Economic Outlook

All's well that ends well

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The economic backdrop as we approach the start of 2024 has much for investors to worry about. From geopolitics, to inflation, to an evident stall in global growth just about everywhere excepting the US, conditions are far from ideal. Bonds are coming off yet another trying year, and higher yields are imposing lower multiples on equities.

But as they say, all's well that ends well, and we expect to close the final chapter on 2024 with the economy offering a much sunnier note for investors in both equities and fixed income assets. At that point, having mostly vanquished inflation, central banks will be in an easing cycle, prompting optimism for growth in 2025.

Getting the bad news out the way

A weak start will likely cement a disappointing year for global growth in 2024, after what was hardly a barnburner in 2023 (Table 1). For the most part, that will reflect deliberate efforts by central banks to lean in with higher interest rates as a means of combatting inflation. Several European economies, including the UK and Germany, are either in recession or on the precipice of one.

Table 1: Real GDP Growth (Y/Y % change)

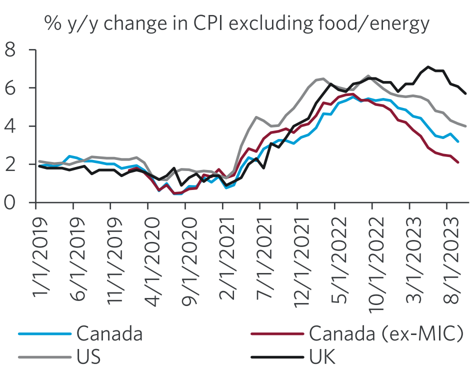
Region	2019A	2020A	2021A	2022A	2023F	2024F	2025F
World[1]	2.8	-2.8	6.3	3.5	3.0	2.6	3.0
United States	2.5	-2.2	5.8	1.9	2.4	1.2	1.4
Canada	1.9	-5.1	5.0	3.4	1.2	0.6	2.1
Eurozone	1.6	-6.1	5.8	3.5	0.5	0.2	1.0
United Kingdom	1.6	-11.0	7.6	4.1	0.5	0.1	1.2
Australia	1.9	-1.8	5.2	3.7	1.8	1.2	2.0
Japan	-0.4	-4.2	2.2	1.0	2.0	1.0	0.7
China	6.0	2.2	8.5	3.0	5.0	4.1	4.3

Source: IMF, CIBC.

China will feel the impact of softening export markets, alongside trade and geopolitical tensions that are seeing it lose export share to other low-cost regions. But it has even greater troubles to address on the home front, owing to financial strains in real estate and banking, and a need to reinvigorate its private sector. Stimulus efforts and financial sector bailouts could allow Beijing to engineer a slight pick-up for 2025, but these longer term challenges will remain.

Canada and the US are also going to feel the brunt of higher interest rates, but the worst of that should be over by the fall of 2024 (Table 2). The scourge of inflation isn't yet behind us, but looks much more manageable than it did a year ago. The Bank of Canada's core inflation measures are still above target, but the country has actually made more progress than others, particularly if one leaves out mortgage interest, as other countries' measures in fact do (Chart 1).

Chart 1: Canada has made more progress on inflation than others



Source: Bureau of Labor Statistics, Statistics Canada, Office for National Statistics UK, CIBC.

[1] At purchasing power parity

Table 2: Economic update

Canada	23Q2A	23Q3F	23Q4F	24Q1F	24Q2F	24Q3F	24Q4F	2023F	2024F	2025F
Real GDP Growth (AR)	-0.2	0.4	0.9	-0.7	1.2	1.8	2.0	1.2	0.6	2.1
Real Final Domestic Demand (AR)	1.0	0.2	-0.1	-0.3	1.4	2.2	2.3	0.6	0.7	2.3
Household Consumption (AR)	0.2	0.5	-0.3	-0.8	1.2	1.7	2.1	2.0	0.4	2.0
All Items CPI Inflation (Y/Y)	3.5	3.7	3.0	3.0	2.3	1.7	1.8	3.8	2.2	1.9
Unemployment Rate (%)	5.2	5.5	5.8	6.2	6.3	6.1	5.9	5.4	6.1	5.6

