Economics

ECONOMIC INSIGHTS

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Economic growth: Assessing the upside from here

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In economics, pleasant surprises needn't beget more of the same. The faster the economy advances, the closer we get to the ceiling posed by its non-inflationary capacity. Given what we're already seeing on inflation, is the optimistic consensus view on North American growth achievable? Or does what we know about Covid also make it a challenge to even reach that non-inflationary ceiling? We have our doubts on both those fronts.

As of January, the consensus had the US economy averaging 4% growth in 2022 and 2.6% in 2023. The Fed was also optimistic, with its average quarterly growth rate consistent with a roughly 4.3% pace for 2022 as a whole. But note that the FOMC anticipates a deceleration to about half that pace in 2023, a reminder from the central bank that the economy has to decelerate to avoid blowing through its non-inflationary limits. Indeed, the 175 bps in Fed hikes we have in our forecast for 2022-23 (Table 2) are aimed at doing just that, with further hikes to the mid-2% range the following year.

The consensus for Canada, as well as the Bank of Canada's projection, sits at roughly 4% growth this year. The Bank is about a half percent above consensus in looking for a 3.5% gain in 2023. That would be two solid years by historical standards, but we question whether there's enough in demand to achieve that pace, and if we somehow managed to do so, whether it would be consistent with a sustained deceleration in inflation.

That questioning has our GDP forecasts generally below consensus and about ½% lower than the Bank of Canada's outlook for Canada in each of the next two years (Table 1). And after a projected 4.0% US pace in 2022, somewhat lower than the Fed's, we've taken a small haircut to our US 2023 growth outlook to call for a slowing to 2.7% in 2023 due to the reasoning outlined in this paper.

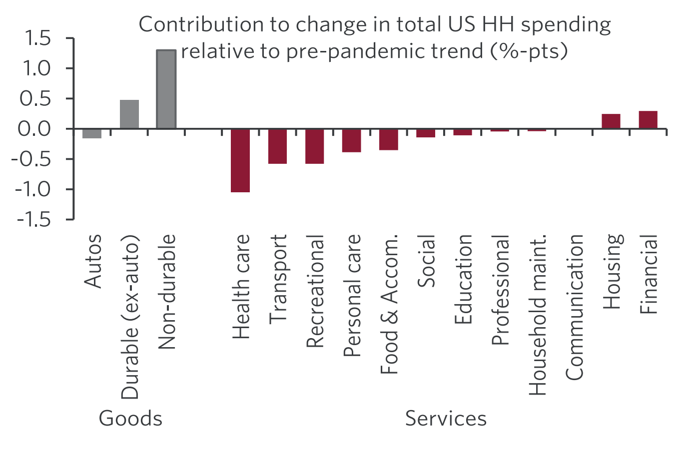
A pi in the face

In both the US and Canada, everyone is counting on the service sector to be the major driver for consumer demand ahead. While vehicles and appliances are on order backlog, some durables demand has already been sated (exercise bike anyone?), and goods producers need time to expand capacity. But it's in services where slack is evident to the naked eye, in empty hotel rooms, lightly filled theatres, empty bar stools, and planes pulled out of service on tarmacs.

In the US, that's quite evident in how various elements of consumer spending have fared relative to their historical trend (Chart 1). Auto sales show the impact of production delays, but other durable and non-durable goods are off the charts. In contrast, there's been broadly-based below trend growth in services. Most of that is where you would expect, in restaurants, hotels, transportation, and other high touch services. The missing health care spending might raise a few eyebrows given hospitals crowded with Covid patients, but non-emergent procedures were squeezed out of such hospitals, and Americans also shied away from routine visits to family doctors and dentists during the worst of the pandemic.

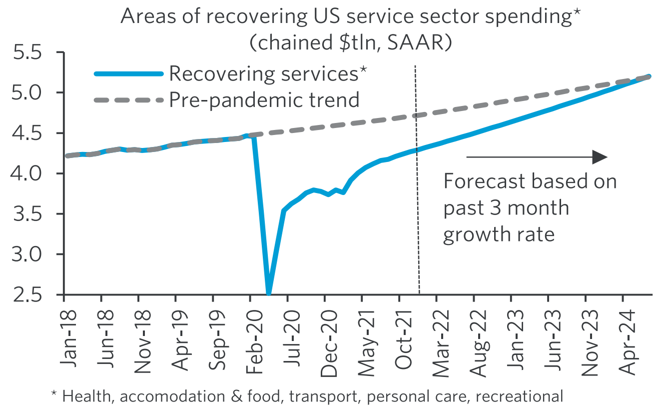
Of importance for assessing the potential for further growth as Omicron-driven case numbers subside, it should be noted that the recovery in these hard-hit services sectors had slowed even

