Economic Outlook

Whatever it takes

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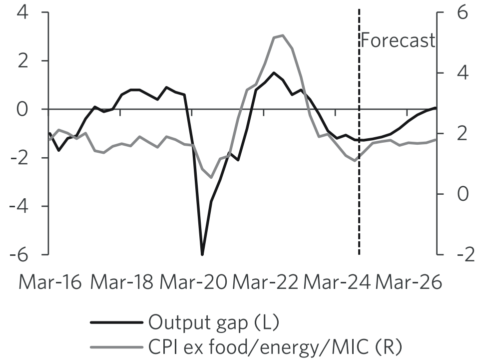
It was a European central banker who made the phrase famous in financial circles, but "whatever it takes" could be the motto for those in that role in North America in 2025, as they turn to protecting growth rather than fending off inflation. In Canada, inflation has been fully vanquished, and economic slack, as captured by a negative output gap, should ensure that our preferred core inflation measure, CPI ex. food/energy/mortgage interest costs, is likely to remain at or below the 2% target (Chart 1).

Chart 1: Key core inflation measure reflects ample economic slack



Source: StatCan, CIBC.

Stateside, the Fed's inflation benchmark, the core PCE price index, isn't "there" yet, but its six-month trend is encouraging, and the central bankers have gained confidence that 2% inflation is in sight. One of the last hotspots, rent inflation, seems to have turned the corner. Wage inflation has also been abating after a normalization in the job vacancy to unemployment ratio, and the annual pace for nonfarm business unit labour costs looks likely to tumble once a big gain in Q1 2024 drops out of the tally.

With inflation fears behind it, the Bank of Canada's task is to deliver enough interest rate relief to accelerate growth and begin to narrow the slack that has opened up in the labour market. The result is that the uncertainties for US trade policy arising from Donald Trump's election will have more bearing on the requisite interest rate path and the composition of growth, than on our projections for overall GDP, inflation and unemployment.

Our base case has the Bank of Canada taking the overnight rate slightly into stimulative territory at 2.25%. But if the country can't win an exemption from as much as a 20% US tariff, the BoC will have to cut deeper, giving a greater push to domestic demand and helping exporters with a weaker Canadian dollar than what's in that base case outlook.

Stateside, the Fed is also on an easing path, but one aimed at protecting against downside risks to growth from high real rates, rather than spurring an acceleration in an economy that isn't that far from full employment. That should take the fed funds rate back to neutral territory by mid-2025, which we estimate is as high as 3½% given America's ability to thrive with rates above 5% for an extended period. The Fed can afford to go that far, and then pause while it awaits greater clarity on fiscal and other policy impacts on 2026.

As in the US, much of Europe doesn't have much labour market slack, pointing to only moderate elbow room for rate cuts to spur non-inflationary growth ahead. In Japan, where policy rates are tightening as inflation has come up from undesirably low levels, an aging population continues to act as a ceiling on growth. China has more room, and is easing policy due to weakness tied to real estate, the threat from tariffs, and increasing economic slack. But without a much more aggressive stance, and perhaps other economic reforms to spur consumption, we don't expect to see an acceleration. The result is that global growth looks to be on nothing better than a sideways trend (Table 1), which barring supply side shocks, should contain the upside in energy and industrial materials prices in 2025.

Table 1: Real GDP Growth (Y/Y % change)

Region	2020A	2021A	2022A	2023A	2024F	2025F	2026F
World*	-2.7	6.5	3.5	3.3	3.0	2.9	3.1
United States	-2.2	6.1	2.5	2.9	2.7	2.0	2.3
Canada	-5.0	5.3	3.8	1.2	1.1	1.8	2.5
Eurozone	-6.1	6.3	3.5	0.4	0.7	1.5	1.7
United Kingdom	-10.3	9.5	5.0	0.4	0.9	1.2	1.5
Australia	-2.1	5.6	3.9	2.0	1.2	1.9	2.2
Japan	-4.2	2.8	1.2	1.7	0.2	1.2	1.0
China	2.2	8.4	3.0	5.2	4.6	4.2	4.0

*At purchasing power parity

Source: IMF, CIBC.