US	23Q2A	23Q3A	23Q4F	24Q1F	24Q2F	24Q3F	24Q4F	2023F	2024F	2025F
Real GDP Growth (AR)	2.1	4.9	1.5	-0.1	0.6	0.6	0.5	2.4	1.2	1.4
Real Final Sales (AR)	2.1	3.5	2.1	0.5	0.6	0.5	0.5	2.8	1.3	1.4
All Items CPI Inflation (Y/Y)	4.0	3.5	3.4	3.0	2.6	2.3	2.3	4.1	2.5	2.1
Core CPI Inflation (Y/Y)	5.2	4.4	3.9	3.3	2.7	2.6	2.4	4.8	2.8	2.2
Unemployment Rate (%)	3.6	3.7	3.9	4.1	4.1	4.2	4.3	3.7	4.2	4.1

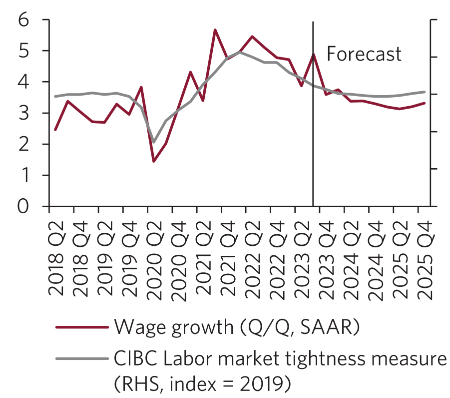
Source: Haver, CIBC.

That said, wage inflation still looks too brisk in both the US and Canada to see the moderation in both business costs and household buying power that would be consistent with a sustained 2% inflation rate. To cool that fire, we'll need the stall in growth already evident in Canada to continue through the first half of 2024. Whether that will constitute an outright recession could end up being a matter of semantics, as population growth could mean that total output and the level of employment creep higher, even as the unemployment rate rises as much as in a mild recession, and GDP falls in per capita terms, weakening average incomes.

The US will also need to see a slower pace of growth to get inflation back to target. The historical relationship seen between CIBC's US Labor Market Tightness indicator, which includes the ratio of job vacancies to unemployment and the quits rate, suggests we're already headed in the right direction, but the last mile will be more challenging (Chart 2). A return to pre-COVID levels of prime-age labor force participation has improved labour supply, but that now looks to have run its course, so a deceleration in hiring, and economic growth, will be needed to add labour market slack.

In Canada, the job-vacancy-to-unemployment and quits ratios are already easing off sharply, and wages should decelerate as that continues (Chart 3A and B). Both these ratios will reflect greater market slack as the lack of growth sends the unemployment rate above our estimate for the non-inflationary jobless rate (5.7%) to peak near 6.3% in mid-2024.

Chart 2: Wage growth to gradually decelerate to 3% by late 2024 or early 2025



Source: Bureau of Labor Statistics, CIBC.

Chart 3A: Labour markets remain tight but showing clear signs of easing

Source: Statistics Canada, Bureau of Labor Statistics, CIBC calculations.

When enough is enough

For financial markets, the key questions are what interest rate environment will prove sufficient to bring growth to heel and open up the required degree of slack, and how quickly policy can ease once that's well underway. On that score, after two quarters of roughly zero growth, there's much more clarity in Canada that rates are already high enough than there is in the US, given the evidence at hand.

If you look under the hood, there are however early signs of a sputtering engine in the US as well, centred on interest-sensitive activity, which should be sufficient to have the Fed eschewing further rate hikes. Seasonally-adjusted commercial and industrial loans have declined for six straight months. That's cutting into related investment spending, with core capital goods orders now up less than 1% in the year to Q3, likely representing a drop after inflation. Housing resales have steadily dropped since February, while starts, despite edging up a bit lately, are still below 1.4 million annualized, having peaked at 1.7 million in Q1 2022. Nonresidential construction spending decelerated in Q3, and still includes gains in office building that will be sharply curtained once current projects are done, given high vacancy rates.

