CIBC Economics

FORECAST

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Canada and the US: The six-sided die

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As every gambler knows, if you roll a fair, single six-sided die, there are six equally probable ways it can land. We're not dealing with an unweighted die these days, so the probability of any result needn't be equal, but Canada's economic and financial market fate, and to a lesser extent that of the US, will depend on such a roll. There are two possible politically-driven courses for fuel prices: higher if the oil blockade in the Straits persists, lower if a solution is found. There are three broad outcomes in play for the politics surrounding Canada-US trade: a deal that eliminates August's new tariffs and materially lowers those imposed in 2025, the status quo including the new tariffs, or a further escalation, as the US has threatened.

Together, there are six possible combinations for these two issues, and the financial market results will also depend on which happens first. If a trade deal is reached while oil prices are still high and rising, the Bank of Canada would be pressed into hiking sooner. If a deal to open the Straits comes soon and oil prices fall, and that's well before any resolution of trade tensions, and Canada's economy softens, the Bank of Canada could even end up cutting rates.

Our base case forecast rests on the assumption that these two pressure points both see some degree of easing by early 2027, but not until then. Crude oil prices would remain in low triple-digit territory, helped by some shipments getting through the Gulf, while Canada's economy feels material headwinds on trade and investment and worries about what comes next. In that scenario, the US economy faces somewhat slower growth, including the impacts of some near term Fed tightening, a bout of higher inflation led by energy costs, but with sluggish growth in the working age population, it still stays near full employment (Table 3).

Canada sees a modest upturn in unemployment in the near term and higher headline inflation (Table 2), but the Bank of Canada holds off hiking rates while it waits for clarity on trade developments. It only begins to take the overnight rate modestly higher when some accommodation on trade issues is reached with the US, and as growth picks up in 2027 on greater certainty and infrastructure spending gains. But for investors and corporate leaders, the risk that the political die lands on another number, and these events therefore differ from the base case, needs to be weighed carefully in portfolio or management decisions.

The US: Upcoming fork in the road on energy prices, and further out, on AI returns

In the US, we're at an important fork in the road for energy inflation, as the outcome for the conflict with Iran will have a significant bearing on inflation and the course of Fed policy. In the near term, the Fed's hand is likely to be forced by surging fuel costs, and the risk that spills over into core inflation and inflation expectations. We've entered the fall season at full employment and with prospects for reasonably healthy Q3 growth, so the economy looks solid enough to withstand two quarter point rate hikes.

Our projections for a deceleration in inflation in 2027, and a stable fed funds rate in the first half of next year (Table 5), rely on free passage through the Straits of Hormuz being attained around the end of this year, or at least something close to that. As long as it believes that the fuel shortage story has reached its climax, even if the denouement is very lengthy, the Fed could opt to go back to a watchful waiting stance after a couple of hikes. It could end up actually easing rates marginally in the latter half of 2027 if the quarterly momentum from AI related capital spending is decelerating, and the Fed needs to broaden the sources of growth.

But given how tight labour markets are, with core inflation running above target, the Fed would have to step in with further rate hikes in the first half of 2027 if oil and refined products remain in short supply with no obvious end in sight for that shock. Relative to our base case projection, risks to US interest rates are tilted to the upside over the next few quarters.

Moreover, in our base case, long term rates won't have room to ease much, even if inflation decelerates, the Fed only hikes 50 basis points, and ultimately takes the overnight rate lower again in the latter half of 2027. Financing federal deficits in the 5-6% of GDP range year after year, in competition with corporate issuance lifted by AI capital spending, while facing reduced treasuries purchases from foreign central banks, now requires sustained higher real yields to find sufficient demand from other investors. Get used to 30-year Treasuries with a 5-handle, and the resulting drag on housing activity is another reason why the Fed might end up trimming short rates later in 2027.

For equity markets, the more critical fork in the road will come when investors are better positioned to judge the return on investment from the massive capital spend on AI. It's quite likely that those ROI outcomes still won't be apparent by the end of 2027. Various restraints on the speed at which data centres will be rolled out will push off the date to judge that process as being closer to completion, and we expect that the full adoption of AI tools, and related robotics, will be further into the future.

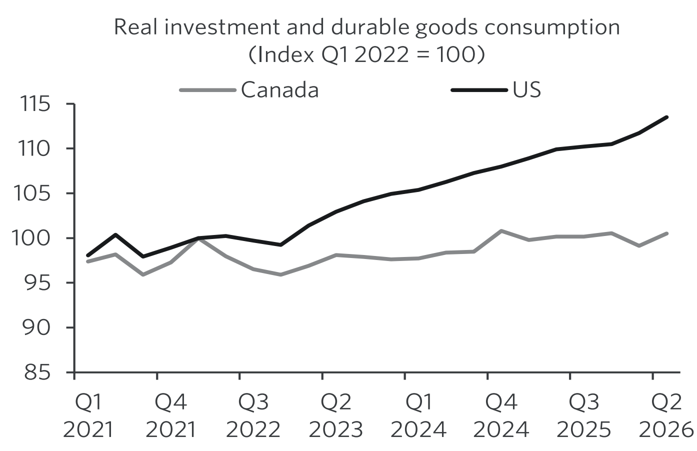
Canada: Market is underpricing risks from trade conflicts

In Canada, the most important roll of the dice will be revealed when it's clear where trade relations with the US will land. As often noted, Canada's overall average tariff rate is lower than that facing other countries. But given the country's greater dependence on exports to the US, those tariffs, applied to pre-tariff export volumes, would represent a higher share of Canadian GDP than is the case for other G-7 countries, and would be well above Mexico's if the threatened 50% tariff on all autos and parts kicks in come January.

