Economics

# FORECAST

September 8, 2021

## A dream deferred

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

A poet famously asked, "what happens to a dream deferred?", and that's the relevant question for the economic outlook. Delta's dawn is the latest disappointment, after a spring Covid wave and a pull back in home sales contributed to a drop in Canadian GDP in Q2. We've made downward revisions to this year's Canadian and US growth rates, chopping about a percentage point from the former, and 0.6% from the latter. The road to better times is anything but smooth these days.

Delta's greater infectiousness has sent case counts soaring, even in heavily-vaccinated regions. But what's less clear is whether such regions will see a parallel climb hospitalizations and fatalities; it has in Israel, but much less so in the UK, and the reasons for these differences aren't fully clear. Waning vaccine effectiveness? Too short a gap between jabs in Israel for full efficacy? Different demographics? That's left the epidemiological forecast for the balance of 2022 a bit clouded in terms of its human toll.

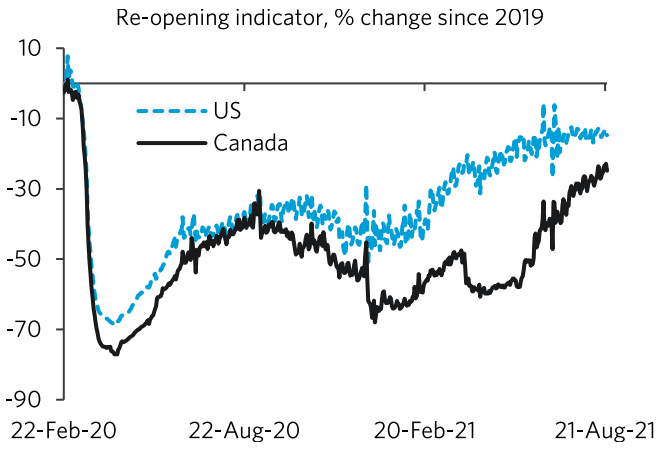
For now, to keep hospitals from overrunning capacity, governments are taking some steps to rein in the pace of infections. In better news for US and Canadian economies than what we saw in prior waves, we're facing mask and vaccine mandates, capacity limits and ventilation improvement costs, rather than more damaging sectoral lockdowns.

Even so, cautious behaviour is eating into demand for indoor services and keeping downtowns quiet as office returns are delayed, flattening our US reopening indicator (Chart 1). Canada's Delta wave was later to take off, but it's trending higher, and we expect to see a similar stall emerge in high-touch services this fall.

The Delta wave has also been a global setback, hitting countries that earlier had Covid under firmer control. That will feed back into North American exports, and plague the goods sector with supply bottlenecks. Other than those boosted by supply disruptions, commodity prices will lose momentum. Crude oil should still settle in the mid-$60/bbl range next year, as a further return of OPEC+ supply keeps it from pressing higher.

Still, getting back to full employment is a dream deferred, not lost for good. Indeed, we're raising our 2022 quarterly Canadian and US growth rates, since we'll enter that year with more pent-up demand. Many epidemiologists expect that a sizeable majority of the unvaccinated will suffer through a case of Covid in the next two quarters, allowing them to join the vaccinated in being less vulnerable to future waves. Covid-19 could become an endemic disease with lower morbidity by next spring, opening the door to a reacceleration in services.

Chart 1: Signs of US slowing, Canada to follow




Source: Google mobility indices for retail and recreation, workplaces, public transit; OpenTable reservations; airport traffic from the US Transportation Security Administration and Canadian Air Transport Security Authority; CIBC

Table 1: Canadian forecast summary (% change except where noted)

| Variable | 2020F | 2021F | 2022F | 2023F |
|---|---|---|---|---|
| GDP at market prices | -4.6 | 11.7 | 5.2 | 4.2 |
| GDP in $2012 | -5.3 | 4.9 | 4.0 | 2.8 |
| Consumer price index | 0.7 | 2.9 | 2.2 | 2.1 |
| Unemployment rate | 9.5 | 7.6 | 6.0 | 5.5 |
| Current account balance (C$ Bn) | -40.1 | -3.2 | -23.6 | -51.0 |
| Pre-tax profits (net operating surplus) | -4.0 | 36.1 | -0.4 | 5.6 |
| Housing starts (K) | 219 | 253 | 215 | 216 |

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

| Variable | 2020F | 2021F | 2022F | 2023F |
|---|---|---|---|---|
| GDP at market prices | -2.2 | 9.3 | 7.6 | 5.0 |
| GDP in $2012 | -3.4 | 5.6 | 4.4 | 2.3 |
| Consumer price index | 1.2 | 4.2 | 3.1 | 2.5 |
| Unemployment rate | 8.1 | 5.6 | 4.0 | 3.7 |
| Current account balance (US$ Bn) | -616 | -793 | -812 | -815 |
| Pre-tax profits (with IVA/CCA) | -5.2 | 19.9 | 6.4 | 2.6 |
| Housing starts (K) | 1,397 | 1,572 | 1,599 | 1,620 |

Table 3: Canadian interest rates (end of period)

| Variable (%) | 2021 8-Sep | 2021 Dec | 2022 Mar | 2022 Jun | 2022 Sep | 2022 Dec | 2023 Jun | 2023 Dec |
|---|---|---|---|---|---|---|---|---|
| Overnight target rate | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.50 | 1.00 | 1.25 |
| 98-Day Treasury Bills | 0.15 | 0.20 | 0.25 | 0.25 | 0.25 | 0.50 | 0.90 | 1.15 |
| 2-Year Government Bond | 0.40 | 0.50 | 0.55 | 0.60 | 0.75 | 1.00 | 1.25 | 1.65 |
| 10-Year Government Bond | 1.23 | 1.50 | 1.60 | 1.70 | 1.75 | 2.00 | 2.15 | 2.50 |
| 30-Year Government Bond | 1.78 | 2.00 | 1.90 | 1.95 | 2.10 | 2.25 | 2.35 | 2.50 |
| Canada - US T-Bill Spread | 0.11 | 0.10 | 0.10 | 0.10 | -0.10 | 0.15 | 0.00 | -0.30 |
| Canada - US 10-Year Bond Spread | -0.14 | -0.05 | -0.10 | -0.10 | -0.25 | -0.15 | -0.20 | 0.00 |
| Canada Yield Curve (10-year — 2-year) | 0.82 | 1.00 | 1.05 | 1.10 | 1.00 | 1.00 | 0.90 | 0.85 |

Table 4: US Interest rates (end of period)

| Variable (%) | 2021 8-Sep | 2021 Dec | 2022 Mar | 2022 Jun | 2022 Sep | 2022 Dec | 2023 Jun | 2023 Dec |
|---|---|---|---|---|---|---|---|---|
| Federal funds rate | 0.125 | 0.125 | 0.125 | 0.125 | 0.375 | 0.375 | 0.875 | 1.375 |
| 91-Day Treasury Bills | 0.04 | 0.10 | 0.15 | 0.15 | 0.35 | 0.35 | 0.90 | 1.45 |
| 2-Year Government Note | 0.22 | 0.30 | 0.40 | 0.50 | 0.80 | 1.00 | 1.45 | 1.80 |
| 10-Year Government Note | 1.37 | 1.55 | 1.70 | 1.80 | 2.00 | 2.15 | 2.35 | 2.50 |
| 30-Year Government Bond | 1.99 | 2.10 | 2.30 | 2.45 | 2.55 | 2.60 | 2.70 | 2.75 |
| US Yield curve (10-year — 2-year) | 1.15 | 1.25 | 1.30 | 1.30 | 1.20 | 1.15 | 0.90 | 0.70 |

