	1.37	1.34	1.32
	USDJPY	103	104	102	101	100	99	108	118
	EURUSD	1.12	1.08	1.10	1.13	1.15	1.17	1.14	1.17
	GBPUSD	1.34	1.25	1.26	1.31	1.35	1.39	1.37	1.46
	AUDUSD	0.76	0.72	0.74	0.75	0.76	0.78	0.75	0.79
	USDCHF	0.98	1.01	0.99	0.97	0.96	0.96	1.01	0.99
	USDBRL	3.27	3.22	3.33	3.41	3.55	3.45	3.44	3.42
	USDMXN	18.53	18.33	18.61	18.55	18.49	18.44	18.42	18.40

widen, and equity gains could be lackluster US economic improvements begin to lift yields on sovereign debt.

That said, sell-offs in long rates in the US and Canada will be extremely muted by past cyclical standards. In Canada, a steady front end as the Bank of Canada stands pat until 2018 (Table 2) will be supportive. The Bank's desire for a rotation of growth into exports and related capital spending will require a much longer run with a competitive exchange rate, and containing the C$ as oil prices recover will necessitate a soft hand on interest rates.

While the Fed will be hiking a tad more than markets now expect, we estimated several years ago that its long-term neutral rate might be only 2½%, given structural changes that mean less capital spending at any given yield.

More recently, we came around to the view that the term premium on longer bonds was also permanently lower, rather than just temporarily depressed by QE. The trend towards a smaller term premium was well underway before QE (Chart 2), as lower observed inflation saw memories of the high-inflation 1970s fade, dampening the need for inflation protection in long yields. More recently, risks around the inflation forecast have become asymmetric, with lots of room to hike rates should inflation spike too high, but limited room for easing (at least monetary easing) should inflation prove too soft. The Treasury curve could therefore be extremely flat by 2018, as Canada's curve already is.

Equities: The Numerator Starts to Count

For the past few years, the North American equity market has been largely driven by its value as a substitute for low-yielding bonds. US corporate profits were weak for the past few quarters, yet discounting that stream of profits and dividends at low rates justified higher multiples. Canada's market benefited from a partial recovery in oil and gold, as well as the same search for yield.

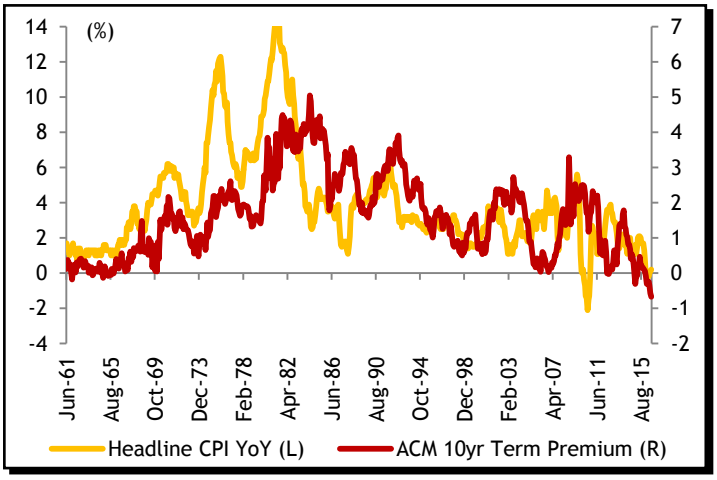
Looking ahead over 2017-18, the numerator in the present value calculation, the stream of profits being discounted, will be the more important story for equities as bond yields drift higher.

Even if US wage gains continue to edge higher, there's room for profits to grab a larger share of GDP, after seeing some slippage in the last couple of years (Chart 3, right). That owed to the combination of soft prices (particularly in energy, but also elsewhere) and negative productivity growth that lifted unit labour costs, both of which should improve (Chart 3, left). Firmer pricing power as economic slack closes will help the former. While the reasons behind the productivity slide are less opaque, odds are that at least a partial rebound is in store given the rarity of long strings of falling output per hour.

Despite more domestic economic slack, corporate Canada should also reap a larger profit share as energy prices continue to rebound, and softness in the labour market contains compensation. Workers, like Canadian policymakers, will have to wait more patiently for the prize of full employment.

Chart 2

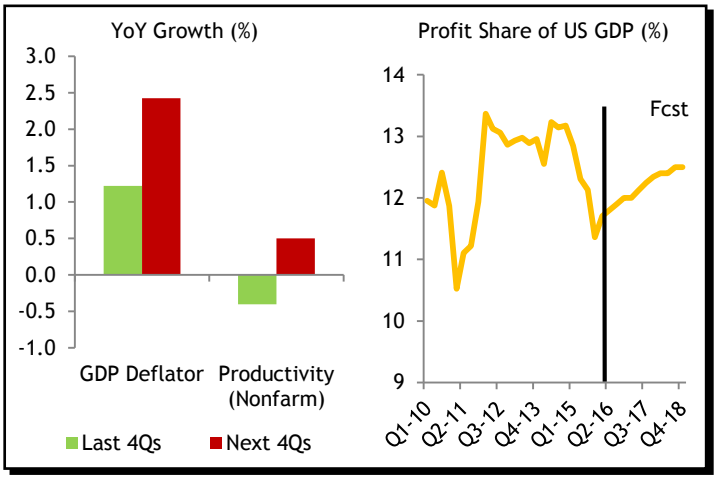
US Term Premium Vanishes as Inflation Memories Fade



Source: BLS, Adrian, Crump & Moench, NY Fed

Chart 3

Prices and Productivity Improve (L); Driving Rebound in US Profit Share (R)



Source: CIBC

Canada: Better, But Scaled Back

Avery Shenfeld and Nick Exarhos

The Canadian economy has taken the worst of what the oil shock could dish out, but we've still had to scale back our expectations for its upcoming acceleration. The dive we've been through in business capital spending, and an unfavourable shift to lower productivity sectors, has dented the economy's non-inflationary speed limit, while the path for fresh capital spending in non-resource sectors also looks to be shallower.

As a result, despite monetary and fiscal stimulus, growth will fall short of 2% in each of the next two years (Table 1). That will disappoint both Bank of Canada and consensus forecasts, and we've taken our outlook for the C$ a bit weaker as a result. That said, growth will be sufficient to make at least some gentle progress towards eliminating slack and restoring full employment—not enough for the Bank of Canada to hike rates before mid-2018, but with core inflation sticky, enough for the central bank to eschew a further rate cut.