One road, which is the base case for our forecast, has Canada and the US restart talks before the end of this year, and agree to fully unwind the tariffs each imposed in August sometime in early 2027. The US offers to reduce its 2025 tariffs on autos, metals and lumber but not as aggressively as we earlier hoped, and Canada eliminates the tariffs it imposed last year in response, and improves the US share of dairy imports. One plausible window to restart talks lies between the US midterm election on November 3rd and a threatened jump in US tariffs on Canadian autos and parts set for January 1st.

In that base case scenario, the Canadian economy still faces a headwind from the remaining tariffs on autos, metals and lumber, and we've pared back our 2027 growth rate as a result. But it will benefit from a reduced drag from housing, more elbow room for consumers as gasoline costs and mortgage renewal pressures abate, and increasingly as we move into 2028, a lift from large scale capital projects. Next year's inflation outlook should remain unproblematic, helped by decelerating rents and a cooling in fuel costs (Table 2).

Chart: Canadian interest-sensitive demand trails US despite lower rates



Source: StatCan, BEA, CIBC

While headline inflation will run well above the BoC's 2% target until oil prices ease, the uncertainties over trade outcomes should keep the Bank of Canada on hold in October. Any scenario in which trade barriers further escalate would represent a material risk to growth and downward pressure on inflation as a result.

Once a trade deal has been reached, the Bank of Canada could begin to nudge rates up, in anticipation of reaching full employment and a zero output gap in 2028. We've moved our call for the first of two quarter-point hikes into Q1, from Q2 previously, due to the higher path for headline inflation tied to the deteriorating situation in the Persian Gulf. But unlike market pricing, we don't see the case to take rates through its 2.75% estimate of where neutral sits. It's hard to argue that current rates are excessively stimulative, given the lacklustre pace for interest sensitive demand relative to the US (Chart). That in part reflects the larger boost the US is receiving from AI capital spending.

In that base case scenario, the Canadian dollar sees some near term weakness as the Fed gets an earlier start to rate hikes, and then a modest rally as the Canada-US interest rate gap narrows, in sympathy with gains by other majors against the greenback. Canadian equity market performance would be supported by the broadening of the economic expansion, even if oil prices look somewhat less lucrative for the energy sector in 2027.

But the risk of an impasse, and a longer trade war, is now greater, given what the last round of talks revealed about the degree to which the US was willing to reach a mutually beneficial deal. Investors, judging not only the modal outcome but the risks around it, have to put material odds that all of today's tariffs stick, and even some chance of an additional escalation given Trump's threat of a 50% tariff on all autos and parts, and less formal musings about punitive steps that would hit other sectors. That's a far cry from what we're projecting in our base case, and would entail a materially slower path for real GDP, lower interest rates, wider budget deficits and softer inflation.

Equity markets barely blinked when August trade talks collapsed, and markets are expecting the Bank of Canada to take the overnight rate well above neutral. That suggests that investors are materially underpricing the odds that the road ahead is harder for Canada on the trade front than our base case. They aren't 50%+, or an all-out trade war would be our base case, but they're not negligible given the unpredictability of the course of trade and other policy decisions from the Trump Administration.

Corporates that need to buy US dollars should therefore consider options strategies that provide some protection against a weakening C$, despite our base case showing it appreciating next year. In fixed income markets, corporate treasurers need to hedge against the wide range of plausible outcomes for interest rates until we know more about where trade talks and oil markets are headed. Many Canadian public companies are well insulated from trade frictions, having substantial assets out of the country, or being in sectors like energy where US tariffs seem highly unlikely, and where an extended Iran conflict could boost earnings. But equity investors should carefully consider their weightings in Canadian non-resource export sectors with a high exposure to US tariffs where a diversion to domestic or other markets is less viable.

Table 1: Real GDP growth rates (% change)

Region	2024A	2025A	2026F	2027F	2028F
World[1]	3.5	3.5	3.0	3.1	3.0
US	2.8	2.1	2.1	1.9	1.8
Canada	2.0	1.9	0.9	1.6	2.0
Eurozone	1.0	1.2	0.8	1.1	1.3
UK	1.1	1.3	0.9	1.2	1.3
Australia	1.0	2.0	1.8	1.9	2.2
Japan	0.1	1.2	0.8	0.8	1.0
China	5.0	5.0	4.5	4.2	3.9

1 At purchasing power parity.

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

Variable	2025A	2026F	2027F	2028F
GDP at market prices	4.4	5.6	3.4	4.0
GDP in $2012	1.9	0.9	1.6	2.0
Consumer price index	2.1	2.8	1.8	1.8
Unemployment rate	6.8	6.6	6.3	5.8
Pre-tax profits (net operating surplus)	6.2	15.4	1.1	3.9
Housing starts (K)	258	245	224	234

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

Variable	2025A	2026F	2027F	2028F
GDP at market prices	5.0	5.9	4.2	3.8
GDP in $2012	2.1	2.1	1.9	1.8
Consumer price index	2.7	3.4	2.4	1.9
Unemployment rate	4.3	4.2	4.3	4.2
Pre-tax profits (with IVA/CCA)	7.3	6.5	4.4	3.6
Housing starts (K)	1356	1334	1359	1420

Table 4: Canadian interest rates (end of period)

