

Economics

FORECAST

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A soft landing, but ample tail risks

by Avery Shenfeld avery.shenfeld@cibc.com

How can we square the circle between sharply elevated economic policy uncertainty, and financial market pricing that exudes certainty and confidence? Trade policy is far from settled, both in US courts and in negotiations with Canada, Mexico and China. The make-up of the Fed's Open Market Committee could change significantly in the coming year. Budget deficits loom large in Europe and the US. Regulatory policies pertaining to stablecoins could change transactions and Treasury holdings, and the Republican majority will be tested in next year's Congressional election.

Yet in capital markets, investors are banking on steady growth, stable inflation, and little risk of an adverse divergence from that base case (Table 1). That's well in evidence in lofty US price-earnings multiples, a tame VIX ratio, and tight corporate spreads.

Our base case outlook is largely in line with that sort of soft economic landing for the US. Growth might be a tad disappointing versus the 2023-24, but that will line up with slower labour force growth to keep the jobless rate from much of a climb. The lack of a broad overheating in demand should, dare we say it, make the inflation pop from tariffs prove to be transitory. But relative to market pricing, there's more risks to that outcome, warranting some caution in portfolio mixes, a

degree of hedging, and caution in equity selection in terms of not counting on as much of a gusher in profits.

Equity markets and US Growth: A lot riding on AI

US economic growth has leaned in on a boom in AI related capital spending, and that's also been a key driver for earnings. The future course of the AI revolution presents an important two-way tail risk. Roughly 40% of first half US growth was driven by spending on information processing equipment and software, and those items, along with related power projects, will likely remain at elevated levels in 2026. The top 5 AI players are spending the equivalent of 1% of GDP on their AI-related projects. Within equity market earnings, chip makers, power plant and data centre builders will be booking massive gains in revenues and profits today, while the tech giants buying their output will only take a depreciation charge covering some part of that same spending.

How quickly those big spenders earn a return on their AI investments will be important for overall large cap earnings ahead. But on the economic front, generating anything above 2% growth in the US will also rest on the extent to which AI delivers a jolt to productivity. That will come as operating companies adapt AI into their processes, a prospect that is still in its infancy versus what might lie ahead, leaving a lot of room for surprises in either direction on the timing and magnitude of the resulting gains.

Those productivity gains will be even more necessary to keep real GDP growth from remaining sluggish. Tight immigration policies are slowing labor supply growth from 0.9% in 2024 to only 0.2% in 2026, a reason why we've shaved our growth forecast for 2026 to a more tepid 1.9% (from 2.2% previously), implying growth of below 2% on a Q4 over Q4 basis next year.

Table 1: Financial markets expecting a soft landing

	VIX	Corporate spread* (bps)	S&P 500 trailing P/E
Historical avg. (2002-2024, ex. 08/09, 20/21)	19.3	131	18.7
Current	15.8	75	25.4

*Note: ICE BofA US Corporate Index Option-Adjusted Spread.

Source: Bloomberg, FRED, CIBC

Canada's Plan B and monetary policy

Canada is also seeing a slowdown in population growth, offset in part by a shift in the mix of new permanent residents towards those with better labour market prospects. But tariffs, and uncertainty over their future direction, remains the greater concern.

Since the trade conflict started, Canada's Plan A was to put in all efforts to reverse it. While some progress towards a lighter US tariff on aluminum, and perhaps a bit of an easing in auto tariffs, still seems possible, even sectors now escaping tariffs will be cautious about adding capacity in Canada if it's aimed at serving the US market. Exports will climb from the depths of Q2, but to get back to full employment, business and governments will be looking for a "Plan B". That will include public and private infrastructure spending to increase resource export prospects, trade diversification efforts, support for home building, and the lift from a made-in-Canada, travel-in-Canada tilt from consumers. Even so, our forecasts project that the recovery will leave excess slack in the labour market through 2026.

Fiscal policy isn't likely to provide much of a near term lift, as a fall federal budget is likely to be lean on operating spending, and heavier on allocations to capital projects that could take a year or two to gather steam. So another element in Plan B entails some further easing in monetary policy (Table 5). A further quarter point rate cut will provide some further relief to variable and short-term mortgage borrowers, even if longer term yields stay elevated from the spillover of US fiscal deficits and an increase in Canadian government bond supply.

Whether additional rate cuts will prove necessary will depend on where Canada-US trade relations go from here. Our forecast assumes some modest relief from existing sectoral tariffs (with aluminum most likely to benefit, and autos less certain), but also rests on Canada retaining free trade access for a broad range of products that meet the requirements on the trilateral Canada-US-Mexico trade pact. Should that pact fail to be extended, and White House wins court approval for the "fentanyl" tariffs, or applies a broad tariff under other legal grounds, Canada will be in need of additional rate cuts in 2026.

Having lagged behind Canada in earlier rate cuts, if tariff inflation proves short lived, the Fed will have room to take the funds rate down to neutral levels, some 100 bps below where they stood prior to September. There too however, a higher term premium to cover for inflation risks and a build up in government debt will mean that long term rates see only short lived relief.

If that base case sounds somewhat comforting, judging by the calm risk metrics we cited up front, it's not as much of a sure thing as markets seem to be counting on. We and investors are counting on the bond market to discipline the Fed quickly if it strays too far into a faster, political motivated easing at the front end. We're assuming that White House talks with key trading partners don't run off the rails, and that the US doesn't scrap the USMCA deal in 2026. Tensions with China and Russia aren't likely to disappear, but need to be contained to their current level. And there's still a lot of uncertainty over the timing and magnitude of the economic rewards for the large scale capital spending now underway in AI-related infrastructure.