Less Bad News is Good News

You can't always get what you want, and that's been the case for the Bank of Canada in terms of how it envisaged the path for eliminating economic slack. A weaker Canadian dollar was expected to restore market share for Canadian exporters and import competing businesses, and propel related capital spending. Instead, export volumes were more than 1½% lower in Q2 than they were a year ago. That's a roughly 10% underperformance versus what our model would have expected given the scale of loonie depreciation.

That has in part reflected elevated inventories of autos, chemicals and machinery stateside, key target markets for Canada's exports. These headwinds will gradually dissipate in the quarters ahead, while profit gains will be supportive for capital spending plans by 2018. But for the coming year, the best news for total capital spending

Table 1

CANADA FORECAST DETAIL

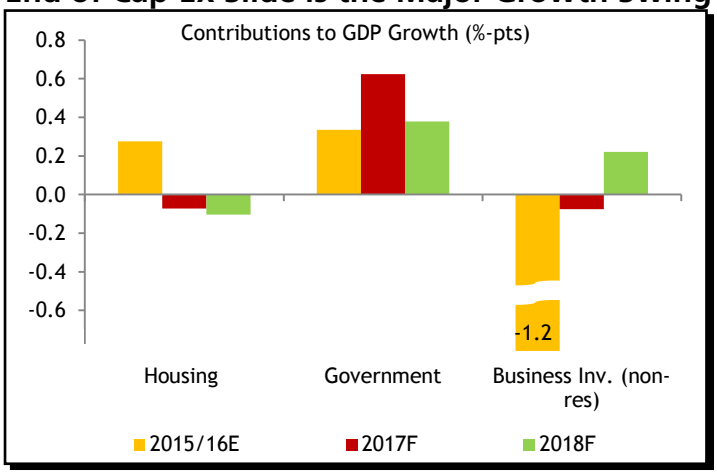
(real % change, s.a.a.r., unless otherwise noted)

	16:1A	16:2F	16:3F	16:4F	17:1F	17:2F	17:3F	17:4F	2016F	2017F	2018F
GDP At Market Prices ($Bn)	1,998	1,997	2,022	2,042	2,065	2,088	2,112	2,132	2,015	2,100	2,191
% change	1.2	-0.2	5.1	4.2	4.5	4.6	4.6	3.9	1.6	4.2	4.4
Real GDP ($2007 Bn)	1,783	1,776	1,791	1,798	1,806	1,814	1,824	1,831	1,787	1,819	1,854
% change	2.5	-1.6	3.3	1.7	1.7	1.9	2.1	1.7	1.2	1.8	1.9
Final Domestic Demand	1.8	2.2	1.4	1.6	1.5	1.7	1.6	1.1	1.1	1.6	1.4
Household Consumption	2.4	2.2	2.1	1.8	1.7	1.7	1.8	1.4	2.2	1.8	1.5
Total Govt. Expenditures	2.1	4.0	2.2	3.6	3.3	2.9	1.9	0.9	1.9	2.9	1.6
Residential Construction	11.3	1.2	1.7	-1.2	-2.0	-2.5	-2.0	-2.2	3.8	-1.3	-1.5
Business Fixed Investment*	-7.6	-1.6	-3.7	-1.9	-0.8	1.7	1.8	2.0	-7.2	-0.5	2.2
Inventory Change ($2007 Bn)	-9.0	0.5	3.5	4.1	4.6	4.8	5.4	5.8	-0.2	5.1	6.1
Exports	8.0	-16.7	7.6	3.0	3.1	3.6	3.2	3.8	0.5	2.4	3.8
Imports	1.6	1.1	3.9	3.1	2.9	2.9	2.1	2.3	-0.6	2.8	2.3
GDP Deflator	-1.4	1.4	1.8	2.4	2.8	2.6	2.5	2.2	0.4	2.4	2.4
CPI (yr/yr % chg)	1.5	1.6	1.3	2.3	2.8	2.2	2.3	2.1	1.7	2.3	2.2
Core CPI (yr/yr % chg)	2.0	2.1	2.0	2.1	2.0	1.8	1.9	1.9	2.1	1.9	2.1
Unemployment Rate (%)	7.2	7.0	7.0	7.0	7.0	6.9	6.9	6.8	7.0	6.9	6.5
Employment Change (K)	11	33	-8	40	37	42	40	47	98	134	202
Goods Trade Balance (AR, $bn)	-25.9	-45.1	-40.0	-38.8	-38.4	-35.8	-32.4	-29.3	-37.4	-34.0	-19.8
Housing Starts (AR, K)	198	198	191	187	186	181	184	178	193	182	178

* M&E plus Non-Res Structures and Intellectual Property and NPISH

Chart 1

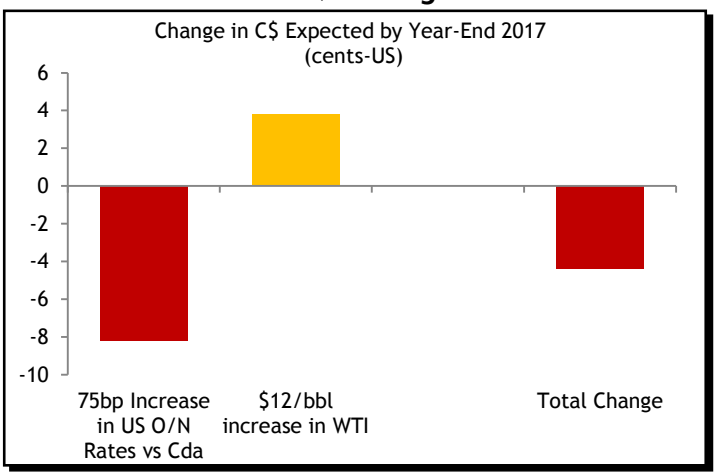
End of Cap-Ex Slide is the Major Growth Swing



Source: Statistics Canada, CIBC

Chart 2

Push and Pull on the C$ Through 2017



Source: CIBC

will be that its annual decline will ease off as we get past the worst of the retrenchment in the oil and gas sector. Less bad news on cap-ex will be the largest positive swing factor for Canadian GDP growth in 2017 (Chart 1).