Table 5: Foreign exchange rates

| Exchange rate | 2021 8-Sep | 2021 Dec | 2022 Mar | 2022 Jun | 2022 Sep | 2022 Dec | 2023 Jun | 2023 Dec |
|---|---|---|---|---|---|---|---|---|
| CAD-USD | 0.79 | 0.79 | 0.78 | 0.78 | 0.77 | 0.77 | 0.76 | 0.76 |
| USD-CAD | 1.26 | 1.27 | 1.28 | 1.29 | 1.30 | 1.30 | 1.31 | 1.32 |
| USD-JPY | 110 | 112 | 114 | 115 | 114 | 112 | 111 | 110 |
| EUR-USD | 1.18 | 1.15 | 1.15 | 1.17 | 1.16 | 1.15 | 1.16 | 1.18 |
| GBP-USD | 1.38 | 1.38 | 1.39 | 1.38 | 1.36 | 1.35 | 1.37 | 1.41 |
| AUD-USD | 0.74 | 0.74 | 0.75 | 0.76 | 0.77 | 0.78 | 0.79 | 0.81 |
| USD-CNY | 6.47 | 6.40 | 6.35 | 6.25 | 6.20 | 6.15 | 6.05 | 5.95 |
| USD-BRL | 5.17 | 5.30 | 5.10 | 5.30 | 5.50 | 5.70 | 5.60 | 5.40 |
| USD-MXN | 19.9 | 20.0 | 19.8 | 19.5 | 20.0 | 20.5 | 21.0 | 21.0 |

Canada has had inexplicably good job gains relative to its GDP track, but if those labour market figures are accurate, they are providing ample fuel for future spending. Despite having seen a full recovery in consumption, Americans still have huge stimulus funds sitting in their bank accounts and waiting to be spent. Fewer disruptions to supply chains should also support growth in goods industries and exports next year. As a result, we see 2022 North America growth running well above potential, tightening labour markets in the process.

## Fine Tuning Financial Forecasts

Short term developments needn't postpone a further winding down of Bank of Canada QE, or a September tapering announcement from the Fed. Both economies can live with that given how low yields are, and the progress to date in restoring employment. But in line with the softer outlook, we halved our call for 2022 Fed rate hikes to a single quarter point move in September. We only had one Q4 2022 rate hike for Canada in our prior call, and we're just able to hang on to that view given some solid quarters in 2022 that would make up for some of this year's slippage.

The subsequent track for Fed hikes will still outgun those in Canada, the opposite of what markets are now pricing-in. Growth and inflation north of the border isn't as fueled by fiscal stimulus, and Canada's economy shows greater interest sensitivity given higher levels of household debt and the absence of 30-year fixed rate mortgages.

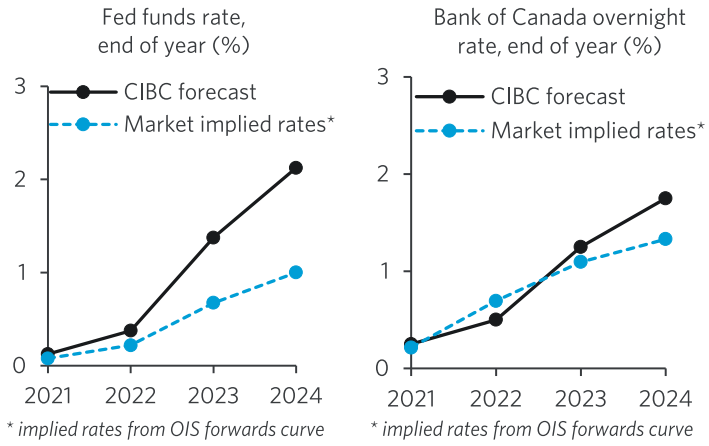
We remain bearish on bonds in both countries. That's not due to a protracted inflation overshoot; we're taking the Fed and the BoC at their word that they will act to return inflation to their targets beyond 2023. Breakeven inflation rates in the US TIPS market, which are counting on the CPI to average a bit over 2% in the decade ahead, are therefore reasonable at this point.

Instead, our expectation for climbing bond yields partially captures the reality that to do the job on inflation in the US, the Fed will have to hike more than the market now allows for (Chart 2). Market implied rates have to balance the views of those who share our expectations for a steady climb in overnight rates post 2022 against those who have doubts about that process getting much underway given other headwinds. Once the Fed actually launches a tightening cycle, those doubts will vanish. That's why we typically see more hikes priced in as the first one is delivered.

As well, bond yields in North America are currently depressed by a three ingredient cocktail: fiscal stimulus that left business and households flush with deposits, quantitative easing that stripped the market of the bond supply that would otherwise have surged, and tame loan demand. That has the banking system caught in a mismatch between massive deposits and tepid loan demand, and a need to park money in scarce government bonds, containing their yields in the process.

Merely tapering QE will reduce the further pressure in that direction, while leaving much of that mismatch in place. But

Chart 2: Rate hikes likely to top what market prices in, particularly in US




Source: Bloomberg, CIBC

joining other institutional investors, banks could be all trying to pare duration in their bond portfolios as overnight rates, and rates paid to their depositors, climb, lest they end up in a negative carry on their holdings.

And don't rule out a much later move by the Bank of Canada to pare back its holdings by selling bonds back to the market, as the Bank of England intends to do at some point. The legacy of QE is that more of the now-larger federal debt outstanding is effectively at floating rates, as the BoC took bonds off the market and replaced them with settlement balances paying the overnight rate. Locking in more of that debt through a reversal of QE would add to near-term funding costs, but provide some insurance against the risks of higher rates in the years ahead. Should "negative QE" add an excessive drag on growth by raising bond yields, the BoC can provide an offset by tempering the pace of overnight hikes.

Solid gains for equities have not been only about a flood of liquidity. US corporate profits have done better than one might assume, as they've touched record highs as a share of GDP, and that includes some hard-hit sectors like main street retailers and restaurants that are underweighted in public markets. That success during the pandemic poses a challenge for domestic earnings growth ahead, as wages and interest costs could squeeze margins. Stocks are also vulnerable to a temporary set-back in the near term as the Delta wave impacts earnings. But large cap stocks also have substantial leverage to the global economy, which has ample room to run once Covid-19 is under better control.

Although the US dollar isn't undervalued on trade fundamentals, it's well supported against other majors, as the US will be earlier than many developed economies in hiking rates. We look for the loonie to be modestly weaker in 2022, with no supportive momentum in commodities, the travel deficit returning to dent the current account, and the Bank of Canada not hiking as aggressively as the market assumes on a relative basis versus the US.

# US Outlook: Different path, similar destination

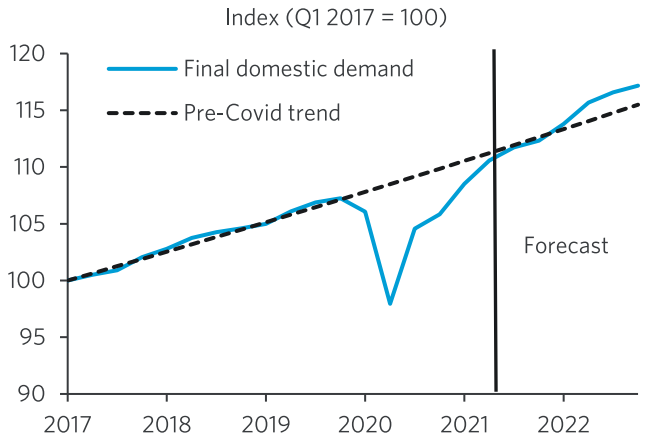
by **Andrew Grantham** andrew.grantham@cibc.com and **Katherine Judge** katherine.judge@cibc.com

The US economy has already recouped its pre-Covid level of activity, and should be only 2.4% behind its pre-pandemic trend when the third quarter data are released. That's obviously quite a feat given the hole that the economy was in a year and a half ago. However, with the pandemic not yet fully behind us, the next leg of the journey back to full health could prove longer and tougher than previously expected. We still anticipate reaching a destination of full employment, above-target inflation, and Fed rate hikes by the second half of 2022, but the path there will be bumpier (Table 1).