Variable	2026 11-Sep	2026 Dec	2027 Mar	2027 Jun	2027 Sep	2027 Dec	2028 Jun	2028 Dec
Overnight target rate	2.25	2.25	2.50	2.75	2.75	2.75	2.75	2.75
98-Day Treasury Bills	2.33	2.25	2.55	2.80	2.90	2.85	2.80	2.75
2-Year Government Bond	3.36	3.15	3.20	3.30	3.15	3.10	3.10	3.15
5-Year Government Bond	3.65	3.55	3.55	3.60	3.35	3.45	3.35	3.50
10-Year Government Bond	3.95	4.00	3.95	3.90	3.85	3.85	3.90	4.00
30-Year Government Bond	4.28	4.25	4.10	4.00	3.95	4.00	4.20	4.40
Canada - US T-Bill Spread	-1.68	-1.85	-1.50	-1.20	-0.80	-0.55	-0.35	-0.40
Canada - US 10-Year Bond Spread	-1.03	-1.00	-1.00	-1.00	-0.90	-0.75	-0.80	-0.85
Canada Yield Curve (10-year — 2-year)	0.59	0.85	0.75	0.60	0.70	0.75	0.80	0.85

Table 5: US Interest rates (end of period)

Variable	2026 11-Sep	2026 Dec	2027 Mar	2027 Jun	2027 Sep	2027 Dec	2028 Jun	2028 Dec
Federal funds rate (midpoint)	3.625	4.125	4.125	4.125	3.875	3.625	3.125	3.125
91-Day Treasury Bills	4.01	4.10	4.05	4.00	3.70	3.40	3.15	3.15
2-Year Government Note	4.64	4.65	4.60	4.50	4.20	3.85	3.75	3.85
5-Year Government Note	4.79	4.80	4.75	4.65	4.30	3.85	3.85	4.10
10-Year Government Note	4.97	5.00	4.95	4.90	4.75	4.60	4.70	4.85
30-Year Government Bond	5.35	5.40	5.35	5.30	5.20	5.10	5.25	5.40
US Yield curve (10-year — 2-year)	0.33	0.35	0.35	0.40	0.55	0.75	0.95	1.00

Table 6: Foreign exchange rates

Exchange rate	2026 11-Sep	2026 Dec	2027 Mar	2027 Jun	2027 Sep	2027 Dec	2028 Jun	2028 Dec
CAD-USD	0.72	0.71	0.72	0.73	0.74	0.74	0.75	0.75
USD-CAD	1.39	1.41	1.39	1.37	1.36	1.35	1.33	1.33
EUR-USD	1.16	1.17	1.19	1.20	1.19	1.18	1.20	1.21
GBP-USD	1.35	1.35	1.38	1.39	1.38	1.39	1.37	1.36
USD-CNY	6.71	6.70	6.68	6.67	6.65	6.65	6.65	6.65
USD-MXN	16.97	17.00	17.00	17.50	17.50	17.00	17.85	18.00
USD-JPY	154	156	154	152	150	148	146	145

US outlook: A slow fade on growth, and the Fed hikes before it cuts

by **Helen Lao** helen.lao@cibc.com

The American economy isn't heading for a cliff– it's heading for a plateau, and then a slow, almost imperceptible fade. The wealth effect, while dissipating, should still support consumption growth. AI investment will remain elevated, but its quarter over quarter growth rate is likely to decelerate in the face of financial and physical infrastructure constraints. That means US economic growth will decelerate but not falter. This year's 2.1% real GDP growth rate will lose a few ticks over the next two years, but our 1.8% forecast for 2028 is still close to the economy's non-inflationary growth rate (Table 1).

The unemployment rate should nudge up only slightly, with labour supply limited by tight borders and increasing retirements (see Who's really missing from the US work force?). Headline inflation is expected to rise in the near term, driven by higher oil prices which will likely feed through into core inflation through higher transportation costs. Alongside climbing health care prices, that would leave underlying inflation pressures well above the Fed's 2% target, arguing for a rate hike. That mounting concern over inflation is expected to drive the Fed to hike rates before the year is out. We expect the Fed to deliver two quarter-point hikes in the next two meetings in September and October.

In 2027, inflation should abate with the effects of tariffs and higher oil prices from the Iran war waning, while growth should decelerate as AI capital spending slows. That would prompt the Fed to bring the policy rate down towards neutral, with two quarter points cuts in the latter half of 2027 and two quarter points cuts in the first half of 2028.

The squeeze on consumers

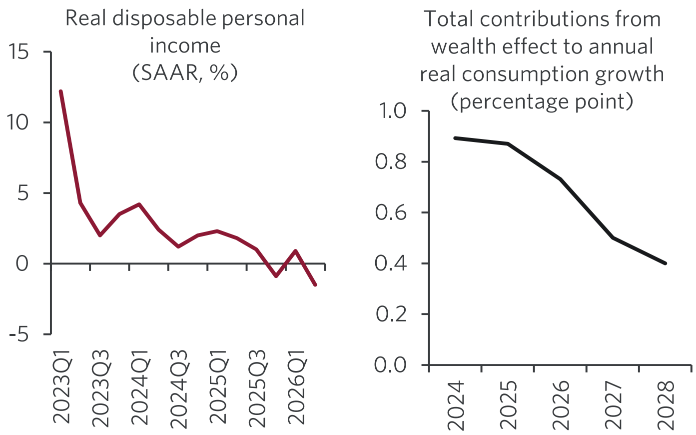
US consumption is likely to slow further as the key supports to household spending weaken. The effects of the temporary boost to income from higher tax refunds are waning. Real disposable income growth is moderating (Chart 1, left), reflecting slower wage growth and lower hiring, while tariffs and still-elevated gasoline prices will erode purchasing power.

A cooling in oil prices will restore some of that lost spending power in 2027, but wealth effects, which have been supporting consumption through stock market gains, are dissipating. Gains for those holding equities are increasingly being offset by a drag from real estate wealth as house prices ease in the face of elevated mortgage rates and slower demographic demand over the next two years (see Show me the money: Measuring wealth-driven consumption) (Chart 1, right).