Johnny Canuck lives up to his potential

If the Bank of Canada does what it takes to get back to full employment by 2026, just how much GDP growth will that deliver, and in what sectors? Our call for better than 2% average growth in 2025-2026 (Table 2), captures significant room for employment gains as the labour market recovers and productivity recovers from a cyclical slowdown.

Table 2: Economic update

Canada	24Q2A	24Q3F	24Q4F	25Q1F	25Q2F	25Q3F	25Q4F	2024F	2025F	2026F
Real GDP growth (AR)	2.1	1.0	1.8	1.8	1.9	2.1	2.6	1.1	1.8	2.5
Real final domestic demand (AR)	2.4	1.0	1.6	2.0	2.2	1.9	2.8	1.5	1.9	2.5
Household consumption (AR)	0.6	0.5	0.9	1.9	1.5	1.8	2.3	1.8	1.4	2.6
All items CPI inflation (Y/Y)	2.7	2.0	2.0	2.2	1.6	1.7	1.9	2.4	1.9	1.9
Unemployment rate (%)	6.3	6.5	6.7	6.6	6.5	6.4	6.2	6.3	6.4	5.8

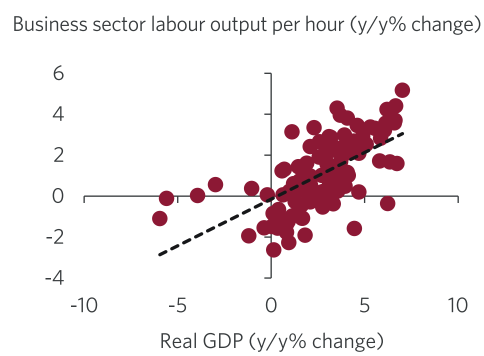
US	24Q2A	24Q3A	24Q4F	25Q1F	25Q2F	25Q3F	25Q4F	2024F	2025F	2026F
Real GDP growth (AR)	3.0	2.8	2.1	1.7	1.6	1.9	2.2	2.7	2.0	2.3
Real final sales (AR)	1.9	3.0	2.4	1.7	1.9	1.7	2.1	2.7	2.1	2.2
All items CPI inflation (Y/Y)	3.2	2.6	2.7	2.0	2.4	2.4	2.6	2.9	2.3	2.6
Core CPI inflation (Y/Y)	3.4	3.2	3.1	2.6	2.4	2.5	2.4	3.4	2.5	2.5
Unemployment rate (%)	4.0	4.2	4.3	4.3	4.4	4.3	4.2	4.1	4.3	4.1

Source: Haver Analytics, CIBC.

True, even assuming it takes a bit longer to reach federal targets for a lower level of foreign students and temporary workers, population growth will decelerate from nearly 3% in 2024 to less than 1% in each of the next two years. But there's still substantial room for job gains, judged by an elevated 6.5% jobless rate, and a sub-par participation rate in both prime-age and youth populations.

Output per worker should be helped in part because many of the temporary workers and students that won't qualify for permanent resident slots will be those currently working in low value-added jobs or only part time. Moreover, year-on-year growth in labour productivity is procyclical, showing a more than 60% positive correlation with real GDP growth in the last decade (excluding 2020-21 to remove the pandemic's distortion in GDP shares for services and goods). A recovery in demand enables businesses to make full use of their staff, so after two years of outright declines in the face of weak economic growth, we look for output per hour to recover to its 2022 levels by 2026 (Chart 2).

Chart 2: Rebound in productivity imminent as demand recovers



Source: StatCan, CIBC.