Table 2: Real GDP growth rates

Region	2021A	2022A	2023A	2024A	2025F	2026F	2027F
World ¹	6.6	3.6	3.5	3.3	2.9	3.0	2.9
US	6.1	2.5	2.9	2.8	1.9	1.9	1.7
Canada	6.0	4.2	1.5	1.6	1.2	1.4	2.0
Eurozone	6.3	3.6	0.4	0.9	1.2	1.4	1.2
UK	9.5	5.0	0.4	1.1	1.3	1.2	1.4
Australia	5.5	4.2	2.1	1.1	1.8	2.1	2.2
Japan	2.7	1.0	1.2	0.1	1.0	0.9	0.8
China	8.4	3.1	5.4	5.0	4.6	4.1	3.8

¹ At purchasing power parity.

Table 3: Canadian forecast summary (% change except where noted)

Variable	2024A	2025F	2026F	2027F
GDP at market prices	4.7	3.6	3.2	4.7
GDP in \$2012	1.6	1.2	1.4	2.0
Consumer price index	2.4	2.0	1.7	2.0
Unemployment rate	6.4	6.9	6.7	6.1
Pre-tax profits (net operating surplus)	-4.5	3.7	5.2	5.5
Housing starts (K)	245	262	276	300

Table 4: United States forecast summary (% change except where noted)

Variable	2024A	2025F	2026F	2027F
GDP at market prices	5.3	4.7	4.8	3.8
GDP in \$2012	2.8	1.9	1.9	1.7
Consumer price index	2.9	2.9	3.3	2.5
Unemployment rate	4.0	4.2	4.4	4.2
Pre-tax profits (with IVA/CCA)	7.9	3.7	3.8	3.2
Housing starts (K)	1389	1371	1499	1531

Table 5: Canadian interest rates (end of period)

Variable	2025 23-Sep	2025 Dec	2026 Mar	2026 Jun	2026 Sep	2026 Dec
Overnight target rate	2.50	2.25	2.25	2.25	2.25	2.25
98-Day Treasury Bills	2.44	2.25	2.20	2.20	2.25	2.25
2-Year Government Bond	2.44	2.40	2.50	2.65	2.80	3.05
5-Year Government Bond	2.73	2.75	2.90	2.95	3.15	3.40
10-Year Government Bond	3.18	3.20	3.25	3.35	3.55	3.75
30-Year Government Bond	3.65	3.60	3.65	3.70	3.75	3.90
Canada - US T-Bill Spread	-1.48	-1.75	-1.45	-1.25	-1.10	-1.10
Canada - US 10-Year Bond Spread	-0.93	-0.95	-0.95	-0.95	-0.80	-0.65
Canada Yield Curve (10-year — 2-year)	0.73	0.80	0.75	0.70	0.75	0.70

Table 6: US Interest rates (end of period)

Variable	2025 23-Sep	2025 Dec	2026 Mar	2026 Jun	2026 Sep	2026 Dec
Federal funds rate (midpoint)	4.125	3.875	3.625	3.375	3.375	3.375
91-Day Treasury Bills	3.92	4.00	3.65	3.45	3.35	3.35
2-Year Government Note	3.58	3.45	3.40	3.40	3.55	3.65
5-Year Government Note	3.67	3.65	3.60	3.65	3.85	3.95
10-Year Government Note	4.11	4.15	4.20	4.30	4.35	4.40
30-Year Government Bond	4.73	4.80	4.75	4.80	4.85	4.80
US Yield curve (10-year — 2-year)	0.53	0.70	0.80	0.90	0.80	0.75

Table 7: Foreign exchange rates

Exchange rate	2025 23-Sep	2025 Dec	2026 Mar	2026 Jun	2026 Sep	2026 Dec
CAD-USD	0.72	0.74	0.74	0.74	0.75	0.75
USD-CAD	1.38	1.36	1.36	1.35	1.34	1.33
USD-JPY	148	140	137	135	134	133
EUR-USD	1.18	1.19	1.20	1.21	1.22	1.23
GBP-USD	1.35	1.35	1.36	1.38	1.39	1.41
AUD-USD	0.66	0.67	0.67	0.67	0.67	0.67
USD-CNY	7.11	7.15	7.13	7.12	7.11	7.10
USD-BRL	5.28	5.75	5.90	6.10	6.10	5.80
USD-MXN	18.36	19.60	19.70	19.80	19.80	19.80

US outlook: Down, but not out

by Ali Jaffery ali.jaffery@cibc.com

It's not quite stagflation, because the US economy is neither stagnant nor doomed to suffer from persistent inflation ahead. But the Fed is still looking at a miss on both its price stability and employment targets, as we feel the combined impacts of trade and immigration policy. That leaves the central bank with the delicate task of steering the economic ship to avoid the shoals of lasting inflation or an outright recession.

The bottom line is the US economy will shift down, but won't be out. The Fed will be successful in helping the economy avoid a recession, and there is enough of a buffer for a soft landing coming from spendthrift wealthy Americans, AI-fueled growth, and fiscal policy support. We expect growth will cool from the breakneck 2.8% annual pace in 2024 to 1.9% this year and next, and then further down to 1.7% in 2027, close to the economy's new trend growth rate (Table 1). The jobless rate should rise slightly to a peak of around 4.5%, but waning labor force participation and anemic job growth should force the Fed to bring policy to neutral next year by cutting three more times between now and the middle of next year to a fed funds rate of 3.5% (upper bound). Assuming central bankers will be central bankers, it's hard to make the case for the Fed to bring rates into

accommodative territory with inflation remaining sticky, at or above 3%, for most of next year.