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

Indicator	26:2A	26:3F	26:4F	27:1F	27:2F	27:3F	27:4F	2026F	2027F	2028F
GDP at market prices ($Bn)	32,486	32,810	33,137	33,457	33,764	34,091	34,427	32,575	33,935	35,235
% change	8.0	4.1	4.0	3.9	3.7	3.9	4.0	5.9	4.2	3.8
Real GDP ($2012 Bn)	24,270	24,421	24,530	24,626	24,742	24,877	24,998	24,350	24,811	25,269
% change	1.5	2.5	1.8	1.6	1.9	2.2	2.0	2.1	1.9	1.8
Final sales	2.2	1.5	1.7	1.6	1.8	2.2	1.8	2.3	1.8	1.8
Personal consumption	3.4	2.0	1.7	1.5	1.8	2.0	1.8	2.1	1.9	1.8
Total government expenditures	-1.0	1.2	1.5	1.2	2.0	1.5	1.7	0.3	1.3	1.8
Residential investment	1.2	-0.8	1.0	2.4	4.7	5.0	3.8	-3.4	2.5	3.6
Business fixed investment	8.5	3.6	3.4	3.5	3.0	2.8	3.0	6.2	3.6	2.2
Inventory change ($2012 Bn)	-53.1	5.8	10.8	9.9	13.8	13.8	23.8	-13.3	15.3	16.3
Exports	4.5	1.5	1.9	2.2	1.7	2.5	1.3	4.2	2.1	1.8
Imports	12.5	4.7	3.0	3.4	3.4	2.0	2.8	2.8	3.8	2.2
GDP Deflator	6.4	1.5	2.2	2.3	1.8	1.7	2.0	3.7	2.2	2.0
CPI (yr/yr % chg)	3.9	3.4	3.8	3.5	2.1	2.2	1.8	3.4	2.4	1.9
Core CPI (yr/yr % chg)	2.7	2.5	2.6	2.5	2.4	2.4	2.2	2.6	2.4	2.1
Core PCE (yr/yr, % chg)	3.4	3.4	3.3	2.9	2.6	2.3	2.2	3.3	2.5	2.2
Unemployment rate (%)	4.3	4.1	4.2	4.2	4.3	4.3	4.3	4.2	4.3	4.2

Chart 1: Real disposable income growth has decelerated (l); wealth effects contribution to real consumption growth is dissipating (r)



Source: BEA via Haver, CIBC calculations

Higher-income households may be able to draw on accumulated wealth to maintain consumption, but many lower-income households, facing higher borrowing costs and rising credit card balances, are likely to scale back spending.

The AI buildout continues but with more constraints

While the AI buildout remains on strong footing, it is entering a phase in which physical and financial constraints will increasingly limit the pace of growth. Indeed, while still booming relative to anything else in the economy, year-on-year growth for two major technology investment components was already decelerating in the first two quarters of 2026 (Chart 2, left and right).

Part of this reflects the structural memory-chip shortage which pushed up prices and mechanically shows up as slower inflation-adjusted investment. Many chipmakers are already sold out of their production capacity next year, and little new fab capacity is set to come online in 2027.

Electricity supply is another structural bottleneck for the AI buildout. Many local and state governments are pausing or slowing decision making for new data centre development, as voter concerns mount over strained electricity capacity.

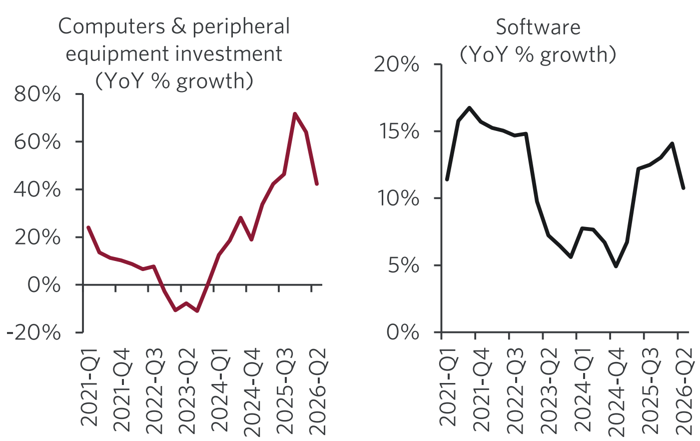
Finally, at some point, financial constraints could set a speed limit on AI investment growth, as limits on some of the hyperscalers' operating cash flows result in ever more debt and equity financing. Markets have still been very receptive to such issues, but credit ratings are slipping, and at some point, the sector will need to show more revenue gains to continue to spend at a rising clip.

To be sure, AI capital spending will still be a major story for the next year, and could have significant benefits for firms adopting these tools. But these constraints on the pace of the AI build-out have us expecting that the contribution from related capex to GDP growth, net of imports, should diminish from 0.4%-points this year to 0.2%-points next year, and as little as 0.1%-points in 2028 (Chart 3).

Structural factors are slowing the economy as well

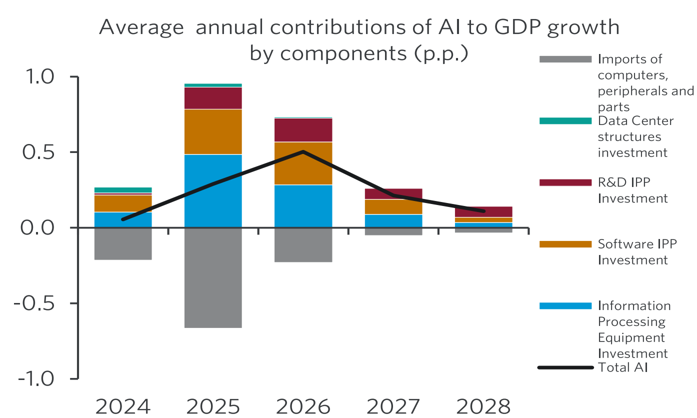
Structural forces, such as slower population growth, driven by strict immigration policies and an aging population, will weigh on growth in the American workforce and limit the pace at which the economy can expand. While 2025 already saw tight borders and deportations squeeze population growth, accelerating retirements as baby boomers move further past their mid-60s and other forces are cutting into the share of the adult population interested in working.

