Economics

IN FOCUS

November 6, 2024

From US platforms to policy: A wide gap and its economic implications

by **Avery Shenfeld** avery.shenfeld@cibc.com, *MD and Chief Economist*

There's a chasm between what's pledged in campaign platforms and what ultimately gets implemented. So, while Donald Trump will be returning to the White House, step one in ascertaining forecasts implications is choosing the most plausible policy base case. In so doing, we also need to account for a Republican majority of the Senate and, as we write, a likely majority in the House.

Broadly speaking, we see the following implications versus our base case, which didn't allow for major fiscal or trade policy shifts ahead:

- Canada-US interest rate differentials could be wider, at least initially in 2025. The threat of a trade war is a negative for Canadian business confidence and capital spending, potentially requiring more monetary stimulus as an offset. We'd lean against market thinking that the Bank of Canada will be more hesitant about a follow-through 50 bp cut in December.
- The Fed's 2025 decisions will not take into account fiscal policy changes for 2026 until these have actually been passed by Congress. So there isn't a clear reason to change from our call for gradual quarter point rate reductions to the 3 ½% range in 2025. A big enough fiscal boost in 2026 could prompt an earlier tightening cycle, but that will depend on the lags in the economic response to the measures enacted, which can be more modest and take longer for some tax cuts than for spending increases.
- Trade policy impacts are much less clear than many believe. A two-way trade war would be negative for US and global growth, and given that drag, the Fed might treat the direct impact of tariffs as a one-time upward shift in the price level rather than an ongoing inflationary force. Other than on China, the future direction of tariff policy is still very much in play.
- Long-term yields will be higher in the US than they would have otherwise, at least through early 2025 as markets weigh the risk of larger budget deficits. But rates may have already priced-in that outcome, or even overreacted, as of today. Our FICC strategy team will be putting out more detailed assessments of the impact on the US and Canadian yield curves.
- The path for the Canadian dollar will be weaker than our prior forecast, and given the uncertain fate of trade issues, forecasts for the loonie entail a wider band of uncertainty that increases the value of hedging against larger swings. We are likely to spend some time around 1.40 for dollar-CAD until there is greater clarity over tariffs and trade.

For the macro picture, the three salient issues are tax/spending changes and their impact on budget deficits and borrowing needs, trade policy, and monetary policy (including Fed appointments). We'll leave implications for on mining/oil/gas, renewable power, and other sectors to CIBC's equity research team.

Fiscal blow up? Maybe not so much

Taken at face value, Trump's platform would have added $7.8 trillion to US budget deficits over the next decade, based on an analysis by the non-partisan Committee for a Responsible Federal Budget. That's on top of a baseline, unchanged-policy outlook from the Congressional Budget Office that already saw deficits soaring to 125% of GDP. So under the Trump plan, debt/GDP would reach 143% of GDP by 2034, a significant bump up from the current path. That explains the pressure we've seen on Treasury yields, at the long end due to the additional issuance of Treasuries, and at the short end by providing economic stimulus that would limit Fed rate cuts beyond 2025.

But that could easily be an overreaction, one reason why we and our partners in CIBC FICC strategy expect long yields to head lower through the next couple of quarters. First, $3 tn of what are ascribed to the cost of the Trump plan covers extending tax cuts enacted in Trump's first term for those earning under $400K. That step had bipartisan support, and so an extension of those tax reductions should have been built into market expectations prior to the election.

Then there were tax cut ideas tossed out in the campaign to appeal to specific voting blocs without any serious analysis of their merits, or we suspect, much support in Congress. Eschewing plans for tax exemptions for overtime work, social security income or tips would pare the cost of the Trump plan by $3.5 tn. Together with the tax cut extension having already been priced-into expectations, that would reduce the upside surprise to deficits from tax cuts by roughly $6.5 tn, leaving the annual hit to budget deficits versus prior expectations of only a little over $100 bn.

True, the CRFB Trump base case included $3.7 revenue gains or spending cuts that might also not be realized, including $2.7 tn in tariff revenues that would disappear if some of these threatened tariffs are used to as negotiating chips rather than final outcomes.