Chart 1: Still plenty of US spending ground to make up in services



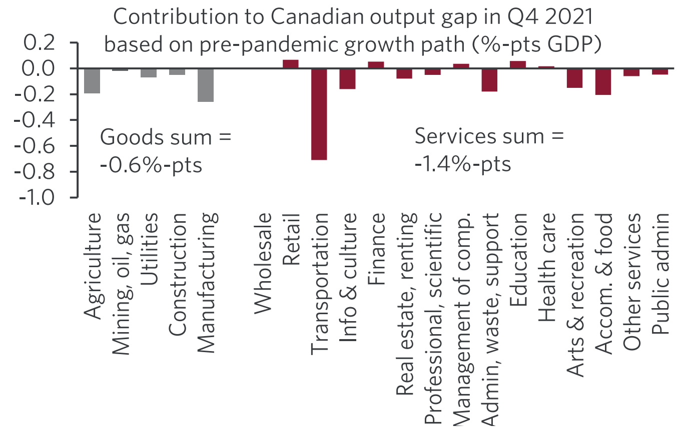
Source: BEA, CIBC

Chart 2: Services recovery has slowed even prior to Omicron



Source: BEA, CIBC

Chart 3: Canadian services still showing largest gap relative to pre-pandemic trends



Source: Statistics Canada, CIBC

before case numbers started to rise again in December. Indeed, at the growth pace seen in Q4 last year it would take until mid-2024 for spending on such services to return to their pre-pandemic trend (Chart 2). Remember that for the US economy this slowing recovery in services spending wasn't a reflection of continued restrictions, but rather caution among some consumers as well as the still limited recovery in tourism with Covid cases still uncomfortably high.

In Canada, just before the Omicron wave, November GDP by industry had finally edged slightly above its February 2020 level. But that's far from a victory, since the economy would in normal times have continued to grow over that nearly two-year period. Chart 3 measures how much each industry has fallen short of its prior trend's contribution to growth since the pandemic began. It's scaled so that the total shortfall aligns with the Bank of Canada's estimate of the gap to the economy's non-inflationary potential, including the ground that would be available if temporary supply bottlenecks disappear, as the Bank expects it will by the end of this year.

The easing of supply shortages for parts and materials should allow the missing ground to be made up in sectors like manufacturing and construction, and a better harvest year would get agriculture back on track. But much of what remains lies in room to grow in services, particularly in transportation (trains, planes, buses and so on), hospitality, and other activities that see pull backs during Covid waves.

Such services are again reopening in Canada after Omicron restraints. But beyond a better spring what lies ahead? The nearest potential for a growth disappointment would come from a Pi in the face of consumer demand. That's the next Greek letter designated for use by the WHO in naming variants of concern after Omicron. Epidemiologists think it's largely a matter of when, not if, we will face future variants, and the concern would be the arrival of one that, like Omicron, had sufficiently mutated to at least partially evade the immunity provided by existing vaccines or prior Covid infections. That could be a few months off, or next year. Nobody can say.

True, economic growth was robust in 2021 despite fresh Covid waves. But it's less easy to repeat that success when so much of the growth potential lies in services. If Covid delayed the delivery of a new refrigerator in one quarter, it would simply defer that same consumption into the next quarter. But that's not as evident in services. Twenty gym classes missed in December and January due to Covid won't be added to one's schedule for March. A hockey game played to an empty arena due to health restrictions doesn't double attendance at a subsequent game post reopening. These slow spots needn't entail government edicts, but could capture consumer caution and businesses shying away from corporate travel or holding large events.

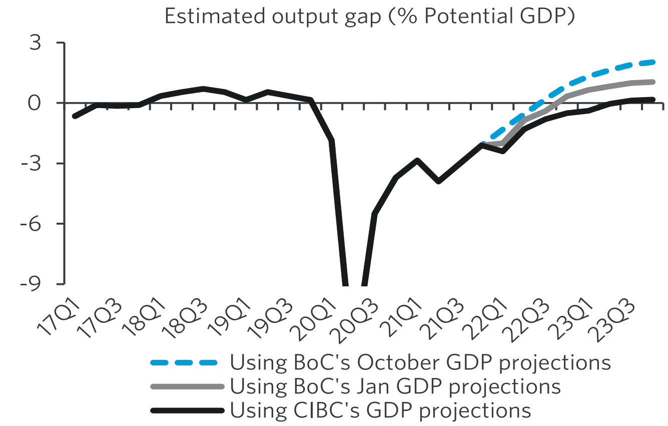
So the economy can end up at the same final place two years from now, but during periods in which a Pi, or Rho variant hits, it will have a soft month or quarter. The result is that when GDP is added up for the year, its average level will have a dent in it, which would show up in the annual growth rate. As a case in point, a hotel could indeed be full at some points in the year if all goes fairly well on Covid, but still fall short of an average year for occupancy if there are other waves ahead.