The key, however, is household spending. Unlike in Canada and Europe, the US saving rate is still below pre-pandemic norms (Chart 4), despite high interest rates that should be cutting into borrowing and spending and increasing the incentive to save. Household financial assets have been eroded in real terms by inflation and all that spending, so we, and the Fed, are watching for signs that savings rates have now bottomed and start to head higher.

Ending well

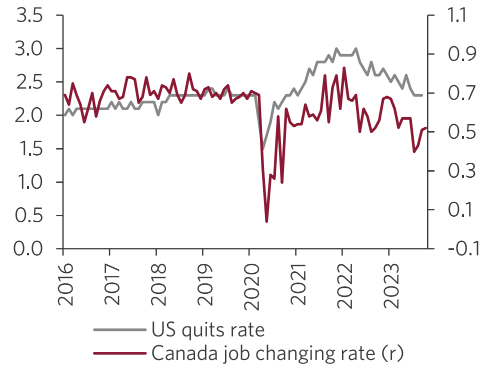
So where's the happy ending? That's in the hands of the central banks, who will need to begin cutting rates to get growth going again, with a late Q2 cut in Canada coming several months ahead of the move stateside given the early start to the economic deceleration north of the border. That should not only see growth improving towards year end, but could make winners out of both stocks and bonds, as markets look ahead to lower policy rates and better earnings prospects in 2025.

With the first cut on tap as early as June, we see the overnight rate in Canada tumbling 150 bps by the end of the year, with a delayed and more measured easing from the Fed given that economy's greater ability to weather the storm of elevated rates. The Bank of Canada might have to move before headline inflation closes in on 2%, because core inflation and near-recessionary conditions will make a convincing case for early action.

The components of inflation likely to be stickiest will be mortgage interest costs (MIC), pushed higher as mortgages renew at today's higher rates, and rents, under pressure as more are shut out of home ownership by those same borrowing costs. If globally determined prices for volatile items like energy remain contained, MIC and rent could both end up being stripped out of the trimmed mean core rate, leaving headline inflation running hotter than core. Ironically, once there is sufficient economic and labour market slack to contain core prices, the last step to getting overall inflation down to 2% will be the interest rate cuts that ease the pain of mortgage renewals.

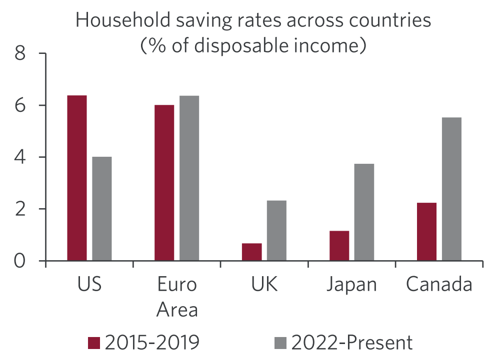
There are of course risks to this sunny outlook, but in contrast to the last couple of years, many of them are ones that a diversified portfolio of stocks and bonds should provide some shelter. A harder landing for growth would dent equities, but would amplify returns on bonds by bringing forward deeper cuts to overnight rates. The best prospects for growth to have some upside is that central banks find that more inflation melts away on its own accord. If so, we might not get as much interest rate relief as bonds are now counting on, but corporate earnings should give a lift to equities, and shorter dated bonds will provide a decent running yield. Barring much more troubling geopolitics, all's well that ends well should apply to diversified portfolios, even if the start of 2024 remains challenging for investors.

Chart 3B: Fewer workers are quitting jobs, another sign of slack



Source: Statistics Canada, Bureau of Labor Statistics, CIBC calculations.

Chart 4: Household saving rates above pre-pandemic levels outside the US



Source: Federal Reserve of New York, CIBC.