But there's a sizeable wing of the Republican Party ready to bring forward other spending cuts if they attain a majority, or at least insist on seeing some reductions in exchange for tax breaks. Elon Musk has, without any details, claimed he could find $2 tn in such savings. Republicans lack the supermajority needed to override Democratic objections to major cuts to entitlements, but fiscal conservatives in the GOP House caucus might end up forcing restraints that were not in the Trump election platform. Defense spending might also be weaker given Trump's isolationist tendencies.

Trade and protectionism: The wild card

As in fiscal policy, on tariffs and other trade barriers, it's not what's said, but what ends up being implemented that will tell the tale. Remember that in Trump's first term, there was a threat to end NAFTA, but the outcome was an updated trade pact, and tariffs on Canadian steel and aluminum that were reversed after a year.

For at least the next couple of quarters, uncertainties over these outcomes could have a material impact on the Canadian economy. Trump's first term saw Canadian manufacturing sector capital spending suffer outright declines, which the Bank of Canada, supported by survey evidence, ascribed to fears of trade barriers in the US. Tariffs on steel products, imposed by the Trump administration in 2018 and removed a year later, saw a reduction in related Canadian exports that was equivalent to a 0.5% hit to nominal GDP. So there's reason to worry, but also a motivation for Canada to do what it takes to reach an amended trade deal with the US and Mexico if that allays American concerns.

Tariffs aren't a big winner for the US economy. A two-way trade war, in which US exporters face retaliatory tariffs aboard, will likely slow both global and US growth. Our base case forecast already had the US economy close to full employment in 2026. Shifting that workforce out of sectors that the US has a competitive edge, into producing goods that America can import more cheaply, is a recipe for weaker productivity and a lower level of GDP per capita.

So there's at least some chance that, as part of the Republican platform suggested, that tariffs are a negotiating tool used to extract concessions from other countries, rather than a desired policy outcome.

Monetary policy: Who decides, and what

We would downplay the threat to Fed independence that some see in a Trump victory. That might be his preference, but Senate approval is needed for Fed appointments, and any job candidate for that institution will be required to assert his or her independence and commitment to the existing dual mandate.

Powell's term as Chair will come up in early 2026, and potential successors will likely be drawn from Trump loyalists, but they will need a CV with sufficient credentials to gain Senate confirmation. Kevin Hassett is likely on a short list, as is former Fed Governor Kevin Warsh, although we judge the latter is a bit too hawkish for Trump's taste, based on his Fed record and his critique of the recent 50 bp rate cut.

Fed policy in 2025 may not be much effected by the election result. Fiscal policy changes won't kick in until 2026, and while the Fed will be mapping out scenarios, they won't be front-running fiscal policy changes until they have a good handle on when they will be implemented. The bigger challenge will be on the trade front, where in 2019, the Fed saw it prudent to take out insurance in the form of three quarter-point cuts in what Powell called a "mid-cycle adjustment". Now, the state of economy is strong and inflation has not yet fully settled back to 2%.

Tariffs will be inflationary up front, especially on the imported durable goods American's consume so much of now, but a trade war would be a drag on growth. How big and broad the tariffs are matters a lot here in terms of the Fed response. Large tariffs could mean weaker demand and price pressures over time, and if future growth expectations are dented, inflation expectations could also nudge down like we saw in 2019. The Fed won't jump to hasty conclusions and will take a careful data-dependent approach.

For 2026, as we noted above, it's not yet clear that the economy will get a material fiscal tailwind versus what we assumed in our pre-election base case. In that base case, we had the Fed on an extended pause in 2026. We'll of course be watching fiscal and trade policy decisions for their Fed implications over the coming months, but an "on hold" outlook for the back half of 2025 and all of 2026 still seems like a reasonable assumption until we know more.