Too good to be disinflationary

Setting aside those bumps along the way, we can also focus on the level of real GDP that forecasters are expecting to reach by the end of 2023. The commitment of both the Fed and Bank of Canada to restore 2% inflation by then stands as the key constraint on how fast their economies can run.

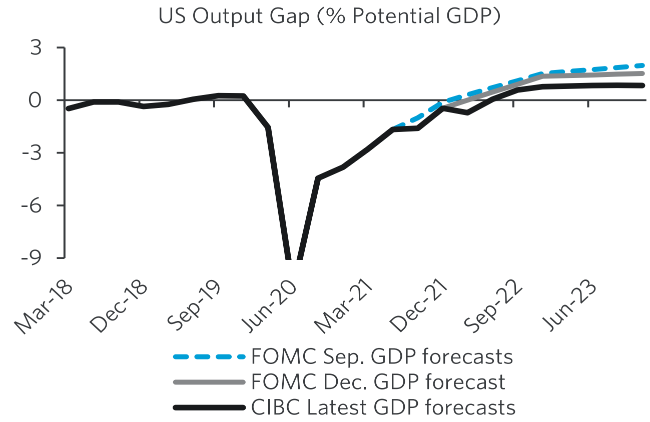
Oddly, the Bank of Canada's own forecast looks a tad hot given that constraint. Its forecast for the level of GDP, even after the latest downgrade, appears to take it sufficiently above its

Chart 4: Even downgraded BoC forecasts would leave positive output gap by end 2023



Source: Bank of Canada, CIBC

Chart 5: US Output gap almost in positive territory already



Source: CBO, Federal Reserve, CIBC

projection for potential GDP that the resulting output gap could be maintaining some excess inflation pressure, even if supply chain issues have abated (Chart 4). In contrast, our more moderate growth outlook would leave the economy running roughly at potential.

Remember as well that the BoC's estimate for the economy's non-inflationary potential next year assumes that all of the constraints coming from supply chain issues are fully resolved by 2023. That might be true in a world in which Covid vanishes, but is less obvious if factories, ports and warehouses in Canada, or even in China, continue to face worker absenteeism during future Covid outbreaks.

Of course, there isn't that much precision in the figures for potential, and upside surprises to productivity or labour force growth could leave more elbow room for non-inflationary growth. But our point is that this far into the cycle, being optimistic on growth, while also expecting underlying inflation to melt away, is getting close to having your cake and eating it too.

These same risks underly some of the more optimistic projections for US growth if they are to be consistent with getting inflation under wraps. Indeed, we've opted to pare back our 2023 forecast by a couple of ticks to 2.7% to account for the deceleration needed to calm the inflation waters.

Being less plagued by Covid-related restraints (due to greater hospital capacity, and a political leaning that in effect tolerated much higher death rates), the US economy saw less GDP downside in 2020 and has powered back close to full potential much faster. CBO estimates for potential GDP growth are more optimistic than the BoC's for Canada, but even with that higher bar the gap is already almost closed. While Omicron could see a step back in Q1, the Fed's forecasts would see output rising well above potential over the forecast horizon (Chart 5).

Given the current focus on inflation, we see the need to moderate growth and calm price pressures as the target that the Fed has in its sights, rather than the FOMC's median growth forecasts. As a result, even if supply-driven hits to inflation ease off, growth might have to be on a disappointing side relative to consensus projections to allow the core PCE price index to stay in the 2% range in 2023 and beyond.

Market implications: A few disappointments

Equity investors don't typically distill their earnings expectations by starting with the economy's overall growth rate and filtering that down to one stock at a time. The industry weights of the equity market differ widely enough from their weight in the economy to preclude that. But investors need to consider the extent to which the goods sector's growth rate has to be capped to leave room for a services recovery in a world in which central banks will be putting a ceiling on the overall pace of the expansion, as well as the risks of softer months for some services during Covid waves ahead.

For the fixed income market, none of this says that the path of rate hikes has to necessarily exceed market expectations to achieve the needed growth deceleration. The economy could be more sensitive to higher rates, or quantitative tightening could provide more of a boost to yields than what the consensus assumes. Covid could also be a more lasting headwind as a substitute for some hikes in the near term.

But the evidence from the last cycle points to a neutral rate in the 2.0-2.5% range in both the US and Canada, and that's the best available guide on where rates should sit come 2024 if Covid is well under control at that point. If so, the market is not only a bit too optimistic on growth, but further out, not allowing for enough of a climb in the fed funds rate to keep the American economy below its non-inflationary growth ceiling.