Second thoughts

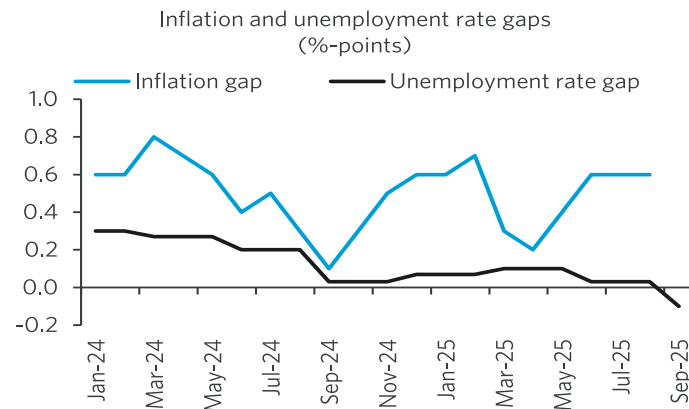
As global tariffs were announced, Powell and the committee initially said that they would prioritize the part of the mandate which was farthest from its goal. That seemed to imply that with inflation stubbornly above 2% even before tariffs started showing up in the data, and a job market on decent footing, the Fed would likely lean towards its price stability mandate. But then came revisions to payrolls and a slight rise in the jobless rate. Despite inflation still being much further from its goal than the labor market (Chart 1), it was enough to prompt a "risk management" cut and what looks like a U-turn on the original strategy. We expect another cut in October to follow, and two more in first half of 2026.

The slowdown in payrolls is mostly symptomatic of the crackdown on immigration, which has dramatically slowed growth in the working age population. The result is that the job gains needed for a steady unemployment rate could fall to 20K

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

Indicator	25:2A	25:3F	25:4F	26:1F	26:2F	26:3F	26:4F	2025F	2026F	2027F
GDP at market prices (\$Bn)	30,486	30,882	31,235	31,612	32,029	32,270	32,564	30,661	32,119	33,335
% change	6.0	5.3	4.7	4.9	5.4	3.1	3.7	4.7	4.8	3.8
Real GDP (\$2012 Bn)	23,771	23,917	24,018	24,117	24,231.7	24,323.8	24,411.8	23,813	24,271	24,682
% change	3.8	2.5	1.7	1.7	1.9	1.5	1.5	1.9	1.9	1.7
Final sales	7.5	3.1	0.9	1.2	1.7	1.5	1.5	2.1	1.9	1.7
Personal consumption	2.5	2.6	0.9	1.1	1.6	1.5	1.3	2.5	1.5	1.6
Total government expenditures	-0.1	1.0	1.0	1.5	1.5	1.5	1.5	1.4	1.2	1.5
Residential investment	-5.1	2.5	5.9	7.3	4.5	3.5	5.0	-0.5	4.5	4.2
Business fixed investment	7.3	1.1	3.1	2.5	2.0	1.6	2.5	3.9	2.5	2.6
Inventory change (\$2012 Bn)	-18.3	-54.8	-9.8	20.2	30.2	30.2	30.2	22.3	27.7	30.2
Exports	-1.8	4.0	4.0	2.0	2.3	2.3	2.0	1.4	2.5	2.1
Imports	-29.3	-2.8	6.2	4.6	2.2	2.6	3.0	3.4	0.6	2.9
GDP Deflator	2.1	2.7	2.9	3.2	3.4	1.5	2.2	2.7	2.8	2.1
CPI (yr/yr % chg)	2.4	2.9	3.4	3.5	3.5	3.3	3.0	2.9	3.3	2.5
Core CPI (yr/yr % chg)	2.8	3.1	3.2	3.4	3.8	3.5	3.2	3.0	3.5	2.5
Core PCE (yr/yr, % chg)	2.7	2.9	3.3	3.0	2.7	2.2	2.0	2.9	3.1	1.9
Unemployment rate (%)	4.2	4.3	4.3	4.4	4.5	4.4	4.3	4.2	4.4	4.2

Chart 1: Inflation is farther from its goal than employment



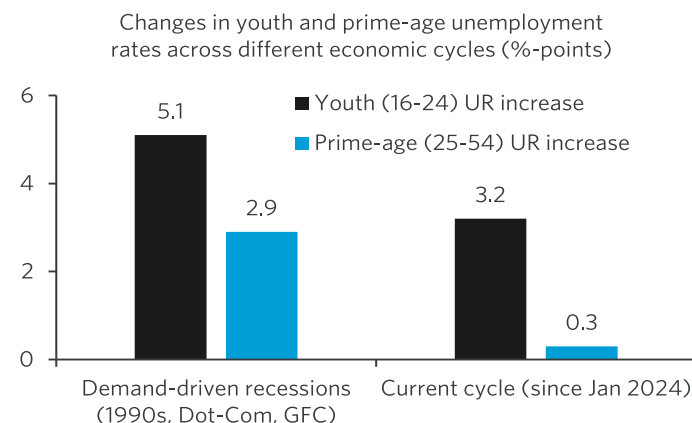
Note: Inflation gap is defined as core inflation less 2% and unemployment rate gap is the FOMC's estimate of u^* less the unemployment rate.

Source: BEA, BLS, Federal Reserve, CIBC calculations

per month if immigration policy remains on this path (See CIBC Economics, [This way to the exit: The economic impact of US immigration policy](#)). Unemployment, while a bit higher, is only a shade above the Fed's estimate of the long-run unemployment rate and is being driven by rising youth unemployment. Younger workers account for 0.4%-points, or two-thirds of the rise in the jobless rate since the start of 2024.

