Economics
FORECAST

September 12, 2024

Declaring victory, reaping the rewards

by **Avery Shenfeld** avery.shenfeld@cibc.com

In the battle against inflation, central bankers in the US and Canada are set to declare victory, and investors and the broader economy will reap the rewards. Canada's CPI sits at 2.5%, and the remaining gap to 2% would be closed by bringing mortgage rates down and reducing the CPI component tied to mortgage interest. In the US, we're not quite there yet, as the core PCE price index likely stood at 2.7% in August, but that includes a lagging estimate of rent inflation that should catch up to the moderation already seen in more current measures.

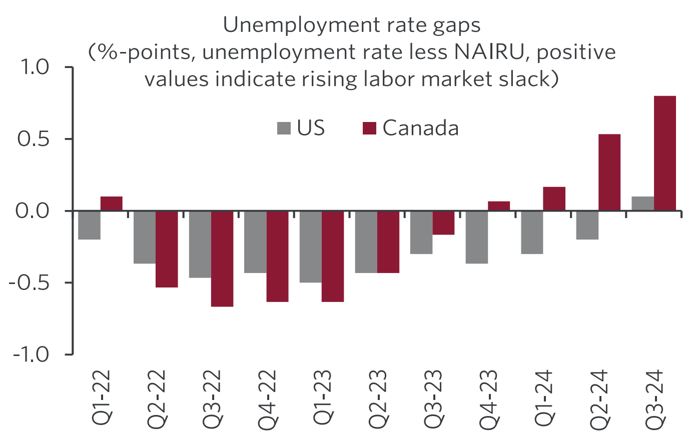
When inflation is somewhat troubling and interest rates are already moderate, you need a lot of economic pain to induce a major drop in interest rates. But with inflation soon to be vanquished, and real interest rates still at restrictive levels, there's no logical reason for central bankers to move too cautiously to provide relief. Both countries are now looking at a softening jobs market that they don't really want or need. So cutting rates materially is really a no brainer.

If we give the central bankers advance credit for doing the right thing, that leaves only two remaining issues for forecasters: how much elbow room there is for a non-inflationary acceleration in growth, and where policy rates will need to sit to take us there. We're not coming out of a deep recession, so that elbow room is more limited, not just in North America, but globally. China remains stuck in a lower gear due to lacklustre domestic demand and headwinds from protectionism elsewhere, and Europe hasn't drifted that far from full employment.

So without a lot of slack today, global growth can't be stellar in the next two years (Table 1), even as central banks ease policy. That has some implications for industrial commodities prices and related equities. While we expect some upside in energy and materials as global demand picks up deeper into 2025, barring supply shocks, the climb will be much more modest than would be the case in a recovery from a deep recession.

For North America, the room for a growth pickup will be tied to what we can squeeze out of the economy while closing the output gap. Measuring that gap in GDP terms has been challenging due to swings on the supply side. But looking at where the unemployment rate now stands versus its full-employment level underscores what the difference in economic performance in the last two years has made clear: Canada has more ground to make up than the US (Chart 1).

Chart 1: Canada has more labour market slack



Source: Statistics Canada, BEA, BLS, CBO, CIBC

That's a prima facie case for the Bank of Canada to take rates lower than where the Fed will have to aim. Moreover, we still face the oft-cited headwind in Canada due to mortgage renewals in the next two years, and the drag from greater household sector indebtedness. Indeed, the weakening labour market in recent months has us lowering our target for Canada's overnight rate by a further quarter point, to 2.25%, which is about a half point below the neutral rate. But to stay out of a recession, we'll also need to accelerate the pace at which the central bank will take us there. After a quarter point cut in October, we now see two half point steps in December and January (Table 2). That's in contrast to a prior forecast that had rates easing at 25 bps at a time, and we no longer expect any pauses on the path to less restrictive rates.

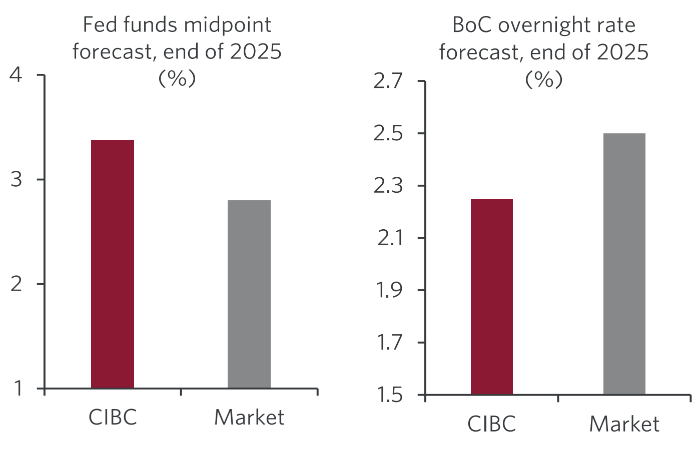
Stateside, the US economy's greater resilience in the face of overnight rates over 5%, and its smaller gap to full employment, suggests that the Fed has less work to do. It too seems likely to try to front load more of the rate cuts than we earlier thought, given a bit more fragility in the labour market. So while we've kept our target for the Fed funds rate unchanged from our prior forecast, we've allowed for two 50 bp cuts following a likely quarter point move this month.

The gap between Canadian and US short rates would typically be a negative for the Canadian dollar and we could still see some short term softness for the loonie this year if the Fed sticks to only a quarter point cut in September. But we see the C$ poised for a modest firming thereafter, driven by a correction in what is now an over-valued US dollar against most major currencies as the Fed cuts rates and the dollar's flight to safety value erodes with diminished global recession risks.