## External pressures weighing

The recovery to date would look even more impressive if it weren't for the weak external environment and supply chain disruptions. Final domestic demand (GDP excluding inventories and net trade) is actually on course to reach its pre-pandemic trend in Q3, with overall GDP held back in recent quarters by net trade and inventories (Chart 1).

Chart 1: Economic activity could reach pre-Covid trend in Q3, when removing inventory and trade

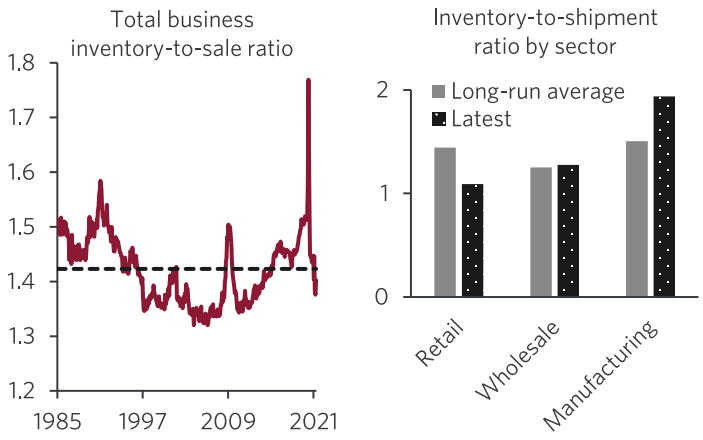



Source: BEA, CIBC

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

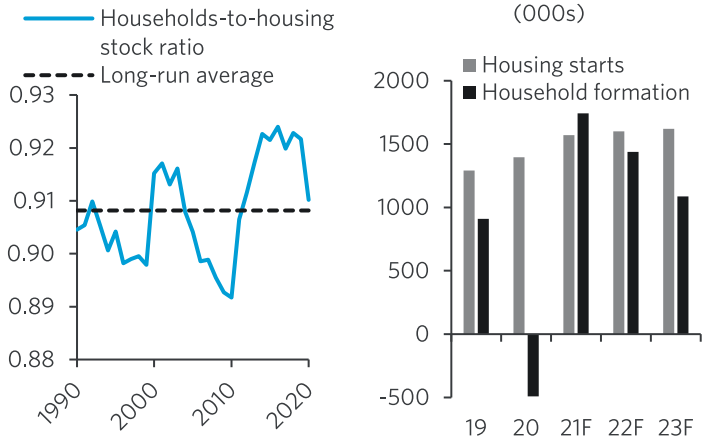
| Indicator | 21:1A | 21:2A | 21:3F | 21:4F | 22:1F | 22:2F | 22:3F | 2021F | 2022F | 2023F |
|---|---|---|---|---|---|---|---|---|---|---|
| GDP at market prices ($Bn) | 22,038 | 22,731 | 23,169 | 23,437 | 23,892 | 24,459 | 24,831 | 22,844 | 24,581 | 25,821 |
| % change | 10.9 | 13.2 | 7.9 | 4.7 | 8.0 | 9.8 | 6.2 | 9.3 | 7.6 | 5.0 |
| Real GDP ($2012 Bn) | 19,056 | 19,361 | 19,556 | 19,660 | 19,909 | 20,236 | 20,393 | 19,408 | 20,257 | 20,724 |
| % change | 6.3 | 6.6 | 4.1 | 2.1 | 5.2 | 6.8 | 3.1 | 5.6 | 4.4 | 2.3 |
| Final sales | 9.1 | 7.9 | 0.4 | 2.1 | 3.8 | 6.6 | 2.9 | 5.4 | 3.6 | 2.5 |
| Personal consumption | 11.4 | 11.9 | 1.4 | 1.3 | 3.5 | 7.5 | 4.0 | 7.7 | 4.1 | 2.3 |
| Total government expenditures | 4.2 | -1.9 | 1.8 | 2.0 | 1.2 | 1.3 | 1.3 | 0.9 | 1.3 | 1.7 |
| Residential investment | 13.3 | -11.5 | -1.6 | 2.4 | 4.5 | 5.3 | 3.6 | 10.1 | 2.2 | 2.7 |
| Business fixed investment | 12.9 | 9.3 | 1.5 | 5.2 | 5.7 | 7.0 | 3.7 | 7.5 | 5.1 | 3.8 |
| Inventory change ($2012 Bn) | -88.3 | -169.4 | 8.5 | 10.4 | 75.0 | 82.0 | 92.3 | -59.7 | 78.9 | 44.7 |
| Exports | -2.9 | 6.6 | 6.3 | 9.6 | 11.8 | 6.1 | 4.7 | 5.1 | 8.0 | 4.8 |
| Imports | 9.3 | 6.7 | 11.2 | 6.3 | 7.3 | 4.7 | 7.3 | 14.1 | 6.8 | 3.8 |
| GDP Deflator | 4.3 | 6.1 | 3.2 | 2.5 | 2.7 | 2.9 | 3.0 | 3.5 | 3.0 | 2.7 |
| CPI (yr/yr % chg) | 1.9 | 4.8 | 5.3 | 4.9 | 4.5 | 3.0 | 2.2 | 4.2 | 3.1 | 2.5 |
| Core CPI (yr/yr % chg) | 1.4 | 3.7 | 4.0 | 3.3 | 3.5 | 2.7 | 2.3 | 3.1 | 2.9 | 2.6 |
| Unemployment rate (%) | 6.2 | 5.9 | 5.2 | 5.1 | 4.9 | 4.0 | 3.5 | 5.6 | 4.0 | 3.7 |
| Housing starts (AR, K) | 1,599 | 1,586 | 1,555 | 1,550 | 1,575 | 1,588 | 1,597 | 1,572 | 1,599 | 1,620 |

Chart 2: Inventories not too far below long-run trend relative to sales (L); Deficit at the retail level but surplus in manufacturing (R)




Source: Census Bureau, CIBC

Chart 3: Still room for healthy homebuilding ahead due to previous undersupply and a rebound in household formations




Source: Census Bureau, IPUMS CPS, CIBC

While the negative contributions we have seen from inventories and trade won't persist, they may not fully or quickly reverse either. In the near term, the Delta variant is having an impact on activity in some key import markets (see global section, pages 11-13), which are causing continued delays of key components for American producers. In the long term, we must also remember that economy-wide inventory levels were somewhat elevated before the pandemic struck, and therefore aren't that far below their long-run average relative to sales currently (Chart 2, left). The problem from an inflation perspective is where inventories are being held, with stock levels piling up in manufacturing, but at historic lows at the retail level (Chart 2, right). The bottom line is that an easing of supply chain disruptions may be a 2022 story, and will be a factor in cooling inflation even while somewhat heating up growth.