While the timing is still fuzzy, the federal government's spending (some of which will flow through to provincial expenditures) on infrastructure should add just over 0.5%-points to growth next year. In contrast, home building has likely peaked in terms of its contribution to economic activity. While demand remains strong in southern Ontario, national starts levels will grind lower to 182K next year, and 178K in 2018.

Even to see that limited turn in capital spending, Canada will have to retain the more competitive exchange rate range that has prevailed since oil prices dropped in 2014. The upward creep in oil prices we expect to see in 2017 as dampened non-OPEC production helps drain inventories would, on its own, tend to push the loonie a few cents stronger, based on our statistical analysis of the FX sensitivities. Countering that will be the 75 bps move in Canada-US overnight spreads as three Fed hikes contrast with a stand-pat Bank of Canada. A longer wait for the first BoC tightening has us weakening our 2017 forecast for the Canadian dollar with a total decline of four cents from now till the end of 2017 (Chart 2).

Mixed Picture for Consumers

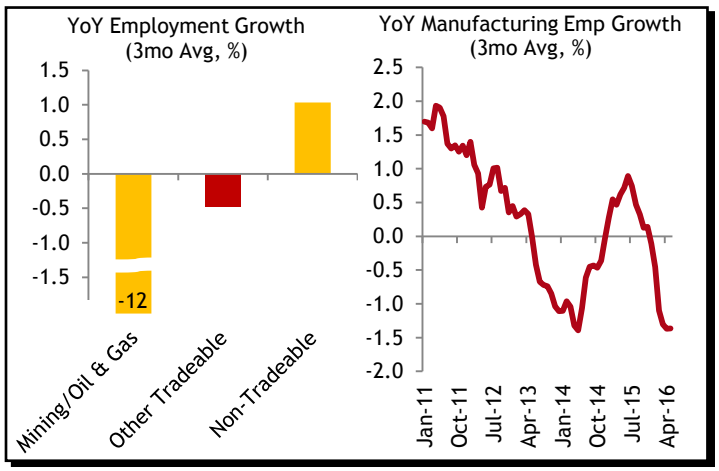
Consumer spending hasn't suffered from the same run of disappointments, but the environment ahead looks to be only mixed. Firmer gasoline prices will eat into household buying power, without being enough to spark a boom in oil industry employment. The longer than expected fuse to ignite export growth has also meant that job performance in high-paid tradable industries has been lackluster, even beyond the expected retrenchment in energy (Chart 3). The drop in non-energy tradeable industry employment reflects ongoing pull-backs in manufacturing, where payrolls are down roughly a half-percent in the past year.

Looking ahead, energy and manufacturing staffing should stabilize by year end, and abetted by hiring tied to infrastructure spending, employment growth will accelerate two tick to 0.7% next year, and 1.1% in 2018. The flip side of weak potential growth is that even a sub-2% pace to GDP can generate enough hiring to ease the jobless rate.

Household incomes have been dented by only modest total job creation and the loss of high-paying oil patch

Chart 3

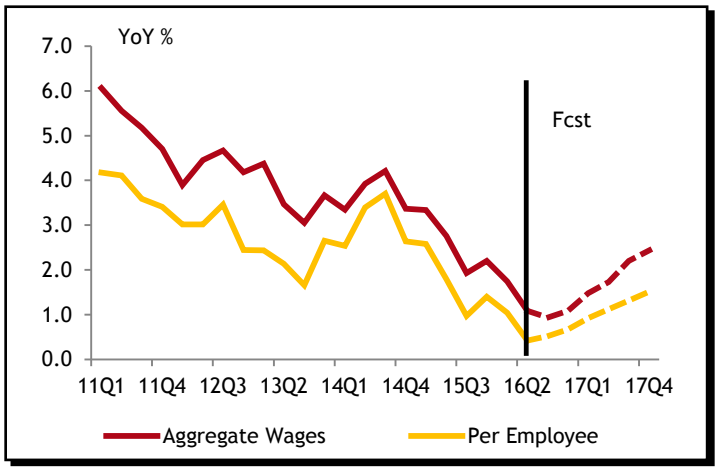
Employment in Export Sectors Has Been Weak



Source: Statistics Canada, CIBC

Chart 4

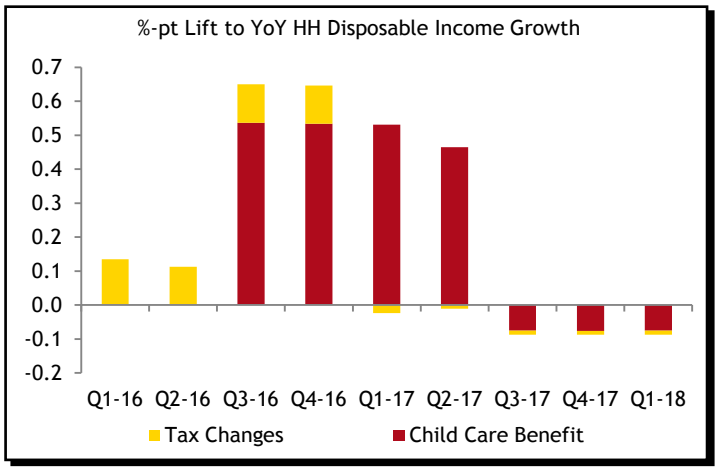
Wages Slow, Only Muted Picked Awaits…



Source: Statistics Canada, CIBC

Chart 5

…But Federal Cheques Will Bolster Family Pocket Books



Source: Statistics Canada, Finance Canada, CIBC

positions, with aggregate wage and salary income decelerating by 3%-pts since the beginning of 2014 (Chart 4). Given the existing labour market slack, expect wage gains to remain muted, leaving the rebound in labour income relatively shallow.

But for middle income families with children, the next few quarters will see a supportive lift from Ottawa in terms of spending power. Child Care Benefit cheques are slated to lift household disposable income growth by roughly 0.5%-pts relative what would have taken place under the prior regime (Chart 5).

That should help support consumption, leaving its growth rate relatively steady next year despite the headwinds to real labour income. The limited scope for further upside in autos and a slowdown in housing suggests that durable goods will cede some of that growth to non-durables and services. Other than foreign travel, services tend to have greater domestic value added, a benefit in terms of multiplier impacts.