While both Canada and the US will deliver significant monetary medicine at the short end of the yield curve, the benefits to longer term yields will soon be behind us. Already, markets may be overdoing the pace at which the Fed will ease policy (Chart 2), given that the US economy is still tracking close to 2% growth in Q3, and as noted, its labour market has less visible slack. So while Treasuries could rally in the near term, as the Fed speeds up the pace of rate cuts, a sell-off seems likely in 2025 as markets nudge up their expectations for where short term rates will come to a rest. History suggests that the easing cycles that accompany true soft landings typically don't take overnight rates below neutral, and the yield curve should be positively sloped once investors judge that short rates have bottomed.

While overnight OIS futures suggest a bit of room for the Bank of Canada to cut rates faster than markets are expecting in the next couple of quarters, further out, there might again be some disappointments in store for bond investors. Two years from now, forward markets are pricing in a one-year rate of 2.3%, essentially on top of where we see the lows in overnight yields. Supply could be another factor adding to pressure on rates in both countries, although with a US election now in play, and one in store for Canada no later than 2025, the fiscal outlook isn't set in stone at this point. Bonds still offer value as a portfolio hedge, since if central banks don't move soon enough to cut rates, the economic damage could not only dent equities, but require a deeper easing in monetary policy to bring the economy back to life.

Chart 2: Fed and BoC: CIBC forecasts versus market expectations for 2025



Source: Bloomberg, CIBC

The economic rewards from lower interest rates will show up initially by stanching the bleeding in the labour market, with only a few ticks of upside in the unemployment rate from here, and then a return to full employment in 2026. Both countries could see slowing population growth that will impact the non-inflationary GDP ceiling, but Canada could have an offset from an overdue recovery in productivity (see pages 9-11), after a period in which soft demand led to outright declines in output per hour. As a result, the Bank of Canada has latitude to bring interest rates to a level that allows for at least a year of growth that's well above potential (Table 2), particularly come 2026 when we'll see the full impact of rate cuts show up in housing and other interest sensitive sectors.

In the US, there's less headroom for employment gains and less reason to expect an acceleration in productivity, since neither has been as anemic as what we've seen in Canada. Job growth will not only be limited by a likely crackdown on undocumented immigration, but also by the fact that labour force participation has already seen strong gains. The result is that Canada could see a period in which GDP growth outpaces what we expect south of the border. But sustaining that beyond 2026 will require Canada to sustain that productivity recovery, a challenge given that we've had decades of trailing the US on that measure.

If equity markets are already pricing in all of the Fed rate cuts in terms of the discount factor on forward earnings, and aren't building in a recession, is there any room for stocks to climb at this point? While we likely face some near term jitters on fears of economic weakness, these could fade if central banks deliver some timely medicine. Cyclical stocks could then get a bit of a lift, if not quite what we see coming out of a recession, as risks to global growth diminish with interest rate cuts.

US valuations don't look that high if one looks beyond the handful of tech giants that drove much of Wall Street's rally, and global equities, including those in Canada, have seriously underperformed the US market. Moreover, there's a flow of funds channel that can kick in as short-rates fall further, even if these declines are already well-anticipated. Households and pension funds channeled more money into low risk but high yielding GICs and money market paper when real rates reached generous levels. As these mature, in the face of much less generous reinvestment opportunities in the fixed income space, some of that could be channeled into dividend-paying equities.

We're still forecasting behind the cloud of significant political uncertainties. US trade policy poses a risk to Canada, fiscal deficits could pressure bond yields if not contained, and we're counting on wars raging in Europe and the Middle East to be contained to their current geographies. But with inflation cooling globally, central banks can now be important players in countering downside risks to growth.

Table 1: Real GDP growth rates

Region	2019A	2020A	2021A	2022A	2023A	2024F	2025F	2026F
World[1]	2.8	-2.7	6.5	3.5	3.3	3.0	2.9	3.1
US	2.5	-2.2	5.8	1.9	2.5	2.6	1.7	2.4
Canada	1.9	-5.0	5.3	3.8	1.2	1.1	1.8	2.7
Euroland	1.6	-6.1	6.2	3.3	0.4	0.7	1.5	1.7
UK	1.7	-10.4	9.6	4.5	0.1	0.9	1.2	1.5
Australia	1.8	-2.1	5.6	3.9	2.0	1.2	1.9	2.2
Japan	-0.4	-4.2	2.7	1.2	1.7	0.2	1.2	1.0
China	6.0	2.2	8.4	3.0	5.2	4.6	4.2	4.0

[1] At purchasing power parity.

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

Variable	2023A	2024F	2025F	2026F
GDP at market prices	2.8	3.9	3.9	5.2
GDP in $2012	1.2	1.1	1.8	2.7
Consumer price index	3.9	2.4	1.7	1.9
Unemployment rate	5.4	6.4	6.4	5.8
Current account balance (C$ Bn)	-21.0	-29.7	-31.0	-24.8
Pre-tax profits (net operating surplus)	-22.5	-4.5	6.0	10.3
Housing starts (K)	242	252	263	291

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

Variable	2023A	2024F	2025F	2026F
GDP at market prices	6.3	5.1	3.9	4.3
GDP in $2012	2.5	2.6	1.7	2.4
Consumer price index	4.1	2.9	2.2	2.5
Unemployment rate	3.6	4.1	4.4	4.3
Current account balance (US$ Bn)	-905	-939	-847	-947
Pre-tax profits (with IVA/CCA)	1.5	5.4	3.3	3.7
Housing starts (K)	1,421	1,367	1,466	1,655

Table 4: Canadian interest rates (end of period)

Variable	2024 11-Sep	2024 Dec	2025 Mar	2025 Jun	2025 Sep	2025 Dec	2026 Jun	2026 Dec
Overnight target rate	4.25	3.50	2.75	2.25	2.25	2.25	2.25	2.25
98-Day Treasury Bills	4.03	3.40	2.60	2.10	2.00	2.00	2.15	2.15
2-Year Government Bond	2.99	2.75	2.45	2.25	2.45	2.60	2.80	3.00
10-Year Government Bond	2.88	2.90	2.90	2.95	3.00	3.10	3.15	3.40
30-Year Government Bond	3.05	3.20	3.15	3.10	3.15	3.20	3.25	3.45
Canada - US T-Bill Spread	-0.96	-0.50	-0.80	-1.10	-1.25	-1.25	-1.15	-1.25
Canada - US 10-Year Bond Spread	-0.75	-0.75	-0.65	-0.55	-0.45	-0.40	-0.45	-0.40
Canada Yield Curve (10-year — 2-year)	-0.11	0.15	0.45	0.70	0.55	0.50	0.35	0.40