## Domestic firepower

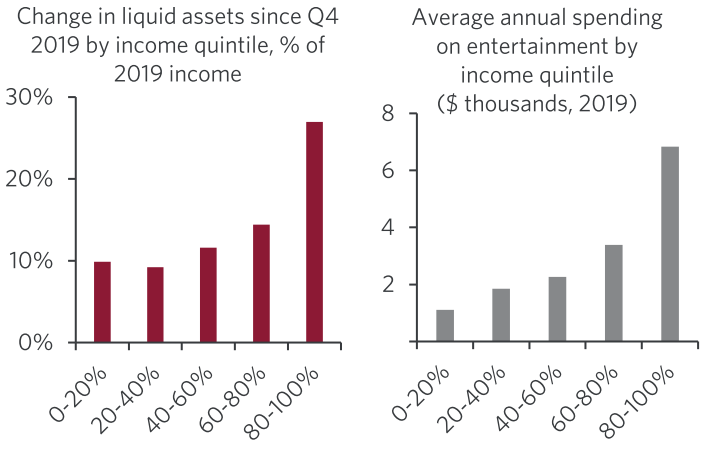
The good news is that there is still room to run for some areas of domestic demand, despite the already impressive recovery to date. While residential investment is still running well above its pre-pandemic trend, even after a pullback in Q2 and likely Q3, that doesn't mean further declines are in store. The pre-Covid trend in that area wasn't particularly brisk, and even after a decline in household formations and a rise in the housing stock in 2020, there is room to build when looking at the ratio of households to housing stock against its long-run average (Chart 3, left). Given that homebuilding generally lagged household formations in the years prior to the pandemic, homebuilding could surpass the expected increase in household formations through 2023 (Chart 3, right).

As for consumers, even though fiscal stimulus is set to take a big step back in 2022 in terms of its dollar value, that's not necessarily the case in terms of its impact on the economy. Bank balances of households across income ranges remain well above levels seen at the end of 2019 (Chart 4, left), suggesting ample ability to spend. And even though the biggest increases are admittedly for higher income groups that have a generally lower marginal propensity to consume, those income groups spend disproportionately more on those services that are still a long way from a full recovery, including entertainment and travel (Chart 4, right).

## Delta dents growth and inflation outlook

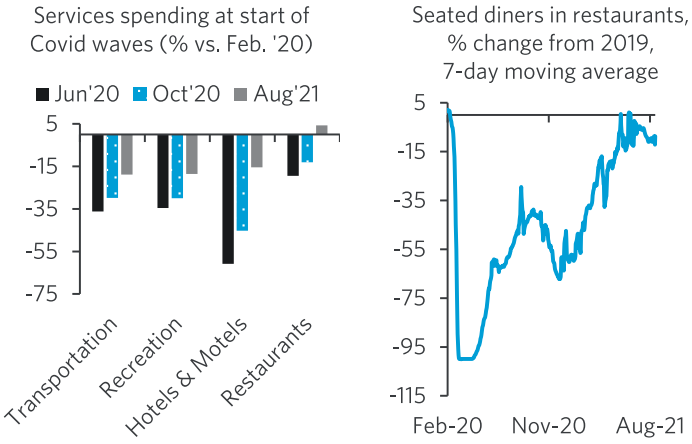
While conditions remain positive for consumer spending in 2022, the upswing in Covid-19 cases due to the Delta variant means that the path forward is likely to be slower and bumpier than we previously expected. The "K" shaped recovery, in which some sectors are left behind, has become much narrower recently. Yes, there are plenty of areas of services spending that are still well below February 2020 levels of activity. But some, most notably restaurants, have made a stunning recovery and as of July were actually seeing activity above their pre-pandemic level (Chart 5, left).

Chart 4: Higher-income earners to drive rebound in services spending



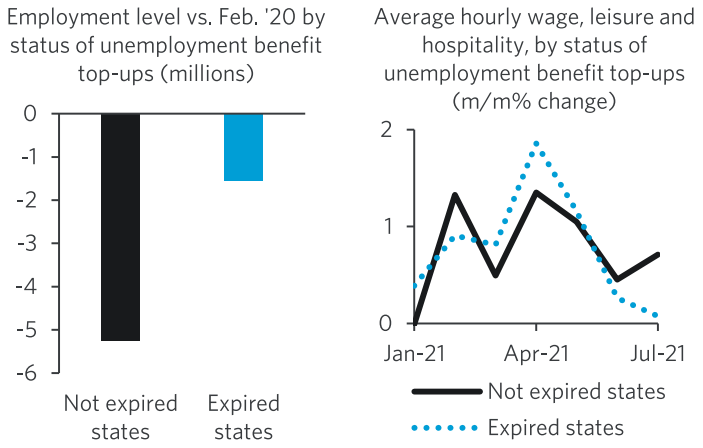

Source: Federal Reserve, BLS, CIBC

Chart 5: Restaurant spending has fully recovered (L), but rise in Delta variant has resulted in softer demand lately (R)




Source: BEA, OpenTable, CIBC

Chart 6: States with unemployment benefit top-ups still in place account for bulk of missing jobs (L); their expiration should work to temper wage pressures (R)




Source: Bloomberg, CIBC

That was a positive for consumer spending in Q2 and into early Q3, and has more than offset a recent moderation in spending on goods. However, it also raises the risk of a near-term pullback if consumers shun such activities due to an increased risk of infection. They may have the ability to spend, but will they have the desire to do so before Covid cases fall again? Judging by industry data for the restaurant sector, a modest softening of demand for services may have already started (Chart 5, right).

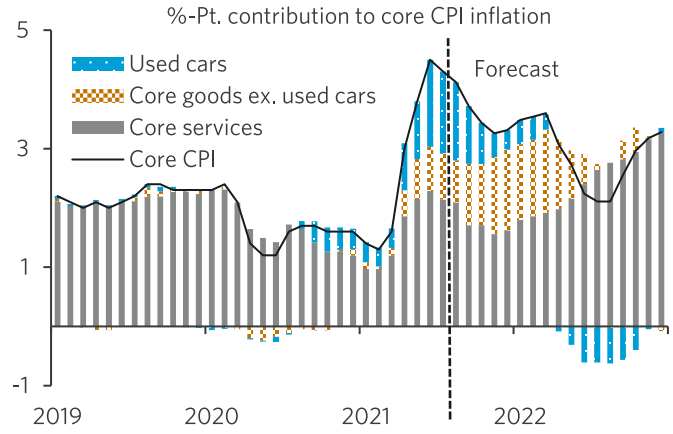
For the near-term inflation outlook, the reason for any slowing in the economic recovery is key. In prior waves, state governments forced businesses to close due to health concerns. Meanwhile, during the reopening phase, generous government support contributed to a slower return of staff to the labor force, and therefore a slower return to full supply and added cost pressures. Recovering demand, but still limited supply, has understandably resulted in inflationary pressure.

However, this wave will be different. It seems unlikely that full scale business closures will happen, as vaccine passport systems are now possible and booster shots are on the way for the most vulnerable. In fact, if the expiry of unemployment benefit top-ups provides even a partial lift to labor force participation, supply may actually increase and some of the wage pressures building in service sectors will ease just as near-term demand is starting to wane. States ending expanded unemployment benefits in September account for about 60% of the population, but 77% of the remaining jobs yet to be recouped (Chart 6, left). States that ended benefits early have recently seen a flattening of previous upward pressure on leisure & hospitality wages (Chart 6, right).

A misstep in the recovery for demand, but this time combined with little change in supply, could ease some of the upward pressure on service prices. That, combined with at least some pullback in extraordinarily high used car prices, may have core CPI falling to 2% in mid-2022, and PCE running slightly below target (Chart 7). However, given the firepower that households have to spend, a fuller recovery in demand as health concerns hopefully ease for good will serve to accelerate growth and inflation again as 2022 progresses, encouraging policymakers to nudge up interest rates.

A full recovery, above-target inflation, and a Fed hike before the end of 2022 isn't a radically different destination than we previously expected. The path there, however, will be somewhat different.