Why has this spooked the Fed to provide insurance so quickly? Historically, higher youth unemployment has signaled higher unemployment for other demographic groups, as firms begin by pulling back on new hires before shedding more skilled labor (Chart 2). Past demand-driven recessions saw prime-age unemployment initially lag, but rise after persistent climbs in youth joblessness.

Chart 2: Historically, higher youth unemployment has lifted prime-age joblessness, but so far, that isn't happening



Source: BLS, CIBC calculations

CIBC Capital Markets

What has us less worried about this development than the Fed, is that we have yet to see this dynamic in the current cycle. The pickup in youth unemployment, which is now above 10%, has not been associated with higher prime-age joblessness over the past 20 months. It could be that the lag period has lengthened, but prime-age unemployment continues to look fairly robust at 3.6%, not far from its multi-decade lows. Other signals, such as wages, job vacancies, and prime-age labor force participation, look healthy and also aren't consistent with a rapid slowdown in the broader job market.

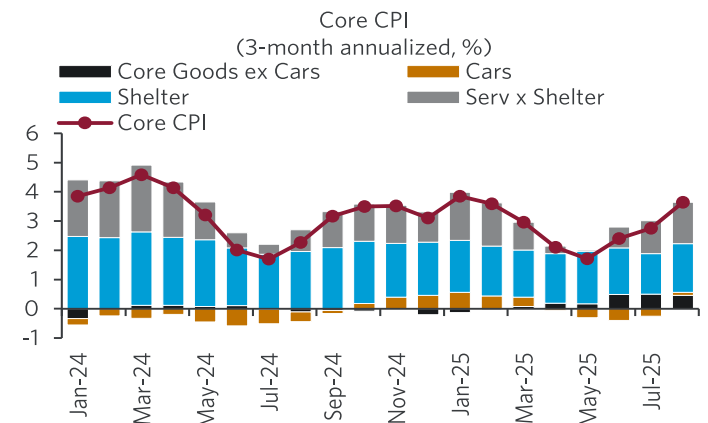
That puzzle makes it hard to rule out the influence of politics on some FOMC members' leanings, but we can also see other reasons they may be having second thoughts on prioritizing the price stability mandate. The reality is no one truly knows how bad of a hit to demand this ultimately may end up being. There isn't a guidebook for monetary policy in the face of a global trade war, a major immigration crackdown, and expansive public debt — and just getting to a neutral setting sooner could be the most prudent option in the face of significant policy uncertainty.

Who pays?

There are other evolving parts of the story that also might be forcing a rethink. The pass-through of tariffs so far has been modest (Chart 3). Core goods prices excluding cars have started to turn up, but their contribution remains small at around 10-15% of what's been driving inflation recently, which is less than their own weight in the basket. Car prices have barely budged, in large part because automakers have decided to absorb cost increases for now.

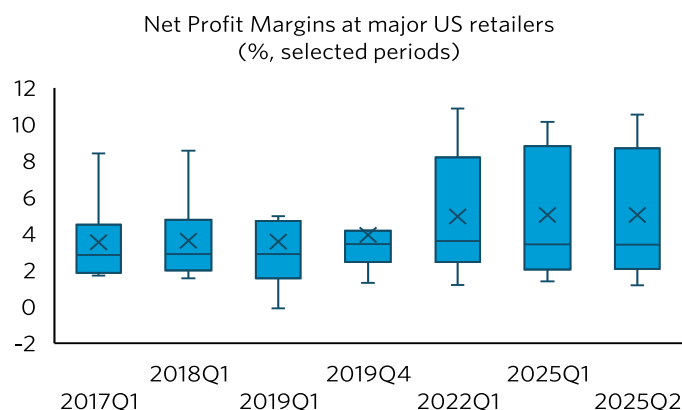
The front-loading of imports at the start of the year is also likely mitigating the inflationary impact, and we expect inflation will gradually rise over the next several quarters as those inventories are worked down. But the American consumer isn't likely to fully bear the entire burden of the tariff, at least in the

Chart 3: Tariff-impacted goods see moderate hit to inflation so far



Source: BLS, BEA

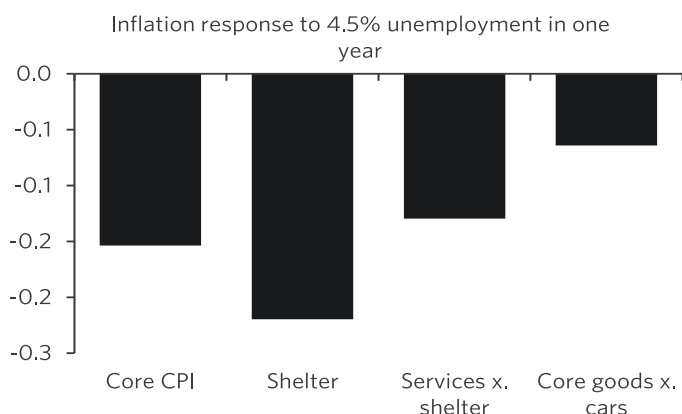
Chart 4: Healthy margins mean continued gradual pass-through of tariffs, even as pre-tariff inventories are drawn down



Note: 'x' denotes the mean of net profit margins across firms, the middle line is the median, the top of the box the upper quartile and bottom of the box is the lower quartile. The end points reflect the maximum and minimum values.