Table 5: US Interest rates (end of period)

Variable	2024 11-Sep	2024 Dec	2025 Mar	2025 Jun	2025 Sep	2025 Dec	2026 Jun	2026 Dec
Federal funds rate (midpoint)	5.375	4.125	3.625	3.375	3.375	3.375	3.375	3.375
91-Day Treasury Bills	4.99	3.90	3.40	3.20	3.25	3.25	3.30	3.40
2-Year Government Note	3.59	3.35	3.25	3.10	3.15	3.20	3.35	3.60
10-Year Government Note	3.63	3.65	3.55	3.50	3.45	3.50	3.60	3.80
30-Year Government Bond	3.95	4.05	4.00	3.95	4.00	4.20	4.35	4.50
US Yield curve (10-year — 2-year)	0.04	0.30	0.30	0.40	0.30	0.30	0.25	0.20

Table 6: Foreign exchange rates

Exchange rate	2024 11-Sep	2024 Dec	2025 Mar	2025 Jun	2025 Sep	2025 Dec	2026 Jun	2026 Dec
CAD-USD	0.74	0.74	0.75	0.75	0.76	0.76	0.76	0.76
USD-CAD	1.36	1.35	1.34	1.33	1.32	1.32	1.31	1.31

US Outlook: Tapping the brakes

by Ali Jaffery ali.jaffery@cibc.com

For several quarters now, the talk has been about a soft landing. 2025 feels like the year where the rubber hits the road and those predictions will finally be tested. While the US economy has decelerated, businesses are tapping, but not slamming, on the brakes. The labor market has cooled materially, risking a slowing in the one consistent source of momentum, consumption, as the rest of the economy has been very lackluster for some time now. Facing tamer inflation, the Fed can deliver a timely push back to a neutral stance that will ultimately cushion the fall, bolstering interest-sensitive sectors like housing and durables manufacturing.

That will still see growth slowing from the strong 2.6% pace in 2024, which is where we believe potential output growth was around in the year, to 1.7% in 2025 and then rebounding to 2.4% in 2026 (Table 1). The deceleration will take the economy below its 2.2% potential growth rate for 2025, which will increase economic slack and see the jobless rate hitting a peak of 4.6% by the middle of next year. After that, the economy should start to turn the corner on the lagged impacts of lower rates, with slack gradually dissipating and growth accelerating in 2026. Headline inflation could fall below the 2% target early next year due to widening slack and lower oil prices, but return sustainably to the Fed's target in 2026 as the labor market moves back to full employment.

We are no longer accepting applications

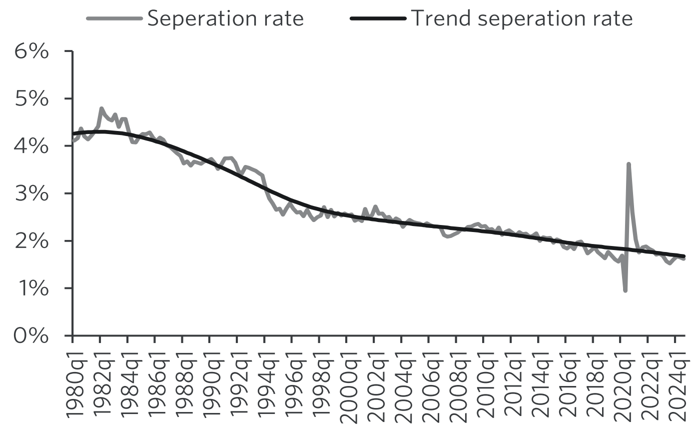
The big buzz right now is the job market, and it's the centerpiece of our US outlook this year. Some, including Fed speakers, have taken false comfort from the fact that the rise in US unemployment has reflected a decline in hiring and very little firing. It's argued that the labor market isn't yet deteriorating, but simply normalizing. The argument goes that firms, after staffing up a lot in the post-pandemic recovery, are no longer accepting new applications but still comfortable enough not to let workers go.

The problem with that view is that it ignores the history of what drives joblessness. Outside of sudden events like the financial

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

Indicator	24:2A	24:3F	24:4F	25:1F	25:2F	25:3F	25:4F	2024F	2025F	2026F
GDP at market prices ($Bn)	28,652	28,946	29,207	29,480	29,737	30,016	30,317	28,769	29,888	31,163
% change	5.5	4.2	3.6	3.8	3.5	3.8	4.1	5.1	3.9	4.3
Real GDP ($2012 Bn)	22,925	23,038	23,119.4	23,209.5	23,296.2	23,403.7	23,522.4	22,960	23,358	23,880
% change	3.0	2.0	1.4	1.6	1.5	1.9	2.0	2.6	1.7	2.4
Final sales	2.2	2.3	1.7	1.6	1.8	1.7	1.9	2.6	1.8	2.4
Personal consumption	2.9	2.2	1.2	0.8	1.3	1.1	0.9	2.3	1.3	1.5
Total government expenditures	2.7	1.0	1.0	1.5	1.5	1.5	2.0	2.9	1.4	2.0
Residential investment	-2.1	2.0	4.0	4.0	5.0	7.0	7.0	5.1	4.1	5.0
Business fixed investment	4.6	2.7	1.5	2.3	3.0	3.1	3.8	3.7	2.6	5.0
Inventory change ($2012 Bn)	69.0	54.3	39.3	39.3	24.3	34.3	44.3	47.8	35.6	44.3
Exports	1.6	3.3	6.0	5.3	4.3	3.6	4.8	2.5	4.5	4.8
Imports	7.0	1.5	2.2	2.0	3.0	2.9	3.0	3.6	2.6	3.0
GDP Deflator	2.3	2.1	2.2	2.2	2.0	1.9	2.0	2.5	2.1	2.0
CPI (yr/yr % chg)	3.2	2.5	2.6	1.9	2.3	2.3	2.5	2.9	2.2	2.5
Core CPI (yr/yr % chg)	3.4	3.1	2.9	2.4	2.2	2.2	2.3	3.3	2.3	2.4
Unemployment rate (%)	4.0	4.3	4.4	4.5	4.6	4.3	4.2	4.1	4.4	4.3
Housing starts (AR, K)	1,340	1,347	1,374	1,401	1,436	1,487	1,539	1367.1	1465.9	1655.1