Chart 7: Core CPI to moderate before rising above target again in second half of 2022




Source: BLS, CIBC

# Canada's Convoluted Convalescence

by **Royce Mendes** royce.mendes@cibc.com

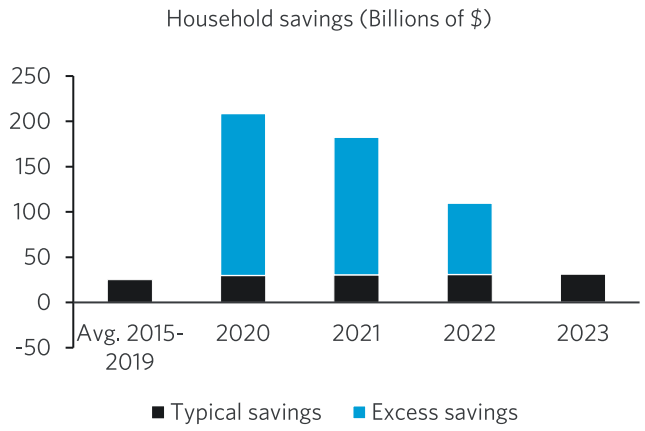
Canada's outperformance on both vaccine procurement and deployment hasn't been the fast-pass to bringing back pre-Covid life it was originally intended to be. The open nature of Canada's economy means that, while vaccines are saving many lives, virus variants and global supply chain bottlenecks are making for a more convoluted route to recovery than we had previously envisaged. As a result, we now see the Canadian economy taking slightly longer to return to full health than in our prior projections (Table 1).

## Waiting a bit more patiently

Covid has clearly had disparate impacts on different industries, but for now the winners are still winning. Despite seeing some signs of pullback recently, both household spending on goods and residential investment are still running well above their pre-Covid levels.

That's because, despite households likely sitting on more than $300bn of excess savings by the end of this year (Chart 1),

Chart 1: Canadians have more than 300 billion reasons to spend



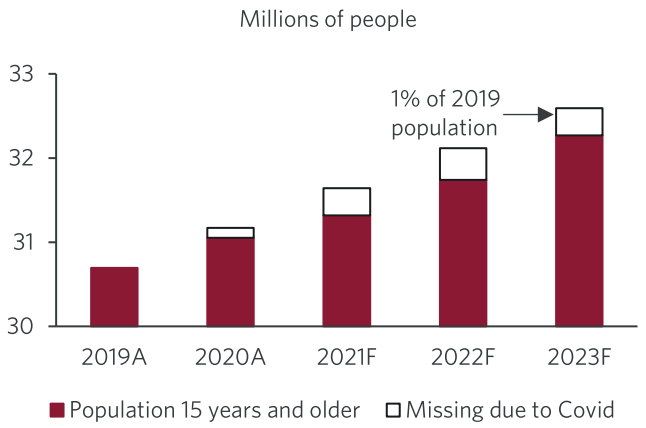

Source: Statistics Canada, CIBC

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

| Indicator | 21:1A | 21:2A | 21:3F | 21:4F | 22:1F | 22:2F | 22:3F | 2021F | 2022F | 2023F |
|---|---|---|---|---|---|---|---|---|---|---|
| GDP at market prices ($Bn) | 2,416 | 2,462 | 2,475 | 2,496 | 2,525 | 2,573 | 2,616 | 2,462 | 2,590 | 2,699 |
| % change | 18.6 | 7.9 | 2.2 | 3.4 | 4.7 | 7.9 | 6.9 | 11.7 | 5.2 | 4.2 |
| Real GDP ($2012 Bn) | 2,077 | 2,071 | 2,094 | 2,108 | 2,127 | 2,163 | 2,188 | 2,088 | 2,170 | 2,230 |
| % change | 5.5 | -1.1 | 4.5 | 2.8 | 3.6 | 6.9 | 4.7 | 4.9 | 4.0 | 2.8 |
| Final domestic demand | 6.5 | 0.7 | 4.3 | 2.0 | 3.0 | 6.3 | 4.3 | 5.4 | 3.6 | 3.3 |
| Household consumption | 2.6 | 0.2 | 7.4 | 2.0 | 2.9 | 8.7 | 5.0 | 4.2 | 4.5 | 4.2 |
| Total government expenditures | 7.1 | 3.8 | 4.4 | 3.0 | 2.3 | 1.8 | 2.1 | 6.0 | 2.7 | 1.5 |
| Residential construction | 42.1 | -12.4 | -14.7 | -2.1 | 2.9 | 3.4 | 3.6 | 16.9 | -1.3 | 0.8 |
| Business fixed investment[1] | -1.5 | 10.1 | 4.6 | 2.8 | 5.2 | 7.8 | 7.5 | 1.0 | 5.7 | 4.5 |
| Inventory change ($2012 Bn) | -5.8 | 8.3 | 5.7 | 4.8 | 7.0 | 5.7 | 4.8 | 3.3 | 5.8 | 6.5 |
| Exports | 3.3 | -15.0 | 9.4 | 10.1 | 4.0 | 5.7 | 6.1 | 2.1 | 4.9 | 3.5 |
| Imports | 4.3 | -0.1 | 6.9 | 6.5 | 3.1 | 2.9 | 4.4 | 7.3 | 4.2 | 5.2 |
| GDP Deflator | 12.6 | 9.2 | -2.3 | 0.6 | 1.0 | 0.9 | 2.1 | 6.5 | 1.2 | 1.4 |
| CPI (yr/yr % chg) | 1.4 | 3.3 | 3.7 | 3.3 | 3.0 | 2.0 | 1.7 | 2.9 | 2.2 | 2.1 |
| Unemployment rate (%) | 8.4 | 8.0 | 7.3 | 6.9 | 6.6 | 6.1 | 5.8 | 7.6 | 6.0 | 5.5 |
| Employment change (K) | 44 | 113 | 279 | 134 | 150 | 194 | 178 | 799 | 686 | 495 |
| Goods trade balance (AR, $bn) | 4.8 | 6.7 | -5.3 | -8.4 | -14.8 | -13.6 | -9.5 | -0.5 | -12.3 | -13.8 |
| Housing starts (AR, K) | 306 | 283 | 215 | 207 | 210 | 213 | 216 | 253 | 215 | 216 |

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

Chart 2: Canadian population growth has slowed due to Covid's impacts on immigration




Source: Statistics Canada, CIBC

opportunities to spend will remain limited for some time given the rise of the Delta variant. Canadian policymakers have taken a more cautious approach to easing restrictions than their US counterparts, and we expect that to happen again during the fourth wave.

Spending growth has also been held back as population growth continues to be hamstrung by Covid's impact on immigration. Indeed, the first half of this year saw the population growing even slower than it was last year. The federal government has pledged to make up the lost ground on immigration. However, even if by 2023 population growth is accelerating, there would still be sizable gap to reattain the prior trend (Chart 2). As a result of both the outlook for economic reopening and the missed immigration, real consumption is no longer expected to return to its previous trend before the end of 2023, even if some Canadians begin drawing down on their savings as the reopening matures (Chart 3).