Source: Marcotrends.com

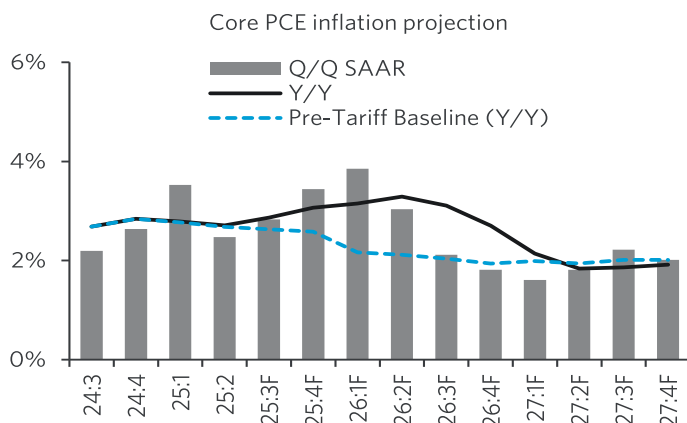
Chart 5: Growing slack in the labor market will partially counteract tariff impacts



Note: Results from the impulse response from a Bayesian SVAR with litterman prior including CPI components, Fed Funds Rate and the unemployment rate.

Source: BLS, BEA, CIBC calculations

Chart 6: Core PCE inflation will peak in the middle of 2026 before gradually coming back to target



Source: BEA, CIBC calculations

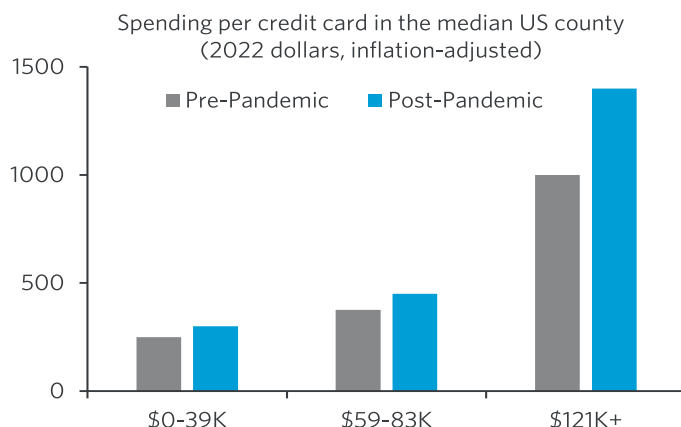
coming year. In our projections, we assume about 75% of the price level shock will filter through to consumers, with the remaining 25% absorbed into margins. Corporations have room to do so, with major companies enjoying very healthy net profit margins over the post-pandemic period (Chart 4). Part of the motivation to absorb the cost will reflect widening slack, making firms cautious about raising sticker prices too quickly (Chart 5).

Assuming the administration's global tariff regime holds up in court, or they are able to cobble together a similar effective tariff rate around 20%, based on other trade legislation, we expect a price level shock of a little over 1%. The combination of margin compression and offsetting slack as the jobless rate gradually rises to 4.5% by the middle of next year will collectively prevent an additional 0.2-0.4% rise in prices. All told, we project core PCE to peak near 3.5% by the middle of next year, before gradually moving back to target by early 2027 (Chart 6).

Spending lifestyles of the rich and famous

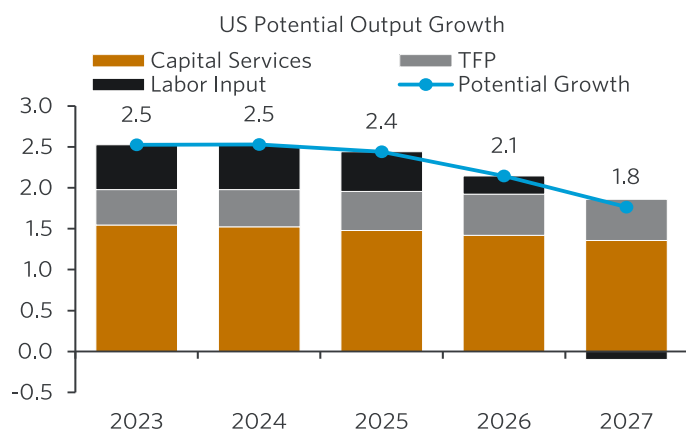
Fortunately for the US economy, there is more going on than just the impact of trade and immigration policies. Beyond the lift from the AI boom (See CIBC Economics, [The AI Boom is more than in stocks](#)), everyone seems to have forgotten the resilience of the American consumer. Recent research from the Boston Fed found that higher-income households have assumed a rising share of overall consumer spending, and these households have seen inflation-adjusted spending growth jump by as much as 40% post-pandemic, compared to about 20% for other households (Chart 7). The authors explain this change partly by the fact that these wealthier households used pandemic-era excess savings to pay down debt, and that extra balance sheet room helped fuel the spending binge since 2022 (Hagler and Patki, 2025). While higher prices will crimp spending power for lower- and middle-income households, these wealthier households will still have sufficient ammunition to keep spending and put a floor on America's growth in the low-1% range on their own. Recent gains in equity prices will add further juice to the spending power of these consumers.

Chart 7: Higher-income consumer spending has risen by about 40%, or double the increase in low and middle-income household spending



Source: Visually extracted and imputed from Hagler and Patki (2025)

Chart 8: America's long-run rate of growth is moving back below 2%



Source: CIBC calculations

The effects of fiscal policy from the administration's signature bill will also feed through next year, as will the rate cuts the Fed is expected to deliver. Altogether, these forces should be more than enough to keep the American economy on a slower but more stable growth path going forward.

2% is good again

The big question however, is where that growth path will ultimately settle given all the different forces emerging today. Actual growth was close to 3% over the past two years, and we estimate that the economy's long-run trend or potential output was at least 2.5% over that period, implying that demand was outstripping supply, and partly explaining why inflation remained stubbornly above target.