Chart 2: Some components of AI investments have already decelerated in 2026Q2



Source: BEA, CIBC calculations

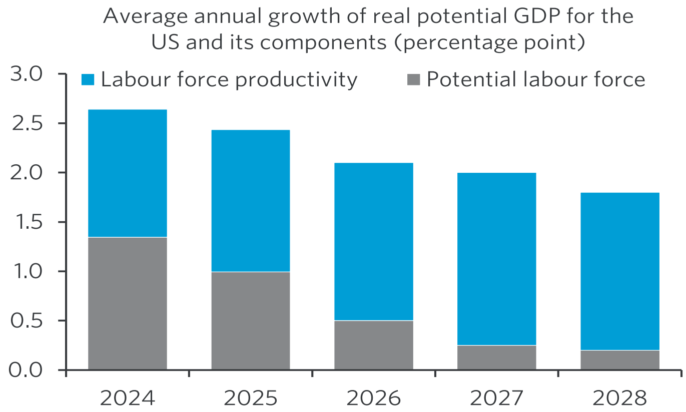
Chart 3: Average annual contributions of AI to GDP growth is expected to diminish over the projection



Note: 2026 Q2 to Q4 based on CIBC forecast.

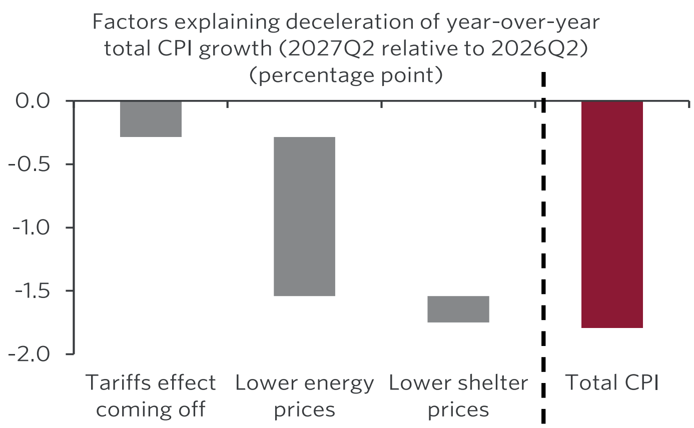
Source: BEA, CIBC calculations

Chart 4: Real potential GDP for the US is expected to slow due to lower labour force growth



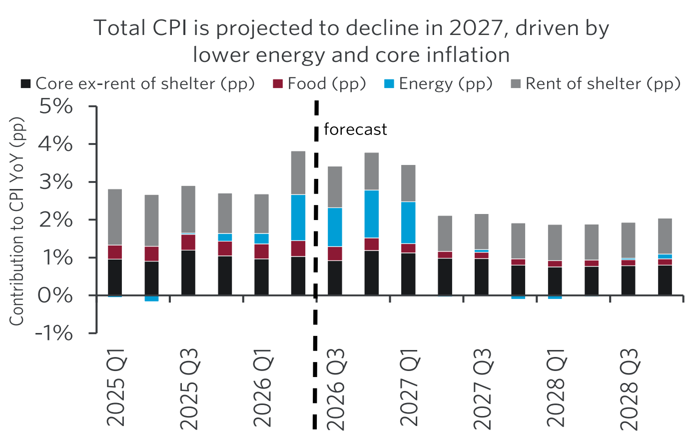
Source: CBO, CIBC calculations

Chart 5: The waning of tariffs impact, lower energy and shelter prices are expected to bring total inflation back to target by 2027



Source: BLS, CIBC calculations

Chart 6: Total CPI is projected to decline in 2027 due to lower energy prices and core inflation



Source: BLS, CIBC calculations and forecasts

A further slowing to as little as 0.2% annual labour force growth over the next two years will weigh on the economy's non-inflationary speed limit (Chart 4). Even so, we expect the economy to dip slightly below that pace in 2027, making room for the Fed to cut in the second half.

Inflation pressures keep the Fed hiking before it eases

Growth and employment aside, the deciding factor for the Fed this year and next will be inflation. Oil prices have recently spiked as the conflict in the Middle East re-intensified, which will likely bleed into core inflation through higher input costs such as transportation. AI, which has been adding to inflation, is expected to contribute 0.4 percentage points to total inflation this year (see Quantifying the AI hit to US inflation). Its contribution is expected to be positive over our forecast horizon, albeit at a lower level starting in 2027 as the capital expenditure growth moderates and productivity gains start to take effect. We also expect healthcare costs to increase further as an aging population and rising provider costs put upward pressures on health care services inflation. That means core inflation will remain sticky, requiring the Fed to raise interest rates two times (by a quarter point each) in the upcoming FOMC meetings in September and October to bring down inflation.

As tariff impacts and oil prices come down next year, year-over-year total CPI inflation is expected to decline starting in 2027Q1 and reach around 2% by mid-2027 (Chart 5 and Chart 6), allowing the Fed to cut starting in the second half of the year and bring rates back to neutral in the first half of 2028.

Canadian outlook: A recovery delayed, but hopefully not derailed

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Just when things were looking more upbeat, Canada's economy has hit another bump in the road. US tariffs on Canadian exports have broadened, and there's a threat of even worse to come, putting the improvements that we were starting to see in the Canadian economy at risk. Whether this is a recovery completely derailed, or simply delayed, heavily depends on where trade and tariff policies head from here.