## In short, supply is a problem

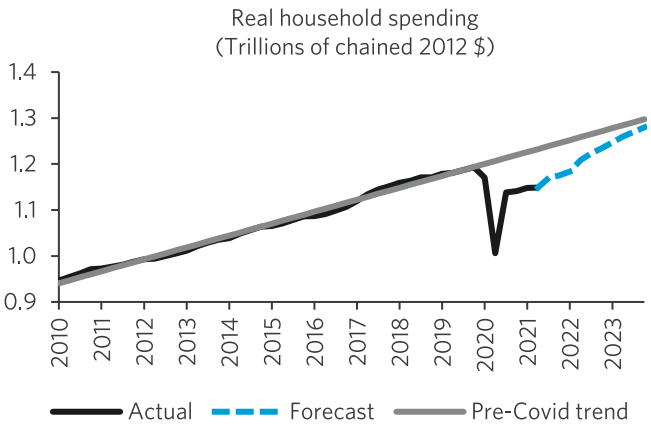
The slowdown in population growth has been an issue for the supply side of the economy too. Hiring in Canada has run well ahead of that in the US, even though the recovery in GDP has lagged. Taken at face value, that means there are fewer potential workers to help pick up the slack in GDP. Indeed, the shortage of potential workers has been widely noted by employers as an impediment to growing revenues without raising prices.

The economy has also been plagued by shortages in the supply of goods. Production shutdowns in Canada's energy sector dented the economy in the first half of this year. While high oil prices and the resumption of production mean nominal energy exports are now as high as they've been since oil prices began to plunge in late 2014, that's only part of the story. As of Q2 2021, oil and gas capital expenditures were still roughly one-third lower than they were in 2019 (Chart 4, left). Investment is expected to increase from this point on, but surveys suggest a wide range of outcomes is possible, none of which see investment in the sector fully regaining its footing anytime soon (Chart 4, right). Indeed, in its latest Monetary Policy Report, the Bank of Canada said it didn't expect oil and gas investment to recover the lost ground for at least two years.

In the first half of 2021, the economy was also affected by supply chain bottlenecks that look set to run for several more months. The global chip shortage saw two-way trade in motor vehicles and parts continuing to fall more than a year and a half after the pandemic began. Similar struggles have reverberated throughout the economy, holding back consumption, inventory building, exports and investment in a range of sectors.

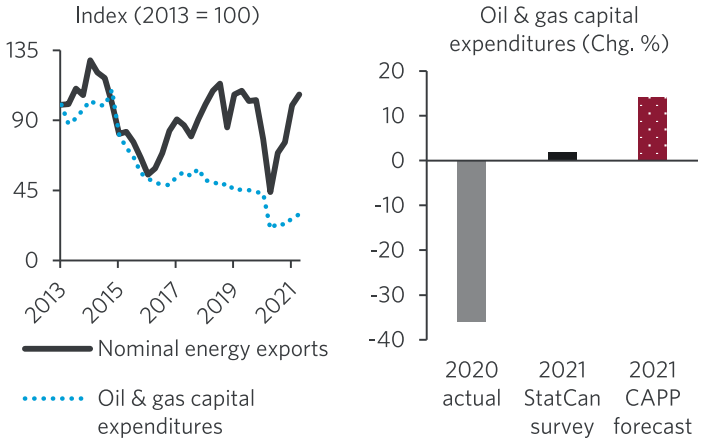
The good news is that these global supply chain issues are likely to ease at least somewhat in 2022, with increasing global vaccination rates making Covid waves less likely to result in shutdowns. However, our outlook is still for a very uneven global recovery. That's why, similar to the period after the

Chart 3: Another wave of Covid and missing population growth will keep spending from reaching its prior trend in the next few years



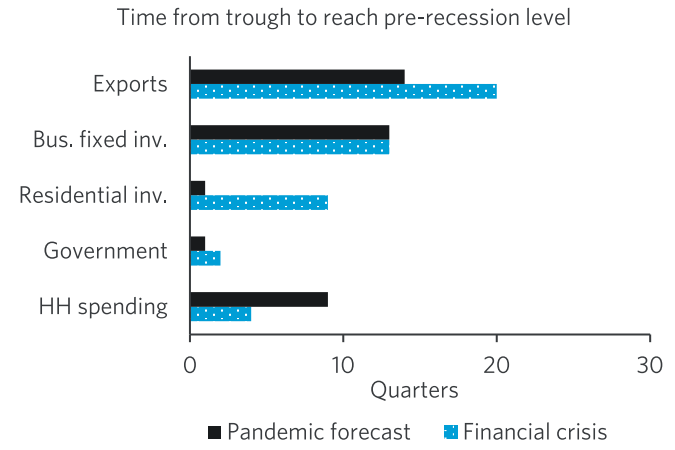

Source: Statistics Canada, CIBC

Chart 4: Oil & gas investment still sluggish even as exports pick up (L); Investment expected to remain weak due to uncertainty in the sector (R)




Source: Statistics Canada, CAPP, CIBC

Chart 5: Exports to be a laggard in the recovery due to global headwinds, similar to post-2008 rebound




Source: Statistics Canada, CIBC

2008-09 financial crisis when Canada had done better than many other countries, export volumes will likely be the last major category of real GDP to recover the ground lost (Chart 5).

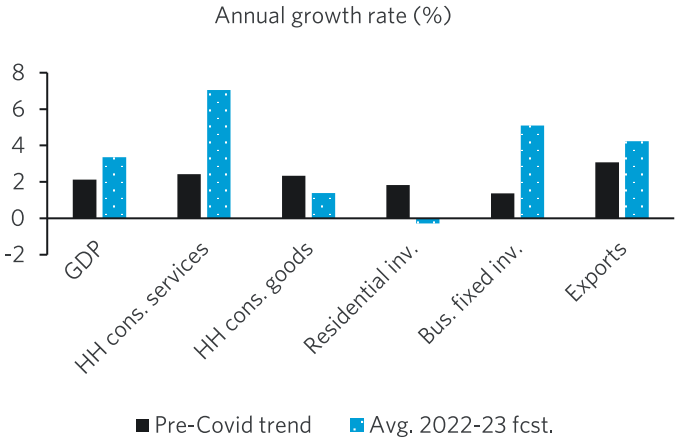
So, with the Delta variant pushing back the timeline for reopening and global challenges holding back business investment and exports, the winners of today might still be the winners of tomorrow. But, as we look further out on the horizon, there's still reason to believe we can make progress towards reorienting our economy back to its pre-Covid ways, even if it takes a bit longer than in our prior projections. To do that, we expect to see above-trend growth in household spending on services, business fixed investment and exports over the next few years as increasingly more Canadians gain immunity to the virus through vaccination or prior infection (Chart 6).

## In my day inflation was 2%

The broad array of supply issues and rising energy prices have combined with base effects to push inflation up to its highest level in years. But, as we've pointed out before, that's an incomplete story. The level of prices is no higher than it would have been if inflation had simply run at 2% because this year's fast pace is just making up for last year's sluggishness. In fact, the Bank of Canada's core common component indicator, which tries to filter out price movements that might be caused by factors specific to certain components and is highly correlated with the output gap, is running comfortably below 2%.

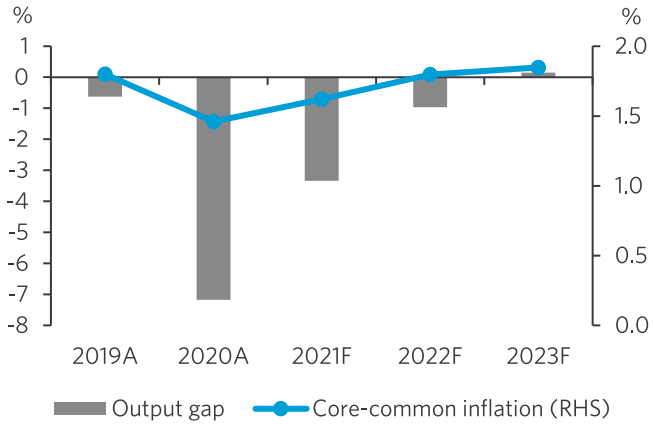
It's showcasing that much of the current inflation is factor specific and not common across goods and services, which is not really the type of inflation the Bank of Canada can control without damaging the recovery. Looking at the past relationship between the output gap and core-common, it seems like true inflationary threats won't appear until later next year, around the time we expect the Bank of Canada to begin taking away the punchbowl (Chart 7).