After a '17 Bounce, Low Growth for Energy Provinces

Looking to next year, oil producing provinces should see a bounce in growth as the impact of the drop in capital spending fades, and—in the case of Alberta—as fiscal stimulus helps lift growth. But after a 2017 bounce, the reality of weak net migration trends and low potential growth in the range of 1% for the longer term, will see Alberta growth rates ease again.

The rest of the country should see a bit more upside in 2018 as the cheaper Canadian dollar provides a slow but nevertheless persistent tail wind to domestic firms. Fiscal stimulus, targeted to both the consumer and infrastructure should also continue supporting growth—albeit to a lesser degree than in 2017.

The country's potential is also likely to edge higher as the retrenchment in highly productive industries ceases, although we aren't likely to see growth as far above potential in 2018. As a result, we'll be looking at better growth prospects over the coming two years, but scaled back from our earlier expectations.

Table 2

Provincial Outlook

Y/Y %	Real GDP Growth				
Chg	2014A	2015F	2016F	2017F	2018F
BC	3.2	3.0	2.5	2.2	2.2
Alta	4.8	-3.2	-2.2	1.7	1.3
Sask	1.9	-0.9	-0.7	1.8	1.3
Man	2.3	2.3	1.6	1.7	1.8
Ont	2.7	2.6	2.6	2.1	2.3
Qué	1.5	1.1	1.5	1.6	1.8
NB	-0.3	1.9	0.7	0.7	0.8
NS	0.6	1.0	1.0	0.6	1.2
PEI	1.5	1.5	0.8	0.7	1.0
N&L	-2.0	-2.0	-1.2	-1.0	0.7
Cda	**2.5**	**1.1**	**1.2**	**1.8**	**1.9**

Source: Statistics Canada, CIBC

US Economy: Barely Living Up to its Potential

Royce Mendes

The US economy didn't live up to its billing during the first half of the year. Growth narrowly outpaced other developed economies, some of which are in much more precarious situations.

But that still leaves the American economy in decent shape in terms of what lies ahead. The US should see a rebound over the remainder of the year as productivity picks up, leading to a long awaited second rate hike from the Federal Reserve in December.

That said, as remaining slack is chewed up next year, growth will decelerate to slightly less than 2% in 2018, a reflection of the subdued potential growth rate of the US economy.

The Virtuous Cycle to Continue

Consumers certainly can't be blamed for the disappointment in first half growth. Ongoing momentum in the job market has seen US households easily show up as the most important contributor to overall GDP growth.

While job creation is expected to moderate as the aging demographic causes growth in the workforce to decelerate, broader measures of labour utilization still indicate that there's slack left to be worked off. Even with a rebound in productivity, our forecasted growth rate will require average monthly net payroll gains of roughly 160K over the next couple of years.

Table 1

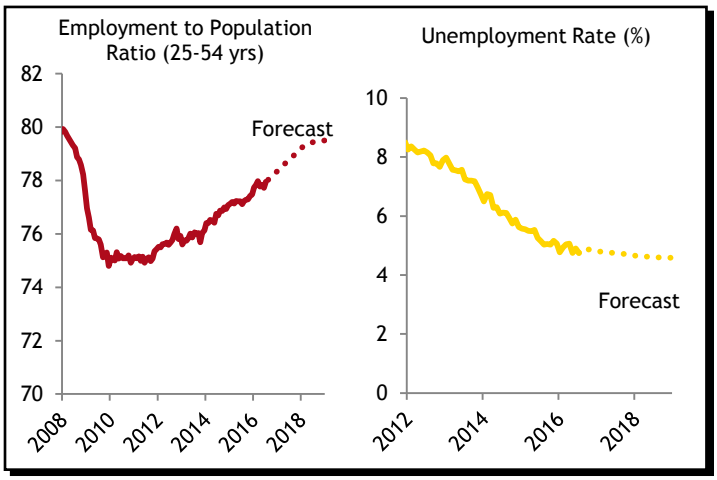
US FORECAST DETAIL

(real % change, s.a.a.r., unless otherwise noted)

	16:1A	16:2A	16:3F	16:4F	17:1F	17:2F	17:3F	17:4F	2016F	2017F	2018F
GDP At Market Prices ($Bn)	18,282	18,437	18,697	18,894	19,087	19,326	19,545	19,762	18,577	19,430	20,291
% change	1.3	3.4	5.8	4.3	4.1	5.1	4.6	4.5	3.0	4.6	4.4
Real GDP ($2009 Bn)	16,525	16,570	16,705	16,798	16,857	16,954	17,045	17,137	16,650	16,998	17,325
% change	0.8	1.1	3.3	2.2	1.4	2.3	2.1	2.2	1.5	2.1	1.9
Final Sales	1.3	2.4	2.1	2.0	1.7	2.2	2.2	2.1	1.9	2.0	2.0
Personal Consumption	1.6	4.4	2.7	2.2	1.9	2.6	2.5	2.3	2.6	2.4	2.1
Total Govt. Expenditures	1.6	-1.5	1.5	0.9	0.3	1.1	1.1	0.9	1.0	0.7	0.9
Residential Investment	7.8	-7.7	8.0	6.0	8.0	6.1	4.7	3.8	6.2	5.5	3.9
Business Fixed Investment	-3.4	-0.9	1.4	2.6	2.8	1.6	3.4	3.7	-0.8	2.3	3.7
Inventory Change ($2009 Bn)	40.7	-12.4	38.4	48.3	38.4	43.7	41.5	44.1	28.7	41.9	37.9
Exports	-0.7	1.2	2.1	3.1	4.1	5.2	5.1	4.0	-0.2	3.8	4.5
Imports	-0.6	0.3	5.0	4.0	5.6	5.2	6.0	4.6	1.2	4.8	5.2
GDP Deflator	0.5	2.3	2.4	2.0	2.7	2.7	2.4	2.3	1.4	2.4	2.5
CPI (yr/yr % chg)	1.1	1.1	1.2	2.0	2.6	2.3	2.5	2.5	1.3	2.5	2.6
Core CPI (yr/yr % chg)	2.2	2.2	2.2	2.2	2.2	2.2	2.4	2.4	2.2	2.3	2.4
Unemployment Rate (%)	4.9	4.9	4.9	4.8	4.8	4.7	4.8	4.7	4.9	4.7	4.6
Housing Starts (AR, K)	1,151	1,156	1,221	1,253	1,282	1,312	1,341	1,360	1,195	1,324	1,397