Chart 1: An aging workforce has led to a secular decline in firing behavior, also known as the separation rate



Note: Separation rate calculated based on methodology laid out in Shimmer (2012)

Source: BLS, CIBC calculations

crisis and the pandemic, it has been a downturn in hiring that presages a rise in the jobless rate, rather than an increase in firing.

In fact, since the 1980s, there has been a secular decline in the separation rate, which measures firing behavior (Chart 1). That decline has been largely attributed to population ageing (Crump et al, 2019). Older workers have more experience and specialized skills, and decades of anemic population growth mean there are fewer workers around to replace them easily. All of that adds up to making firing a very costly choice for many businesses, one that isn't widespread unless the economy is already in a full blown recession.

Declining hiring, expressed in a falling job-finding rate, has been the main driver and a leading indicator of joblessness over economic cycles (Chart 2). Even in major shocks, mass layoffs occur briefly and it's slow hiring that ultimately keeps the jobless rate elevated thereafter.

So we find this talk about lower hiring being part of a "normalization" as somewhat misguided, and risks missing the forest for the trees. Hiring has been falling off very quickly since 2023, and in an economy with a plentiful supply of workers, it's a matter of when and not if the labor market shows slack.

We're predicting the Fed will soon recognize that after another bad job report or two, and will aggressively ease policy to support the economy. But the lags in monetary policy impacts will mean that the job-finding rate will only begin to stabilize by the end of this year, and the unemployment rate will take longer to start improving.

Boiling the frog

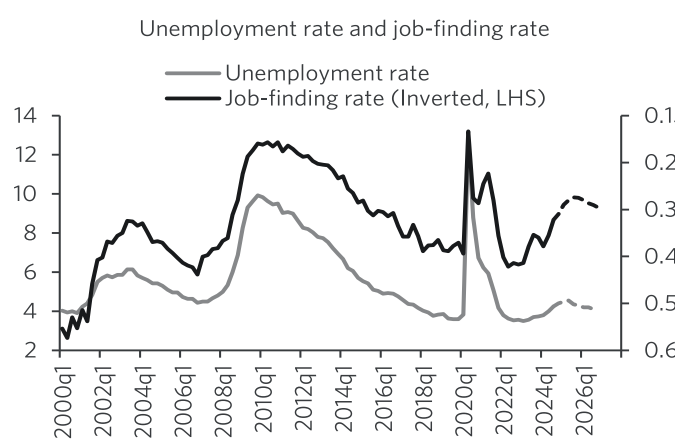
After the job market, the biggest question mark for the outlook is how much growth will slow, and in particular, where does the consumer land next year.

We've argued very early on that there is more going on with consumption than meets the eye, with elevated wealth and WFH pushing durable goods consumption to a new trend level (See How boomers and work-from-home changed American spending patterns). But those forces look like they don't have much juice left, and as the job market heads in the wrong direction, consumers' spending power will be further crimped. The consumer is already burning the candle at both ends with the saving rate close to near-rock bottom lows.

Spending could also take a hit from slower population growth. Border patrol activity suggests that the surge in illegal immigration, which the CBO predicted would not ease materially until 2026, is already slowing rapidly (Chart 3). The Democrats are clearly doing everything it takes to contain a porous border in a tight election race. Population growth could be cut in half by late next year, taking some of the steam out of consumption.

What's less talked about is how the rest of economy has performed, which is far below its pre-pandemic trend (Chart 4)

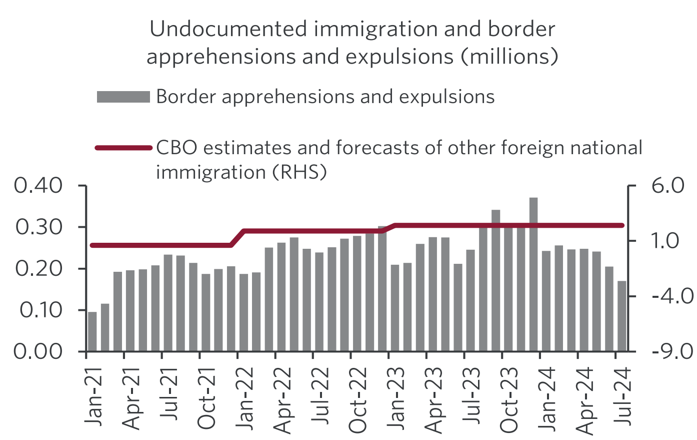
Chart 2: Hiring is highly cyclical and what ultimately leads the jobless rate



Note: Job-finding rate calculated based on methodology laid out in Shimmer (2012)