Chart 6: Growth reorientation to see services consumption, business investment and exports rising faster than trend




Source: Statistics Canada, CIBC

Chart 7: Closing output gap to push underlying inflation higher, prompting BoC to hike rates in late 2022




Source: Statistics Canada, Bank of Canada, CIBC

# Global forecast: trimming, not chopping

by **Andrew Grantham** andrew.grantham@cibc.com

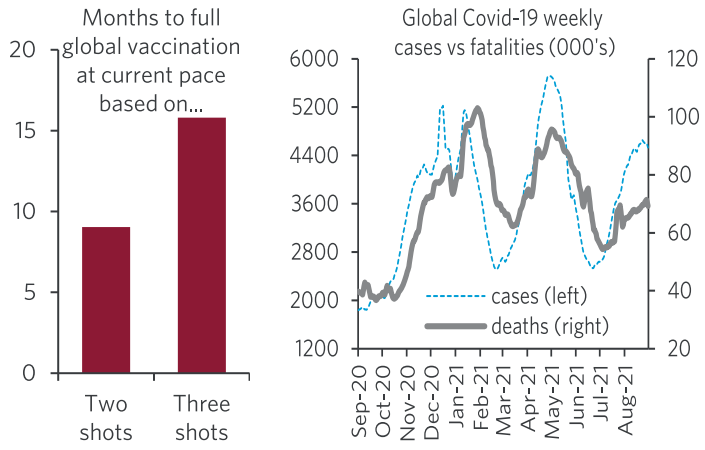
The Delta variant has changed the way in which we think about the virus. Out are expectations that we will reach herd immunity, and in is the realization that Covid-19 will become endemic and that we may need booster shots to ensure it won't continue causing serious illness. However, the economic implications of this aren't as severe, and as such we have trimmed, rather than chopped, our global growth forecasts (Table 1).

## A new reality

With Covid-19 case counts rising again, even in countries with relatively high vaccination rates, it's little surprise that vaccination efforts picked up again in August after slipping in July. However, with real-world evidence suggesting that a third booster shot may be needed to protect more fully against the virus, even at the currently high vaccination rate it would take until early 2023 to adequately protect the global population (Chart 1, left). That's in contrast to the mid-2022 timeline based on a two-shot requirement.

The good news is that even though vaccines haven't proven quite as effective as hoped against infections, they are proving effective at preventing the worst possible outcomes. Indeed, there has been a clear gap between global cases and Covid-related deaths during the latest wave, relative to earlier peaks (Chart 1, right), particularly in highly vaccinated countries. That has enabled countries with both high vaccination rates but also high case numbers, such as Israel and the UK, to largely avoid reintroducing economic growth damaging restrictions (Chart 2).

Chart 1: Need for booster shots delays full return to "normal" (L), but vaccinations have broken the link between cases and fatalities (R)




Source: Bloomberg, CIBC

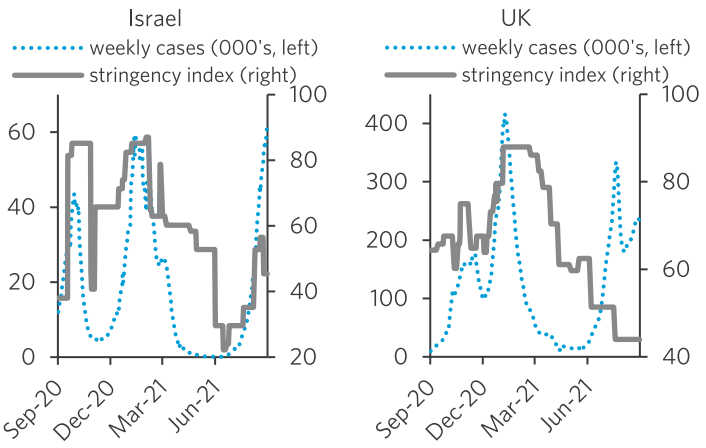
However, not every country is in that same position, and as such some, including many in the Asia-Pacific region, are continuing to deal with the virus by using widespread shutdowns. The problem is that the Delta variant seems harder to control through such means. In Australia, for example, the current Delta-driven rise in cases is clearly not flattening as quickly as earlier outbreaks (Chart 3, left). Additionally, restrictions have been more widespread across the country, resulting in the steepest decline in mobility since the initial wave (Chart 3, right).

Table 1: Real GDP growth rates

| Region | 2018A | 2019A | 2020A | 2021F | 2022F | 2023F |
|---|---|---|---|---|---|---|
| World[1] | 3.5 | 2.8 | -3.3 | 5.6 | 4.4 | 3.2 |
| United States | 2.9 | 2.3 | -3.4 | 5.6 | 4.4 | 2.3 |
| Canada | 2.4 | 1.9 | -5.3 | 4.9 | 4.0 | 2.8 |
| Eurozone | 1.9 | 1.4 | -6.5 | 4.4 | 3.7 | 2.2 |
| United Kingdom | 1.3 | 1.4 | -9.8 | 6.9 | 5.6 | 2.5 |
| Australia | 2.8 | 1.9 | -2.4 | 3.9 | 3.0 | 2.9 |
| Japan | 0.6 | 0.0 | -4.7 | 2.4 | 2.5 | 1.6 |
| China | 6.7 | 6.0 | 2.3 | 8.2 | 5.6 | 5.3 |

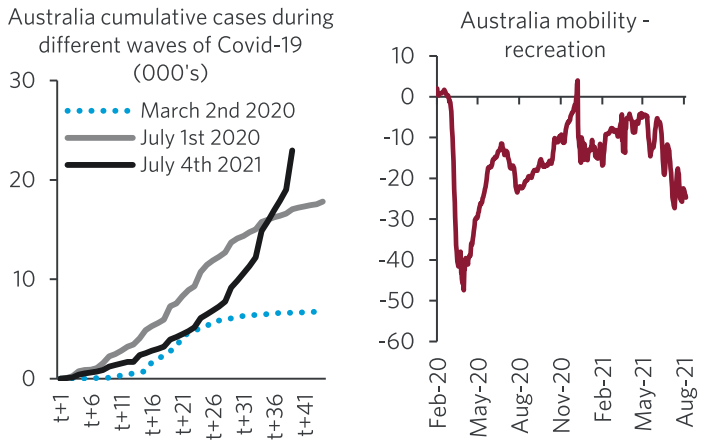
[1] At purchasing power parity.

Chart 2: Restrictions haven't been tightened as much in Israel (L) at all, as yet in the UK (R) during latest wave




Source: Bloomberg, CIBC

Chart 3: Australia not taming latest wave as quickly (L), resulting in biggest economic hit since initial outbreak (R)




Source: Bloomberg, Google, CIBC

While the government has conceded that completely containing the virus may not be possible anymore, the vaccination target of 70% to start easing restrictions is a long way away, suggesting that economic consequences seen in Q3 could also spill into the beginning of Q4.

For the North American economy, economic fears of Delta-driven outbreaks globally have played out in financial markets and are being reflected in commodity prices. However, there is also the potential inflationary impact stemming from supply chain disruptions. This has been getting increased attention due to escalating shipping costs globally. The good news, however, is that the some of those fears may be overblown. While a weighted average of stringency indexes in key importers to North America is up from where it stood before Delta hit, it remains well below the peak earlier in the year (Chart 4). Of particular importance, it appears as if China is having greater success taming Delta-driven outbreaks than other countries in the region, with much of the disruption in shipping recently instead driven by heavier than normal flooding for the time of year.