Chart 1

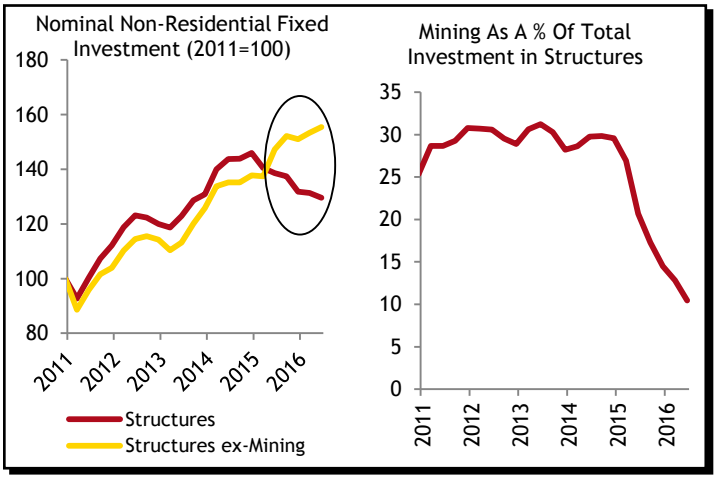
Labour Market Expected to Improve (L); But Gains Aren't Likely to Show Up in Unemployment Rate (R)



Source: FRED,CIBC

Chart 3

Mining Has Weighed on Investment (L), But It's Now a Much Smaller Component (R)



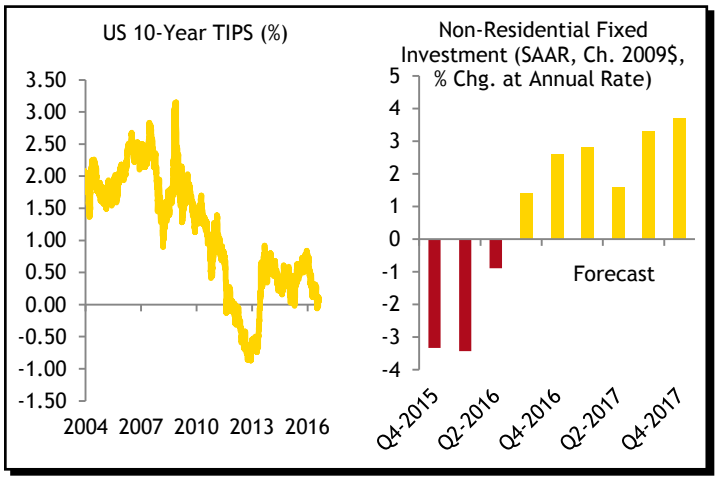
Source: Haver Analytics, CIBC

But the resulting decline in labour market slack won't be captured by the unemployment rate, which will remain little changed over the projection horizon (Chart 1 right). As those that had previously dropped out of the labour force are drawn back in, the gains will instead show up in improving participation rates—including our preferred measure of slack, the prime-age employment-to-population ratio (Chart 1, left).

Above-potential growth in the jobs market next year will provide the income fuel for household spending to remain the top economic growth engine in the US. Combined with a rebound in productivity growth, GDP should increase slightly more than 2% next year. Thereafter, with fewer new workers available to come on board, both consumption and overall GDP growth will moderate.

Chart 2

US Real Rates Remain Near Historic Lows (L), But That Hasn't Spurred Much Investment (R)



Source: Bloomberg, CIBC

Investment: The Rough Ride Is Almost Over

While consumption is firing on all cylinders, investment in the US remains in the doldrums. Not even rock bottom interest rates have been able to spur the type of investment that would typically characterize an economy reaching escape velocity (Chart 2, left). Real business fixed investment has averaged in negative territory over the past seven quarters. That said, the rough ride could be coming to an end (Chart 2, right).

While investment in the mining sector has weighed heavily on spending (Chart 3, left), 2017 should see less of a drag as the sector sees some measure of stabilization. Mining has also become a smaller portion of overall investment (Chart 3, right), meaning that, even if it falls further in the near term, the sector will have less of an effect on overall growth. Moreover, 2018 could see a pickup in mining investment as oil prices continue to rise.

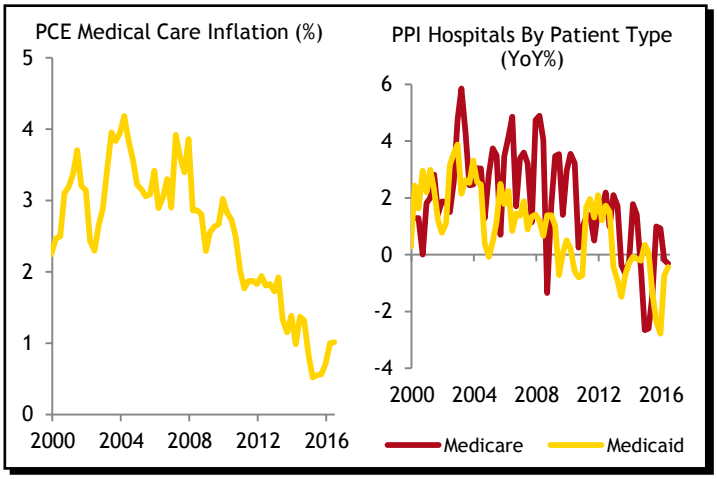
In addition to the waning effects of the mining sector, manufacturers have been showing some signs of life again. While the most recent ISM and factory payrolls data have taken a small step in the wrong direction, manufacturing is unlikely to be a drag on growth next year as global demand accelerates. While a boom is not in the cards, growth in business fixed investment should resume at a moderate pace over the next two years.