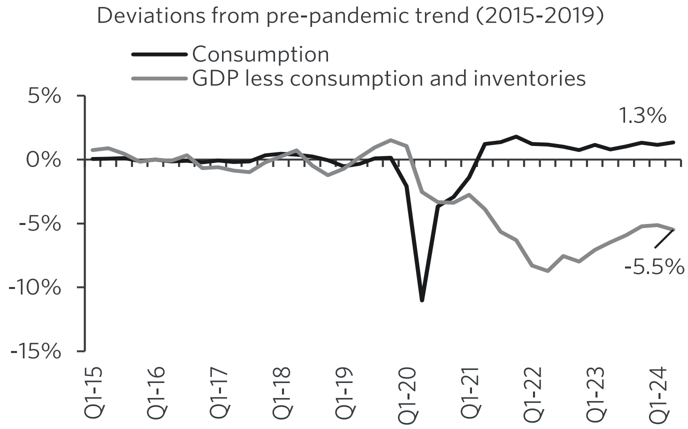
Source: BLS, CIBC calculations

Chart 3: Border patrol activity suggest undocumented immigration could be slowing sharply



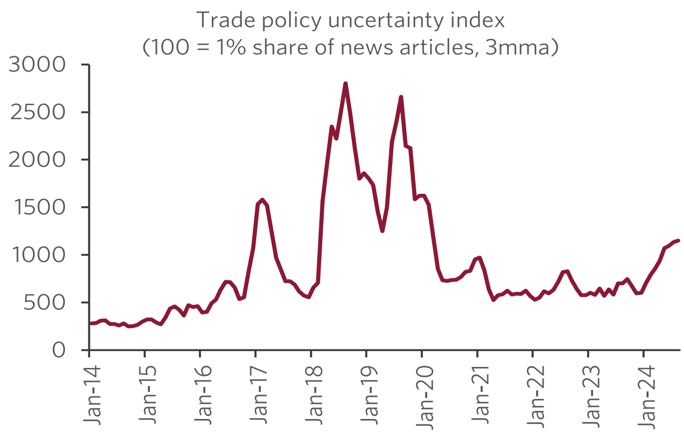
Source: US Customs and Border Protections, Congressional Budget Office, CIBC

Chart 4: Outside of consumer spending, the economy has been weak for some time



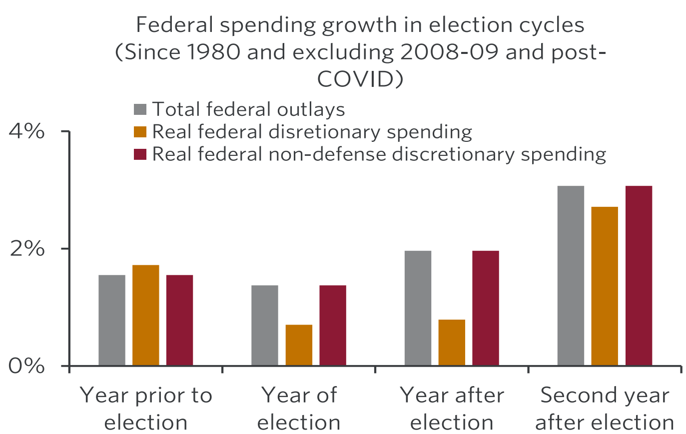
Source: BEA, CIBC calculations

Chart 5: Uncertainty around trade policy while not at fever pitch, is rising



Source: Caldara et al (2020), CIBC

Chart 6: Federal spending slows down during and immediately after elections



Source: OMB, BEA, CIBC calculations

and feels like a case of boiling the frog, where the economy gets cooked without anyone noticing for a while. And this is no small part of the economy, accounting for a third of GDP. Soft business investment and exports make up the bulk of that gap, and would be even worse were it not for an airplane buying frenzy.

These sectors are partly interest-rate sensitive but also dependent on economic fortunes beyond the US. Rising trade policy anxiety might also be a factor, (Chart 5) if corporates are deferring plant location decisions until the dust settles on future tariffs and trade barriers. Lower rates will help boost this segment of GDP, and exports could benefit from an easing in monetary policy abroad as long as trade wars don't stand in the way.

No post-election afterparty

Growth in 2023 and 2024 has been aided by strong government spending, both in terms of federal and state and local spending. But weaker government hiring and softening public construction spending mean government spending is likely to slow a bit in the second half of 2024.

That would be in keeping with historical patterns, as election years and the year immediately after an election typically see softer spending by the federal government, particularly in real terms (Chart 6). It isn't until two years after an election, that spending starts to ramp up.

That seems to be a reasonable guide for the current election. The hastily put together Harris team won't have the advantages of the running start that an incumbent administration sees, while a potential Trump administration would need to fight for its legislative agenda before their projects are shovel ready.

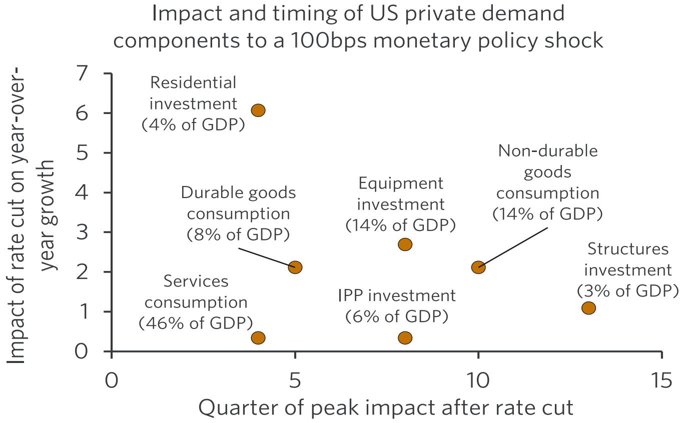
Housing to lead the recovery in 2026

Despite the near term deceleration in hiring and consumption, and lacklustre growth already in place elsewhere, Fed policy should be a powerful force to stop the bleeding over the latter half of 2025. For one, the housing market should respond very quickly to rate cuts, and that will gradually catalyze housing-related consumer spending. Altogether these components add up to about a quarter of GDP.

Housing is well known to be the most interest-rate sensitive sector, as it's about four times more sensitive than the average private domestic demand component (Chart 7). The peak impact from a 100bp monetary policy easing boosts residential investment growth by around 6%-points in a year. Some new research suggests, it could be even faster, with house prices responding to news about the Fed within a few weeks (Gorea et al, 2022).