Slower population growth will cut into demand, but should be more than offset by the stimulus of lower interest rates. Cheaper credit and lower returns on savings should see household spending grow faster than incomes after an extended period in the other direction, and with a lag, we'd look for housing starts to gather steam. Should trade barriers hold back exports, we'll need even lower rates to power an even greater pick-up in domestic demand.

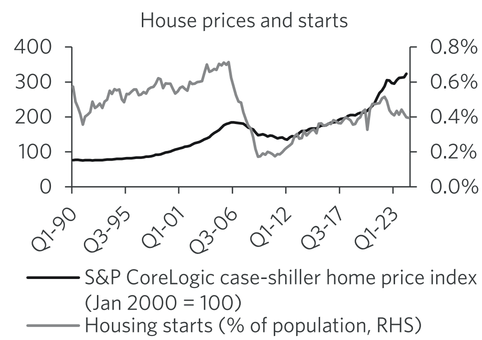
Two is the magic number for the US

If you're going to keep one number in mind for the US, its two. That's the inflation target, but also, after a period of elevated potential growth, likely where the economy's non-inflationary real GDP pace will settle.

The US has thus far managed to achieve something closer to a "no landing" outcome, in the sense that inflation has mostly dissipated without much of a deceleration in growth. That's been helped by improved global supply chains, but also a pick-up in productivity and population that made 3% the economy's non-inflationary potential pace. That's underscored by the ability to achieve that pace while still easing up on labour market tightness and inflation.

But 2% might be the new benchmark for non-inflationary growth ahead. Population growth will decelerate, or even turn slightly negative, in the face of tighter border controls. The Trump administration will surely tighten the screws further with deportations of those without legal status, and perhaps a slower pace for legal immigration. That lowers the economy's non-inflationary potential, as would a likely cooling off from a red hot pace for productivity growth.

Chart 3: Pent-up demand and lack of supply driving up home prices



Source: Haver Analytics, CIBC.

But subtle signals of labour market softening, and sluggish activity in interest sensitive sectors like housing, suggest that current real interest rates might still be too high to sustain even 2% growth, and we will lose the demand push from new immigrants. Bringing real interest rates to more moderate levels looks like a reasonable risk-reward calculation for a central bank with a dual mandate. Lower mortgage rates should unleash an upturn in homebuilding, which has languished relative to demographic demand, with insufficient supply showing up in rising home prices (Chart 3). Business capital spending could also use some help as we move past the one-time lift from the CHIPS act, and face a potentially slower pace of fresh government funding for renewable power. Fiscal stimulus would provide a substitute for Fed rate cuts, but that's not going to be in play for 2025, given that new tax and spending bills will be all about fiscal and calendar 2026. Even then, we're skeptical of market fears that there's massive stimulus ahead that would deter a modest additional easing by the central bank in 2025, or sustain a lot of pressure on long rates through upside surprises in Treasury financing needs. For one, tariffs act as a tax on consumer spending, thereby slowing growth.

Much of the "cost" of the Trump election platform was for maintaining existing tax rates, which is neither fresh stimulus nor a surprise to market expectations, given that the extension for those earning $400K or less had bipartisan support. Several of his other suggestions, including tax exemptions for tips and overtime wages, don't appear to have much Congressional backing. And there are fiscally conservative Republicans who will push for spending cuts to offset the budgetary costs of tax reductions.

Trade policy is the major wildcard for any forecast at this point, and lacking the details, we haven't incorporated a two-way tariff war into our inflation projections in Table 2. While tariffs raise the price level, whether that prompts a retightening by the Fed, or prevents rate cuts in 2025, depends on how much that's offset by the downward pressure on growth from a two way tariff war that hits US exports and cuts into consumer spending power through an implicit sales tax on imported goods. The labour market might not be tight enough for the initial hit to prices from tariffs to spark a broader and sustained inflation push, and tariff increases in 2025 could give way to trade deals with other countries that lower tariffs in 2026. We, and the FOMC, will have to wait for more details to judge that balance of risks.