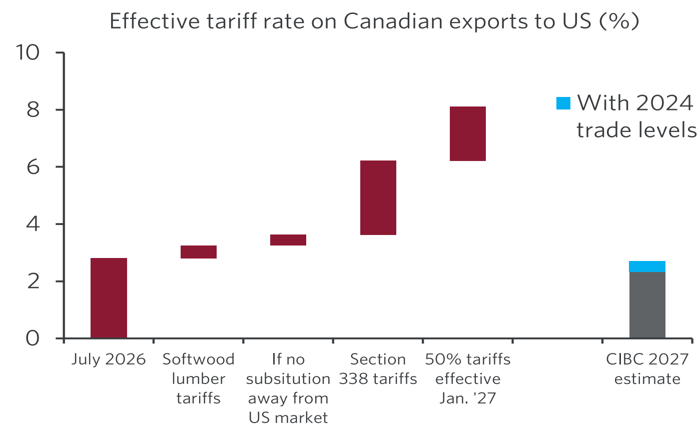
Our forecasts assume that the two sides will get back to the negotiating table in the months ahead, that some progress will be made in lowering sectoral tariffs, eliminating those added in August, and calling off the further escalation threatened for January 1st. However, with recent developments showing that any deal will leave higher trade barriers in place relative to what we previously hoped for, we've trimmed our growth forecast for 2027 and slightly delayed the timing of a return to full employment (Table 1). That said, this is now a forecast with more downside risks should trade relations continue to sour.

Too much weight on the weighted average?

When assessing the impact of US tariffs, it is now commonplace to calculate a weighted average based on US customs data. Such calculations show that the average tariff on Canadian exports lies below that of other countries thanks to CUSMA exemptions, even after the new section 338 tariffs imposed in August.

But as we have discussed previously, Canada trades more with the US than other countries. So yes, Canadian exporters face lower average tariff rates than other American trading partners,

Chart 1: Expectations for a deal to lower tariffs, but risk of worse



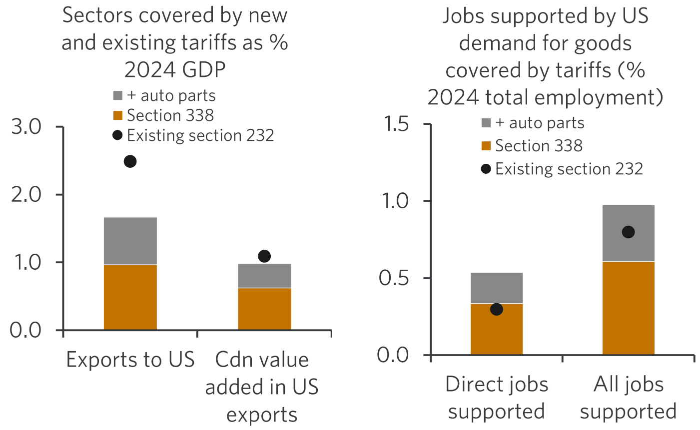
Source: US Census Bureau, CIBC

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

Indicator	26:2A	26:3F	26:4F	27:1F	27:2F	27:3F	27:4F	2026F	2027F	2028F
GDP at market prices ($Bn)	3,438	3,456	3,492	3,505	3,530	3,553	3,594	3,429	3,545	3,688
% change	13.8	2.2	4.2	1.5	2.9	2.6	4.7	5.6	3.4	4.0
Real GDP ($2012 Bn)	2,524	2,534	2,539	2,548	2,560	2,570	2,584	2,525	2,566	2,618
% change	3.3	1.6	0.7	1.5	1.8	1.6	2.1	0.9	1.6	2.0
Final domestic demand	3.9	0.9	1.2	1.6	2.1	2.1	2.2	1.5	1.8	2.2
Household consumption	3.3	1.2	1.5	1.4	2.0	1.9	2.2	2.2	1.7	2.3
Total government expenditures	1.4	1.1	1.9	3.1	2.5	2.4	2.0	1.5	2.3	1.9
Residential construction	10.4	1.0	-2.5	-0.5	2.0	2.6	2.2	-2.2	1.0	2.1
Business fixed investment[1]	8.7	-1.5	0.4	0.1	1.5	1.7	2.4	1.1	1.1	2.3
Inventory change ($2012 Bn)	-16.1	0.2	8.5	10.7	11.2	9.3	9.0	0.7	10.1	6.5
Exports	15.1	-3.2	-3.9	0.7	1.6	1.9	2.2	2.4	0.6	2.1
Imports	1.1	2.8	2.1	2.0	2.6	2.4	2.2	2.8	2.2	2.1
GDP Deflator	10.3	0.5	3.5	0.0	1.0	1.0	2.5	4.6	1.8	1.9
CPI (yr/yr % chg)	2.9	3.1	3.2	2.9	1.7	1.5	1.3	2.8	1.8	1.8
Unemployment rate (%)	6.7	6.4	6.6	6.5	6.3	6.2	6.0	6.6	6.3	5.8
Housing starts (AR, K)	255	239	245	235	227	225	210	245	224	234

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

Chart 2: Newly implemented and threatened tariffs represent a smaller share of exports (l), but larger share of jobs (r)



Source: Statistics Canada, CIBC

but the tariffs paid as a percentage of the exporting country's GDP are higher in Canada's case than for other countries. Additionally, the weighted tariff calculation does not take into account the fact that trade in some of the impacted sectors, particularly steel and lumber, is now well below pre-2025 levels. Applying the current tariff rate on those sectors to 2024 trade volumes, the weighted average tariff would be almost 0.5%-pts higher. Add in the anti-dumping and countervailing duties on lumber that the US customs data doesn't pick up, and suddenly the starting point isn't as favourable (Chart 1).