What could make this effect far greater this time around is the current state of the housing market. The US is facing a burgeoning national housing shortage, with estimates of the housing deficit ranging from 1.5 million to 5.5 million (McCue and Huang, 2024). House prices have remained elevated

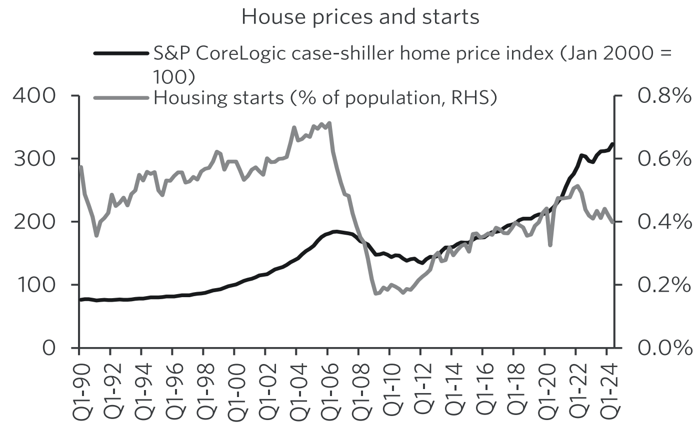
Chart 7: Housing investment is very interest sensitive and responds very quickly to rate cuts



Note: Monetary policy shock series from Nakamura and Steinsson (2018)

Source: Nakamura and Steinsson (2018), BEA, CIBC calculations

Chart 8: Rate cuts could unleash pent-up demand for housing, where supply has been crimped



Source: S&P CoreLogic, Census Bureau, BLS, CIBC calculations

despite high rates in this cycle, and housing starts never returned to their pre-financial crisis peak as a share of the population (Chart 8).

It won't be just about housing of course; other segments of the economy will benefit from lower rates and employment in cyclically sensitive sectors will gradually improve. Solid growth elsewhere will aid in the US recovery. But our optimism clearly rests on the Fed doing the right thing, starting with a quarter point cut this month, but delivering a couple of 50 bp moves thereafter to get the ball rolling. Over to you, Chairman Powell.

Canadian outlook: Room to run, but just jogging for now

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

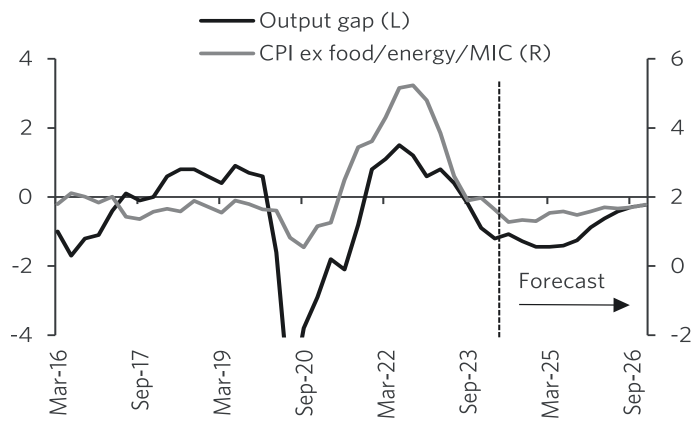
Whether it's the rise in the unemployment rate, the decline in per-capita consumer spending, or sluggishness in inflation excluding mortgage interest costs, there's plenty of evidence to suggest that significant slack has opened up within the Canadian economy. In other words, there's plenty of room for the economy to run without inflation picking up.

However, while the Bank of Canada has started cutting interest rates, and term mortgage rates have dropped as well, further reductions and more time will be needed before the economy's slow jog turns into a run. Indeed, we see interest rates having to drop below neutral by mid-2025, and staying there throughout 2026, to ensure growth is quick enough to bring the unemployment rate back down and prevent an undershoot of the 2% inflation target.

Plenty of headroom

While the economy was working in very cramped conditions in 2022 and into last year, there's plenty of headroom for growth today. Supply chains may not be back to where they were pre-

Chart 1: Slack in the economy to keep inflation under control even as growth picks up