## Good news, bad news, beyond Covid

While the ability of China to quash outbreaks quickly has aided the economic recovery there relative to other areas of the world, there are some cracks beneath the surface and reasons for caution regarding longer term growth prospects. Even before the worst of the flooding hit central and southern regions, economic growth appeared even more reliant on exports than it was pre-pandemic. Indeed, annualized growth in retail sales since 2019 was less than 5% even in June, compared to a year-over-year growth rate of 8% in 2019 (Chart 5, left).

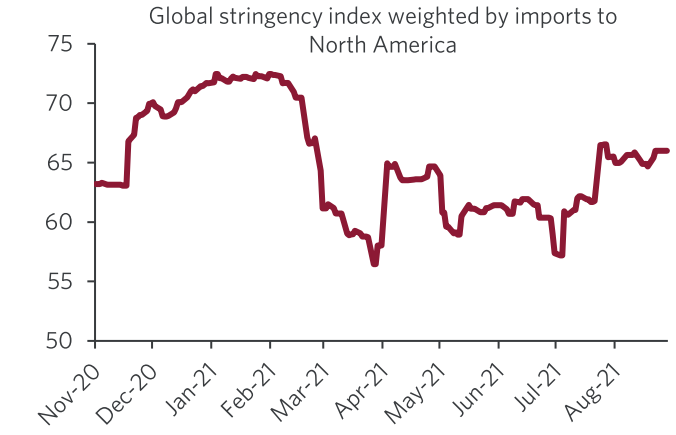
In contrast, export growth has been much more rapid during the pandemic. The risk, of course, is that when western countries are able to fully reopen their economies and households devote more of their money towards services spending, demand for some of the goods that China has been exporting over the past year-and-a-half is likely to fade.

Longer-term, concerns over China's weak demographics have also intensified with last year's census data putting the birth rate of the country closer to the lower end of previous projections (Chart 5, right). If maintained, that would see the overall population begin to decline around 2026, and explains the government's surprise move to allow three child families earlier this year.

For the Eurozone, on the other hand, there are some longer-term positives coming out of the pandemic. While it's true that fiscal policy hasn't been as supportive as in some other parts of the world, which plays into our forecast for the Eurozone to be lagging a little by the end of this year, it does appear that the mistakes of the financial crisis have been learnt.

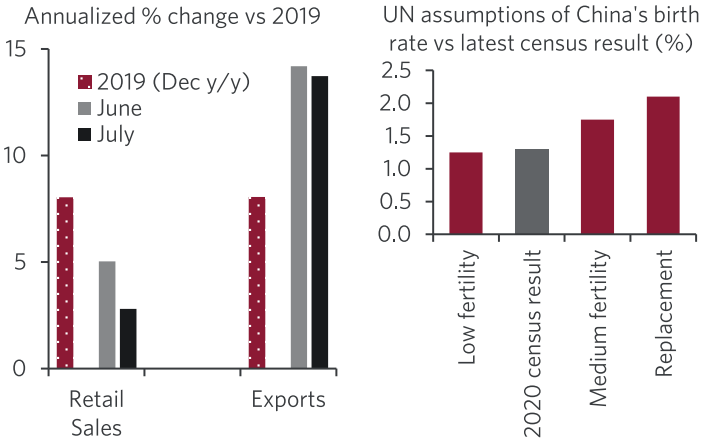
The European Central Bank has shifted its inflation target and, despite some protests from more hawkish members, won't be

Chart 4: Global stringency weighted by North American imports hasn't reached levels seen in winter



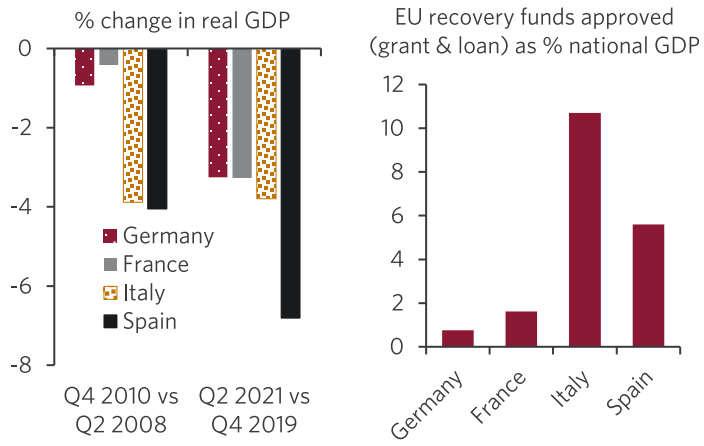

Source: Bloomberg, CIBC

Chart 5: China domestic demand soft even before flood-hit July (L), demographic trends on weaker side of prior expectations (R)



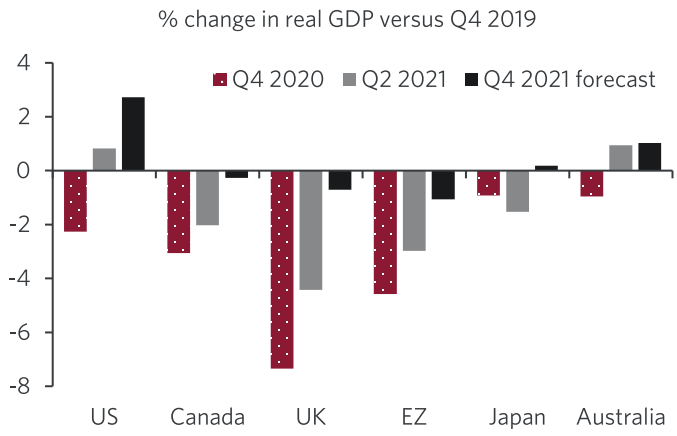

Source: Bloomberg, UN, CIBC

Chart 6: Economic impact of pandemic more uniform across Eurozone than financial crisis (L); Previously lagging economies tapping recovery fund (R)




Source: Bloomberg, European Union, CIBC

Chart 7: Recoveries start to converge across countries/regions




Source: Bloomberg, Haver, CIBC

making the same mistake it made a decade ago by removing stimulus too soon and too quickly. And the same can be said for fiscal policy. Even though its scale thus far hasn't been as big as that seen in North America, through the EU recovery fund countries that had been left behind in the aftermath of the global financial crisis will be able to support their economies through large scale spending (Chart 6).

## Trimming, not chopping

Greater difficulty in controlling outbreaks of the highly contagious Delta variant through lockdown measures is bringing a convergence in terms of the global economic recovery (Chart 7). Those areas that had greater success in keeping case counts low earlier in the pandemic, but also have relatively low vaccination rates, are seeing pullbacks in economic activity as restrictions have been re-implemented.

In contrast, with vaccinations helping to keep hospitalizations lower than in previous waves, countries with high vaccination rates are being able to get through the current outbreak without applying the same economically damaging measures on businesses. Indeed, the recovery seen so far in the UK has been even stronger than we were previously anticipating.

While the recovery in the Eurozone appears to be lagging slightly, due to difficulties for highly tourism-driven economies such as Spain as well as somewhat smaller fiscal stimulus, there are some positives for the longer-term outlook given that previous fiscal and monetary policy mistakes appear unlikely to be repeated. In contrast, the Chinese economy, despite its swift post-pandemic recovery, could be viewed as a little weaker than its headline numbers suggest.

Overall though, changes to our global growth outlook reflect a slight trimming, not a chopping, in the pace of this economic recovery, with the expectation that an easing of supply chain disruptions and continued progress on vaccinations will bring a re-acceleration in the global recovery as 2022 progresses.

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