From this starting point, the recent application of 50% tariffs on $28bn of additional Canadian exports, plus the threatened escalation of auto tariffs on January 1st, could take this calculation towards 9%. Tariffs at that level would have a significant negative impact on the Canadian economy.

While new and threatened tariffs would impact fewer exports (based on 2024 shares) compared to the ongoing tariffs on autos, steel, aluminum and lumber, their total domestic value add is actually similar as a percentage of GDP (Chart 2, left). With new tariffs impacting more labour intensive industries, the proportion of jobs directly at risk is actually higher (Chart 2, right). That is still the case if we include jobs indirectly supported by US demand, such as bars and restaurants in major steel or auto producing towns.

This potential impact is also, however, one reason why we think a deal will eventually be reached, even if it's unlikely to be as good as previously hoped for. A reduction in steel and aluminum tariffs back to 25%, reversing most of the new section 338 tariffs and preventing a broadening of section 232 tariffs to auto parts would still leave a weighted average tariff of between 3-3.5% based on 2024 export volumes.

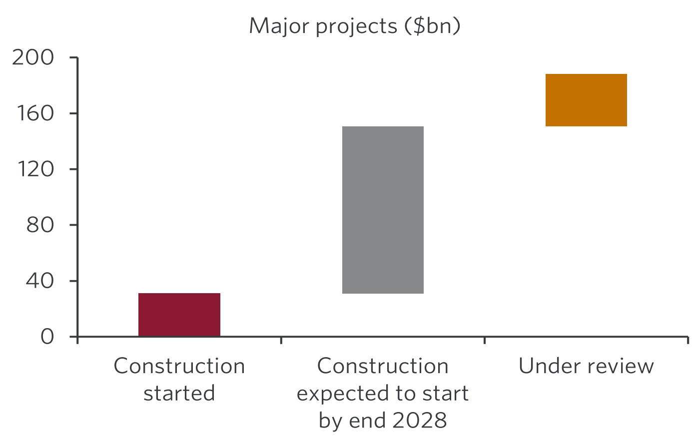
Looking through the storm

If Canada manages to navigate the storm clouds of renewed tariff threats without turbulence extending into next year, there are reasons to believe that the Canadian economy could be flying higher in 2027 and 2028. Fiscal policy and infrastructure spending should pick up next year, even if exact timelines for many projects are still uncertain and the largest positive contributions could come later on. While some projects have already started and will add more to GDP when they get closer to the peak building phase, there will also be a positive economic impact from the generally larger projects due to break ground before the end of 2028 (Chart 3).

Perhaps more immediately, residential investment should turn back into a modest positive contributor to GDP. In 2027, that's not likely to come from new construction, as the overhang of previous building in certain segments of the market, combined with slower population growth, has limited the need for new starts. But there's plenty of scope for renovation and home sales activity to continue recovering from very depressed levels, particularly if, as we expect, the Bank of Canada hikes interest rates less than markets currently expect, which will see term rates move lower again (Chart 4).

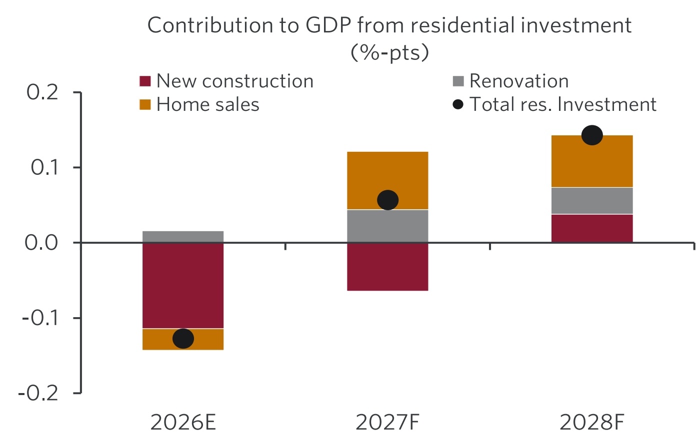
Moreover, and as we've discussed elsewhere, the outlook for consumer spending in 2027 and beyond is brighter, assuming we avoid a prolonged trade war that would dent employment

Chart 3: Major projects could inject almost $200bn in years ahead



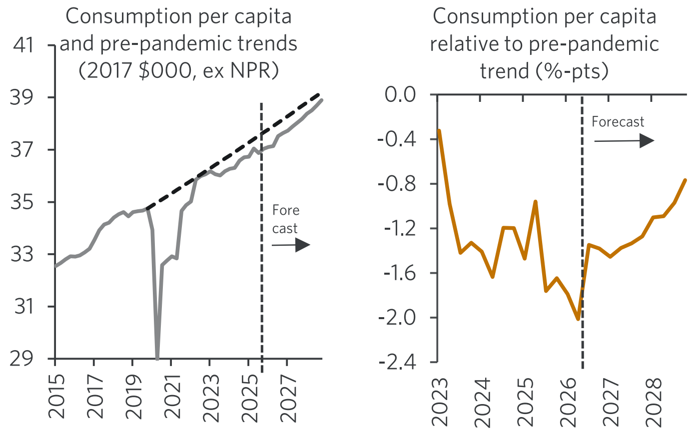
Source: Major project announcements, CIBC

Chart 4: Residential investment to be positive contributor even as new building struggles