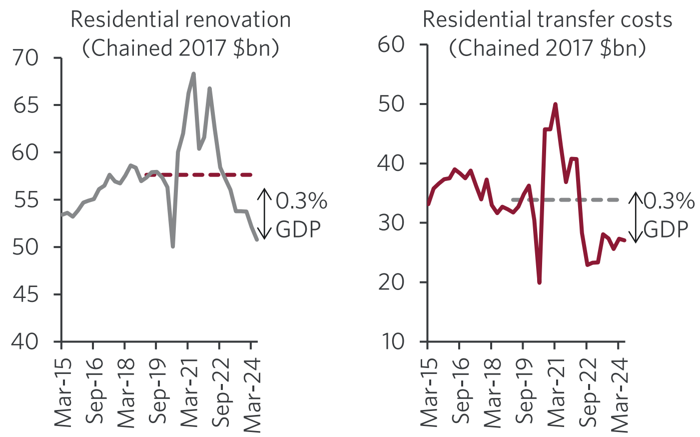
Source: Statistics Canada, CIBC

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

Indicator	24:2A	24:3F	24:4F	25:1F	25:2F	25:3F	25:4F	2024F	2025F	2026F
GDP at market prices ($Bn)	3,005	3,016	3,039	3,068	3,100	3,137	3,180	3,004	3,121	3,283
% change	7.1	1.4	3.1	3.9	4.2	4.9	5.5	3.9	3.9	5.2
Real GDP ($2012 Bn)	2,379	2,385	2,391	2,402	2,414	2,428	2,449	2,380	2,423	2,489
% change	2.1	1.0	1.1	1.8	1.9	2.4	3.4	1.1	1.8	2.7
Final domestic demand	2.4	1.0	1.3	2.0	2.2	2.2	3.5	1.5	1.9	2.7
Household consumption	0.6	0.3	0.8	1.9	1.5	2.3	3.2	1.7	1.5	2.8
Total government expenditures	6.7	2.6	2.0	2.2	3.0	1.5	4.0	2.5	2.6	1.8
Residential construction	-7.3	1.6	3.0	1.0	3.0	4.0	4.5	-0.6	1.9	4.3
Business fixed investment[1]	8.8	0.9	1.0	2.9	3.7	2.5	3.8	-0.7	2.8	3.5
Inventory change ($2012 Bn)	25.7	25.9	28.0	28.5	29.5	31.1	28.5	26.2	29.4	28.5
Exports	-1.8	0.4	1.3	2.4	1.7	3.2	4.0	0.7	1.7	3.2
Imports	-0.5	0.7	2.8	3.2	3.0	3.2	3.0	0.7	2.5	2.9
GDP Deflator	4.6	0.5	2.0	2.0	2.2	2.4	2.1	2.8	2.1	2.4
CPI (yr/yr % chg)	2.7	2.1	1.8	2.1	1.5	1.5	1.9	2.4	1.7	1.9
Unemployment rate (%)	6.3	6.6	6.8	6.6	6.5	6.4	6.2	6.4	6.4	5.8
Employment change (K)	120	20	48	120	83	55	24	323	292	299
Goods trade balance (AR, $bn)	-8.7	-7.0	-8.5	-8.6	-12.7	-10.9	-7.0	-6.1	-9.8	-7.5
Housing starts (AR, K)	250	259	254	260	263	265	266	252	263	291

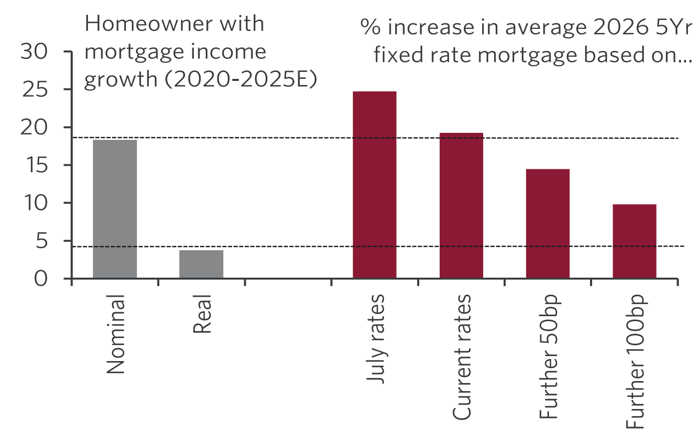
[1] M&E plus Non-Res Structures and Intellectual Property and NPISH.

Chart 2: Residential renovation (L) and resale activity (R) have plenty of room to recover



Source: Statistics Canada, CIBC

Chart 4: Mortgage rates will have to come down slightly further to ease refinancing pain

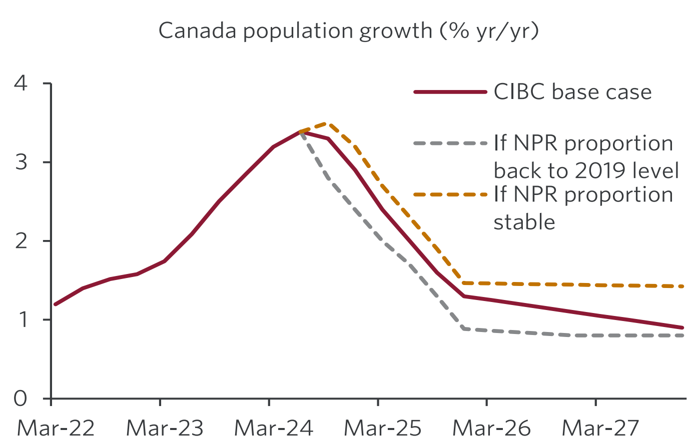


Source: CIBC

pandemic, thanks to trade tensions with China and ongoing global conflicts, but demand has weakened to such an extent that the stock-to-sales ratio is now well above where it stood on average in the prior cycle. Slack is also opening up on the services side of economy, particularly excluding shelter. The economy should therefore be able to withstand a sizeable pick-up in demand, without seeing a sharp acceleration in inflation again (Chart 1).

There's also plenty of room for housing activity to pick up, with renovation spending and resales well below pre-pandemic norms (Chart 2). New construction clearly needs to pick up to help offset the underbuilding relative to a surging population in recent years. Given such a weak starting point, residential investment should be able to add between 0.5-1.0% to GDP without exceeding pre-pandemic levels on aggregate, and therefore still being below in per-capita terms. But weak pre-construction sales of condos in 2024 implies that we still have a soft year ahead for multiple unit starts.

Chart 3: Population growth to slow quickly, even if non-permanent resident targets aren't met



Source: Statistics Canada, CIBC

While shelter has been a big contributor to inflation recently, that has mostly come from mortgage interest costs (MIC) and rents. While we expect other housing costs (including owner transfer fees and replacement costs) will rise as residential investment recovers, that shouldn't be large enough to completely offset the smaller contribution from MIC.

There should also be a helping hand from an easing in rental price inflation as population growth cools. While it's unclear just how much population growth will slow in the years ahead, any reasonable estimate is well below the current torrid pace. If the Federal government achieves its target of reducing the proportion of non-permanent residents back to the pre-pandemic share of the population, the current 3%+ growth rate would soon turn into less than 1%.