Table 1: Canada forecast detail (real % change, SAAR, unless otherwise noted)

Variable	21Q4F	22Q1F	22Q2F	22Q3F	22Q4F	23Q1F	23Q2F	23Q3F	2021F	2022F	2023F
Real GDP Growth (AR)	6.3	0.4	6.2	3.7	3.0	2.3	3.4	2.7	4.7	3.5	3.1
Real Final Domestic Demand (AR)	3.2	-0.1	3.6	3.8	3.5	3.0	3.5	2.8	5.3	2.6	3.3
Household Consumption (AR)	3.8	-1.7	3.8	4.6	4.8	4.1	5.1	3.9	5.3	3.9	4.4
All Items CPI Inflation (Y/Y)	4.7	4.9	3.7	2.7	2.0	1.7	1.9	2.0	3.4	3.3	1.9
Unemployment Rate (%)	6.3	6.4	5.9	5.7	5.6	5.6	5.6	5.6	7.4	5.9	5.6

Table 2: US forecast detail (real % change, SAAR, unless otherwise noted)

Variable	21Q4A	22Q1F	22Q2F	22Q3F	22Q4F	23Q1F	23Q2F	23Q3F	2021A	2022F	2023F
Real GDP Growth (AR)	6.9	1.1	5.4	4.3	2.9	2.2	2.2	2.1	5.7	4.0	2.7
Real Final Sales (AR)	1.9	2.3	5.3	4.0	2.3	2.3	2.5	2.3	5.4	3.1	2.7
All Items CPI Inflation (Y/Y)	6.7	7.1	5.4	3.9	2.2	1.6	1.5	2.0	4.7	4.6	1.9
Core CPI Inflation (Y/Y)	5.0	6.1	5.0	3.8	2.5	1.9	1.6	2.1	3.6	4.3	2.1
Unemployment Rate (%)	4.2	4.0	3.7	3.5	3.5	3.5	3.5	3.5	5.4	3.7	3.5

Table 3: Canadian interest rates (end of period)

Variable	2022 7-Feb	2022 Mar	2022 Jun	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
Overnight target rate	0.25	0.50	0.75	1.00	1.25	1.25	1.50	1.75	1.75
98-Day Treasury Bills	0.33	0.45	0.70	0.95	1.00	1.20	1.45	1.70	1.75
2-Year Government Bond	1.35	1.40	1.60	1.70	1.85	1.85	1.90	2.15	2.20
10-Year Government Bond	1.85	2.00	2.10	2.15	2.25	2.30	2.35	2.40	2.40
30-Year Government Bond	2.10	2.15	2.30	2.35	2.35	2.40	2.45	2.40	2.45
Canada - US T-Bill Spread	0.10	0.10	0.05	0.05	-0.15	-0.15	-0.15	-0.10	-0.10
Canada - US 10-Year Bond Spread	-0.07	0.00	0.00	0.00	0.05	0.05	0.05	0.05	0.00
Canada Yield Curve (10-year — 2-year)	0.51	0.60	0.50	0.45	0.40	0.45	0.45	0.25	0.20

Table 4: US Interest rates (end of period)

Variable	2022 7-Feb	2022 Mar	2022 Jun	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
Federal funds rate	0.125	0.375	0.625	0.875	1.125	1.375	1.625	1.875	1.875
91-Day Treasury Bills	0.24	0.35	0.65	0.90	1.15	1.35	1.60	1.80	1.85
2-Year Government Note	1.31	1.20	1.40	1.60	1.80	2.00	2.15	2.30	2.40
10-Year Government Note	1.93	2.00	2.10	2.15	2.20	2.25	2.30	2.35	2.40
30-Year Government Bond	2.23	2.20	2.30	2.40	2.50	2.55	2.60	2.65	2.70
US Yield curve (10-year — 2-year)	0.62	0.80	0.70	0.55	0.40	0.25	0.15	0.05	0.00

Table 5: Foreign exchange rates

Exchange rate	2022 7-Feb	2022 Mar	2022 Jun	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
CAD-USD	0.79	0.78	0.77	0.76	0.76	0.76	0.76	0.77	0.78
USD-CAD	1.27	1.28	1.30	1.32	1.31	1.31	1.31	1.30	1.29
USD-JPY	115	115	116	115	114	113	112	111	110
EUR-USD	1.14	1.12	1.11	1.10	1.10	1.11	1.12	1.13	1.15
GBP-USD	1.35	1.34	1.33	1.33	1.33	1.33	1.33	1.35	1.36
AUD-USD	0.71	0.73	0.74	0.75	0.76	0.76	0.77	0.77	0.78
USD-CNY	6.36	6.30	6.25	6.20	6.15	6.10	6.05	6.00	5.95
USD-BRL	5.31	5.70	5.70	6.00	5.70	5.90	5.70	5.50	5.30
USD-MXN	20.6	21.0	21.5	22.0	21.5	21.0	21.5	21.3	21.5

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