Headwinds to Inflation Remain

The combination of slightly slower consumption growth and a stabilization in investment will still leave the economy running barely fast enough to erase the

Chart 4

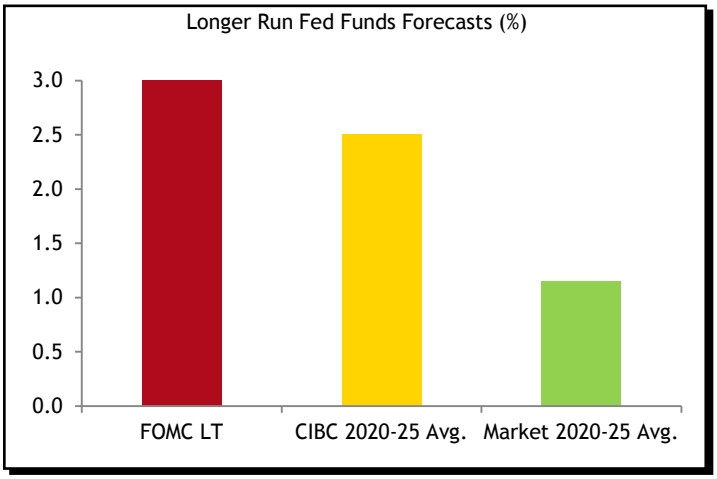
Medical Care Costs Dragging Inflation Lower (L), In Particular Public Health Care Costs (R)



Source: BEA, FRED, CIBC

Chart 5

While the Fed is Likely to Raise Rates Very Gradually, the Market is Still Set Up for a Selloff



Source: FRB, Bloomberg, CIBC

remaining slack and certainly not enough to risk seeing inflation run too much above the Fed's target.

US prices have made headway this year, both on headline and core measures, but excluding energy, further gains won't come easily. A push towards full employment will put upward pressure on some private sector prices, particularly those like shelter with a high domestic component. But a counterweight will come from medical care costs (Chart 4), which are a particularly heavy share of the core PCE price index, the Fed's preferred inflation measure. Medical care costs have been weighed down by public health care prices (Medicare and Medicaid) which are projected to remain low, in part due to rules tied to the Affordable Care Act.

Moreover, the decline in inflation expectations over the past six quarters across a variety of indicators will also provide an anchor to core inflation. In the wake of the financial crisis, a huge output gap did not push core inflation as low as some models might have expected, capturing the stickiness of inflation and wage rates for those still employed. Now, as the economy returns to employment, the same stickiness can be expected to mute core inflation measures in terms of their upside.

Rates to Rise Gradually

The Fed may also be willing to err a bit on the side of ensuring that the recovery has legs, leaving risks for headline inflation to drift a bit above their medium term target. As a result, look for a very gradual pace of tightening ahead. Economic performance is likely to warrant only two rate increases a year over the course of 2017 and 2018, less than the three predicted by FOMC members.

That has our forecast stilll a bit more dovish than the consensus of FOMC members. The most recent Summary of Economic Projections suggested that participants see the federal funds rate averaging roughly 3% over the longer-run (Chart 5). While that's lower than it has been in the past, the repeated misses in their core PCE forecasts and the subdued pace of capital spending even at very low interest rates suggest that the Fed will be ratcheting down its rate hike projections yet again.

Although we are more cautious than the Fed on the room to press on with rate hikes, the market remains overly skeptical about the degree to which the economy can withstand higher yields. The market's implied average funds rate is less than 1.2% between 2020-25, well below where we see the medium term neutral rate. That could simply reflect a tilt in the balance of risks, one that might be cleared up as the US economy proves its ability to regain momentum after the disappointments of the first half of 2016.

All told, the solid, but uninspiring, trajectory of the US economy shows that Fed policymakers have been justified in their patience. While the show will go on and see the US close its output gap, we're learning to live with growth rates that are barely more than half of what would have been judged as being robust in the past. Some of that is simply capturing the growing number of retirees, but the extent to which the rest is a long-tailed legacy of the financial crisis, or a permanent loss of productivity growth, remains to be seen.

Global Growth: Stimulus Rethink to Bring Modest Results

Andrew Grantham

If it wasn't obvious before this year, it is now—monetary policy has lost its ability to boost global growth. Despite the large stimulus efforts in Europe and Japan, combined with a much slower path towards tightening than was expected in the US, global growth has disappointed so far in 2016. Fortunately, a policy rethink appears to be occurring, with fiscal stimulus expected to drive a pick-up in 2017 (table 1). Even so, that pick-up is likely to be only modest, with many countries unwilling or unable to launch big government spending plans.

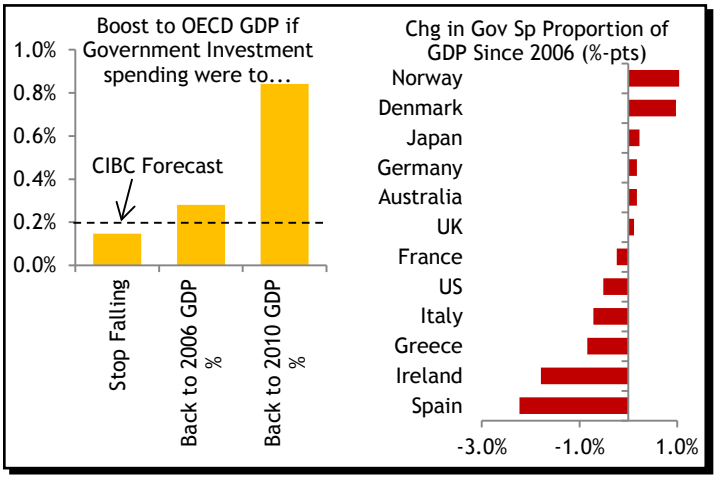
Fiscal Turn, But No Big Lift

Here in Canada, we've been a frontrunner in the trend towards government stimulus. However, we're now seeing a turn elsewhere as well, with new stimulus announced in Japan and talk of fiscal discipline in Europe becoming much quieter. The UK is set to ease up on fiscal tightening, although that's largely a response to an expected slowdown from its vote to leave the EU.

Even if government investment were to just stop falling as a share of GDP, that would be a positive for average growth rates in developed economies (Chart 1, left). A return to the sort of stimulus levels seen during the financial crisis is clearly unlikely. But even returning government spending to the proportions seen in 2006 may be expecting too much as well. Most major countries where spending is a materially smaller part of the economy now are located in peripheral Europe—countries that were clearly over-investing prior to the recession (Chart 1, right). In the US, any boost from fiscal policy will depend heavily on the upcoming elections.