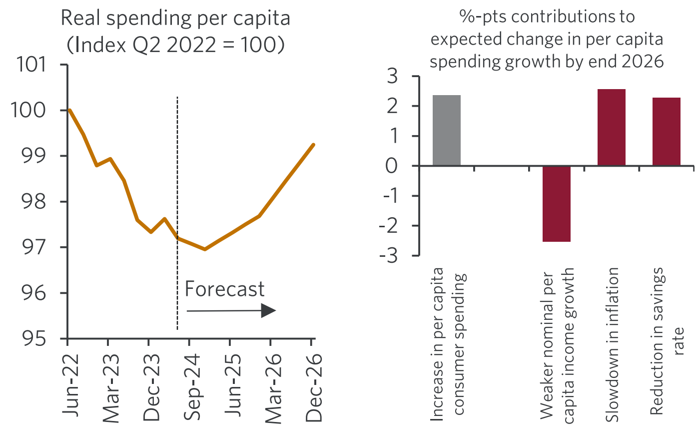
That may turn out to be a tough target to achieve, given lags within the system, the potential for those here to overstay their visas, and a pushback from businesses and universities. However, even if the proportion of non-permanent residents simply stopped increasing, the pace of population growth would still be halved, to around 1.5%. Our working assumption is something near the midpoint (Chart 3).

How low do rates need to go?

The question now isn't whether there is room for Canadian growth to accelerate, but rather how low interest rates need to go at to achieve this. Even though rates have already come down, real interest rates remain restrictive and homeowners who purchased during the ultra-low rates of the pandemic will still face higher financing costs as they renew.

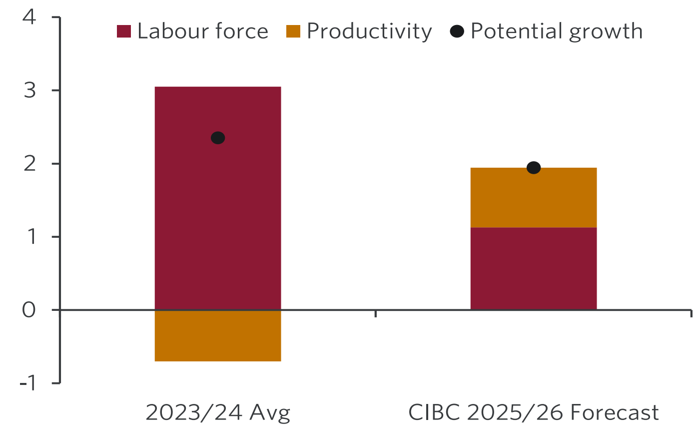
Indeed, even though the Bank of Canada has started to reduce its overnight rate, and financial markets have reassessed the expected pace of cuts to also bring five-year rates lower, an average homeowner who purchased in 2021 would still face a mortgage payment increase that would surpass their income growth if they refinanced today (Chart 4). Five-year mortgage rates would have to be 50-100bp lower still for the increase in

Chart 5: Real per capita spending to recover in late 2025/26 (L), driven by slightly lower savings and slower inflation (R)



Source: Statistics Canada, CIBC

Chart 7: Rebound in productivity would limit deceleration in potential



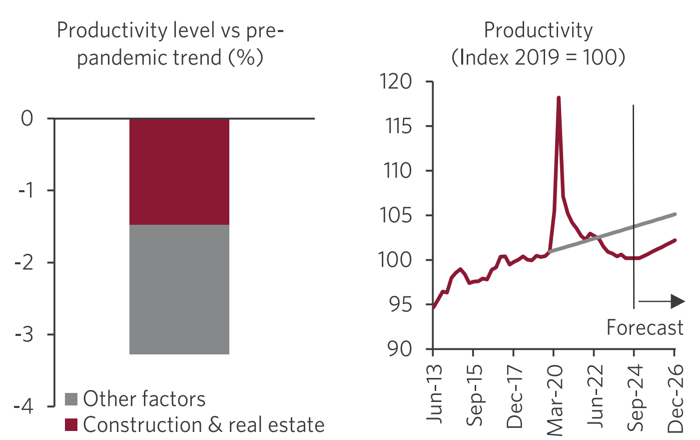
Source: Statistics Canada, Bank of Canada, CIBC

refinancing costs to fall short of the rise in nominal incomes, although inflationary pressures have cut into income growth in real terms.

Interest rates may not reach levels low enough to ease that refinancing pressure until the middle of next year, which is when we expect to see clearer signs of a pick-up in per-capita consumer spending (Chart 5, left).

While we have our doubts that a big pot of excess savings is waiting to flow into spending, we don't need to see a large reduction in the savings rate ahead in order to drive a rebound in per-capita consumer spending. A modest 2%-pt reduction in the saving rate, and a period in which wage gains exceed a now slower inflation rate, would be enough to drive a recovery in spending volumes even if household income growth decelerates (Chart 5, right).

Chart 6: Construction and real estate driving a chunk of productivity woes (L), lower rates could bring a rebound (R)



Source: Statistics Canada, CIBC

Raising the bar

While we think that there's plenty of slack in the economy and headroom for growth in the near-term, that could be absorbed quickly if the potential output of the economy is not increasing as well. With potential growth solely reliant on labour force expansion in recent years, there's valid concern that, as population growth eases due to new restrictions, any additional headroom within the economy will grow only slowly.

We are somewhat more optimistic, expecting a partial recovery in productivity to offset some of the deceleration in population growth. While many of the issues plaguing productivity in Canada will not be solved overnight, including a larger public sector, an increasing number of lower paid jobs, and a shrinking oil & gas sector as a share of GDP, there may be a cyclical element to the recent extreme weakness.

Some service businesses need a minimum number of employees even if demand is weak. Moreover, highly cyclical elements of the economy such as construction and real estate have driven almost half of the undershoot in productivity relative to the pre-pandemic trend (Chart 6, left). Even if this gap closes only slightly to the end of 2026 (Chart 6, right), that would be enough to ensure that the economy's potential growth doesn't decelerate too much relative to the current trend (Chart 7).

Overall, there's plenty of room to run for the Canadian economy before we hit the wall of its economic potential and start seeing inflation accelerate again. However, we likely need a further boost from even lower interest rates before the gentle jog that the economy is currently doing turns into a run. Indeed, it will likely take until well next year for the relief from low interest rates to really shine through.

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

FICC Strategy
Ian Pollick
ian.pollick@cibc.com

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

economics.cibccm.com