Contacts:

Avery Shenfeld
avery.shenfeld@cibc.com

Benjamin Tal
benjamin.tal@cibc.com

Andrew Grantham
andrew.grantham@cibc.com

Ali Jaffery
ali.jaffery@cibc.com

Katherine Judge
katherine.judge@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
Bloomberg @ CIBC

economics.cibccm.com

CIBC Capital Markets is a trademark brand name under which Canadian Imperial Bank of Commerce ("CIBC"), its subsidiaries and affiliates (including, without limitation, CIBC World Markets Inc., CIBC World Markets Corp. and CIBC Capital Markets (Europe) S.A.) provide different products and services to our customers around the world. Products and/or services offered by CIBC include corporate lending services, foreign exchange, money market instruments, structured notes, interest rate products and OTC derivatives. CIBC's Foreign Exchange Disclosure Statement relating to guidelines contained in the FX Global Code can be found at www.cibccm.com/fxdisclosure. Other products and services, such as exchange-traded equity and equity options, fixed income securities and futures execution of Canadian securities, are offered through directly or indirectly held subsidiaries of CIBC as indicated below.

Distribution

This report is written by the economics team at CIBC Capital Markets and is not the product of a CIBC Capital Markets research department. This report is issued and approved for distribution: (a) in Canada, by CIBC World Markets Inc., a member of the Canadian Investment Regulatory Organization, the Toronto Stock Exchange, the TSX Venture Exchange and a Member of the Canadian Investor Protection Fund; and (b) in the United States, by either: (i) CIBC World Markets Inc. for distribution only to U.S. Major Institutional Investors ("MII") (as such term is defined in SEC Rule 15a-6) or (ii) CIBC World Markets Corp., a member of the Financial Industry Regulatory Authority. U.S. MIIs receiving this report from CIBC World Markets Inc. (the Canadian broker-dealer) are required to effect transactions (other than negotiating their terms) in securities discussed in the report through CIBC World Markets Corp. (the U.S. broker-dealer).

This report is provided, for informational purposes only, to institutional investor and retail clients of CIBC World Markets Inc. in Canada and does not constitute an offer or solicitation to buy or sell any securities discussed herein, including (without limitation) in any jurisdiction where such offer or solicitation would be prohibited.

The distribution of this report in the United Kingdom is being made only to, or directed only at, persons falling within one or more of the exemptions from the financial promotion regime in section 21 of the UK Financial Services and Markets Act 2000 (as amended) ("FSMA") including, without limitation, to the following:

- authorised firms under FSMA and certain other investment professionals falling within article 19 of the FSMA (Financial Promotion) Order 2005 ("FPO") and directors, officers and employees acting for such entities in relation to investment;
- high value entities falling within article 49 FPO and directors, officers and employees acting for such entities in relation to investment; and
- persons who receive this presentation outside the United Kingdom.

The distribution of this report to any other person in the United Kingdom is unauthorised and may contravene FSMA. No person falling outside such categories should treat this report as constituting a promotion to them or rely or act on it for any purposes whatsoever.This report is distributed solely to eligible counterparties or professional clients and not retail clients as defined in point (8) of Article 2 of Regulation (EU) No 2017/565 as it forms part of UK domestic law by virtue of the European Union (Withdrawal) Act 2018.

For all other jurisdictions, this report is distributed solely to institutional clients and not retail clients as defined by the applicable securities legislation and regulation to which CIBC Capital Markets may be subject in any jurisdiction.

Miscallaneous

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of CIBC. Before making an investment decision on the basis of any information contained in this report, the recipient should consider whether such information is appropriate given the recipient's particular investment needs, objectives and financial circumstances. CIBC suggests that, prior to acting on any information contained herein, you contact one of our client advisers in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

The information and any statistical data contained herein were obtained from sources that we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. All estimates and opinions expressed herein constitute judgments as of the date of this report and are subject to change without notice.

This report may provide addresses of, or contain hyperlinks to, Internet web sites. CIBC has not reviewed the linked Internet web site of any third party and takes no responsibility for the contents thereof. Each such address or hyperlink is provided solely for the recipient's convenience and information, and the content of linked third-party web sites is not in any way incorporated into this document. Recipients who choose to access such third-party web sites or follow such hyperlinks do so at their own risk.

Unauthorized use, distribution, duplication or disclosure without the prior written permission of CIBC World Markets Inc. is prohibited by law and may result in prosecution.

CIBC Capital Markets and the CIBC Logo Design are trademarks of CIBC, used under license.