Chart 1

Fiscal Policy Can Be Supportive (L), But Biggest Gap Relative to Pre-Crisis in Peripheral Europe (R)



Source: OECD, CIBC

In terms of infrastructure in particular, national governments will keep in mind the necessity of projects relative to demographic needs. While there are infrastructure gaps in the US and UK for example, other countries such as Japan and Australia may actually need a lower proportion of spending in the future due to ageing and declining populations (Chart 2). Such countries should instead be boosting private sector spending through targeted tax incentives, rather than adding infrastructure that the economy may not need.

Table 1

Real GDP Growth Rates

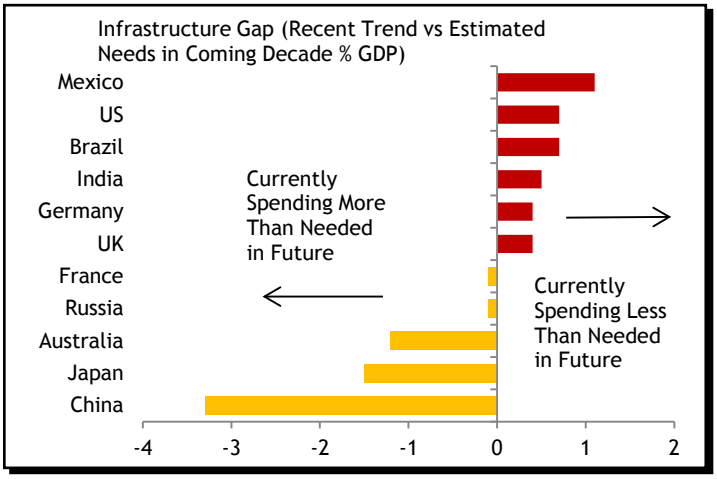
	5 yrs before recession, avg	2014A	2015A	2016F	2017F	2018F
World*	4.8	3.4	3.1	2.8	3.2	3.1
US	2.9	2.4	2.6	1.5	2.1	1.9
Canada	2.6	2.5	1.1	1.2	1.8	1.9
Euroland	2.2	0.9	1.6	1.6	1.5	1.3
UK	3.3	3.1	2.2	1.8	1.2	2.0
Japan	1.8	0.0	0.6	0.5	0.7	0.5
Brazil	4.0	0.1	-3.8	-3.1	1.9	4.2
Russia	7.5	0.7	-3.7	-1.5	1.8	2.5
India	8.9	6.6	7.2	7.3	7.5	7.0
China	11.6	7.3	6.9	6.5	6.3	6.0

** at Purchasing Power Parity*

Source: National statistical agencies, IMF, CIBC

Chart 2

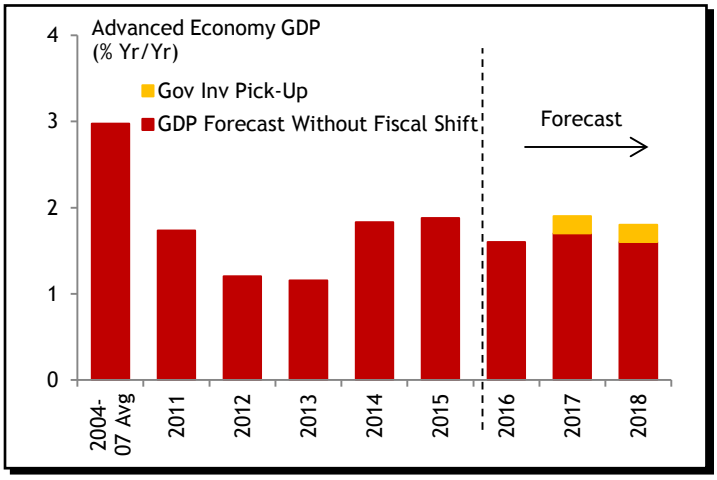
Not All Countries Under-Investing Relative to Future Needs



Source: McKinsey Global Institute, CIBC

Chart 3

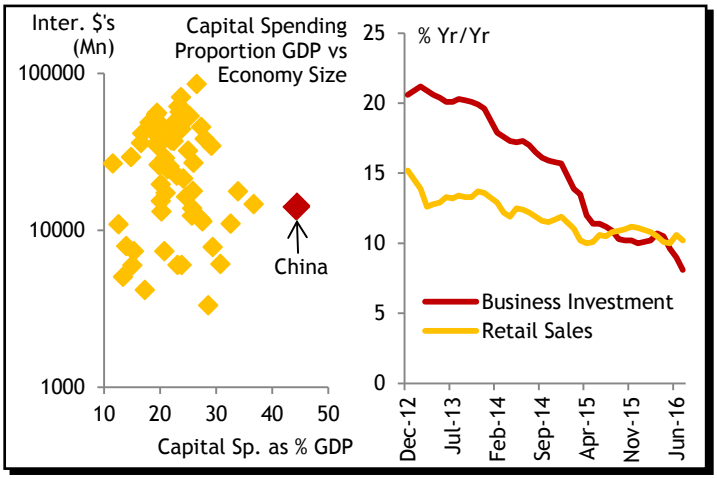
Developed Economy Growth to Return to 2014/15 Levels But Then Wane Again



Source: IMF, OECD, CIBC

Chart 4

China Over-reliant on Capital Spending (L), Consumers Not Stepping Up to Fill Gap (R)



Source: NBS, CIBC

As a result, while we expect that the turn towards modest fiscal stimulus will be beneficial to GDP in developed countries, growth will probably only just get back to 2014/15 levels. Rates seen prior to the financial crisis will remain a distant memory (Chart 3).

China—Rotation Still Missing

China is one country where we certainly shouldn't depend on extra investment to stimulate growth. While there's no hard and fast rule on the proportion that capital spending should contribute to GDP, China is a clear outlier in terms of its dependence (Chart 4, left). Actions to rotate the economy away from capital spending have seen that area slow in recent years. However, other drivers of growth haven't stepped in to fill the void (Chart 4, right).

That appears to have led China down the familiar path of trying to stimulate growth through exports, letting the yuan depreciate both against the US$ and on a trade weighted basis in recent months. However, with global demand still fairly subdued, even with a slight pick-up expected in 2017, export growth will be hard to come by. For the global economy, market share gains driven off the currency will simply eat into other countries' growth rates.

All told, we expect that growth in China will continue easing toward 6% by 2018. That won't constitute a hard landing, but the approach to that destination will remain turbulent.

Brexit Impact Overblown?