But now, we expect potential output growth to decline by 0.7 percentage points by the end of our projection horizon, to 1.8% (Chart 8). The population slowdown is the main driver of that decline, accounting for 0.5 percentage points by reducing the trend labor input (or total hours worked) as employment growth sharply decelerates. The trade war should also reduce trend growth by 0.4 percentage points, adding to costs for import-dependent businesses and discouraging capital spending, and weakening productivity by allocating resources to less-productive sectors to supplant imports as well as hampering productivity growth. We have penciled in a modest 0.2% offset from AI investment and productivity gains associated with AI. There is a wide range of estimates and guesses out there, but given it's early days, we have sided with some of the more conservative assessments until we see more concrete evidence of the technology being deployed more widely and put to its full potential (Acemoglu, 2024).

The bottom line here is that we are back in a world of 2% growth as the trend, and the economy will dip below trend as the economy absorbs these shocks. But despite that, even as it slows, America's growth will stand out as amongst the best of its peers. The US economy may be down, but it is certainly not out.

Canadian outlook: The road to recovery

by Andrew Grantham andrew.grantham@cibc.com and Katherine Judge katherine.judge@cibc.com

Having slipped into reverse in Q2 while navigating the roadblock of US tariffs, the Canadian economy should start on the road to recovery through the remainder of this year and into 2026. Assuming that some sectoral tariffs are reduced when a US-Canada deal is reached, and that CUSMA exemptions for other products are maintained, exports should continue to recover but remain below their pre-tariff trend.

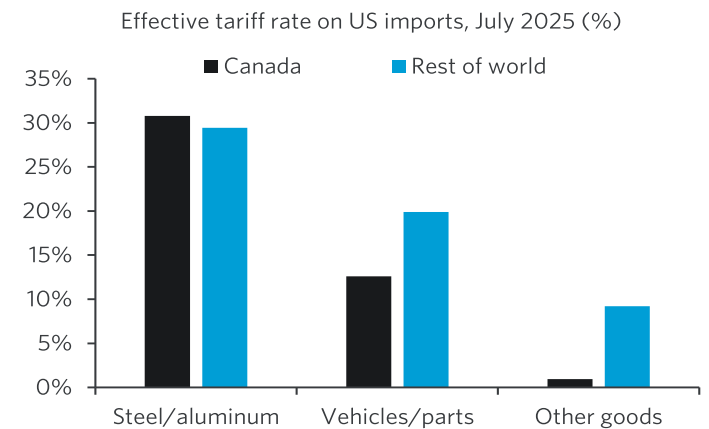
The road to recovery is likely to be slow at first, with business investment still muted by trade uncertainties and consumer spending held back by weak income growth and an elevated unemployment rate. However, the return to interest rate cuts from the Bank of Canada should help accelerate the recovery in 2026, and there are reasons why a higher speed can be reached, relative to the BoC's own projections, before we have to worry about navigating demand-driven inflationary pressures.

The CUSMA cushion

The blow from US tariffs and related trade uncertainty has been partly cushioned by exemptions granted for goods that comply with the USMCA (or CUSMA) trade deal. While this has been

no help for steel/aluminum producers, who have yet to receive any exemptions and whose effective tariff rate remains in line with other countries, other exporters are paying lower average tariffs than other countries due to CUSMA exemptions, including on vehicle parts (Chart 1). That said, in autos, metals

Chart 1: Apart from sectoral tariffs, Canadian exports are competitive in terms of tariff rates due to CUSMA exemptions