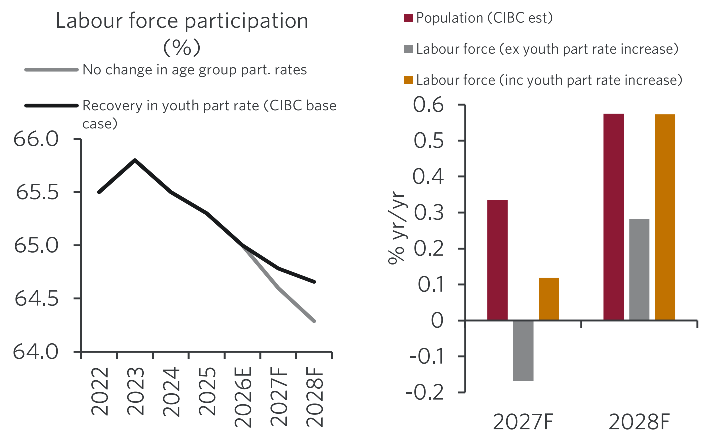
Source: Statistics Canada, CIBC

Chart 5: Per-capita consumer spending to return closer to pre-pandemic trend



Source: Statistics Canada, CIBC

Chart 6: Participation rate will fall only slowly assuming greater youth engagement (l), but labour force growth still slow in 2027, accelerating in 2028 (r)



Source: Statistics Canada, CIBC

and incomes. A smaller drag from mortgage refinancings, expanded benefits for lower income families, and, at some point, an easing in gasoline-driven inflationary pressure, will free up more disposable income for discretionary purchases.

While aggregate real consumption growth averaging 2% in the coming two years may not seem impressive, in per capita terms we expect that consumer spending will recover more than half way back to its pre-pandemic trend by the end of 2028 (Chart 5). With unemployment possibly ticking up a little in the near-term due to the latest escalation in tariffs and high fuel costs persisting the near term, much of this acceleration in per capita spending will likely be delayed to the second half of 2027 and 2028.

Lowering the limit

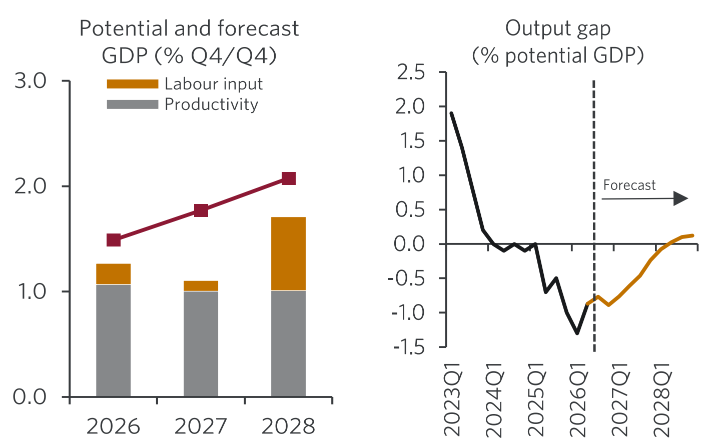
The slower growing, and aging, population will have a broader impact on the economy, as it limits the availability of workers to help the economy grow. Population aging and the resulting increase in retirements will continue to see the participation rate gradually fall in the next couple of years, even if the declining youth unemployment rate brings in more young job-seekers (Chart 6, left).

In terms of population growth, we suspect that the recent trend has been stronger than official data suggest, since those estimates make aggressive assumptions about how quickly those with expiring visas leave the country. But the flip side of that is that it will take longer than many are assuming to reach Ottawa's target for non-permanent residents as a share of the total population. As such, instead of a return to faster population growth next year, we expect that net immigration levels will remain tight for another year, and that 2028 will be the true turning point to a more typical pace for population growth.

Add these factors together, and the labour force is expected to grow only marginally in 2027, and would actually decline if it wasn't for the forecasted improvement in youth participation, before accelerating a bit more in 2028 (Chart 6, right). The slow growing labour force is also a primary reason why we aren't forecasting a more dramatic increase in unemployment in the near term, despite the escalating tariff threat. Laid-off workers may find it easier to land a new job than they would be able to in a faster growing pool of job seekers, while companies may be more reluctant to lay off staff in response to what is hoped to be a temporary escalation in US tariffs. The breakeven pace of monthly employment growth needed to keep the jobless rate stable may be as low as 2K in 2027, rising to 10K in 2028.

The slower growing labour force also places a speed limit on the potential (non-inflationary) growth rate for real GDP, barring an unexpected surge in productivity. Indeed, this low speed limit means that, even on our downgraded 2027 forecast, Q4/Q4 growth is still expected to be quick enough to reduce slack in the economy. On the flip side, the acceleration in GDP growth expected in 2028 is largely due to a higher potential, as population growth picks up, and needn't put a lot of pressure on inflation as a result (Chart 7, left). Indeed, the lagged effects of

Chart 7: Higher potential driving most of 2028 acceleration (L); output gap little changed in near-term, closing in late 2027 (R)



Source: Statistics Canada, CIBC

a couple of interest rate hikes in 2027, bringing rates back up to a neutral level, should have slowed growth enough by the end of 2028 to prevent the economy from overheating (Chart 7, right).

That outlook for the output gap sees us continuing to forecast a return of inflation to the 2% target over the next twelve months, and temporarily dipping below if gasoline prices ease as we expect in 2027, before holding close to that target thereafter. While Canada's retaliatory tariffs could add a few decimal places to inflation in the near term, they would be dropped in the trade deal that we assume will be signed to reduce current US tariff rates. And even if no deal were reached, the outlook for inflation would likely tilt lower, rather than higher, as a weaker economy with greater slack would result in disinflationary pressures elsewhere.

However, under our base case assumption that a trade deal is achieved to dial down the tariff war, the outlook for the Canadian economy is one of a recovery delayed, rather than derailed, and for inflation to remain close to the BoC's 2% target.

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