In Europe, the main talking point has been the UK's surprise decision to leave the EU, which has raised a number of questions regarding business investment, trade and the UK's position as a financial centre. Poised for a negative impact on the economy, Bank of England Governor Mark Carney has already added stimulus and there could be more help on the way from fiscal policy.

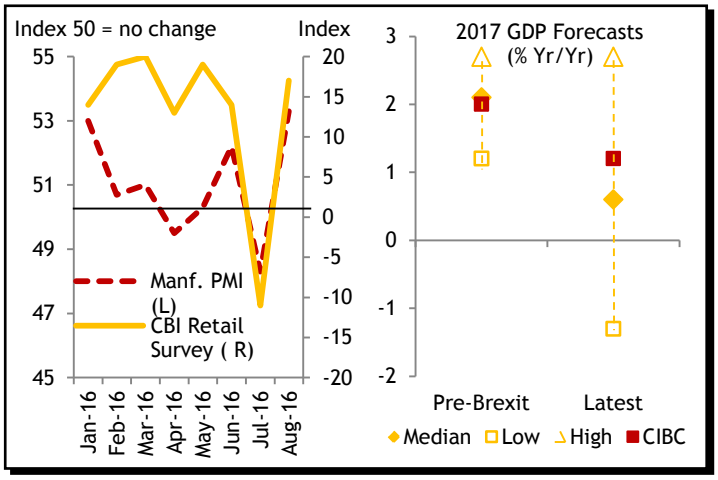
However, sentiment regarding the impact that a "Brexit" will have on the economy may have turned too sour. Strong July retail sales figures showed that consumers aren't delaying purchases due to the uncertainty. Real consumer spending growth could ease as import price increases are passed through or if job losses occur, but that would occur over a long period.

The impact on investment is more uncertain, but could also be drawn out over a long period rather than coming as a sudden shock. Certainly after a knee-jerk reaction following the vote, sentiment within the manufacturing and retail sectors has rebounded nicely (Chart 5, left). That leaves us more optimistic than the consensus regarding UK growth in 2017, with our forecast having been trimmed by roughly half the 1½%-pt cut to the consensus (Chart 5, right).

Brexit will also have implications for the rest of Europe, particularly given that the UK imports more from the EU than it exports (Chart 6, left). Ireland is the obvious example of a country very much tied to developments in the UK. But even German exports have become more dependant on the UK recently, given slow demand growth in the rest of Europe. While the UK still accounts for only about 7% of total German exports, it has accounted for 17% of the growth in recent years (Chart 6, right).

Chart 5

Decline in Sentiment After Brexit Didn't Last Long (L), CIBC Less Pessimistic Than Consensus (R)



Source: Markit, CBI, Bloomberg, CIBC

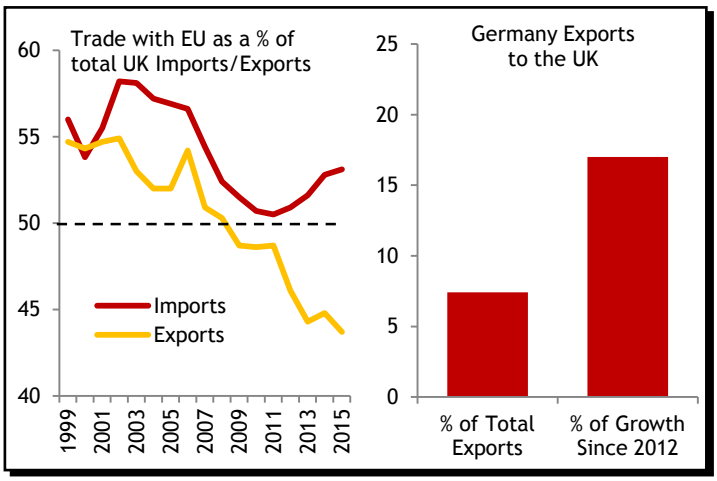
Europe is, however, starting from a somewhat stronger footing than in previous years. Even though GDP growth has been modest at best, it has been sufficient to bring the unemployment rate down from a peak of over 12% in 2013 to just over 10%. And tourism, which is a big factor for many countries, is on the whole performing well despite the recent terror attacks in France and Belgium. While visitor numbers to those two countries are down, that's been more than offset by large increases elsewhere, most noticeably in Spain.

Japan: Still Searching for Answers

In Japan, no matter what policymakers try, the economy still appears to be stuck in a 0-1% growth rut. The big monetary stimulus of the BoJ that weakened the currency didn't do the job, so recently a second fiscal arrow was launched. However, the stimulus is likely to be a lot less than the headlines suggest. Of the total package announced, much of it is loans for projects that may have happened anyway. The new "freshwater" stimulus amounted to less than a quarter of the total package, and is only marginally more than seen in the prior year, therefore adding little to growth (Chart 7). As with the global economy more generally, a turn towards fiscal stimulus in Japan is only likely to reap modest results.

Chart 6

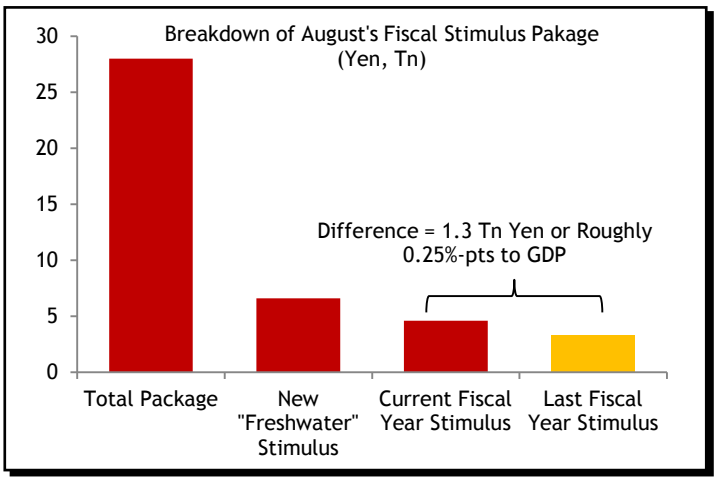
EU a Bigger Proportion of UK Imports (L), German Exports More Reliant on UK Recently (R)



Source: ONS, Eurostat, CIBC

Chart 7

Japan's Fiscal Boost Not As Large as Headlines May Suggest



Source: Bloomberg, CIBC