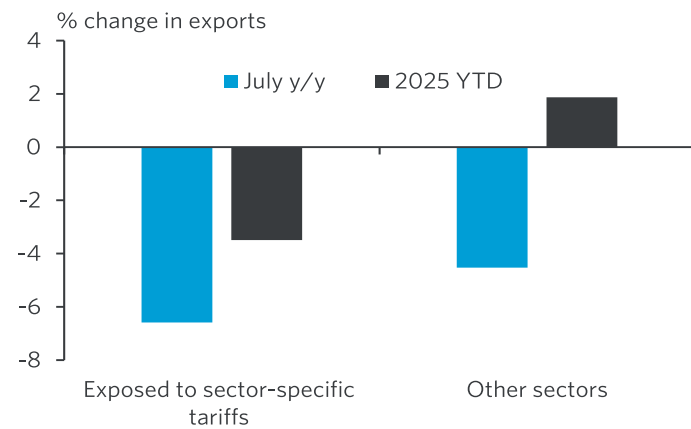
Source: US Census Bureau, CIBC

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

Indicator	25:2A	25:3F	25:4F	26:1F	26:2F	26:3F	26:4F	2025F	2026F	2027F
GDP at market prices (\$Bn)	3,163	3,188	3,207	3,227	3,265	3,304	3,347	3,183	3,286	3,440
% change	-1.6	3.2	2.5	2.4	4.9	4.9	5.3	3.6	3.2	4.7
Real GDP (\$2012 Bn)	2,445	2,450	2,457	2,467	2,481	2,493	2,506	2,452	2,487	2,537
% change	-1.6	0.7	1.3	1.5	2.3	1.9	2.2	1.2	1.4	2.0
Final domestic demand	3.5	1.3	1.7	1.8	2.0	2.1	2.2	2.2	1.9	2.2
Household consumption	4.5	1.2	1.9	2.5	2.2	2.7	3.0	2.8	2.4	2.3
Total government expenditures	5.7	1.3	1.3	0.2	1.2	1.1	0.7	2.6	1.2	1.7
Residential construction	6.3	2.0	2.5	1.0	2.9	1.7	2.4	1.3	2.3	2.9
Business fixed investment ¹	-7.6	0.9	1.1	2.3	2.4	1.9	1.5	-0.7	1.2	2.2
Inventory change (\$2012 Bn)	26.9	12.8	12.3	12.8	13.8	14.3	14.8	15.0	13.9	14.3
Exports	-26.8	13.6	2.1	2.2	3.2	1.9	1.9	-1.8	1.5	2.4
Imports	-5.1	6.3	3.0	3.3	2.6	2.8	2.1	1.2	2.8	2.7
GDP Deflator	0.0	2.6	1.2	0.9	2.5	2.9	3.0	2.3	1.8	2.6
CPI (yr/yr % chg)	1.8	1.9	1.9	1.5	1.7	1.7	1.8	2.0	1.7	2.0
Unemployment rate (%)	6.9	7.1	7.0	6.8	6.7	6.6	6.6	6.9	6.7	6.1
Employment change (K)	20	-23	17	46	102	109	92	268	206	433
Goods trade balance (AR, \$bn)	-78.4	-61.6	-63.3	-69.5	-67.4	-71.2	-72.9	-51.3	-70.3	-80.3
Housing starts (AR, K)	283	275	266	271	275	277	280	262	276	300

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

Chart 2: Exports not hit by tariffs still up healthy amount year to date



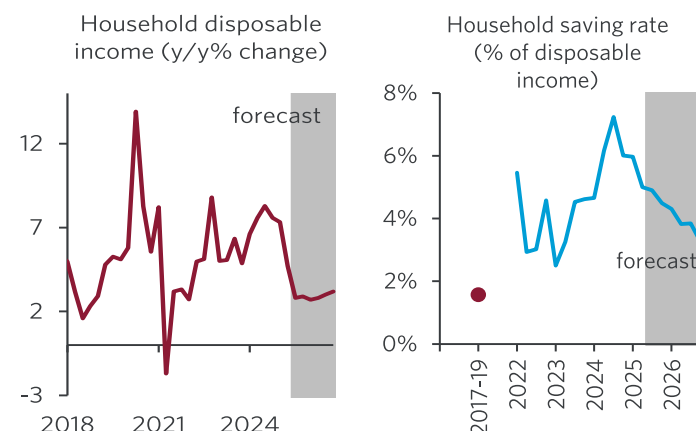
Source: Statistics Canada, CIBC

and lumber, Canadian firms were more dependent on the US market than overseas businesses had been.

At first glance this cushion doesn't appear to have supported exports particularly well, as even areas not subject to sector-specific tariffs have seen a noticeable decline in year-over-year terms. However, this is partly because some of these sectors (for example building materials, machinery and others) had more success in raising exports to front-run threatened tariffs earlier in the year, and as a result have held up better in year-to-date terms (Chart 2).

With recent data suggesting that exports were stabilizing, albeit at a lower level, and under the assumptions that CUSMA can be successfully renegotiated next year while some sector-specific tariffs are reduced, the main impacts of US tariffs going forward will be on business investment and hiring, and the latter's spillover effect on household incomes.

Chart 3: Sluggish income growth to continue (l), but modest drop in saving rate could be an offset for spending (r)



Source: Statistics Canada, CIBC

Rate relief

Indeed, a slowdown in hiring, combined with weaker wage inflation, has already seen household income growth decelerate noticeably, and we expect that to continue into the start of 2026 (Chart 3, left). Even though exports are stabilizing, which should limit downside risk to manufacturing jobs, we have previously shown that hiring has also been weak in less trade sensitive sectors, particularly in the SEPH payrolls data. Plans to trim public sector spending could also impact jobs in certain areas in 2026, possibly before planned infrastructure investment creates staffing needs in other areas.

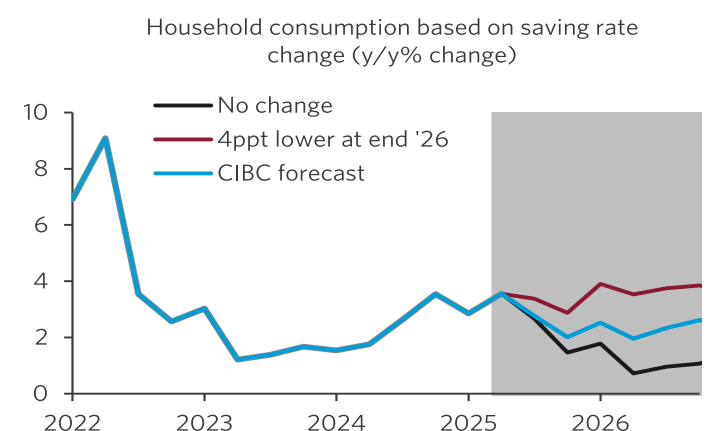
Fortunately, the return to interest rate cuts from the Bank of Canada should help support household spending by encouraging a further modest drop in the saving rate. While we don't anticipate (or want) savings to drop as low as they were pre-pandemic (Chart 3, right), a further reduction of roughly 2%-pts would at least ensure that consumer spending doesn't slow too much from here (Chart 4) even amid weaker income growth.

Bringing back the other "T" word

This year has so far been dominated by "T" words, most notably Trump and tariffs. But perhaps another "T" word should be making a comeback — transitory. An uptick in inflation earlier this year delayed the Bank of Canada from delivering the further rate cuts that the economy needed. However, it looks increasingly like this was, dare we say it, transitory, with recent figures pointing to much tamer core inflation readings.

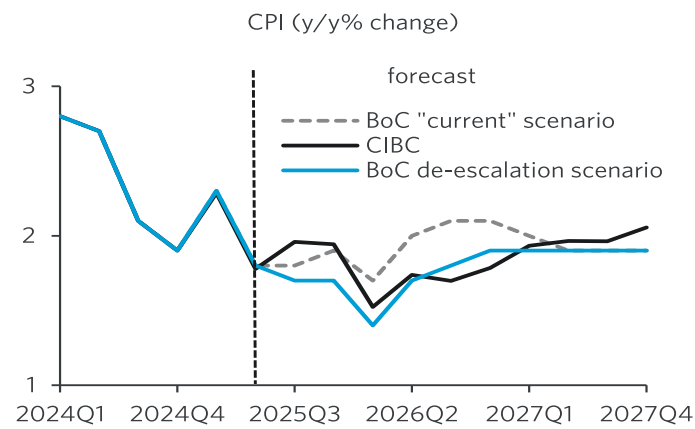
Retaliatory tariffs imposed by Canada on the US resulted in a level shift higher in some prices over the spring, particularly for certain food products. However, once passed through, there was little underlying inflationary pressure. And with the federal government recently announcing the removal of retaliatory tariffs for CUSMA compliant goods, the earlier pass through could be reversed and leave headline CPI tracking closer to the

Chart 4: Drawdown in saving rate will help keep consumption growth afloat



Source: Statistics Canada, CIBC

Chart 5: Inflation to be below target through 2026



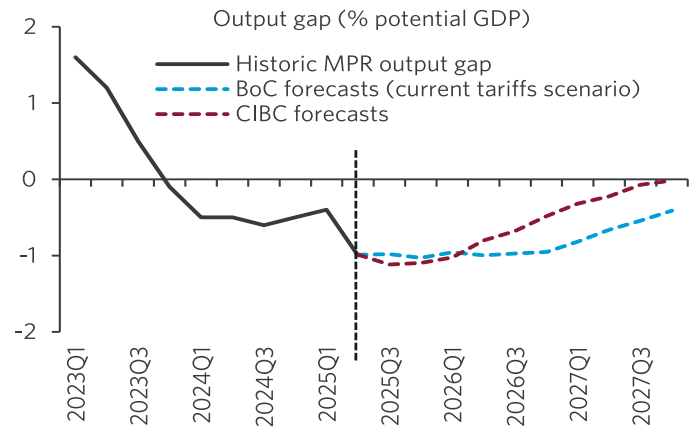
Source: Bank of Canada, Statistics Canada, CIBC

Bank of Canada’s “de-escalation” scenario from July’s MPR by early 2026 (Chart 5).

Moreover, GDP growth may be able to accelerate quite a bit from here, and potentially more than the BoC expects, before we have to worry about lasting inflationary pressures. The Bank’s own estimates for the current output gap, combined with expectations for future GDP and potential growth, would be consistent with modest slack remaining in the economy by the end of 2027, suggesting a degree of conservatism (Chart 6). Under our forecast, a slight easing in some sector-specific tariffs, modestly accommodative monetary policy, and the beginning of federal infrastructure investments result in stronger GDP growth than the Bank forecasts, particularly towards the end of 2026 and into 2027. However, slack would still remain within the economy until late 2027, so only then would interest rates need to be brought back up to a neutral level.

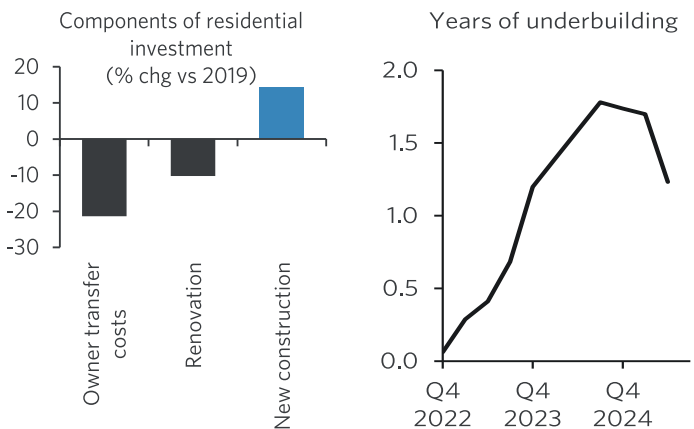
Of course this would accelerate growth in interest-rate sensitive sectors of the economy including residential investment, but

Chart 6: Economic slack could diminish faster than BoC expects as interest rates are cut



Source: Bank of Canada, CIBC

Chart 7: Room for a rebound in residential investment (I), to help bring down the housing shortage (r)



Source: Statistics Canada, CIBC

even here there appears to be plenty of room for growth before we have to start worrying about inflationary pressures. Two areas of residential investment (owner transfer costs and renovation activity) were still at levels well below pre-pandemic norms in Q2 (Chart 7, left). New homebuilding has accelerated and is well above 2019 levels, but that is helping to offset an underbuilding relative to population growth which should eventually prove disinflationary.

While there is plenty of regional variance, across the country as a whole the years of building required to return the housing stock/population ratio back to 2019 levels has fallen to 1.2, after having peaked at 1.8 years in mid-2024 (Chart 7, right). That reflects both stronger housing starts and a slowdown in population growth.

The road to recovery

The Canadian economy’s road to recovery may be slow at first, but there is plenty of scope for acceleration in 2026. Some easing of trade uncertainties, combined with the impact of further BoC rate cuts, could bring faster growth next year than the consensus and central bank itself expects, and all without the headwind of demand-driven inflationary pressures.

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